Briefing note on legislative procedures and suggested reforms of the Solvency II 2020 Review

Interim score of the Solvency II reforms

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The Solvency II 2020 Review process is in full swing. As part of the legislative procedure, the European Parliament and the Council of the European Union have recently provided their first responses to the suggested reforms from the European Commission. In this briefing note we summarise the views of the parties involved with respect to four key topics: the extrapolation of the risk-free interest rate curve, the (dynamic) Volatility Adjustment, the risk margin and sustainability. In addition, we provide background and the expected timelines of the legislative process.

Introduction

On 17 December 2020, the European Insurance and Occupational Pensions Authority (EIOPA) published its opinion[1] of the Solvency II 2020 Review. Building on EIOPA's opinion, the European Commission published its proposal in September 2021 to amend the Solvency II Directive.[2] The Commission also outlined its intentions for the Delegated Acts in its communication. In June this year, a rapporteur of the European Parliament[3] and the Council of the European Union[4] responded with their views on the Commission's proposal. On 1 August other Members of the European Parliament (MEPs) published[5] over 600 amendments as a response to the views from the rapporteur that serve as input for further negotiations.

This briefing note provides an overview of the legislative procedure for amending the Directive and Delegated Acts. The suggested reforms of the Solvency II Directive encompass many elements. In this note we focus on the views of the institutions on the Solvency 2020 Review regarding four key topics. These are the extrapolation of the risk-free interest rate curve, the (dynamic) volatility adjustment, the risk margin and sustainability. Lastly, we discuss how insurers can prepare to deal with remaining uncertainties.

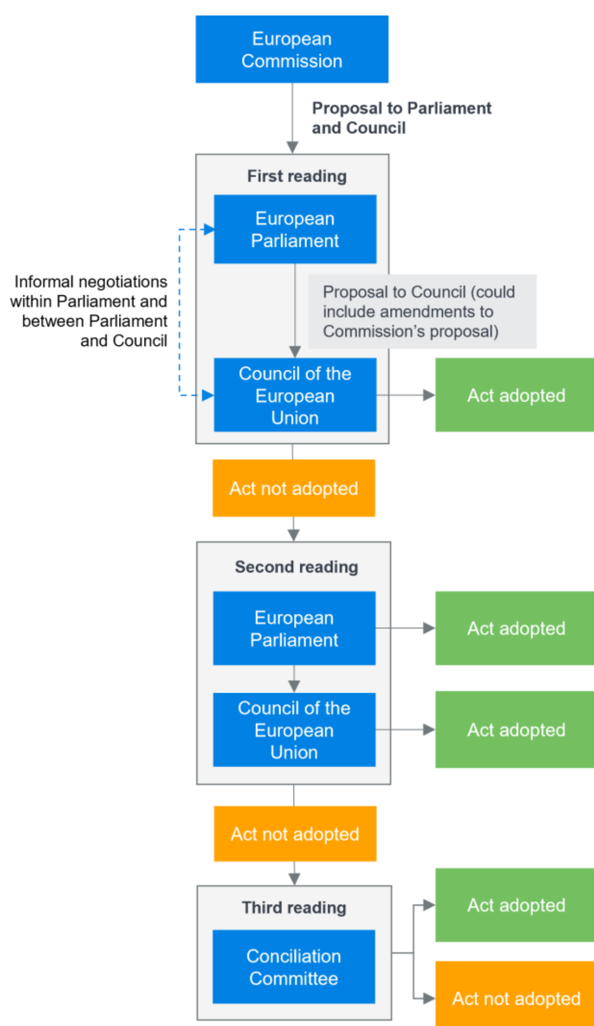
Legislative procedure

In this section, we describe the institutions involved, their roles and responsibilities and the expected timelines with respect to the implementation of the revised Solvency II legislation.

The institutions involved in the legislative process[6] for amendments to the Solvency II (SII) Directive are EIOPA, the European Commission, the European Parliament, and the Council of the European Union. Within the legislative process, the European Commission has asked EIOPA to provide technical advice for a comprehensive review of the Solvency II framework. The European Commission is the only institution that is empowered to initiate legislation.

Amendments to the Directive require approval from the Parliament and Council. The legislative procedure is illustrated in figure 1. Although the Parliament and the Council examine the Commission's proposal simultaneously, the Parliament is the first to either approve the Commission's proposal directly, amend or reject it. To facilitate the Parliament's response, a rapporteur is appointed by the responsible committee within the Parliament.[7] The responsibilities of the rapporteur include negotiating with the Council and the Commission and preparing a draft report on behalf of the responsible committee. This report may contain amendments to the Commission's proposal. The rapporteur is the first MEP to propose amendments to the Commission's proposal.

