Ania
Associazione Nazionale fra le Imprese Assicuratrici

TRENDS – Solvency
Year IV | n.7 |September 2023

In a nutshell…

On September 8th, *the European Council Working Group* ***discussed the main differences between the Council's and the Parliament's proposals on the Solvency II Review****;* ***on September 19th****, the* ***last phase of negotiations****, the so-called Trilogue,has* ***begun.***

New reports and publications *include (i) an ESRB* ***Paper on the investment behavior of European insurers during the pandemic crisis****; (ii) the* ***EIOPA Risk Dashboard*** *based on Solvency II data for the first quarter of 2023; and (iii) an* ***ESAs Report on risks and vulnerabilities in the EU financial system****.*

In the focus section*, we provide coverage on the* ***main contents*** *of the text* ***approved by European Parliament*** *no the proposed Insurance Recovery and Resolution Directive (****IRRD****).*

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Highlights

Review 2020: Recent developments

On September 8th, the *European Council Working Group* ***discussed the main differences between the Council and Parliament proposals on Solvency II revision****.*

In addition, **on September 19th**, the last phase of negotiations, the **s.c. Trilogue**, has begun for both the Solvency II Directive Review and the upcoming Insurance Recovery and Resolution Directive (IRRD). During this phase, a compromise between the texts approved by the Council and the European Parliament will have to be reached, with the active support of the Commission.

Upon reachment of consensus, the final text will then be published in the **Official Journal of the European Union** and, within 18 months, will have to be transposed into national law.

New consultations

There are no consultations to report.

Completed consultations and new reports

ESRB: Paper on the investment behaviour of European insurers during the pandemic crisis

On **September 15th**, the European Systemic Risk Board (ESRB) has published a **paper** **aimed at analysing the investment behaviour of European insurers during the pandemic crisis from Covid-19**.

Through an empirical study, the paper's authors investigate the reaction, in terms of investment dynamics, of **insurance companies to asset price shocks** recorded **in the first quarter of 2020**.

The analysis also **considers the specificities** of different countries **in terms of the structure of insurance supply and the impact of LTG** (Long-Term Guarantee) measures, i.e., measures provided by the Solvency II framework to reduce the effects of so-called "artificial volatility" on long-term insurance products.

Other Reports

EIOPA: Risk Dashboard al Q1 2023

On **July 27th**, EIOPA has published the **Risk Dashboard** based on Solvency II data **for the first quarter of 2023.**

The Authority's analysis notes that the **main concerns** for the European insurance industry continue to be **exposures to macro risks**, the level of which remains high, **despite an improvement in GDP** growth forecasts (**+0.74%**) **and consumer price forecasts** (decreased **to 3.22% for the next four quarters**). All other risk categories remain at average levels.

Regarding **credit risks**, the Report shows **an increase in credit default swap (CDS) spreads for financial covered bonds** in the second quarter of 2023 and a **slight decline for other fixed income market segments**; it also points to a reduction in the industry's exposure to such securities (especially government).

Regarding **market risks**, the Report indicates a **downward trend compared to the previous analysis**, thanks to the decrease in volatility in the equity markets recorded in June; however, **with reference to the end of 2022**, a **deterioration compared to the previous year in the levels of investment return spreads compared to company's guaranteed rates** is recorded, mainly due to the increase in interest rates and a reduction in the duration mismatch between assets and liabilities. Overall, the **outlook for the next 12 months** is rated **upward**.

Regarding **profitability and solvency risks** - considered to be at medium level and with **stable trends and outlooks** - the Authority notes, in particular: i) **a decrease in investment returns for life insurers in 2022 compared to 2021**, mainly attributable to the increase in unrealized losses caused by rising interest rates; ii) **a decrease** - in the first quarter of 2023 - in the median of the **Solvency Capital Requirement Ratio** (SCR) for insurance groups and life insurers.

Regarding **other major risks to the insurance industry**, the Authority notes (i) a **decline in insurance risks**, with the median year-on-year growth in non-life insurance premiums falling to end-2021 levels; (ii) **an upward trend in the level of risks related to ESG factors**, both compared to the previous three months and the projections for the next 12 months, due to increased median exposure to climate-relevant assets and worsening loss ratios of catastrophe risks; and (iii) an upward trend in **cyber risks** as well, driven by an increase in the frequency of incidents of this nature compared to last year.

