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# In a nutshell…

***Regarding developments on the proposed review of the Solvency II Directive and the proposed Insurance Recovery and Resolution Directive** (IRRD), the negotiation phase, **the so-called Trilogue,** begun on September 19, **continues**. **The upcoming meetings will be decisive to conclude the negotiations and reach an agreement by the end of the year.***

***New reports and publications** include: i) ESAs Draft ITS amending of the **allocation of credit assessments of** the external credit assessment institutions (**ECAI**); ii) **EIOPA Risk Dashboard** as of Q2 2023; iii) Bank of Italy **Report on financial stability**; iv) FSB Paper on **identification of critical functions** for insurers.*

***An overview of the prudential review process in UK insurance sector** is covered in the focus section.*

# Index


### Highlights

- *Review 2020: Recent developments*

### New consultations

- *No new consultations to report*

### Completed consultations and new reports

- *ESAs: Draft ITS on the allocation of credit assessments of the external credit assessment institutions (ECAI)*

### Other reports

- *EIOPA: Risk Dashboard as of Q2 2023*
- *Bank of Italy: Financial Stability Report*
- *FSB: Paper on the identification of critical functions of insurers*

### Focus

- *Overview of the prudential review process in the UK insurance sector*

### Appendix

- *Volatility Adjustment: trends and components*


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# Highlights

## Review 2020: Recent developments

**Regarding developments on the proposed review of the Solvency II Directive and the proposed Insurance Recovery and Resolution Directive** (IRRD), the negotiation phase, **the so-called Trilogue,** begun on September 19, **continues. The upcoming meetings will be decisive to conclude the negotiations and reach an agreement by the end of the year**.

# New consultations

No new consultations to report

# Completed consultations and new reports

## ESAs: ITS on the allocation of credit assessments of the external credit assessment institutions (ECAI)

On **November 13th**, **the Joint Committee of the European Supervisory Authorities** (EBA, EIOPA and ESMA) **published the new Implementation Technical Standards (ITS) on the mapping of credit assessments of credit rating institutions (ECAIs)** for the application of Solvency II directive**.** The **amendments** to the Regulation currently in force **reflect the outcome of a monitoring exercise on the adequacy of the existing mappings**.

# Other Reports

## EIOPA: Risk Dashboard as for Q2 2023

**On November 6th**, EIOPA published its **Risk Dashboard** based on Solvency II data **for the second quarter of 2023**.

In the opinion of Authority **main concerns** for the European insurance industry **continue to be exposure to macro and market risks**; **all other risk categories** (credit, liquidity and funding, profitability and solvency, underwriting and ESG-related risks) continue to be **at medium level**, apart from **cyber risks which increased to high levels**.

In particular, the Authority reports a **worsening in GDP growth forecasts** over the next four quarters and **high levels of inflation projections**, regarding macro risks, high **levels of volatility in equity and bond markets**, for market risk; and an **increase in the frequency of cyber incidents**.

## Bank of Italy: Report on financial stability

**On November 24th**, **the Bank of Italy published** its second **Financial Stability Report for 2023**, **containing**, as usual, a section on the insurance sector. **The Report shows an increase in the average solvency ratio in September 2023** compared to December of the last year (260% and 249% respectively), mainly **attributable to the increase in the value of assets portfolio**.

## FSB: Paper on the identification of critical functions for insurers

**On November 10th**, the Financial Stability Board (**FSB**) **published a Paper on the identification of critical functions in the insurance sector**, outlining **the approaches taken in Australia, China, France and the Netherlands**.

The paper is **part of the FSB's work in identifying the key elements of resolution frameworks including critical functions**.

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# Focus

## *Overview of the prudential review process in the UK insurance sector*

**On June 22nd, the UK government published the draft regulations to replace Solvency II** and **reform insurance regulation in the UK**. The aim of the reform is to **create a new regulatory framework ('Solvency UK')** more **aligned with the features of the UK market**. According to Government's guidance, **some new regulatory measures should come into force by the end of 2023, the remaining ones in 2024**.

**The review process** for the creation of Solvency UK **involves a combination of Government and Prudential Regulation Authority** (PRA) **regulatory decisions**, the latter operating within the Bank of England.