FIGURE 1: LEGISLATIVE PROCEDURE



However, the Parliament's first reading position very often changes. Further amendments can namely be proposed by other MEPs. It is also common that first reading negotiations take place before the committee responsible adopts its report. The recently published draft report of the rapporteur on the SII reform hence does not necessarily represent the view of the European Parliament as a whole.

Subsequently, the Council may decide to approve or amend the Parliament's position. This is formally known as the Council's first reading. In the first case, the legislative act is adopted. Otherwise, the Council communicates its position to the Parliament, after which a second reading takes place. The Parliament can approve, amend or reject the Council's position. In case the Council does not approve all of Parliament's amendments in this second reading, a Conciliation Committee is convened with the intention of reaching an agreement by means of negotiations between the Parliament and the Council. However, there is no certainty that an agreement will be reached at this final stage.

In contrast to Directives that follow from the above ordinary legislative procedure, Delegated Acts are adopted by the European Commission and enter into force only if the European Parliament and the Council of the European Union have no objections. Delegated Acts should be consistent with the Directive, providing technical measures and additional guidance.

CURRENT STATUS AND NEXT STEPS

Presently, first reading negotiations are underway on the new Solvency II Directive. The recent publication of amendments proposed by other MEPs indicates that responses to the rapporteur's initial position vary extensively across MEPs. Therefore, the final position of the Parliament to the Commission's proposals is still up for debate. Noting that no firm deadlines have been communicated, we would expect the vote in the European Parliament to be no earlier than towards the end of this year.[8]

Thereafter, the ball is in the Council's court. Please note that the position the Council recently published concerns what is known as a General Approach. A General Approach is a political agreement, pending the first reading position of the Parliament. The Council uses this document to give the Parliament an idea of its position on the Commission's legislative proposal and to provide a mandate for first reading negotiations. Hence, it should not be confused with the Council's first reading.

If the Council approves the Parliament's first reading not long after the end of this year, the process for establishing the Delegated Acts could take place in 2023. That would allow implementation by the beginning of 2025 or even 2026. If the Council rejects the Parliament's position, the second reading phase starts and timelines for implementation could take substantially longer.

Different points of view

The parties involved—EIOPA, Commission, Council and Parliament—have different points of view with respect to key elements of the Solvency II Review. The proposals with respect to the extrapolation of the risk-free interest rate term structure, the (dynamic) Volatility Adjustment, the risk margin and sustainability are summarised in the paragraphs below.

One interesting general item to highlight is that the rapporteur has proposed to directly include key aspects of the Solvency II framework in the Directive instead of Delegated Acts. The rapporteur is of the opinion that these key aspects, in particular in relation to the Long-Term Guarantees (LTG) framework, are a political issue that cannot be appropriately dealt with through Delegated Acts.

EXTRAPOLATION OF THE RISK-FREE INTEREST RATE CURVE

- **EIOPA** proposed an alternative method for the interest rate extrapolation compared to the current Smith-Wilson approach as follows:
  - Market information is taken into account beyond the traditional last liquid point.
  - Convergence towards the Ultimate Forward Rate (UFR) is governed by the parameter alpha.
  - The parameter alpha is set at 10% and the first smoothing point, the start of the extrapolation, is set at 20 years. Insurers with-long term liabilities[9] need to disclose the impact of decreasing alpha to 5%.
  - Depending on the interest rate levels, a transitional regime may apply from implementation until 2032. Insurers with long-term liabilities[9] should disclose the impact of the fully phased-in approach. Dividend restrictions would apply if insurers would not comply with the SCR without phasing-in.
- The **European Commission** follows EIOPA's proposal to consider market information after the traditional last liquid point. Some important details are deferred to Delegated Acts, but the Commission "will consider building on the formula and parametrisation proposed by EIOPA."

  For the SII Directive, the Commission also proposes phasing in a transitional mechanism[10] that is not optional and always triggered (regardless of rate levels). This runs until 1 January 2032. Furthermore, the impact of the mechanism needs to be disclosed.
- **The European Parliament rapporteur** explicitly incorporates the extrapolation method in the amendments for the Directive (instead of deferring these details to Delegated Acts). The same holds for the convergence parameter alpha, set at 20%, and the first smoothing point, at 20 years for the euro.

  The proposed amendments do not a include a transition period. Given this value of alpha, the resulting curve would be appreciably closer to the current curve than the curve under the parametrisation proposed by EIOPA.

