SLAUGHTER AND MAY/

INSURANCE CLIENT BRIEFING

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EUROPEAN COMMISSION PROPOSALS ON THE REVIEW OF SOLVENCY II

On 22 September the European Commission published legislative proposals for amendments to the Solvency II Directive arising out of the 2020 Solvency II Review. This is the first major review of the directive since its implementation at the beginning of 2016 and follows on from EIOPA's final opinion to the Commission on the review, published in December 2020.

Alongside the proposals for amendments to Solvency II, the Commission has also published a legislative proposal for a new Insurance Recovery and Resolution Directive. Recovery and resolution measures are not part of the existing Solvency II regime.

Both sets of legislative proposals will now be considered by the European Parliament and the EU Council. The ultimate implementation date for the proposals is therefore not yet clear.

Background

The current proposals arise out of the 2020 review of the Solvency II regime. This review was implemented partly to meet requirements embedded in the directive, for example to assess the functioning of the long-term guarantee measures and to review calculations of capital requirements by a certain date after implementation of the regime. In practice the review has been more-wide ranging than this and EIOPA's final opinion on the Solvency II review, responding to the European Commission's call for advice, covered a much broader list of topics.

Key elements of the review

In its communication on the proposals, the Commission has stated that the key elements of the regulatory framework targeted by the review are:

- improving risk sensitivity and better mitigating undue volatility through changes to the long-term guarantee measures, in particular extrapolation of risk-free interest rates and the volatility adjustment
- making prudential rules more proportional by allowing more small insurers to be exempted from Solvency II rules and by creating a more suitable framework for insurers identified as low risk
- refining the rules on transparency by better adapting disclosures required from insurers to the information needed by recipients, differentiating between the information for policyholders and analysts
- improving the quality of supervision and levelling up the playing field through several changes, in particular as regards ongoing compliance with prudential rules, cross-border insurance business and insurance groups
- ensuring that climate and systemic risks are better managed and supervised by introducing new requirements on long-term climate change scenario analysis.

Structure of changes to the regime

The legislative proposals put forward by the Commission only cover some of the changes which are intended to be made to the regime. Proposed amendments to the Level 2 Delegated Regulation are still being worked on and will be published separately. The Commission has stated that this is because new powers to make delegated acts will need to be included in the revised Solvency II directive to allow some of the required amendments to the Delegated Regulation be made. This is somewhat unsatisfactory as it means the overall changes to the regime cannot be looked at in the round at this stage.

Changes to the directive

The legislative proposal makes extensive amendments to the directive, although this includes updating of references to other European legislation, removal of UK specific provisions and the addition of clarificatory detail, as well as more substantive changes. Some key areas where substantive changes are proposed are:

- changes to the operation of the proportionality principle
- new rules on macroprudential and climate change considerations
- changes to the structure and content of the SFCR
- changes to the method for extrapolation of risk-free interest rate term structures
- amendments to the volatility adjustment
- amendments to a number of aspects of the group supervision rules, including clarifications around the scope of undertakings included within a group and the introduction of direct supervision of insurance holding companies and mixed financial holding companies.

These proposed changes are discussed in detail in the **Appendix** to this briefing.

Further changes in the Level 2

Some significant aspects of the Solvency II review will not be addressed until changes are proposed to the Level 2 Delegated Regulation. Some of these will involve policy decisions relating to the European Commission's approach to investment in long-term assets by insurers. Others will supplement changes being proposed to the directive. Some key areas where the Commission has said it expects to make changes are:

- Long-term equity investments: The Commission will consider simplifying the conditions under which equity investments, including via infrastructure funds, would be treated as "long-term", thereby attracting preferential treatment in the standard formula. The Commission anticipates that this might result in a EUR 10.5 billion decrease in capital requirements for equity risk across the industry, which it says can be further invested by insurers in the economy. It is not clear, however, how or whether insurers will be incentivised to invest this extra capital in the EU economy rather than returning funds to shareholders
- Risk margin: Changes to the risk margin to make it less volatile and less sensitive to interest rates have been one of the priorities of the insurance sector under the 2020 review of Solvency II. The Commission has indicated that it will develop a version of the amended risk margin formula proposed by EIOPA and also (in contrast to EIOPA's advice) consider reducing the cost-of-capital rate from 6% to 5%
- The volatility adjustment: Some changes to the directive have been proposed to allow a higher percentage of the risk–adjusted spread to be included in the volatility adjustment. The Commission intends to introduce a safeguard in the Level 2 Delegated Regulation to avoid "overshooting" of the adjustment. It is not clear at this stage how the safeguard will work
- Matching adjustment: In line with EIOPA's advice, the Commission intends to change the regime so that diversification benefits can be recognised between the matching adjustment portfolio and the rest of the undertaking. Whilst this may be a welcome amendment for affected firms, less welcome will be the intention to limit the benefit which can be recognised by firms where the matching adjustment portfolio contains restructured assets which depend on the performance of underlying (ineligible) assets – although in the UK some measures have already been introduced to similar effect
- Extrapolation: As with the volatility adjustment, amendments to the way in which extrapolation of the risk-free rate structure works will be partly a result of changes to the directive and partly changes to the Level 2 Delegated Regulation. The overall result is intended to be in line with EIOPA's advice on extrapolation and will be subject to a phasing-in period
- Interest rate risk: EIOPA has twice advised that the interest rate risk sub-module is under calibrated. The Commission plans to adjust the capital requirement for interest rate risk in the standard formula to reflect recent experience of a low interest rate environment.

Recovery and resolution

Neither the Solvency II regime nor the UK regulatory regime currently include recovery and resolution rules for insurers. This is in contrast to the banking sector, where a recovery and resolution regime was introduced by the Bank Recovery and Resolution Directive 2014. Despite some scepticism from industry stakeholders as to whether recovery and resolution planning is needed for insurers, given their very different business models from banks, international bodies such as the Financial Stability Board and the IAIS have proposed the introduction of such measures, to apply at least in the case of systemically important insurers.

The PRA has indicated that it is looking at recovery and resolution of insurers but it is not clear yet whether the UK will follow the EU in introducing a formal regime.

The proposed Recovery and Resolution Directive would apply to all (re)insurance undertakings established in the EU which are within scope of Solvency II and to insurance holding companies and mixed financial holding companies. Some simplifications can be introduced by supervisory authorities for certain undertakings to reflect the proportionality principle, and EIOPA will be asked to publish guidance on this. The key provisions of the proposed directive cover:

- the establishment of insurance resolution authorities equipped with a minimum harmonised set of powers
- pre-emptive recovery plans to be prepared by insurers and insurance groups. Supervisory authorities can decide, on the basis of certain criteria, which insurers are subject to recovery planning requirements. This should cover at least 80% of the Member State's life, non-life and reinsurance market respectively. Low-risk profile undertakings are not required to prepare pre-emptive recovery plans on an individual basis
- resolution plans to be prepared by resolution authorities in respect of selected (re)insurance undertakings, setting out the resolution actions envisaged if the conditions for resolution are met. Supervisory authorities can decide, on the basis of certain criteria, which insurers are subject to resolution planning requirements. This should cover at least 70% of the Member State's life, non-life and reinsurance market respectively. Low-risk profile undertakings are not subject to resolution planning on an individual basis
- the conditions for resolution, which are that:
    - the insurance or reinsurance undertaking is failing or likely to fail;
    - there is no reasonable prospect that any alternative private sector measures or supervisory action would prevent the failure of the undertaking within a reasonable timeframe; and
    - resolution action is necessary in the public interest
- the resolution tools which can be used by resolution authorities, which include:
    - write-down or conversion of capital instruments, debt instruments and other eligible liabilities (on the basis of a specified hierarchy)
    - withdrawal of authorisation to write new business, allowing run-off of existing contracts
    - sale of all or part of an undertaking's business
    - transfer of all or part of an undertaking's business to a publicly controlled entity, with the aim of selling the business to a private purchaser
    - temporary moratorium on payment of claims under insurance policies
    - stays on the redemption rights of policyholders in relation to life insurance contracts.

