

From Solvency II to Solvency III?



Since 1 January 2016 some 4000 insurance and reinsurance firms in the EU apply the new risk based solvency capital regime, called Solvency II. The new regime has not been applied yet for a year and there is already pressure for change. Are we on our way towards Solvency III?

It took about 15 years to develop Solvency II. Although this might appear a long period of time, one should not forget that the introduction of a risk based solvency capital regime constitutes the biggest reform in insurance regulation in the EU since thirty years.

Many stakeholders have been actively involved in the development of Solvency II. The regulatory process was bottom-up rather than top-down. The active engagement of so many people and experts throughout the process has no doubt helped to smooth the transition from Solvency I to Solvency II. ▶

Solvency II establishes a link between risk and capital. This will lead to a more professional way of conducting insurance business. From the conception of the insurance product, through the sales process and the claims handling, insurers will have to be mindful about the capital consequences of the risks that they are taking.

A crucial element of the reform is the dialogue which is established between the supervisory authority and the supervised entity. This dialogue is enshrined in Solvency II through the supervisory review process which automatically starts when an insurer breaches the Solvency Capital Requirement (SCR). It is also present in the discussion between the supervisory authority and the supervised entity about the Own Risk and Solvency Assessment (ORSA) which must be carried out by the insurer at least once a year. This dialogue should not be a monologue. Both parties will have to learn to discuss solvency issues based upon a relationship of trust.

Solvency II comprises four levels of regulation: the Solvency II Framework Directive¹ (level 1), the Delegated Regulation from the European Commission² (level 2), the Regulatory and Implementing Technical Standards developed by EIOPA (level 3) and the (non-legally binding) Guidelines developed by EIOPA (level 4). The total regulatory package now comprises too many pages. This is clearly not in line with the principles based approach that

1 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance, OJ L 335, 17.12.2009, p. 1.

2 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance, OJ L 12, 17.1.2015, p. 1.

3 Commission Delegated Regulation (EU) 2016/467 of 30 September 2015 amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings, OJ L 85, 1.4.2016, p. 6.

was one of the objectives of Solvency II. Neither insurers, nor insurance supervisors will be able to monitor in detail all the rules that make up Solvency II. This is not a problem in itself. It is crucial that from day one both insurers and insurance supervisors concentrate on the important issues and that they apply the principle of substance over form. It is equally important that national legislators as well as insurance supervisors avoid introducing further rules at national level (gold plating). This will require some discipline: not all problems can or should be resolved. Some experimentation is unavoidable and is good. From applying the rules in practice, all parties concerned will learn where the strengths and the weaknesses in the new regime can be found.

It appears that in most Member States, the introduction of Solvency II went rather smoothly. Of course, not everything goes well from day one. That cannot be expected. Important regulatory reforms take time to bed down in daily practice. One should therefore be cautious not to amend the regime before sufficient experience has been gained. Solvency II was designed as a flexible regime which can be adapted when needed in order to bring the rules in line with changed circumstances. There is however pressure already now to change the regime. Changes should only be carried out after careful study and a thorough impact assessment.

4 EIOPA, Final Report on Consultation Paper no. 15/004 on the Call for Advice from the EC on the identification and calibration of infrastructure investment risk categories, EIOPA-BoS-15-223, 29 September 2015, 194 p.

5 Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority), OJ L 153, 22.5.2014, p.1

A first amendment of the Delegated Regulation already took place on 2 April 2016³. There are always good reasons to have a second go at a legal text. Even though one cannot possibly argue that Solvency II has not been properly prepared and consulted about, there are always new developments which make people look differently at what has been agreed. In a low interest rate environment, insurers have difficulties in finding good investment opportunities. On the other hand, governments are interested in finding institutional investors which are prepared to invest in infrastructure projects particularly at times when interest rates are low and economic growth must be stimulated. The amendment of the Delegated Regulation therefore introduces a new investment category “qualifying infrastructure investments” with an adapted calibration. Following the advice from EIOPA⁴, using this investment category requires insurers to apply specific risk management measures. Although this makes the standard formula more complicated, a more granular approach can certainly be justified if the risks are properly calculated.

There is a risk that political authorities and the insurance industry will exercise pressure for further rapid changes of the new solvency regime.

Recital 60 in the Preamble to Omnibus II⁵ states the following concerning the review of Solvency II: “In order to ▶

ensure that the Union's objective of long-term sustainable growth and the objectives of Directive 2009/138/EC of primarily protecting policyholders and also ensuring financial stability, continue to be met, the Commission should review the appropriateness of the methods, assumptions and standard parameters used when calculating the standard formula for the SCR within five years of the application of Directive 2009/138/EC."

Not even one year later, recital 60 in the Preamble to the EC's Delegated Regulation states that a review of the standard formula should take place before December 2018, i.e. two years after the application of Solvency II. The EC justifies this early review by referring to "the experience gained by insurance and reinsurance undertakings during the transitional period and the first years of application of these delegated acts."

On 18 July 2016, the EC sent a formal request to EIOPA for technical advice on possible amendments of the implementing measures of Solvency II⁶. The request takes into account the feedback received by the EC on its call for evidence on the EU regulatory framework for financial services, launched on 30 September 2015. The areas which EIOPA should look into and on which it is asked to report back to the EC by 31 October 2017 include: proportionate and simplified application of the requirements, removal of unintended technical

inconsistencies and removal of unjustified constraints to financing. The EC lists a series of specific issues which EIOPA has to look at for the first two areas. As for unjustified constraints to financing, the EC is still in the process of conducting an in-depth assessment of investment classes that merit further investigation. The idea is to identify those investments which create growth and jobs and that offer sufficient transparency and credit quality to justify a lower calibration in the standard formula. The EC might request EIOPA's technical support for this at a later stage.

In its response letter to the EC, dated 13 October 2016⁷, EIOPA explains how it intends to prepare its advice. It should be welcomed that EIOPA proposes to proceed on the basis of reported data and that it intends to ensure a thorough involvement and consultation of stakeholders even if this would result in the final advice to be delivered by end February 2018 rather than by 31 October 2017 as requested by the EC. That date was indeed unrealistic and a respect of that deadline would not allow EIOPA to deliver evidence based advice.

The next review, which will deal with the Framework Directive, is scheduled for 2021. That review will include the treatment of long-term guarantees and will take stock of the experience gathered with the application of the long-term guarantee package introduced by Omnibus II.

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The letter to EIOPA including an attachment with specific requests for advice is published on the EC's website (<http://ec.europa.eu/dgs/finance/>).

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The letter from EIOPA is published on its website (<https://eiopa.europa.eu/>).

It is unclear whether at that time it will be possible to also benefit from progress achieved at the international level in the context of the development of an international capital standard for insurance.

A regular review of the new solvency regime was part of the design of Solvency II. It is the reason why the Framework Directive of 2009 is principles based and is further implemented by measures at levels 2 to 4. The principles included in the Directive should only be touched with great care. There is no need to move from Solvency II to Solvency III.

Many countries in the world are looking at the experience which the EU has gained with the development of Solvency II. Much can indeed be learned from the in-depth analyses that have been carried out and from the sometimes difficult negotiations that have taken place. This does not mean that Solvency II is a perfect regime or that it is the best solvency regime in the world. It is however a regime that came about after much reflection and debate. It is therefore in the interest of any country in the world that wants to move its solvency regime in the direction of a risk based capital solvency regime to learn from the experience with the development of Solvency II. ♦