  The recent proposals from other MEPs show that there does not seem to be consensus on including the methodology and parameters for the extrapolation in the Directive or the Delegated Acts. Various MEPs include explicit formula like the rapporteur, whereas several other MEPs don't include such explicit formula in their proposals regarding interest rate extrapolation. There also seems to be no consensus on the parameter alpha (proposals: 5%, 10%, 18% and 20%), the first smoothing point (some MEPs propose 30 years as a minimum) and the end of the transitional period (proposals: 1-1-2029, 1-1-2030, 1-1-2032, no transitional period). A group of MEPs has copied EIOPA's proposal to disclose the impact of decreasing alpha to 5% -- and go even further by introducing dividend restrictions if insurers would not comply with the SCR under this alpha.
- **The Council of the European Union's** response contains little change to the Commission's proposal for the SII Directive. In line with the EIOPA approach, it adds, "The extrapolated part of the relevant risk-free interest rate term structure shall be based on forward rates converging smoothly from the applicable forward rate at the first smoothing point to an ultimate forward rate."

Takeaways

The Commission, the rapporteur and other MEPS and the Council all follow the direction of EIOPA's proposal for the methodology. The parametrisation and transitional mechanism have however not been established. The proposal of the rapporteur would have modest implications, whereas the proposal of other MEPs would be more significant. Under proposals for a longer first smoothing point and an alpha of 10% or lower, the changes in extrapolation would lead to liabilities with a longer duration and exposures to longer tenors. It would require

insurers to rethink their hedging strategies. While the potential phase-in period would dampen the initial impact, capital generation—and hence long-term solvency—would still come under pressure if long-term swap rates remain low. The possible mandatory external disclosure of solvency, without phasing-in, might also give analysts and investors a new metric to focus on.

(DYNAMIC) VOLATILITY ADJUSTMENT

- **EIOPA** proposed several changes to the volatility adjustment (VA):
  - The general application ratio is increased from 65% to 85%.
  - The country component of the VA is replaced with a macroeconomic VA for EUR countries, based on the country-specific reference portfolio and with a gradual and smooth activation to avoid a "cliff-edge" effect.
  - The VA also contains a factor that prevents overshooting by taking into account the undertaking's overall volume and duration mismatch in credit spread sensitivity.
  - In addition, it contains a factor for the illiquidity of the undertaking's liabilities.
  - A third factor has been proposed that scales up the sovereign and corporate weights in the reference portfolio to 100%.
  - EIOPA has also recommended basing the risk-correction in the VA on a percentage of the prevailing spread and to allow negative aggregated spreads for corporate and government bond portfolios.

  For the Dynamic VA (DVA), only applicable for undertakings with an internal model, EIOPA introduces the DVA prudency principle: Solvency Capital Requirement (SCR) after DVA should be at least as high as SCR with EIOPA VA and as SCR with a VA based on the EIOPA methodology applied to the undertaking's investment portfolio. Moreover, changes to the macroeconomic VA should be excluded from the DVA.

- **The European Commission** largely adopts the proposals of EIOPA for the SII Directive. Important details around the risk-correction and the factor to prevent overshooting are deferred to Delegated Acts. The most important deviation from EIOPA's proposal is the removal of the component that represents the illiquidity of the undertaking's liabilities from the VA calculation. The Commission hasn't mentioned the illiquidity factor, which could be interpreted as being excluded from the proposal. However, some caution is advised as the Commission has not explicitly stated that it is rejecting the illiquidity factor. The overshooting factor has also not been spelled out yet in the proposal for the Directive and could still leave room for an illiquidity factor. For the currency component in the VA (permanent VA), the Commission has proposed the risk-corrected spread should be based on a reference portfolio of *debt* instruments, which could be interpreted as an implicit inclusion of the scale factor. Here again, some caution is advised as the Commission has not been explicit on how this change to the Directive should be interpreted.

  The Commission's proposal also contains restrictions to DVA—in line with EIOPA's prudency principle—and exclusion of the macroeconomic VA from the DVA.

- **The European Parliament rapporteur** explicitly incorporates the current formula for the risk-corrected spread in the Directive, thereby not only relocating this detail from the Delegated Acts, but also rejecting EIOPA's proposal for risk-correction and the allowance of negative spreads. With respect to the Commission's other proposals the rapporteur has made no changes, although there is ambiguity around the proposed changes for the country component. The rapporteur proposes to delete the recital in the Commission's proposal concerning changes to the country component, but the paragraphs containing the formula for the macroeconomic VA are not proposed to be deleted.

