Introductory Speech

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The Solvency II Review: What happens next?

Check Against Delivery

Seul le texte prononcé fait foi

Es gilt das gesprochene Wort

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organised by the National Bank of Belgium

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Ladies and Gentlemen,

I would like to congratulate the National Bank of Belgium, Jean Hilgers and his colleagues, for organising this event and thank you for the invitation to deliver the introductory speech, which I do with great pleasure.

Ten years after the emergence of the financial crisis, we are now in a different phase of the regulatory cycle naturally influenced by the new political priorities of increasing investment and economic growth. While in my view it makes perfect sense to evaluate and review the recent reforms in order to mitigate any unintended consequences and increase proportionality, I strongly believe that we should not abandon the core values of stability and consumer protection that presided to these reforms.

We cannot forget that the post-crisis regulatory agenda was the right response to restore the loss of confidence in the financial sector. Furthermore, to build up sustainable long-term investment and economic growth we need a stable and strong insurance sector that adequately prices risks, applies robust risk management strategies and treats customers fairly.

Regulatory certainty is an important value that we all should preserve. In line with this principle, the review of Solvency II follows a structured process envisaged in the legislative texts:

- **by 2018**, the review of the Solvency Capital Requirement (SCR) and,
- **by 2021**, the overall review of the regime, including the treatment of long-term guarantees (LTG).

Review of the SCR

EIOPA received calls for advice from the EU Commission focused on three main themes:

- Reducing complexity,
- Enhancing proportionality and,
- Removal of unjustified constraints to financing.

EIOPA is committed to evidence-based policymaking and to the overall principles of Solvency II. That means that our proposals will be based on the data available on the different risks and our judgements will be always focused on the main objectives of Solvency II, namely the protection of policyholders and beneficiaries and the stability of the market.

Changes must be carefully justified and clearly necessary. If there are unintended consequences, we must tackle them.

In terms of evaluation, we always put to ourselves a number of basic questions:

- What is the evidence available?
- Is this a material issue?
- Would the change be prudent and in line with the Solvency II objectives?
- Are there trade-offs, for example between greater granularity and simplicity?
- What is the overall impact of the changes?

We developed very detailed technical and analytical work and followed an open and transparent consultation process, which allowed all stakeholders to contribute to the review.

At the end of October last year, we submitted to the EU Commission the first set of advice covering a number of important issues.

EIOPA's proposed changes foresee simplifications to the calculation of risks such as lapse and mortality. To reduce over-reliance of insurance undertakings on external credit ratings in the calculation of the SCR, EIOPA recommended applying simplified calculations by nominating only one credit rating agency and calculating capital requirements for the remaining non-complex assets only subject to credit quality step 3 (i.e. BBB rating).

EIOPA also advised to create a new asset class for non-listed guarantees issued by regional governments and local authorities to ensure improved risk-sensitivity of the calculations.

Furthermore, the Advice identified the need for the extension of the application of the look-through approach to related undertakings that invest on behalf of the insurer. It also included the proposal for the use of undertaking specific parameters for reinsurance stop-loss treaties to allow for better reflection of the risk profile. With respect to risk mitigation techniques, EIOPA recommended to better recognise strategies to hedge financial risks where the exposure is changing frequently.

Finally, EIOPA carried out an analysis of the loss-absorbing capacity of deferred taxes (LAC DT) across the European Economic Area including supervisory and industry practices. The results of the analysis showed that for 75% of the close to 100 billion euros of LAC DT there are consistent practices but for the remaining 25% of LAC DT, namely the part related to the calculation of expected future profits, there are material differences in approach. Our second Advice, to be submitted to the European Commission at the end of this month, will include proposals to deal with this issue.

This second advice will also cover, in between others:

- The recalibration of a number of risks (standard parameters of premium and reserve risks, mortality and longevity risks and natural catastrophe risks)
- The review of the methodology on interest rate risk, in light of the emergence of negative interest rates
- The review of the cost of capital methodology included in the calculation of the risk margin
- A more granular treatment of the risks related to unrated debt and unlisted equity

Long-term guarantees

Another important area in the overall review of Solvency II is the LTG. What is our role here? We are required to provide an annual report on the LTG measures until 1 January 2021. We already published two of our annual reports in December 2016 and December 2017. These reports are fact based and provide a good basis to understand the impact and the sensitivity of these measures.

It is already clear that the LTG measures, taken collectively, are being widely used. More than 25% (783 out of 2945) of the undertakings in the European Economic Area use one of voluntary measures, accounting for 74% of technical provisions of European insurers. On a Europe-wide basis, the volatility adjustment is the most frequently used measure.

The impact of the LTG measures is significant. For the ones using them, they result in an increase in the SCR ratio of an average of 69 percentage points.