Appendix – Key proposed changes to the Solvency II Directive

Proportionality

A more structured approach to applying proportionality under the regime is an important aspect of the proposals. The changes would introduce definitions of low-risk profile undertakings and low-risk profile groups and formalise the proportionality measures which should automatically apply to them. Low-risk profile undertakings will be classified by Member States on application by the undertaking, using criteria set out in the revised directive. These criteria consider factors such as: the amount of business written outside the home Member State; the level of technical provisions; and the proportion of investments in "non-traditional investments", as well as, for life insurance undertakings, the level of interest rate risk, and, for non-life insurance undertakings, the annual gross written premium. Undertakings using full or partial internal models are excluded from being classified as low-risk.

Proportionality measures set out in the directive which will automatically apply to low-risk profile undertakings include:

- frequency of regular supervisory reporting
- combining of key functions (excluding internal audit)
- exemption from climate change analysis requirements
- less frequent performing of the ORSA
- exemption from the requirement to draw up a liquidity risk management plan.

The use of proportionality measures by undertakings which are not classified as low-risk will not be prohibited but will be subject to prior approval from the relevant supervisory authority.

Some of the thresholds for exclusion from scope of the directive are also proposed to be increased, in the case of annual gross written premium income from EUR 5 million to EUR 15 million and in the case of technical provisions from EUR 25 million to EUR 50 million.

Macroprudential requirements

New macroprudential requirements are introduced in the context of both the ORSA and the prudent person principle.

The ORSA requirement would mean firms had to consider, as part of the ORSA, the macroeconomic situation, possible macroeconomic and financial markets' developments and macroprudential concerns which may affect the undertaking's risk profile, risk tolerance, business strategy, investment decisions and solvency needs. Arguably, to the extent that these aspects are relevant to an undertaking they should already be taken into account in the ORSA under existing rules, although the change would mean that firms have to formally consider macroprudential aspects in their assessment. The proposed amendments would also require undertakings to consider and analyse the activities of the undertaking which may affect macroeconomic and financial markets' developments and have the potential to turn into sources of systemic risk. This information is likely to be of more use to the supervisory authorities than to the undertaking itself.

Separately, amendments are proposed to the directive to require undertakings to take account of macroeconomic and financial markets' developments and, at the request of the supervisory authority, macroprudential concerns, when they decide on their investment strategy. These requirements are introduced in the context of the prudent person principle. Firms will also be required to assess the extent to which their investment strategy may affect macroeconomic and financial markets' developments and have the potential to turn into a source of systemic risk, and to incorporate these considerations into their investment decisions. There is, clearly, the potential here for tension between the interest of policyholders and shareholders and the interests of the wider economy and it will be interesting to see how these are reconciled by insurers if the amendments are implemented.

Climate change

In addition to the new requirements regarding macroeconomic conditions, the proposed amendments include the introduction of a formal requirement for firms to assess whether they have any material exposure to climate change risks as part of the ORSA. Where any material exposure exists, firms (other than low-risk profile undertakings) must analyse the impact of at least two long-term climate change scenarios on their business– one where the global temperature increase remains below two degrees Celsius and one where it is equal to or higher than two degrees. This is consistent with EIOPA's opinion on the supervision of the use of climate change risk scenarios in the ORSA, published in April 2021.

In addition, the European Commission proposes adding into the directive a requirement for EIOPA to consider whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/ or social objectives would be justified. In the past EIOPA has been reluctant to find that such an approach is prudentially justifiable. EIOPA must submit a report on its findings by 28 June 2023.

Liquidity risk

An additional macroeconomic tool proposed in the amendments to the directive is the introduction of a requirement for firms (with the exception of low-risk profile undertakings) to draw up and maintain liquidity risk management plans projecting the incoming and outgoing cash flows in relation to their assets and liabilities. Under the proposals, supervisory authorities should monitor the liquidity position of (re)insurance undertakings and Member States should ensure that supervisory authorities have the appropriate powers to required undertakings to reinforce their liquidity position when liquidity risks or deficiencies are identified.

The SFCR

The SFCR in its current form has been criticised for being insufficiently policyholder-friendly and therefore failing properly to fulfil part of its function. The solution proposed by EIOPA and adopted here by the Commission is to divide the SFCR into two parts – one part consisting of information addressed to policyholders and beneficiaries and one part addressed to other market participants. The overall SFCR is made up of both parts. Reinsurance undertakings can choose not to disclose the part of the SFCR addressed to policyholders and beneficiaries.

