NATIXIS
INVESTMENT MANAGERS

# SOLUTIONS

## SOLVENCY II REVIEW : KEY TAKEAWAYS

FOR FINANCIAL PROFESSIONALS ONLY

On 22 September 2021, the European Commission adopted a comprehensive 'review package' of Solvency II rules. The overall aim is to ensure that insurers and reinsurers in the EU keep investing, and support the political priorities of the EU. In particular:

- financing the post-Covid recovery
- completing the capital markets union
- channelling funds to implement the European green deal.

The European Parliament and the Council will now discuss the Commission's proposals. In parallel, the Commission will launch the work on Delegated Acts supplementing the amendments to the Solvency II Directive (known as Level 2). The overall impact will only become clear when the EC clarifies its plans for Level 2.

The changes to Solvency II rules are meant to avoid an overall increase of total capital requirements across the EU insurance (and reinsurance) sector in the long term. In the short term, capital of up to €90 billion could be released at EU level due to the phasing-in of certain rules. This significant release of capital is supposed to help insurers ramp up their contribution as private investors to the recovery from the Covid-19 pandemic.

This paper includes a brief summary of the proposed changes that we see as potentially having an impact on the future management of insurers assets.

## CLIMATE CHANGE & ESG

- Obligation to conduct long-term climate scenario analysis (in relation to being below or above 2°C) as part of the Own Risk and Solvency Assessment (ORSA)
- The European Insurance and Occupational Pensions Authority (EIOPA) is to report by 2023 where changes to Solvency Capital Requirement (SCR) calibration for environmentally or socially harmful investments should be justified
- EIOPA will conduct centralised climate stress tests

## LONG TERM GUARANTEE MEASURES

### Volatility Adjustment (VA)

- Proposal for higher VA in order to effectively compensate for fluctuations in assets prices in the valuation of insurance liabilities (with additional safeguards in the shape of undertaking specific characteristics and supervisory approval)
- Proposal to disclose the impact of VA to market participants and not policyholders

### Matching Adjustment (MA)

- Proposal to allow the assumption of full diversification between the assets and liabilities of the MA portfolio and the rest of the undertaking

### Interest Rate Extrapolation

- The method for the interest rate term structure extrapolation should make use of information derived from relevant financial instruments other than bonds, where such information is available from deep, liquid and transparent markets for maturities where the bond markets are no longer deep, liquid and transparent

### Risk Margin

- Proposal to reduce the value and volatility of the risk margin for long-term business
- Proposal to reduce cost-of-capital rate used in risk margin calculation from 6% to 5%

## CAPITAL CHARGES

### Equity Risk

- Proposal to increase 'equity dampener' range up to 17% instead of 10%
- Revision of the eligibility criteria of the long-term equity asset class to make it easier for insurers to benefit from preferential capital treatment on equity investments

### Interest Rate Risk

- The Commission will consider reflecting EIOPA's advice on the calculation of the capital requirement for interest rate risk with the standard formula (with a five-year phasing-in period after the adoption of the amendments as proposed by EIOPA)

### Mortgage Loans

- The Commission will also consider amending the delegated acts to better align the calibration of the standard formula counterparty default risk for mortgage loans with the credit risk framework for the banking sector



## Climate change & ESG

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| **Climate scenarios** | The Commission proposes to add in the framework of the Own Risk and Solvency Assessment (ORSA) an obligation to conduct long-term climate scenario analysis. The insurer should specify at least two long-term climate change scenarios, including:<br>• a long-term climate change scenario where the global temperature increase remains below two degrees Celsius<br>• a long-term climate change scenario where the global temperature increase is equal to or higher than two degrees Celsius.<br>Such analysis should be undertaken at least every three years (except for low-risk profile undertakings).<br>At a later stage, the Commission may consider extending this requirement to other environmental risks |
| **Environmental Capital Charge** | While there is not sufficient evidence at this stage on risk differentials between environmentally or socially harmful and other investments, such evidence may become available over the next years. In order to ensure an appropriate assessment of the relevant evidence, EIOPA should monitor and report by 2023 on the evidence on the risk profile of environmentally or socially harmful investments.<br>Where appropriate, EIOPA's report should advise on changes the SII Directive and to the Level 2. EIOPA may also inquire whether it would be appropriate that certain environmental risks, other than climate change-related, should be taken into account and how. |
| **Climate Stress Tests** | EIOPA will conduct centralized climate stress tests in the (re)insurance sector and the Commission will launch a Climate Resilience Dialogue and explore ways to improve the collection of insured loss data. |



