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TRENDS – Solvency

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In a nutshell…

On July 18th, *the European Parliament's Committee on Economic and Monetary Affairs has* ***approved both the report on the proposed Solvency II Review and the report on the proposed Insurance Recovery and Resolution Directive*** *(IRRD).*

This will now be followed by the so-called "Trilogue phase," in which a compromise between the texts of the Council and the European Parliament must be reached *with the active support of the Commission.*

A new EIOPA ***consultation*** *was launched* ***July 10th*** *on a* ***Supervisory Statement on third-country reinsurance supervision.***

New publications *include (i)* ***IVASS Measure No. 132, amending the rules for calculating technical provisions;*** *(ii)* ***the EIOPA Financial Stability Report 2023****; and (iii)* ***draft UK Government Regulations on Solvency II reform****.*

The ***main contents of the text approved by the European Parliament in connection with the revision of the Solvency II framework*** *are anazlyzed* ***in the focus section****.*

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Highlights

Review 2020: Approval of the European Parliament reports on Solvency II and IRRD

On July 18th, the European Parliament's Committee on Economic and Monetary Affairs **has approved both the report on the proposed Solvency II revision and the one on the proposed Insurance Recovery and Resolution Directive** (IRRD).

The so-called "Trilogue phase" will follow, in which a compromise between the texts of the Council and the European Parliament must be reached with the active support of the Commission.

Upon reaching consensus on the report, the final text will be published in the Official Journal of the European Union and, within 18 months, must be transposed into national law.

The text **ensures high levels of protection for policyholders,** allowing the industry to increase its **contribution to the financing of the real economy**. In addition, **countercyclical mechanisms, such as the Volatility Adjustment**, necessary to mitigate the impacts of short-term market turbulence on the capital position of insurance companies, **are confirmed and strengthened**.

Regarding sustainability aspects to be introduced in the Solvency II framework, Parliament introduces mandatory drafting of so-called **transiton plans**.

New consultations

EIOPA: Consultation on Supervisory Statement on third country reinsurance supervision

On July 10th, EIOPA has launched a public consultation on a Supervisory Statement on the supervision of third-country reinsurance. The draft **Supervisory Statement outlines the expectations of national and industry supervisors when using third-country reinsurance** and aims to **ensure high-quality, convergent supervision of insurers that have reinsurance agreements with third-country reinsurers**.

The paper sets out supervisory expectations in several areas, including assessing the business environment when using third-country reinsurance and the importance of early dialogue with supervision. In addition, it includes supervisory **considerations on how to assess reinsurance arrangements and firms' risk management systems in relation to the use of third-country reinsurers**. Finally, the supervisory document **includes tools that will help mitigate any additional risks that may arise**. The consultation **will end on October 10th, 2023**.

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Other Reports

IVASS: Publication of Regulatory Order No. 132, amending the rules for calculating technical provisions

On June 6th, IVASS published **Regulatory Order No. 132** on amendments and additions to Regulation No. 18 of March 15th, 2016, **concerning the application rules for determining technical provisions**.

The document has gone through a consultation process in recent months and **transposes the EIOPA Guidelines** published on July 6th, 2022, **into national lawon Solvency II requirements concerning the valuation of technical provisions** (*Guidelines on Valuation on Technical Provisions*) and the determination of contractual limits (*Guidelines on Contract Boundaries*) and applied from January 1, 2023.

EIOPA: Financial Stability Report 2023

On June 22nd, EIOPA has released its **new Financial Stability Report**, which describes the main developments and risks in the European insurance and occupational pension sectors in 2022 and early 2023.

In the report, **EIOPA** notes that **the European economy is experiencing a new period of high uncertainty and high risk to financial stability, mainly** due to factors such as persistent inflation, the difficult geopolitical landscape, and rising financing costs.

As for the **insurance sector**, the Authority reports **solid solvency positions in 2023**, despite losses due to natural disasters, lower investment returns, higher-than-expected inflation and continued economic uncertainties, and **a reduction, according to 2022 data, in the share of government and corporate bonds, shifting their investment portfolios towards less interest-rate-sensitive assets**.

UK government: Draft regulations for Solvency II reform

On June 22nd, the **UK government has published the draft regulatory texts** that form the basis of the **new prudential framework** following the Solvency II reform in the UK.

Major changes from Solvency II include, in particular: i) **the Risk Margin**, where the Cost of Capital value is reduced from 6% to 4 %); ii) **the Matching Adjustment**, where the requirements for fixed-rate assets are relaxed slightly, provided that floating-rate assets make up a limited portion of the portfolio to which the adjustment relates. The introduction date of the adjustments is expected to be no later than June 2024.