In future, the part of the SFCR addressed to policyholders will contain only a description of the business and performance of the undertaking and a brief description of the capital management and risk profile of the undertaking. The part addressed to market participants will include information regarding the system of governance and detailed information on capital management and risk profile.

Long-term guarantee measures

Changes are proposed to the directive to amend the rules on the extrapolation of the relevant risk-free interest rate term structure (the "risk-free rate structure") and the volatility adjustment.

The directive sets out the principles for extrapolation of the risk-free rate structure, under which the risk-free rate structure should be extrapolated for maturities longer than the "first smoothing point" up to an ultimate forward rate. The proposed amendments to the directive specify how the first smoothing point for a currency should be determined and that the extrapolation should take into account information from financial instruments other than bonds for relevant maturities, where the markets for those instruments are deep, liquid and transparent. Powers are then granted to the Commission under the directive to amend the Level 2 Delegated Regulation to specify the formula for the extrapolation and other factors affecting the extrapolation. The detail of this will not be set out until the proposed later consultation on the Level 2 measures, although the Commission says in its communication on the proposals that it will "consider building on the formula and parametrisation proposed by EIOPA". The new extrapolation method will be phased in linearly over a period running to 2032.

The key changes proposed to the volatility adjustment are:

- making prior supervisory approval for the use of the volatility adjustment mandatory – this was previously a Member State option, albeit one which had been implemented in the UK
- increasing the amount of the risk-adjusted credit spread which can be included in the volatility adjustment
- introducing a macro volatility adjustment element for the euro.

Group supervision

A large number of amendments are proposed to the group supervision rules, although many are clarificatory and reflect issues of interpretation which have arisen since the directive was first implemented. Proposed changes include:

- amendments to the rules for the identification of undertakings which form a group, for example to ensure that undertakings which are jointly controlled are identified properly
- bringing insurance holding companies and mixed financial holding companies into the scope of the regime, so that they are directly regulated by supervisory authorities, and allocating specific responsibilities to those entities
- clarification of the definition of an insurance holding company*
- amendments to the rules on how participations in undertakings regulated under other financial sectors should be included in the group solvency calculation

- introduction of more detailed governance requirements and macroprudential requirements applicable to groups
- introduction of new enforcement measures with respect to groups, which would include, among other things, the suspension of voting rights attaching to shares in subsidiary (re)insurance undertakings held by an insurance holding company or mixed financial holding company in certain circumstances
- provision of additional details of "other methods" which might be applied where an ultimate parent undertaking is outside of the EU, drawing on the experience of how supervisors have dealt with this issue in practice since the regime came into effect.

* Under the new definition of an insurance holding company, the proposed changes specify that subsidiary undertakings are mainly (re)insurance undertakings or third-country (re)insurance undertakings where more than 50% of the parent undertaking's equity, consolidated assets, revenues, personnel or other indicator considered relevant by the supervisory authority are associated with subsidiaries that are (re)insurance undertakings, third country (re)insurance undertakings, insurance holding companies or mixed financial holding companies.

Miscellaneous other proposed changes

Regular supervisory reporting

A number of changes are proposed to the rules for regular supervisory reporting, mainly aimed at clarifying when reporting can be limited or exemptions from item-by-item reporting can be applied. This reflects a general move toward reducing the burden of reporting requirements for the industry. Recent consultations on reporting requirements published by each of EIOPA and the PRA are part of this general approach.

Capital add-ons

An additional rationale for applying a capital add-on is proposed. This would apply where an undertaking applies a transitional measure affecting the calculation of technical provisions, the undertaking would not comply with the SCR without the application of the transitional measure and the undertaking has failed to comply with the requirements relating to phasing-in plans.

Key function holders

The Commission proposes introducing a requirement that different persons hold the key functions of risk management, actuarial, compliance and internal audit - although there is a partial exemption for low-risk profile undertakings.

Audit requirements

A new audit requirement is proposed in respect of the balance sheet disclosed as part of the SFCR.

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