

# **Towards the level 1 review of the Solvency II Directive**

Submitted by France and the Netherlands

**Insurance companies play an important role in the European economy. Their task is to cover risks that consumers, private and/or public organizations cannot or do not want to bear themselves.** Insurers offer policyholders protection from risks through transferring and pooling, and an adequate insurance cover is essential for economic growth and welfare: at a macro level, productive activities are strengthened, since their risks are covered; and at a micro level, insured persons are better able to master their consumption and savings over their lifetime and optimize their allocation of resources.

**Apart from this key role of insurers in the economy (the liability side of their balance sheet), insurance companies are also important institutional investors (the asset side) because of their reverse business cycle, allowing them to invest for the long term,** especially in the life insurance business. That is why insurance companies are well suited to play an important role in the long-term financing of the economy, and to move the economy towards a sustainable direction.

**The main focus of prudential supervision, Solvency II, is giving protection to policy holders, and this European framework is a one of a kind example of such harmonization in the world.** However, this prudential supervision should be organized in such a way that insurers can still fully play their role in the European society.

**In the context of this overall view on the role of insurance companies in the European economy, this preliminary non paper proposes some building blocks with respect to the 2020 Solvency II review.** In our views, this review of Solvency II should not result in substantially lower or higher levels of technical provisions or capital requirements. Yet, progress remains to be made as regards mitigation of unintended effects on the economy, simplicity and controllability of the framework and the long term orientation.

## **1. Advocating for simplification and correction of unintended consequences of Solvency 2**

**The Solvency II regime has become rather complex.** To a certain extent this is caused by the complexity of the insurance business as such. However, it is worth considering whether the current complexity in the capital calculation contributes to good risk management. Indeed, the many specific provisions embedded in the framework can result in a ticking the box culture which does not concur to proper risk management and could therefore have an impact on insurers stability. Thus, Solvency II suffers from too much complexity which also creates unintended effects.

**One unintended effect is, that because of the importance of diversification effects, an insurer undergoing difficulties could be encouraged to acquire new insurance activities which provide for diversification, rather than to adapt its risk profile by reducing its size.** In other words, the framework could paradoxically incentivize an insurer to jeopardize more policyholders when trying to recover, rather than mastering its risk. This phenomenon could be corrected through reducing the largest diversification effects for underwriting risks, while lowering certain capital charges for long term investments so as to maintain the same level of prudence.

**In the same vein, one of the often underlined and most detrimental biases created by Solvency II is its short termism,** and the current market risk module is a strong disincentive to invest for the long-term, even if there is rationale to do so. The framework already underwent several adjustments on the subject matter: a solution for long term infrastructural projects, the creation this year of the Long Term Equity Investment portfolio, which is a step in the right direction, and a more favorable treatment of private equity and private debt. However, we should avoid additional adjustments and asset classes that introduce further complexity in the calculation of the capital requirements, all the more as the current

assets classes are increasingly overlapping. We need to shift from this piecemeal approach to a more ambitious one, encompassing all the existing market risk classes. Such a reform would be adapted to a long-term vision throughout the balance sheet: as long as insurers are able to pass a liquidity test, which would not discriminate between asset classes, they prove that they are able to keep their assets for the longer-term, and that they are immune to the short term volatility of these assets, in accordance with the Solvency II key principle of market consistent valuation, lower capital requirements could apply.

**Thus, the subject matter of long-term investments should be taken into account appropriately in the review, and from an ambitious and holistic standpoint.** We would welcome a simplification of the market risk modules and correlation matrices of the Solvency Capital Requirement (SCR) in a way that fits into the goal of the Capital Market Union, while improving the risk management of insurers, which is currently biased towards short-termism. For instance, an important simplification would be to introduce a single correlation matrix, with the same parameters in case of upward and downward shocks.

## **2. Improving the calculation of technical provisions for long-term guarantees**

**It is worth mentioning the long-term guarantee measures that are to be reviewed in 2020.** In this regard, we need to acknowledge that the very goal of the volatility adjustment is to mitigate the impact of exaggerations of spreads on own funds of insurers caused by temporary over- or undershooting of market prices of their investments in financial markets, while preventing pro-cyclical behavior. We can concur with the common agreement that this mechanism needs to be improved in the details, notably when it results in over compensations or under compensations within their own funds. For instance, it should be possible for insurers which experience more volatility due to this adjustment to opt for a lower adjustment, and the volatility adjustment itself should be adapted to particular situations such as short term exaggerations of spread that affect only a part of Europe.

**However we would not support a revision whereby the illiquidity or other characteristics of the technical provisions would play a role in the VA calculation:** the effect of the exaggerations of spread on the market prices of the insurers' investments caused by market volatility are solely originated in the asset values and not in the technical provisions.

**Indeed, from a conceptual standpoint, cash flow matching and illiquidity requirements do fit well in another long-term guarantee measure, the matching adjustment.** Of course, the rules regarding the MA can be improved slightly, notably to allow for other types of assets and liabilities in the MA (mortgage loans for instance), but VA and MA should not be mixed up with each other, since the MA has a completely different purpose than the VA: the idea behind the MA being that when cash flows are predictable and match well, the implicit returns of the investment portfolio may be used partly in the interest rate curve for technical provisions calculation.

**On top of these two measures, we would also advocate for a comprehensive review of the calculation of technical provisions,** as the European Commission asked EIOPA, encompassing other important subject matters such as the determination of the risk free interest rate curve just after the last liquid point, which should be more consistent with relevant reliable market data.

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**In a nutshell, we need more practical rules and principles that ensure a high level of protection of policyholders while giving insurers incentives to remain active as institutional investors and as providers of insurance products for saving and risk mitigation, not to mention the overall objective of simplifying the framework.**