Focus

Analysis of the text approved by the European Parliament on the Solvency II review proposal.

On July 18th, the European Parliament's Committee on Economic and Monetary Affairs has approved both the report on the proposed Solvency II revision and the report on the proposed Insurance Recovery and Resolution Directive (IRRD).

The so-called "Trilogue phase" will follow, in which a compromise between the texts of the Council and the European Parliament must be reached with the active support of the Commission.

Upon reaching consensus on the report, the final text will then be published in the Official Journal of the European Union and, within 18 months, must be transposed into national law.

The Parliament's Report **contains changes** both from the current regulatory framework and from the text of the Commission's proposal, related to the **following areas**:

- Long Term Guarantees measures (LTG) and evaluation of technical provisions
- Solvency Capital Requirement: Standard Formula and Internal Models
- Proportionality and simplification
- Reporting and audit requirements
- Supervision and macroprudential tools
- Sustainability risks
- Group supervision
- Cross-border supervision

The following analysis outlines **the main contents of the Report**, grouped by topic area:

Measures LTG and evaluation of technical provisions

The text introduces modifications to the Commission's text with reference to: i) Volatility Adjustment, ii) risk-free rate curve extrapolation methodology, iii) Risk Margin.

The following changes are made to **the Volatility Adjustment (Art. 77d)**: i) **reintroduction of the current risk-correction** methodology, calculated as the fundamental spread of the Matching Adjustment (Art. 77c and based on the long-term averages of portfolio yield; ii) **introduction of an application ratio** that takes into account the mismatch - in terms of risk-corrected spreads - of the company's portfolio compared to the average European portfolio (the so-called **quality overshooting ratio**); the application ratio will be optional and subject to approval by the national Supervisory Authority, subject to certain application conditions and capped at 125%.

As for **the mechanism for extrapolating the risk-free rate curve (Art. 77a)**, the text sets some parameters of the new methodology introduced by the Commission's proposal (the value of **the first smoothing point - 20 years** for the euro - **and the convergence period beyond the FSP - 40 years**) and the conditions for defining the **convergence parameter**, which would then be around 13% (an improvement over the Commission's proposal, which put it at 10%).

Regarding **the Risk Margin (Art. 77)**, the text **reduces** the value of **the Cost of Capital rate to 4.5 %** (6% currently in effect).

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Solvency Capital Requirement: Standard Formula and Internal Models

The text introduces changes to the treatment of interest rate change and equity risk for Standard Formula users and reduces the Commission's proposed operational burdens for internal model users.

On the **Interest Rate Risk module**, the Report amends Article 111 by introducing reference to **a new methodology for calibrating** this submodule that incorporates the assumptions of (i) **the existence of negative interest rates** and (ii) **a negative term-dependent** floor "*such that the likelihood of interest rates across relevant currencies and across maturities not being at all times above the negative floor is sufficiently small*".

With reference to the prudential treatment for **equity investments**, the text: i) introduces a new article (Art. 105a) that **defines** and moves to Level 1 the category **Long-Term Equity investments** - currently defined by Art. 171bis of the Delegated Acts- **replacing** some of the previous criteria with "more flexible" requirements and based on the individual company's ability to manage these assets through risk-management, asset-liability management and investment policy tools; ii) **excludes investments backing unit-linked policies from the scope of the Symmetric Adjustment** (Art. 106) - the adjustment applicable to the capital requirement for equity risk - and **changes its lower and upper limits** (-17%/+17% instead of -10%/+10%).

Regarding internal models, the text: i) **introduces the possibility** for full or partial internal model users to **be classified as low-risk profile undertakings** (LRPUs) (Art. 29a), thus benefiting from the proportionality measures provided for these undertakings. Compared to the Commission's proposals, the following **are removed**: i) **the requirement to regularly report to the Authorities the result of the SCR calculation obtained by using the Standard Formula** (Art. 112); ii) **the requirement to re-evaluate internal models every 5 years**.

Finally, the text proposes **the review of all calibrations based on datasets that include the UK** (recital 83) and, in general, the periodic review of all calibrations (art. 111).

Proportionality and simplifications

The text makes changes to both the thresholds for exemption from Solvency II and the thresholds, criteria and scope for low-risk profile undertakings.

