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SOLVENCY II-REVIEW: MAIN POSITIONS OF THE AAE

Solvency II has proven to be a well-functioning risk-based framework which is suitable to ensure policyholder protection and financial stability in Europe. It is regularly reviewed.

The current Solvency II review considers particularly the long-term guarantee measures introduced by the Omnibus II-Directive and sustainability. Proportionality and expectations from politics should be considered as well.

These issues had been addressed in EIOPA's comprehensive technical advice. Proposed legal texts developed by the EU-Commission have built on this advice. The Commission's proposal is the starting point for proposals by EU-Council and EU-Parliament.

The AAE strives to contribute to this development by providing objective, independent, professional advice to European institutions and stakeholders on all matters of actuarial relevance, in pursuit of the public interest. The current protection level of insured must be maintained unless altered explicitly based on political will. Therefore, capital requirements must always remain risk based. So called green-supporting/brown-penalising factors are jeopardising policy holder protection, unless justified to properly reflect risk.

Long-term business, long-term investments

The primary demand for the insurance sector to better serve the long-term needs for European citizens and to act as long-term investors requires an appropriate valuation of long-term business and a risk-adequate treatment of long-term investments as well. One important criterion for an appropriate valuation is the suitability to mitigate the impact resulting from short-term market turmoil on the solvency position of insurers in line with Commission's action plan. This will help to avoid artificial volatility and thus contribute to a reduction of systemic risk that might otherwise result from pro-cyclical behaviour of market participants.

The valuation of technical provisions necessitates the use of risk-free rate term structure (RFR). For durations where deep, liquid, and transparent market cannot be observed an extrapolation is required to allow the required valuation also for contracts with very long durations. The extrapolated curve directly affects the technical provision (best estimate and risk margin) and can be adapted by a volatility adjustment.

a) The extrapolation requires the determination of a starting point and a model to perform the extrapolation. In absence of market information, political choices are required to determine the extrapolation process, especially to facilitate the mitigation of volatility of the solvency position of insurers. A proven method to mitigate short-term market turmoil is a reliable convergence of the forward rates towards the ultimate forward rate (UFR) – for the current method concretised in recital 30 of the Omnibus II-Directive for the Euro. When changing the methodology crucial requirements concerning the extrapolation of the

RFR should again be laid down in the Directive to preserve the political will. They should ensure that the extrapolated forward rates after 40 years at the latest are close to the UFR. A transition period after entering into force of a new regulation should be avoided, as it is an unproportioned administrative burden complicating comparability. The extrapolation method should be flexible enough to cope with changing financial developments (including the unprecedented protracted low – and even negative – interest rate environment)
The starting point of the extrapolation should be chosen considering the availability of a sufficient amount of outstanding fixed-income instruments with that duration. The relevant threshold should be laid down in the Directive.

b) Volatility adjustment (VA): Due to their business model, insurance undertakings are not forced to react on daily spread changes. This should be appropriately considered by the VA. The risk-correction of the observed spreads should consider the long-term nature of life insurance business. Currently, this is achieved by taking the long-term average spread as a measure. If daily spreads were considered, as proposed by EIOPA, volatility could increase. In addition, it should be considered that the spread is determined from a currency-specific reference portfolio, which can significantly differ from undertakings' own assets. Adapting the RFR by a VA can therefore result in a mispricing of technical provisions if size of the VA is not justified by undertakings' assets. Including an undertaking-specific element in the formula as currently proposed does not completely remedy this gap. The risk related to the use of a VA should be thoroughly analysed as part of undertakings' ORSA.
c) The interest rate down stress needs a recalibration to ensure an adequate stress also for negative values of the RFR. Basically, we support the shifted approach proposed by EIOPA. But the stress should be applied to the liquid part of the RFR only. The stressed liquid part should be extrapolated in the same way as the basic-RFR. In essence: first stress – then extrapolate. A phasing-in period may facilitate a smooth implementation.
d) The risk margin is the *cost of capital* that is required by investors to provide the needed regulatory risk capital to ensure that policyholders are appropriately safe. It is a major component of the technical provisions and thereby directly affects the own funds of undertakings.
Investors' requirements are assumed to be consistent with risk charges observed in capital markets for investments in industries with highly regulated capital requirements. Any change of the value shall be underpinned by the observable information from the financial market relevant for the insurance industry. While the current value may appear somewhat high when applied to multi-year projected SCRs, an in-depth technical analysis by AAE in 2019 did not provide sufficiently conclusive evidence. The commission's proposals will result in a considerable reduction in risk margin and therefore in a material capital relief for long-term business. AAE will monitor the further discussion in this regard thoroughly. Capital relief and policyholder protection must be well-balanced.