**The revision process began with the Bill published in July 2022** (Financial Services and Markets Act) and is designed to give new powers to the UK Government and the PRA to make changes to EU financial services and markets legislation and, among other things, to revoke Solvency II. **Secondary legislation**, on the other hand, **provides** for the definition of the main features of the Solvency UK framework through **Statutory Instruments** (i.e. Delegated Regulations) drafted by HM Treasury, which are expected to be **presented to Parliament in late 2023 and early 2024**.

Most of the **Regulations and provisions under Solvency II will**, moreover, **be replaced** with requirements **in the PRA Rulebook**, which will be amended after a consultation process.

**A first PRA consultation** on the texts published by the Government was conducted **between June and September** and **includes proposals to rationalise the reporting requirements** for companies, to **simplify** and improve **flexibility in the assessment of internal models**, to **encourage new entries in the UK insurance market** and to **facilitate access for international insurers** operating through branches.

**A second consultation** involving life insurance companies, was launched **on September 28th** (with deadline in January 2024) with the aim of **proposing new rules** to allow larger investments by insurance companies **in their Matching Adjustment (MA) portfolios**, while at the same time strengthening corporate responsibility in terms of risk management.

Finally, in early **October**, **a new consultation paper on the authorisation of operations and supervision of insurance branches** was published in order to consolidate and formalise existing supervisory policies **with respect to foreign insurers operating in the UK** through the establishment of a third-country branch and to provide greater clarity on supervisory expectations in this area.

**The main changes with respect to Solvency II** envisaged by **the provisions contained in the Draft Government text** and in the **consultation documents are outlined below**.

### *The main UK Government' changes*

**The main changes with respect to Solvency II contained in the UK Government's texts** published last June concern: i) Risk Margin, ii) Matching Adjustment, iii) Fundamental Spread.

With reference to the **Risk Margin**, so far calibrated according to the European Solvency II's approach, **the UK Government reduces the Cost of Capital from 6% to 4%** and **introduces** - for life companies - **an exponential risk tapering factor of 0.9 (with a floor of 0.25) that takes into account the time dependence of the future capital requirements projections**. The Government

expects that this will reduce the Risk Margin for long-term life insurance business by 65% and for general insurance business by 30%. These **changes** will be **implemented on 31 December 2023**.

About the **Matching Adjustment**, the main change is represented by a **slight easing of the requirements for assets to have fixed cash flows**, provided the assets with variable cash flows constitute a limited portion of the overall portfolio to which the Matching Adjustment relates (so as not to compromise the quality of the matching). **The changes should be implemented no later than June 2024**. **No changes** are expected **to the methodology and calibration of the Fundamental Spread** used in the calculation of the MA in the current Solvency II framework because Government considers the introduction of current spreads to replace the current long-term averages of spreads to have significant negative impacts. The government will assess their adequacy in five years' time.

### *The proposals consulted by the Prudential Regulatory Authority*

**The proposed changes consulted** by the PRA concern, in particular: i) the streamlining of **reporting requirements**; ii) the simplification of the **Transitional Measure on Technical Provisions** (TMTP); iii) the adoption of a 'principle-based' approach for **the assessment of companies' internal models** and for the calculation of **group capital requirements**; iv) the introduction of a **'mobilisation' regime** to allow for more flexibility for newly authorised insurers and the increase of the **thresholds for the application of the Solvency UK framework**; v) the removal of some **requirements for subsidiaries of foreign companies**; vi) changes to the **scope of the Matching Adjustment** and to the **granularity of the Fundamental Spread calculation**.

More specifically, about the **Matching Adjustment**, the key points under discussion are:

- **investment flexibility**: the Authority identifies a set of criteria for the inclusion of assets with highly predictable cash flows;
- **credit ratings within the MA**: the removal of the ban on the inclusion of sub-investment grade assets and introduction of new requirements for internal credit assessment are proposed;
- **MA permissions and breaches**: the PRA proposes to create a streamlined approach for granting MA permissions in certain situations, and eases the consequences of breaching MA eligibility conditions;
- **Corporate responsibility for risk management**: it is proposed to identify a senior manager to attest on the sufficiency of the Fundamental Spread as well as the quality of the resulting MA;
- **Change in reporting**: it is proposed to introduce new reporting requirements related to the MA;
- **Granularity of the Fundamental Spread**: to require firms to derive a more granular Fundamental Spread by rating notch, by linearly interpolating the technical information published by the PRA for each relevant CQS.

