Mercer

Solvency 2.5. A €90 billion reboot?

Q4 2021

welcome to brighter

The European Commission (EC) has published proposed changes to Solvency II (SII), representing the most significant revisions since the rules came into force in 2016. Estimates are that this could result in €90 billion of capital savings across the European insurance industry. Here, we present Mercer's view of the proposals.

Area	What's changing?	Mercer view
Long-term equity (LTE)	Rules will be changed to make it easier for insurers to apply long-term equity treatment.	Changes are likely to increase appetite for European equities (which can qualify as LTE), just as prior changes to SII led to appetite for qualifying infrastructure. Future take-up, however, is uncertain.
Symmetric adjustment for equities	Upper and lower bounds increase from 10% to 17%.	The change to the countercyclical measure for equity capital charges will generate modest increases in equity holdings. It should also reduce the likelihood of forced sales of equities while increasing the potential for dynamic equity allocations.
Volatility adjustment	Volatility adjustment increases, encouraging the matching of credit to liability duration.	This will lead to reduced technical provisions (TPs) for firms that match asset spread duration to liabilities, incentivizing firms that do so. A new country-specific component will be welcome in peripheral Europe, where sovereign spreads have greater volatility.
Green New Deal	Climate stress testing will be required, and review of future green asset capital relief is announced.	This approach is potentially both a carrot and a stick. Larger insurers will perform climate stress testing given likely pressure from regulators. This is a positive, as climate risk is material for investments, notwithstanding effects on the wider business. Green capital charges may be a reduction for green assets or an increase for harmful activities. Insurers should make plans for how to integrate climate change into their investments, underwriting and operations.
Proportionality	More small firms are excluded from SII, and a new low-risk category of insurers is introduced.	This is likely to encourage more onshoring of captive programs and greater use of captives. It will also encourage insurers to adjust their asset mixes to qualify for the new low-risk category given the reduced regulatory burden.
Interest rates	Discount rates are more market consistent, with changes forthcoming to interest rate risk.	Liability valuations that use more market-related discount rates should increase hedging, although accounting will remain a constraint.
Risk margin	The risk margin is reduced for all insurers.	Risk margin reduction for longer-dated liabilities only partially offsets the impact of reduced discount rates. For medium-dated liabilities, there may be a net benefit across the two.
Macroprudential risks	A new requirement for carrying out macro and liquidity risk analysis is established.	It is unclear how much these changes will influence investments given that liquidity remains a secondary risk for many insurers while macro risks can be difficult to define. The additional requirements will increase the reporting burden for insurers.

In light of the proposed changes, at a minimum, insurers should consider their strategic asset allocations and asset-liability management. The highlight is that European equities — both listed and private — will become more attractive to insurers on a return-on-capital basis given the combination of enhanced LTE eligibility criteria and an increased symmetric adjustment. At the same time, the need for **interest rate hedging** may also become more pressing due to changes in discounting and interest rate risk methodologies.

Introduction

Although, in broad terms, the EC considers that SII (which came into effect in January 2016) functions effectively, there is nevertheless a sense that the regime it brought about can and should be enhanced. As it stands, SII acts as a disincentive for long-term equity investment. It does not capture long-term sustainability risks, nor does it reflect the low-interest-rate environment appropriately. As a consequence, these and other legacies can generate excessive balance-sheet volatility and be overly complex for smaller and less risky insurers.

The capital implications are also likely to vary significantly from firm to firm, and perhaps from country to country, depending on the type of business written and the asset mix.

The EC has now set out proposals[1] to amend the framework. According to estimates, the proposals may initially release up to €90 billion of capital, although this amount is expected to reduce over the long term as other changes take effect. We note that the projected capital savings depend on a number of factors, including:

- **Prevailing market conditions**
  The €90-billion figure is based on mid-2020 market conditions. It is worth noting that the EC's analysis suggests the savings might have been significantly different under other market conditions.
- **Forthcoming changes to the Delegated Regulation**
  For example, changes to the interest rate stress and risk margin (discussed in the accompanying impact assessment) may influence the level of potential savings.
- **Widespread adoption of the long-term equity (LTE) treatment by insurers and national supervisors**
  Until now, take-up has been limited.

The capital implications are also likely to vary significantly from firm to firm, and perhaps from country to country, depending on the type of business written and the asset mix. The EC's proposals also include a range of macroprudential tools to assess the impact of plausible macroeconomic and financial market developments, along with liquidity risk and a European Insurance Recovery and Resolution Directive.