<u>Sustainability</u>

We believe that the proposals by EIOPA and the European Commission are a very valid basis for addressing climate related risks.

The increasing frequency and severity of natural catastrophes linked to climate change is scientifically based and well documented in the reports of the Intergovernmental Panel on Climate Change (IPCC) and several other research institutions. The inclusion of climate change

considerations in a future update of the Solvency II Standard Formula, as proposed by EIOPA in its Methodological paper from July 2021[1], is a necessary step towards integrating the latest scientific evidence into this framework. In particular, the AAE supports the conclusion from EIOPA that the Solvency Capital Requirements (SCR) for natural catastrophe underwriting risk should be regularly updated to reflect the expected impact of climate change with the aim to ensure continuing policyholder protection and stability of the insurance market.
In addition, the potential impact of climate risk on an insurance company's solvency position is not limited to short-term physical effects on natural catastrophes. Longer-term considerations and transition risks must be considered as well, which can and must be done in the Own Risk and Solvency Assessment (ORSA) as proposed by EIOPA in their Opinion on the supervision of the use of climate change risk scenarios in ORSA published in April 2021[2]. As pointed out in the Opinion, only a minority of insurers currently assess climate change risks in the ORSA using scenario analysis, usually limited to a short-term time horizon. The AAE agrees that the inclusion in Solvency II's ORSA of climate-related risks follows the intent of the existing prudential regulation. Proportionality considerations are included in the Opinion through the need to first perform a materiality assessment for climate-related risks. For companies with limited expertise in this area, EIOPA has also published and consulted on (optional) guidance in December 2021[3].

Finally, the request from the EU Commission for EIOPA to analyse whether risk differentials between green and other assets may justify a different prudential treatment does not amount at this stage to a reform proposal, but merely highlights the urgent need for more research into an area which is becoming a global financial stability concern. Similar analysis work has been started by the Network for the Greening of the Financial System (NGFS, of which EIOPA is a member) since 2020[4], and EIOPA's sister institution the European Banking Agency (EBA) is already consulting on this matter[5].

Climate risk has become a top priority for the insurance industry in Europe and beyond, and the AAE considers it to be a serious threat which shall be carefully monitored and its adequate reflection in the Solvency II framework reviewed on a regular basis. Through insurers' roles as investors, underwriters and risk managers, the sector also has an important role to play in climate risk mitigation and climate change adaptation (notably to support the UN targets set at COP21 in Paris in 2015 and more recently at COP26 in Glasgow in 2021).

[1] https://www.eiopa.europa.eu/document-library/methodology/methodological-paper-potential-inclusion-of-climate-change-nat-cat_en
[2] https://www.eiopa.europa.eu/media/news/eiopa-issues-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa_en
[3] https://www.eiopa.europa.eu/document-library/consultation/consultation-application-guidance-running-climate-change-materiality-0
[4] https://www.ngfs.net/sites/default/files/medias/documents/capturing_risk_differentials_from_climate-related_risks.pdf
[5] https://www.eba.europa.eu/eba-launches-discussion-role-environmental-risks-prudential-framework