With regard to the **transitional measure on technical provisions**, the PRA proposes **the introduction of a new simplified methodology for calculating TMTP**, which consists of calculating technical provisions as the sum of a Risk Margin component, a Best Estimate of Liabilities component for annuities and a Best Estimate of Liabilities component for non-annuity products, adjusted for an amortisation adjustment. The calculation should be **based exclusively on figures produced under Solvency II** data, removing any reliance on Solvency I. However, companies **may continue to use the traditional method if they can demonstrate** to the supervisory authority **that the simplified method is not appropriate**.

About **internal models**, the Authority's proposals provide **companies will be allowed to continue using existing models** subject to authorisation. **The PRA** also **intends to streamline the internal models' tests and standards** but, at the same time, **to introduce a range of safeguards against internal models' non-compliance**. **The standard formula SCR was not in the scope of the Government's Solvency II review,** but **the PRA will consult in due course** on changes to better reflect the nature of the UK market.

Regarding the **reporting** regime, the Authority's proposals aim **to remove requirements deemed unnecessary for the UK market** to **increase the level of proportionality and reduce complexity**. The proposals build on previous work, which have led to a

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reduction in reporting for small/medium-sized companies by up to 40 percent and the removal of some requirements (for all companies) that are considered overly burdensome.

**Publication of final PRA policies** resulting from the outcome of the consultations conducted (including updated reporting templates) **is expected during 2024**; the deletion of relevant retained EU law and **implementation of the remainder of the Solvency UK regime is expected for December 31st, 2024**.

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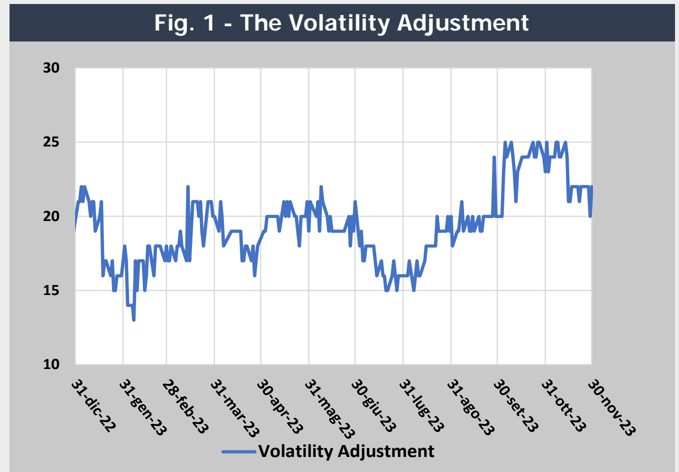
# Volatility Adjustment: trends and components

On **November 30th**, the **Volatility Adjustment** applicable by European companies **was 22 bps**, slightly down from the value recorded at the end of October, which was 23 bps (fig. 1; ANIA elaborations).

The change is attributable to the **slight decrease in yields on government** (euro-denominated) **and corporate bonds** held by the average European company (fig. 3) **and** to **the level of the reference risk-free interest rates curve** (fig. 4); the **risk-corrected currency spread** thus **decreased from 35 to 33 bps** (fig. 2).

Fig. 5 shows the impact, at 10 and 20 years of the decrease 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 Italy | RFR 10y (+VA) | RFR 20y (+VA) |
| 30/11/2023 | 22 | 22 | 3,06% | 3,06% |
| 31/10/2023 | 23 | 23 | 3,48% | 3,48% |