## Long Term Guarantee Measures

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| **Volatility Adjustment** | The volatility adjustment seeks to mitigate the short-term volatility of insurers' solvency by taking into account the long-term perspective of the insurance company. It reduces the impact of short-term changes in credit spreads on the valuation of insurance liabilities, thereby making capital resources less volatile.<br><br>The proposed Directive increases the percentage of the risk-adjusted credit spread that forms the basis of the volatility adjustment. A higher volatility adjustment resulting from this proposed change can more effectively compensate for fluctuations in assets prices in the valuation of insurance liabilities.<br><br>Note that for the euro, in order to ensure that exaggerations of bond spreads in a specific Member State whose currency is the euro are mitigated effectively, the country component should be replaced by a macro component which is to be calculated based on the differences between the risk adjusted spread for the euro and the risk adjusted spread for the country. In order to avoid cliff-edge effects, the calculation should avoid discontinuities with respect to the input parameters.<br><br>In order to avoid excessive benefits from the volatility adjustment, the volatility adjustment should be subject to supervisory approval and its calculation should take into account undertaking-specific characteristics related to the spread sensitivity of assets and the interest rate sensitivity of the best estimate of technical provisions. In light of the additional safeguards, insurance and reinsurance undertakings should be allowed to add up to an increased proportion of 85% of the risk-corrected spread derived from the representative portfolios to the basic risk-free interest rate term structure.<br><br>The Solvency Capital Requirement (SCR) should be floored, where supervisory authorities allow insurance and reinsurance undertaking to take into account the effect of credit spread movements on the volatility adjustment in their internal model, at a level below which benefits on the SCR in excess of a mitigation of exaggerated bond spreads are expected to occur.<br><br>While insurance and reinsurance undertakings should publicly disclose the impact of not applying the matching adjustment, the volatility adjustment and the transitional measures on risk-free interest rates and on technical provisions on their financial positions, such disclosure should not be assumed to be relevant to the decision-making of an average policyholder. The impact of such measures should therefore be disclosed in the part of the solvency and financial condition report addressed to market participants and not in the part addressed to policyholders. |
| **Matching Adjustment** | Insurance and reinsurance undertakings which use the matching adjustment should be allowed to calculate their SCR based on the assumption of full diversification between the assets and liabilities of the portfolio and the rest of the undertaking, unless the portfolios of assets covering a corresponding best estimate of insurance or reinsurance obligations form a ring-fenced fund. |
| **Extrapolation** | The proposed method for the extrapolation should make use of information derived from relevant financial instruments other than bonds, where such information is available from deep, liquid and transparent markets for maturities where the bond markets are no longer deep, liquid and transparent. The resulting new extrapolation method is phased in linearly over a period running until 2032, during which insurers will have to disclose the impact of the new extrapolation method without phasing in. |
| **Risk Margin** | The formula used for the calculation of the risk margin shows a tendency, for long-term insurance business, of producing more volatile and higher values than expected to be observed in arm's length transactions. The Commission proposes to amend the risk margin formula with a time dependent "lambda" parameter that would on its own reduce the value and volatility of the risk margin for long-term business. The reduction would be particularly significant for longer-term business.<br><br>The Commission will also consider reducing the cost-of-capital rate used in the risk margin calculation from 6% to 5%, in line with the reduction in capital cost for insurance and reinsurance companies over the past years. |



## Capital Charges

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| **Equity** | The symmetric adjustment should be amended so that it allows for larger changes to the standard equity capital charge and further mitigates the impact of sharp increases or decreases in stock markets. The symmetric adjustment made to the standard equity capital charge covering the risk arising from changes in the level of equity prices shall not result in an equity capital charge being applied that is more than 17 percentage points lower or higher than the standard equity capital charge. |
| **Long Term Equity** | Additional measures under Delegated Regulation (EU) 2015/35 will strive to ensure the appropriateness of the eligibility criteria for the long-term equity asset class. In particular, it will consider simplifying the conditions under which equity investments, including via infrastructure funds, would be treated as "long-term". This would expand the scope of equities that can be subject to the more favourable 22% risk factor (instead of the reference 39% for listed equities and 49% for unlisted equities). |
| **Interest Rate Risk** | Recent analyses have shown that Solvency II rules do not appropriately reflect the risks related to movements of interest rates, where those rates are low or even negative. The Commission therefore will consider reflecting EIOPA's advice on the calculation of the capital requirement for interest rate risk with the standard formula, with the exception of an allowance for extrapolation for long-term interest rates.<br>To that end, for each currency, the stressed risk-free interest rates for maturities up to the starting point of the baseline extrapolation will be derived on the basis of the approach and parametrisation proposed by EIOPA in its Opinion. The remaining rates could be extrapolated in the same manner as the risk-free rates of the baseline, however, towards a stressed ultimate forward rate.<br><br>Similar to the amendments to the extrapolation rules, the Commission will consider phasing in the changes to the standard formula calculation for interest rate risk over a period of five years after the adoption of the amendments as proposed by EIOPA in its Opinion. |
| **Mortgage Loans** | Further work on risk assessment related to mortgage loans originated by insurers is needed, to avoid any risk of cross-sector regulatory arbitrage. In this context, the Commission will consider amending the delegated acts to better align the calibration of the standard formula counterparty default risk for mortgage loans with the credit risk framework for the banking sector. |

Sources:


- COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the review of the EU prudential framework for insurers and reinsurers in the context of the EU's post pandemic recovery
- Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision
- Questions and Answers: Proposals for amendments to the Solvency II Directive and a new Insurance Recovery and Resolution Directive



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