Specifically, the Report modifies **the thresholds for Solvency II exemption** (Article 4) for Groups, raising **the level of gross technical provisions from 25 million to 50 million.**

As for the implementation of the **proportionality principle**, however, the text proposes some changes from the Commission's proposal, including: i) **automatic inclusion** of **captive companies** among LRPUs (Art. 13 - Art. 29) and **exclusion of reinsurance companies** (Art. 29a); ii) introduction of **additional proportionality measures** (e.g.; simplified calculation for specific risk sub-modules) (Art. 109); iii) **simplifications, clarifications and further automaticity** in the application of proportionality measures.

Reporting and audit requirements

The text mitigates some reporting requirements for LRPU companies (see "Proportionality and Simplification") and eliminates some reporting and audit requirements introduced by the Commission for standard formula users.

In terms of reporting applicable to all companies (see also the specific sections for LRPUs and internal models), the document **introduces**, in particular, **the division of the SFCR into two sections** (Art. 308d), one dedicated to policyholders and the other to the market (with the specification of the impact of the application of the Volatility Adjustment, Matching Adjustment and transitional measures for the section dedicated to the market only) and the **inclusion**, in the former, of **a description of the risk profile that also takes into account sustainability risks**.

Regarding **audit requirements**, the text **proposes both a requirement for external audit for balance sheet items** presented as part of the SFCR and **a requirement for external audit for LRPUs.**

Supervision and macroprudential tools

The text reintroduces and strengthens the Commission's proposals with reference to increased supervisory powers in macroprudential issues and related instruments.

In the area of **macroprudential supervision**, the text: i) grants **additional powers to EIOPA** in deciding about the extension of reporting deadlines in **"exceptional" situations** (Art. 35b); ii) **extends** (giving broad discretion) **the powers of national supervisors in the presence of liquidity risks or sectoral market shocks of an exceptional nature** (suspension of dividends and share buy-backs and repayments, etc.), extending, in part, the Commission's proposal.

Sustainability risks

The text reintroduces, as proposed by the Commission, references to environmental risk monitoring and management.

The text **introduces** (in line with what the Commission proposed): i) a requirement to consider **climate change scenarios** in its risk management assessments and in **ORSA** (Art. 45a); iii) a **requirement** for EIOPA to **explore a separate prudential treatment for ESG-compliant investments** and to explore the possibility of **extending the analyses** done for climate change risk **to other environmental risks** (Art. 45a). In contrast to the Commission's proposal, it instead introduces a **requirement to draw up so-called transiton plans** (except for LRPUs) and to and include a **description of their implementation in the SFCR**.

Group supervision

The text eliminates Commission proposals to expand the scope of Group supervision and related powers of the Authorities.

The text reverts to the Commission's proposed solution on "trigger inversion" and defines the minimum consolidated group SCR (**group MCR locked at 45% of group SCR**). It also amends Article 213 by **eliminating the Authority's ability** to require reorganization of the Group structure and deletes Article 246a, which defines how **liquidity risk** is managed at the Group level.

Cross-border supervision

The text proposes changes to the definition and supervision of companies and cross-border activities.

The text introduces: i) the definition of **significant cross-border activities** (Art. 13); ii) **the mandatory nature of the cross-border collaboration platform** introduced in 2019 as part of the Review of ESAs (152b); iii) **the possibility of a joint inspection** between the Supervisory Authorities of the "Host" and "Home" states if solvency requirements are not respected.

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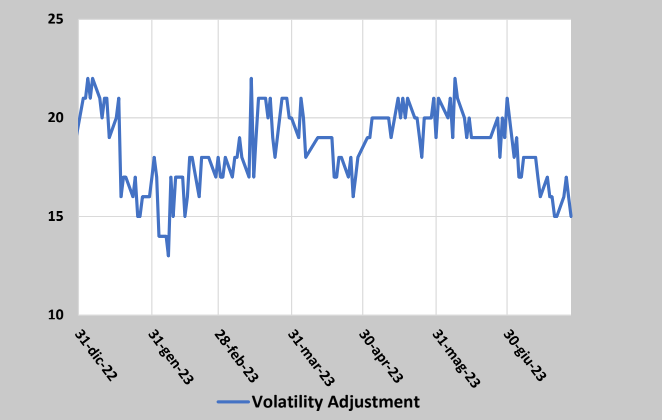
Volatility Adjustment: trends and components

On July 27th, the **Volatility Adjustment** applicable by European companies **was 15 bps** (according to ANIA elaborations), lower than the value recorded at the end of June (21 bps) (fig. 1).