ESAs: Report on risks and vulnerabilities in the EU financial system

On September 18th, the Joint Committee of the three European Supervisory Authorities (EBA, EIOPA and ESMA: ESAs) has published the **Report on Risks and Vulnerabilities in the EU Financial System**, containing the main findings and the development of financial risks in the European financial sector.

In the report, the authorities note that, **despite the difficult macroeconomic environment and recent pressures in the banking sector, most European financial institutions have demonstrated a comfortable degree of capital strength.**

However, given the continuing economic uncertainty, **the Committee advises** the relevant national authorities, financial institutions, and market participants **to take specific policy actions** such as, **for example, monitoring rising interest rates and inflation risk and taking measures to manage liquidity risk.**

IRRD Legislative Proposal: an overview of the text approved by the European Parliament

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**", during which a compromise between the texts of the Council and the European Parliament must be reached with the active support of the Commission, **has begun last September 19**.

Upon reaching consensus on the report, **the final text** will have to undergo the Parliament's vote before being published in the **Official Journal of the European Union** and being **transposed,** within 18 months, **into national law**.

The **purpose of IRRD is to create** a **harmonized EU-wide framework** for the timely handling of a potential failure or bankruptcy of an insurance company, including cross border cases. In the Commission's view, the new framework should provide greater protection for policyholders, minimizing the impact on the economy and on the financial system.

While **IRRD is based on the Bank Recovery and Resolution Directive (BRRD)** and the **Central Counterparty Recovery and Resolution Regulation (CCPRR)**, the proposal **aims to adapt to the specificities of the insurance sector** and its prudential framework.

The IRRD will be **complementary to Solvency II**, which, to date, establishes in Chapter VII (Insurance and Reinsurance Undertakings in Difficulty or Irregular Situation) the actions to enforce in case of non-compliance with the Solvency Capital Requirement (Article 139) or minimum capital requirement (Article 139), supervisory powers in case of deteriorating financial conditions (Article 141), basic features of recovery and financing plans (Article 142) and conditions for the withdrawal of the authorization (Article 144).

At present, there are no harmonized procedures for the resolution of insurance companies at European level, and the rehabilitation systems, which exist in only a few member states and differ substantially among each other, are such that they lead to uneven levels of protection for policyholders and beneficiaries.

The following analysis outlines the **changes from the text of the Commission's proposal and** the **main contents** of the Report:

- Scope of Directive
- Designation of resolution authorities
- Pre-emptive recovery planning
- Resolution planning
- Resolution funding arrangements
- Insurance Guarantee Schemes

Scope of Directive (art. 1)

The Parliament's text is in line with the one of the Commission on the scope of the Directive, however, it introduces the possibility of drawing up a single preventive recovery plan for financial conglomerates.

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The **scope of the Directive**, proposed by the Parliament is **in line** with the one of the **Commission** and includes companies already included In the Solvency II scope, parent companies based in the European Union, insurance holding companies, mixed financial holding companies and branches of companies established in third countries. In addition, the Parliament introduces the possibility, for **conglomerates**, to prepare a **single preventive recovery plan** (however, giving the national supervisory authorities the option of requiring one specifically for the individual firm) and prohibits member states from providing exemptions to companies.

Designation of resolution authorities (article 3)

The Parliament's proposal removes the requirement to establish National Resolution Authorities.

Regarding the **designation of resolution authorities**, the Parliament's proposal gives each member state the power **to designate,** within national central banks, relevant ministries, or Public Administrative Authorities, **one or more authorities** bearing resolution powers. The designated National Authorities will have to respect the principles of independence and have appropriate structures to avoid conflicts of interest.

Pre-emptive recovery planning (articles 5-8)

The Parliament's proposal introduces changes regarding significance thresholds for drafting recovery plans.

As for the scope of preventive recovery plans, the Parliament's proposal **eliminates** the Commission's proposal, which required at least 80 percent of a member state's life and non-life market to draft a plan (where non-life market rate is based on gross premiums written and life market rate on gross technical provisions). According to the Report, companies subject to **drafting pre-emptive recovery planning** are undertakings, individual or part of a group, which alternatively meet the following conditions: i) gross premiums written for non-life business or gross technical provisions for life business of the undertaking amount to at least **3 percent of the country total**; ii) the company has **significant cross-border activities**. The Report **excludes** Low Risk Profile Undertakings (LRPU) which do not represent a risk at the national or regional level.

