Solvency II Delegated Acts

Industry key outstanding issues

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Background

- These slides are intended to help explain the type of issues that need to be addressed in finalising the draft Delegated Acts and why it is important to invest the effort required to get them right
- The Delegated Acts can have a very large impact on the final design of Solvency II and whether it works as intended and therefore on the price and availability of products and the role insurers play in long-term investment
- The industry has identified the highest priority points out of a full list of over 120 issues and concerns covering methodologies, calibrations as well as errors and omissions
- The industry is continuing its work on prioritisation as it recognises that while it is vital that the most important issues are addressed, not all the issues can be solved at this stage given the tight deadlines

Areas with key issues to resolve

- Long term guarantees
- Long-term investments
- Equivalence
- Contract boundaries
- SCR calibrations
- Own Funds

Long-term guarantees

- Products with long-term guarantees provide essential social benefits, such as retirement provision, in many countries
- To ensure insurers can continue to offer these long-term guaranteed products at appropriate prices it is vital that Solvency II recognises the significant benefits that can be achieved through both product design and by backing these products with long-term assets and does not apply unnecessarily high capital requirements for these products
- Issues with artificial volatility (in Own Funds) and pro-cyclicality would prevent insurers investing in longer-term assets and instead drive a move towards holding only short-term, low-risk assets
- As well as threatening the availability of long-term guaranteed products this can have significant unintended adverse macroeconomic impacts:
  - Limiting the insurance industry’s traditional role of investing in, and assisting growth in, the European economy
  - Reducing the insurance industry’s traditional role as a stabiliser in financial markets, and thereby its ability to reduce systemic risk and market volatility
- To help address this, Omnibus II introduces a range of measures to better reflect the impact of long-term nature of insurance on risk and valuation

Long-term guarantees

- In the trilogue agreement, legislators (EP, Council and EC) made it clear that they want to maintain the capacity of the industry to provide long-term guaranteed products

- It is vital that this agreement should not be undone by the Delegated Acts

- The Level 1 measures that are impacted by Delegated Acts include:
  - The Volatility Adjustment
  - The Matching Adjustment
  - The Credit Risk Adjustment
  - The extrapolation and interpolation of the risk-free interest rate
  - Transitional measures

Long-term investments

- With the long-term guarantees package, legislators recognised that asset risk can be significantly reduced due to the combination of long-term assets backing long-term liabilities – the same issue that was addressed for the balance sheet should also be addressed for the SCR calibrations
  - We were disappointed that the EIOPA study into the treatment of long-term investments did not recognise this fundamental issue

- The key question a risk-based system should address is: “What are the actual risks that a company is exposed to?” – i.e. in this case - whether the company exposed to losses on forced sales, and…
  - if so, how to measure this risk taking into account the long-term nature of the business
  - If not, then it is exposed to defaults and how to measure this risk correctly

- This is important because it can have an enormous impact on the correct levels of capital, and therefore the potential costs to customers, and disincentives the insurance companies from holding such assets

- Not addressing these issues will create problems for a range of important assets and will make provision of long-term guarantee products unnecessarily difficult or expensive and discourage long-term investments

- Relevant asset classes particularly effected include:
  - Infrastructure investment, securitisations, long-term corporate bonds, SME investment, bonds with guarantees and collateral

Other important issues include…

Equivalence

- Provisional equivalence was introduced in Omnibus II to ensure European insurance companies were not competitively damaged unnecessarily
  - The concept of being (provisionally) equivalent will not work as intended unless undertakings located in equivalent or provisionally equivalent third countries can apply the Deduction and Aggregation Method (method 2)

Contract boundaries

- The current definition of contract boundaries leads to unnecessary reductions in own funds. If not addressed this could result in increases to product prices and/or availability

SCR Calibrations

- There are a number of issues with the SCR calibrations, most of which are issues which have been major concerns since the first draft of the Delegated Acts but have never been addressed
  - These include: currency risk, lapse risk, non-proportional reinsurance, and the way deferred tax assets are treated in the calculations

Own Funds

- There are a number of issues with the classification and definitions of own funds at group or solo level which unnecessarily restrict the availability of these items and therefore increase can increase costs significantly