[1] European Commission. *Proposal for a Directive of the European Parliament and of the Council Amending Directive 2009/138/EC as Regards Proportionality, Quality of Supervision, Reporting, Long-Term Guarantee Measures, Macro-prudential Tools, Sustainability Risks, Group and Cross-Border Supervision*, September 22, 2021, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0581.

Long-term equity

The Commission announced that it intends to make it easier for insurers to apply the long-term equity treatment to their equity holdings. Details will be revealed as part of the forthcoming Level 2 Delegated Regulation changes. The Commission describes a "cautious scenario" in terms of equities that may meet the "long-term" criteria — the assumption being that an additional 15% would qualify (bringing a reduction in capital requirements of around €10.5 billion).

The Commission also announced plans to remove the duration-based equity risk submodule in favor of the new preferential treatment for long-term investments in equity. The duration-based equity risk submodule was subject to stricter criteria and had seen little use.

€10.5 billion

Projected reduction in capital requirements

Symmetric adjustment for equities

To date, insurers have been able to apply a "symmetric" adjustment to the market-risk solvency capital requirement (SCR) charge of equity holdings. This was designed to reduce pro-cyclicality by reducing the stress when equity markets are low and increasing the stress when markets are high. This dampens the impact on the liability side of the SII balance sheet at those times when the asset side has fallen but inflates the liability side when the asset side is elevated, stabilizing the overall position. The adjustment is currently limited to +/-10%, with the proposal to increase the limit to 17%.

The central case of 39% is unaffected, so simply looking at return on capital does not tell the full picture. We believe the real benefits for insurers will be borne out in downside-equity scenarios, such as stress testing equity losses or value-at-risk analyses.

From January 2016 to the end of August 2021, the full 10% benefit has been effective for 76 out of a total of 2,070 days (3.5% of the time), with the full capital add-on never experienced. These figures are low by historical standards, with the upper and lower bounds activated close to 25% of the time — split almost equally between the floor and ceiling — when we extend the review period back to the early 1990s. This reflects the relatively stable upward trajectory of equity markets since SII was introduced. All but one of the 76 days when the full 10% benefit was available to insurers occurred at the onset of the COVID-19 pandemic. The full additional 7% reduction would have been available some days in late March 2020 had the proposed rules been in force.

Symmetric adjustment over 2020

Volatility adjustment

The Commission proposes a number of changes to the volatility adjustment (VA):

Supervisory approval
Insurers seeking to use the VA are required to obtain supervisory authorization.

Increase in size
The VA will increase to 85% of the risk-adjusted spread, from the current 65%, with the calculation of the risk-adjusted spread remaining as is. This should increase the VA, thereby potentially saving capital for insurers.

Duration matching encouraged
Currently, an insurer may apply the VA and carry less spread duration in its assets than its liability. As such, the VA may compensate the insurer beyond the losses on investments caused by an increase in credit spreads. To prevent this, the Commission proposes scaling down the VA in cases in which the sensitivity of the assets of an insurer to changes in credit spreads is lower than the sensitivity of its liabilities to changes in interest rates.

Country component
To mitigate the impact of increased country-level spreads while avoiding cliff-edge effects in the current country component, a macro VA for euro-denominated countries is proposed. This increases the risk-corrected spread in the VA calculation, where a country's risk-corrected spread increases to 30% higher than that for the euro as a whole. To avoid overshooting, this increase is scaled down by a factor related to the percentage of investments in fixed income for insurers in that country.

Dynamic VA
The Commission also specifies how supervisors should allow insurers to use an internal model, which takes into account the effect of credit-spread movements on the volatility adjustment (otherwise known as the "dynamic volatility adjustment").

Green New Deal

The Commission has proposed changes in relation to the European Green New Deal, specifically requiring insurers to carry out climate stress testing alongside potentially favorable capital treatment for green assets. In particular, the Commission is keen to ensure that SII does not impede sustainable investments by insurers and reflects the full risk of investments in environmentally harmful activities. It states that there is insufficient evidence at this stage on risk differentials between environmentally or socially harmful and other investments but that such evidence may become available in the coming years. The European Insurance and Occupational Pensions Authority (EIOPA) will be required to monitor and report by 2023 on the evidence available at that time.

In terms of stress testing, the EC has proposed that own risk and solvency assessments (ORSAs) should contain an assessment of whether the insurer has any material exposure to climate-change risks. If the insurer has material exposure to climate-change risks, it will need to specify at least two long-term climate-change scenarios, including the following:

- A long-term climate-change scenario where the global temperature increase remains below two degrees Celsius
- A long-term climate-change scenario where the global temperature increase is equal to or higher than two degrees Celsius

Proportionality

A common criticism of SII is that it places an undue regulatory burden on insurance entities that are either small or have relatively simple business models. The most obvious example is captive insurers and reinsurers. Indeed, due to the prohibitive nature of the SII rules, many multinational organizations have favored "offshore" when establishing or expanding their captive insurance programs. National supervisors simply have not had a sufficient level of discretion to put into practice the proportionality principle that was part of the original Directive.