  The recent proposals from other MEPs show diverging views on the risk-corrected spread: whether to explicitly include the formula in the Directive or not, and whether the current mechanism needs to be changed (like EIOPA proposed) or not. Various MEPs have proposed to include an additional factor for the illiquidity of the undertaking's liabilities (like EIOPA proposed). Additional amendments include an adjustment to account for portfolio composition mismatches (iterating on what the Council has proposed, see next bullet). The Commission's proposal for restrictions to the DVA has also been rejected by some MEPs (from Italy in particular).

- **The Council of the European Union** proposal is in line with that of the Commission but has proposed an additional adjustment to the VA that addresses mismatches between the composition of the undertaking's investment portfolio and the VA reference portfolio.

Takeaways

Both the rapporteur and other MEPs and the Council of the European Union have made amendments to the proposal of the Commission. The common theme is that spread mismatches are expected to be reduced in general, in particular to address the VA overshooting in times of stress. Furthermore, the asset mix of insurers will directly influence solvency. For instance, hedging with bonds versus swaps changes the overall volume and duration mismatch for credit spreads and hence the VA. Together with the other proposed VA changes, a reduction of the VA offset (currently benefitting insurers) is expected. The DVA prudency principle, that is contested by some MEPs, would remove the benefit of SCR reduction of DVA for internal models.

RISK MARGIN

- **EIOPA** proposes to incorporate time-dependence of risk in the risk margin and reduce its interest rate sensitivity. This is achieved by introducing a factor, lambda, that governs the exponential reduction of the future SCR. Lambda is set at 0.975. The reduction factor is floored at 50%. In EIOPA's proposal, the cost of capital (CoC) parameter is kept at the current 6%.
- **The European Commission** notes that it supports the goal to account for the time-dependency of risks. However, this does not lead to an adjustment of the Directive. For Delegated Acts, the Commission will consider using the lambda approach proposed by EIOPA as a basis, but without the floor parameter. In addition, the Commission will consider reducing the CoC rate used in the risk margin calculation from 6% to 5%.
- **The European Parliament rapporteur** has suggested amendments to the proposal of the Commission, in which the calculation of the risk margin is explicitly included in the Directive, instead of deferring these details to Delegated Acts. The approach is in line with the Commission, i.e., exponential decay without a floor. The parametrisation would, however, lead to a lower risk margin than the Commission's considerations; with a lambda of 0.9 and a CoC rate of 4%. The rapporteur remarks that "the Cost-of-Capital rate remains risk-based and is not set at an overly conservative level."

  The recent proposals from other MEPs show that there does not seem to be consensus on explicitly including the formula for the risk margin in the Directive or the Delegated Acts. There also seems to be no consensus on the factor Lambda (proposals: 0.9, 0.975, 0.995), flooring of the reduction factor and the CoC rate (proposals: 4%, 4.5%, 6%, or mandate the Commission to set the CoC rate based on an EIOPA opinion).
- **The Council of the European Union** made no reference to the risk margin.

Takeaways

There seems to be consensus between the lawmaking bodies on the risk margin mechanism. The proposals of all parties would result in a reduction of the level risk margin, although the extent of the reduction differs. Furthermore, the interest sensitivity is reduced. The degree of this will depend on the final parametrisation. The proposed changes will be welcomed for insurers with long term liabilities.

SUSTAINABILITY

- **EIOPA** makes several references to sustainability risks. Both environmental, social and corporate governance (ESG) and climate risks need to be included in the Solvency and Financial Condition Report (SFCR). Furthermore, the SFCR would have to cover sustainability risks in the underwriting policy, development of products and services, remuneration policy, valuation methods and risk management. Part of this has already come into effect via Delegated Acts.[11]
- **The European Commission** makes clear that the Solvency II Review should also support the EU's political agenda by "providing incentives for insurers to contribute to the long-term sustainable financing of the economy." As part of the requirements, climate risk needs to be considered in own risk and solvency assessment (ORSA) scenarios, if it proves material. In addition, EIOPA is requested by the European Commission to investigate whether a dedicated treatment of certain asset classes is justified.
- **The European Parliament rapporteur** removed all references to sustainability from the Directive. According to the rapporteur, he "considers that there is little evidence to suggest that insurance undertakings are systematically underestimating sustainability risks" and "any amendment in this area may lead to viable and sustainable businesses becoming 'un-insurable' or 'un-investable' for no good reason."