The Parliament's proposal moves the definition of qualitative and quantitative indicators for recovery plans **from EIOPA's Guidelines** (as proposed by the Commission) **to the Regulatory Technical Standards** (RTS), which will be developed and sent to the Commission by EIOPA (within 18 months of the Directive's entry into force).

Resolution planning (articles 9-12)

The Parliament's proposal introduces changes regarding significance thresholds for drafting resolution plans.

Regarding **the scope of resolution plans**, the Report eliminates the 70%threshold (in terms of gross written premiums for non-life business and gross technical provisions for life business) of companies per member state. The Parliament defines a risk-based proposal, which includes a public interest assessment for both individual firms and those that are part of a group. Companies, except for LRPUs, subject to the requirement to prepare such plans are those which perform **s.c. "critical" functions**, i.e., activities, services and/or operations that may have impacts on the financial system or the real economy. Critical functions Identification criteria are moved, according to the Commission's proposal, from **Level 3 of the Regulations to Level 2.** However, the Parliament proposes to include at **least the five riskiest companies** in each Member State's life and nonlife markets (where nonlife market share is based on gross premiums written, life market share on gross technical provisions) **in the scope of resolution planning**. In addition, the Parliament's proposal requires resolution plan and recovery plan to be updated **at least every two years, more specifically** for those companies which are likely to experience a **significant deterioration** in their financial position (changing the annual frequency, for all firms, proposed by the Commission).

The conditions proposed by the Parliament according to which an undertaking shall be subject to resolution procedures, are in line with those proposed by the Commission and provide that the (re)insurance company is failing, likely to fail with no prospect of its failure being avoided (**s.c.** "**Failing or Likely to Fail**"); and, more specifically, when the following conditions occur: i) violation of the MCR; ii) violation of the conditions for operating license; iii) inability to repay its debt or other liabilities; and iv) need for extraordinary public financial support.

Resolution of fundings arrangements (article 26)

The Parliament's proposal, unlike the Commission's, requires Member States to ensure that resolution funding agreements are in place.

According to the Parliament's proposal, **financing plans should include** a combination of **ex-ante and ex-post contributions** and should be instituted **to compensate at least the policyholders of the (re)insurance company**, if the "no creditor worse off" principle cannot be respected. Funding **is needed to cover any reasonable expenses** incurred in connection with the use of the tools or the exercise of resolution powers.

Insurance Guarantee Schemes (article 91a-b)

The text introduces common minimum standards for Insurance Guarantees Schemes (IGS).

Regarding **Insurance Guarantees Schemes** (IGS), defined as a system guaranteeing the payment of claims to policyholders if the company is unable to meet its obligations, the Parliament's proposal introduces a **request to the European Commission to prepare a report**, to be submitted to the Parliament and the Council by January 1, 2024. This report should outline necessary actions **to establish minimum common standards** for the implementation of IGS and introduces the **possibility for a National Resolution Authority to transfer the portfolio** of companies under resolution **to existing national protection schemes**.

[1]Member states must ensure that any shareholder or creditor who has suffered greater losses than he or she would have suffered in a liquidation under ordinary insolvency proceedings is entitled to payment of the difference.

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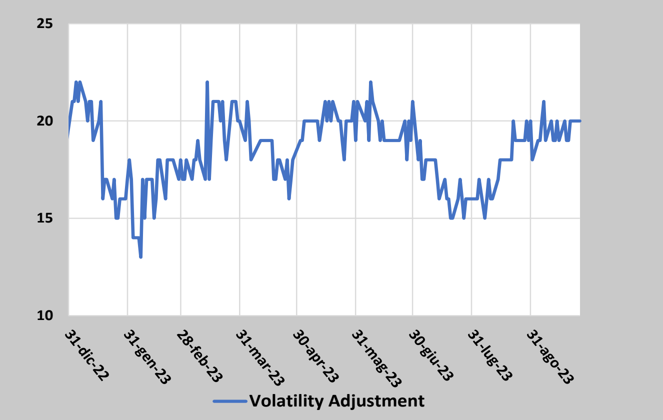
Volatility Adjustment: trends and components

On September 26th, the **Volatility Adjustment** applicable by European companies **was 20 bps** (according to ANIA elaborations), compared to the value recorded on August 31 (fig. 1).

The **slight increase in yield spreads on government bonds** (euro-denominated) held by the average European company was **partly compensated for by the slight decrease in corporate spreads** (fig.3); the risk-corrected currency spread thus remained almost stationary (31 bps, fig, 2), also due to the increase in risk-free rates.