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

Fig 2 - Risk corrected spreads: currency vs. country

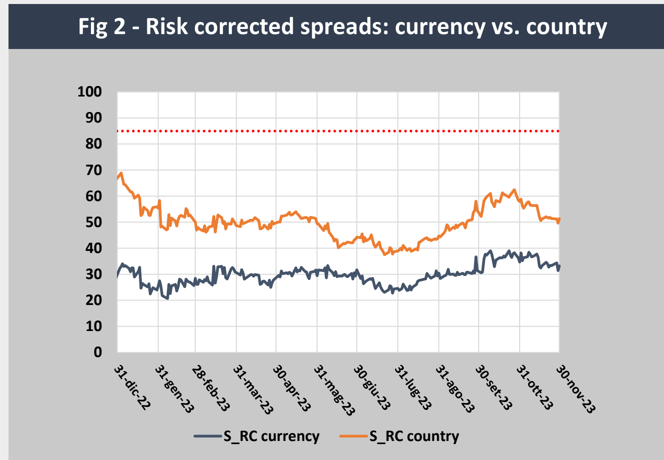



Fig. 3 - Government and corporate spreads

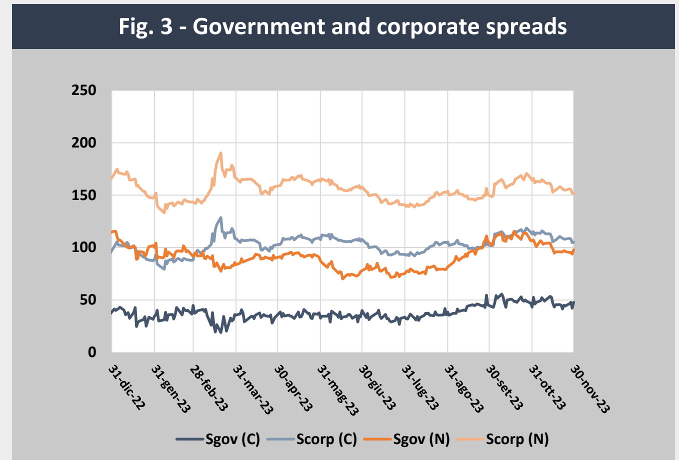



Fig. 4 - The risk-free rate curve

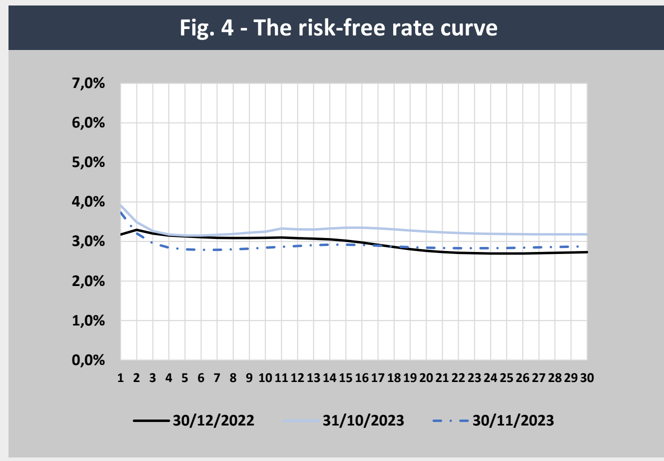
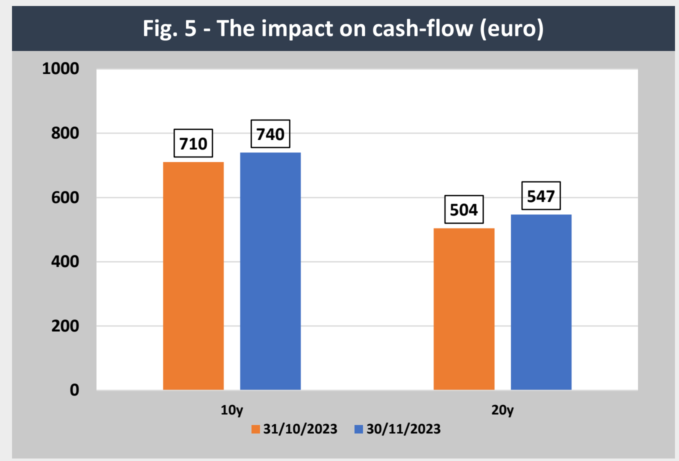



Fig. 5 - The impact on cash-flow (euro)




Source: ANIA calculations on EIOPA and Refinitiv data

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