The decrease was driven by lower levels in the value of internal rates of return for portfolios, both government and corporate, **representative of the average portfolio of European companies** (fig. 3), and the resulting decrease in the risk-corrected currency spread from 32 bps to 23 bps (fig. 2).

Fig. 5 shows the impact, at 10 and 20 years, of the rise in the risk-free rate curve over the same period (fig. 4) on a cash flow amount of 1,000 euros.

Fig. 1 - Volatility Adjustment



Volatility Adjustment and risk-free rates				
month	VA euro	VA Italy	RFR 10y (+VA)	RFR 20y (+VA)
27/07/2023	15	15	3,10%	3,00%
30/06/2023	21	21	3,09%	2,87%

Source: ANIA calculations on EIOPA and Refinitiv data (bps where no specified)

Fig 2 - Risk corrected spreads: currency vs. country

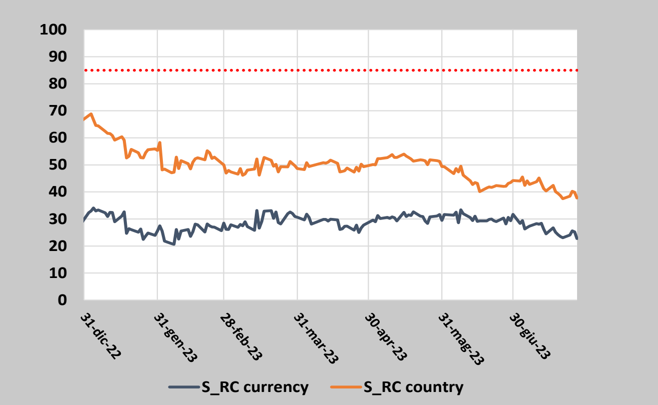


Fig. 3 - Risk corrected spreads: govies vs. corporate

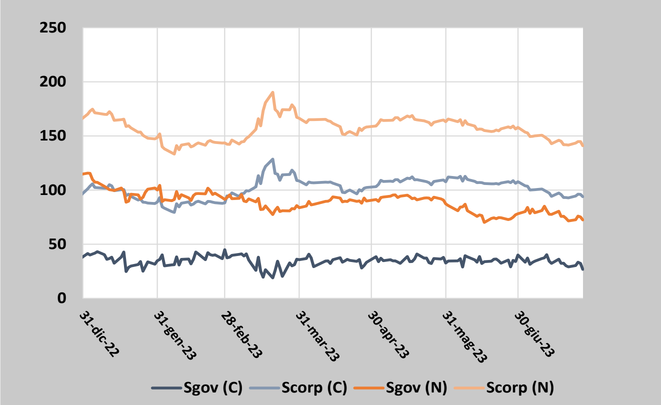


Fig. 4 - The risk-free rate curve

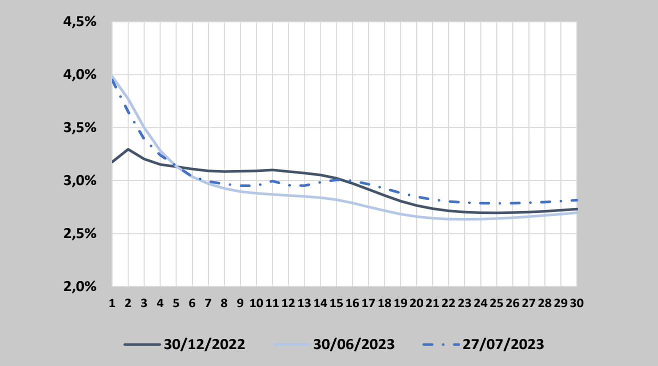
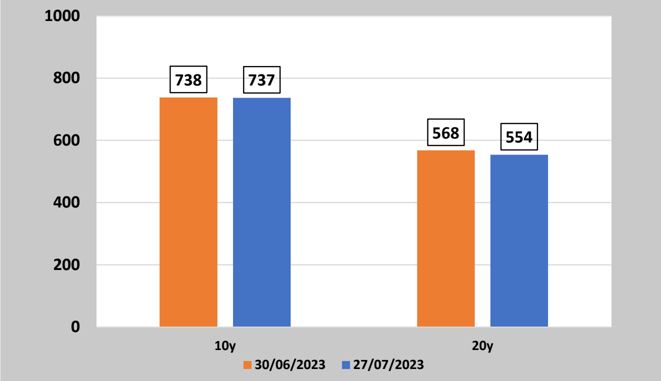


Fig. 5 - The impact on cash-flows (euro)



Source: ANIA calculations on EIOPA and Refinitiv data

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