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 - The Volatility Adjustment



Volatility Adjustment and risk-free rates

month	VA euro	VA Italia	RFR 10y (+VA)	RFR 20y (+VA)
26/09/2023	20	20	3,44%	3,38%
31/08/2023	20	20	3,12%	3,02%

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

Fig 2 - Risk corrected spreads: currency vs. country

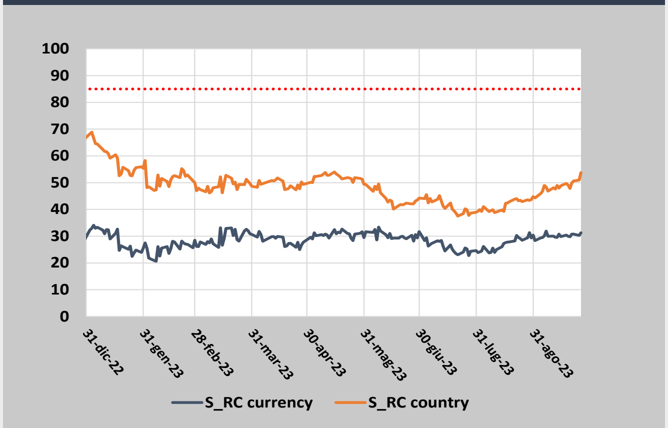


Fig. 3 - Government and corporate spreads

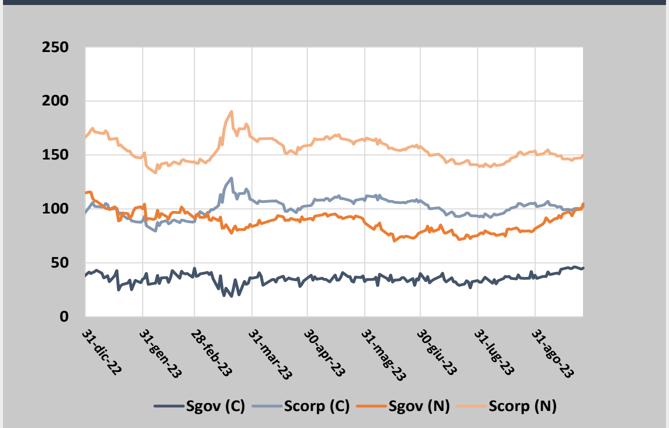


Fig. 4 - The risk-free rate curve

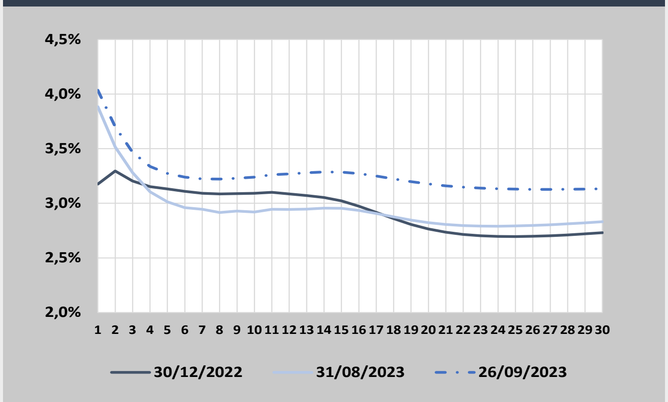
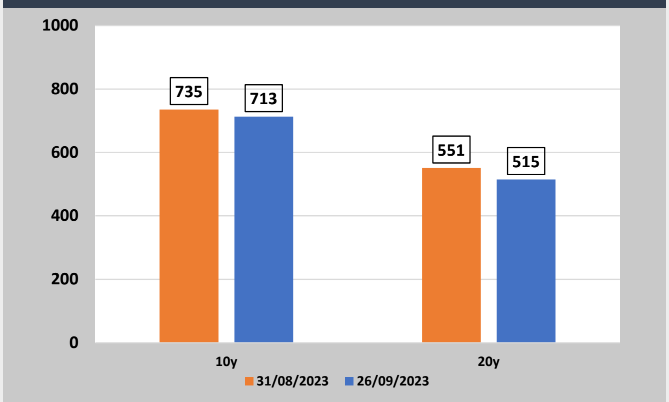


Fig. 5 - The impact on cash-flow (euro)



Source: ANIA calculations on EIOPA and Refinitiv data

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