Under the proposed reforms:

- More small firms will be excluded from SII altogether, specifically where annual premiums do not exceed €15 million and gross technical provisions (TPs) do not exceed €50 million.
- A new category of "low-risk-profile undertakings" will be introduced; such undertakings stand to benefit automatically from simplified reporting and governance requirements, including the ability to appoint a single individual in multiple key-function roles. Broadly speaking, to qualify for this category, an entity's business must be limited (for example, premia < €100 million p.a. for a nonlife undertaking and TPs < €1 billion for a life undertaking). From an investment perspective, it must have less than 20% in nontraditional investments.

Interest rates

The methodology used to determine the relevant risk-free interest rates (for SII purposes) will be updated. As it currently stands, the market inputs only use the curve up to the "last liquid point" (LLP); for example, the 20-year term for the euro risk-free curve. In the revised methodology, curve construction will make use of yield inputs from sufficiently deep, liquid and transparent financial instruments for points beyond the LLP. We note that the current differential between longer-term market-related yields and the yields at the long end of the EIOPA curves is substantial, particularly for the euro curve.

As a result, the relevant SII yield curves will be more market driven at the longer end of the curve. Intuitively, this will have the most material impact on life undertakings with longer-term liabilities, although other types of undertakings may feel the effect. For reference, the life insurance market (excluding health and unit-linked liabilities) had TP liabilities of around €5.6 trillion as of December 31, 2020.[2] It is estimated that this change will result in a reduction of around €60 billion in available capital (using June 30, 2021, market conditions). Although, as part of the Delegated Regulation changes to be proposed, more significant standard-formula interest rate risk stresses will also increase solvency capital requirements for affected firms.

~€5.6 trillion

TB liabilities in the life insurance market

Risk margin

Although stopping short of including potential amendments to the calculation of risk margin in its proposal, the EC has signaled a willingness to relax its approach to the risk margin, something that has always been a controversial component of an insurer's TPs.

Besides an estimated €50-billion reduction in TPs, the EC sees the proposed amendments as a means of reducing balance-sheet volatility. Drawing on some but not all of EIOPA's recommendations, the EC is contemplating a reduction in the cost of capital from 6% to 5% and the introduction of a decay parameter into the formula, which means SCR runs off more quickly compared to the current regime, thereby reducing the risk margin. This decay factor is also not floored at 50%, unlike the original EIOPA proposal, leading to a greater reduction in the risk margin.

This reduction would benefit insurers with longer-dated liabilities and assist that same cohort in managing phasing-out of the ultimate forward rate (UFR). For life insurers that currently hedge the interest rate sensitivity of the risk margin and whose overall TPs remain broadly similar, the combination of UFR and risk-margin changes will likely be welcomed, as they collectively facilitate greater hedge effectiveness.

[2] "Technical Provisions — Life (Excluding Health and Index-Linked and Unit-Linked)" entry within the Y2020 entry of the EIOPA annual solo balance sheet, available at https://www.eiopa.europa.eu/tools-and-data/insurance-statistics_en#Balancesheet.

Macroprudential risks: Liquidity and macroeconomic scenarios

The Commission has included more of a focus on macro and liquidity risks within the Directive:

When deciding on investment strategy, macro considerations are now to be included within the ORSA, whereas macro factors should also be considered within the prudent person principle. Macro risk here predominantly relates to risks that affect the economy as a whole.

A more defined approach to how liquidity risk is considered is also to be included, requiring in-scope insurers/reinsurers to calculate liquidity-risk indicators and perform liquidity projections. Although the specifics of these liquidity indicators are yet to be determined, EIOPA's January 2021 paper on liquidity is likely to be a relevant guide[3] on expectations.

Contact us

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[3] European Insurance and Occupational Pensions Authority. *EIOPA Publishes the Second Paper on the Methodological Principles of Insurance Stress Testing With Focus on Liquidity,* January 26, 2021, available at https://www.eiopa.europa.eu/media/news/eiopa-publishes-second-paper-methodological-principles-of-insurance-stress-testing-focus_en.

[4] The Insurance Asset Outsourcing Exchange. *The Insurance-Focused Investment Consultant Compendium*, October 2021. US$684 billion under advisement across 118 clients globally.

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