In line with the SII Directive requirements, EIOPA will continue to publish annual reports on the LTG and intend to finalize its work by 2020 with an advice to the EU Commission.

Analysing the impacts of Solvency II

Building up evidence and knowledge towards the 2021 overall review, EIOPA is attentive to the different impacts on the market. The recent investment survey points to a search-for-yield behaviour of insurers, which is a natural reaction to the low interest rate environment. The increased exposure to more illiquid investments and to non-traditional asset classes, such as infrastructure, improves asset diversification but also demands new risk management capabilities from insurers and closer supervisory scrutiny. At the same time, in line with our expectations, the first observations from the impact of Solvency II point to an increase in long-term investment and a stable allocation to equity.

Another consequence of the low interest rate environment is the acceleration of the pace of change in business models, especially in life insurance, with the move towards contracts with lower and more flexible guarantees and, in some countries, the significant increase of pure unit-linked products. While this is a natural management reaction to ensure the long-term sustainability of the insurers commitments and optimise capital in a Solvency II environment, it also increases the transfer of risks to policyholders. I believe that this last evolution deserves further reflection from a regulatory perspective.

We will thoroughly analyse the new evidence available on the risks and characteristics of the long-term life insurance products, especially concerning the illiquidity characteristics of the liabilities and the corresponding ability of insurers to mitigate short-term volatility by holding assets throughout the duration of the commitments, even in times of market stress.

There is specific work to do in this area, in order to explore the development of a specific regulatory treatment to the spread and equity risk charges associated to long-term assets backing certain types of truly long-term illiquid liabilities, while maintaining the sound market consistent orientation and the principles of policyholder protection of Solvency II. The intention should be to study possible adjustments to the regime to better recognize the true risks of long-term transparent retirement savings products, for the benefit of consumers and the whole economy.

Towards a comprehensive insurance regulatory framework

While Solvency II is undoubtedly a great achievement for the European Union insurance sector and for the protection of policyholders, there are still some areas where progress is needed to complete a comprehensive European Union insurance regulatory framework. I am talking about a **macro-prudential framework**, including the specific issue of systemic risk, **recovery and resolution mechanisms** and **insurance guarantee schemes**.

The macro-prudential framework

The insurance sector plays a relevant role in achieving a stable financial system, supporting long-term sustainable economic growth. Thus, mitigating the likelihood and the impact of a systemic crisis in insurance should be an important policy objective.

Work needs to be done towards the establishment of a comprehensive European Union macro-prudential framework for insurance that takes into account the specific nature of the insurance business and funding models and defines insurance specific objectives and instruments. In our view, this framework needs to be consistent with Solvency II.

EIOPA will be publishing in the coming days two papers in this area, covering a possible holistic framework to analyse systemic risk in the insurance sector and the Solvency II tools with a macro-prudential impact. We want to foster a proper discussion with all stakeholders on these important issues and we look forward for your input.

Recovery and resolution mechanisms** and **insurance guarantee schemes

In July 2017 EIOPA published an Opinion on the Harmonisation of the Recovery and Resolution Framework for (Re)Insurers across the European Union addressed to the European Parliament, the Council of the European Union and the European Commission.

The existing fragmented landscape of national recovery and resolution frameworks could cause significant barriers to the resolution of (re)insurers, particularly of cross-border groups. To reduce this risk, to avoid unnecessary economic cost stemming from uncoordinated decision-making processes between national authorities and to ensure orderly resolution, European action is required.

Therefore, EIOPA calls for a minimum degree of harmonisation in the field of recovery and resolution for (re)insurers with the objective to increase policyholder protection and financial stability in the European Union. To achieve this objective EIOPA proposes the following four building blocks where the definition of a common approach is key:

- Preparation and planning
- Early intervention
- Resolution
- Cross-border cooperation and coordination

The harmonised recovery and resolution framework should cover all (re)insurers subject to the Solvency II framework and be applied in a proportionate manner.

EIOPA is continuing its work in this area focussing on resolution funding and insurance guarantee schemes.

We believe that the overall review of Solvency II in 2021 should consider all these issues to ensure the coherence between the micro and the macro elements, avoid the emergence of conflicting incentives to insurers, and facilitate the implementation of the regimes by the respective authorities.

To finalise I would like to emphasize that the work on the review of Solvency II will benefit from the ongoing EIOPA initiatives on ensuring a consistent implementation of the new regime.

Supervisory convergence is the main strategic priority of EIOPA and its objectives are to develop a common supervisory culture, guaranteeing a level playing field and preventing regulatory arbitrage in the internal market with the ultimate goal of safeguarding a similar level of protection to all policyholders and beneficiaries in the European Union.

Thank you for your attention.