  We note that several MEPs however have expressed their disagreement with the removal[12]. In their counterproposals, some MEPs have proposed to further build on the suggestions from the Commission by proposing more stringent requirements with respect to sustainability. For example, multiple MEPs have suggested to incorporate climate related financial risks in the equity and spread risk module and to mandate a transition plan covering activities to ensure the transition to a sustainable economy.

- **Council of the European Union** added two points to the Commission's proposal. First, EIOPA should evaluate (re)insurance undertakings' assessments of their material exposure to risks related to biodiversity loss and define future actions, if necessary. Second, guidelines need to be developed by the European Supervisory Authorities that ensure that consistency, long-term considerations and common standards for assessment methodologies are integrated into the stress testing of ESG risks, which should start with climate-related factors.

Takeaways

Both MEPs and the Council of the European Union make amendments to the European Commission's proposal, but the amendments are very diverse. The rapporteur removed the sustainability topic as a whole, whereas the Council and other MEPs consider providing more emphasis to the subject. The divergence with respect to this subject may be a point of discussion in future proposals by these institutions.

How insurers can prepare

Given the point of views from the institutions, insurers may find it opportune to take stock of the potential consequences that the suggested reforms may have. Where views between the institutions diverge, or are not yet fully clear, insurers may benefit from considering multiple potential scenarios and gauging their likelihood. It will be the details that matter; for the extrapolation of the risk-free interest rate curve and the risk margin, the parameters are not pinned down, leading to a range of possible outcomes. With respect to the (dynamic) volatility adjustment, the views appear to have converged (although some elements are not pinned down yet), which would allow insurers to prepare. Meanwhile, the views on the integration of sustainability and the Green Deal in Solvency II seem to be the furthest apart.

Nonetheless, the implications of the Solvency 2020 Review may be far-reaching, varying from capital management and product pricing to overhauling hedging strategies and updating internal models.

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ENDNOTES

[1] EIOPA's opinion on the 2020 review of Solvency II is available at https://www.eiopa.europa.eu/document-library/opinion/opinion-2020-review-of-solvency-ii_en. This opinion has been summarised in a previous briefing note, which can be found at https://www.milliman.com/-/media/milliman/pdfs/2021-articles/1-11-21-sii-2020-eiopa-opinion.ashx?la=en&hash=FA745BC619909A5D742A0C5D2839D625.

[2] More information about the proposed amendments by the European Commission is available at https://ec.europa.eu/info/publications/210922-solvency-2-communication_en.

[3] On 6 June 2022, the European Parliament's rapporteur on the Solvency II reform has published a draft report concerning the Commission's proposal, which is available at https://www.europarl.europa.eu/doceo/document/ECON-PR-732668_EN.pdf. Markus Ferber, a German Christian-Democratic EP, is the rapporteur of the European Parliament for the update of the Solvency II Directive.

[4] On 17 June 2022, the Council of the European Union has published its position (General Approach) on the Commission's proposal for the Solvency II Directive, which is available at https://www.consilium.europa.eu/en/press/press-releases/2022/06/17/solvency-ii-council-agrees-its-position-on-updated-rules-for-insurance-companies/.

[5] On 1 August other Members of the European Parliament published 3 documents with over 600 amendments to the Commission's proposal which is available at https://www.europarl.europa.eu/committees/en/econ/documents/latest-documents

[6] This paragraph is a summary of information on the Ordinary Legislative Procedure that is on the website of the European Parliament (https://www.europarl.europa.eu/olp/en/ordinary-legislative-procedure/overview) and on the website of the Council of the European Union (https://www.consilium.europa.eu/en/council-eu/decision-making/ordinary-legislative-procedure/).

[7] The Committee on Economic and Monetary Affairs (Econ) when it concerns SII legislation.

[8] Consideration of amendments will take place on 31 August and 1 September. The Econ committee will vote on 30 November and 1 December, with a view to the Parliament's plenary voting on 20-22 December.

[9] Insurers for which the sum of the long-term cash flows beyond the first smoothing point is more than 10% of the total cash flows.

[10] The transitional mechanism has been discussed in a previous briefing note, which can be found at https://www.milliman.com/en/insight/the-transitional-mechanism-for-the-alternative-extrapolation.

[11] The amendment of sustainability risks and ESG to the Solvency II Delegated Regulation as of April 2021 has been discussed in a previous briefing note, which can be found at https://www.my-milliman.com/-/media/milliman/pdfs/2022-articles/6-2-22_sustainability_and_esg_risk_update_to_delegated_regulations.ashx.

[12] EU committee shocked as Ferber deletes climate measures in Solvency II reforms | InsuranceERM

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