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IMPACT ASSESSMENT REPORT

Accompanying the documents

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

and Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of insurance and reinsurance undertakings and amending Directives 2002/47/EC, 2004/25/EC, 2009/138/EC, (EU) 2017/1132 and Regulations (EU) No 1094/2010 and (EU) No 648/2012

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7. CONCLUSIONS

Based on the assessment presented in the previous sections, this section presents the conclusions of the targeted evaluation of the Solvency II framework. Although it is beyond the scope of the evaluation to provide any policy conclusions or follow-up action to take, the section also highlights the main areas with potential to improve the framework for the future, possibly in the process of the forthcoming review.

7.1. Conclusions on the Solvency II framework

Overall, the current Solvency II Directive and Delegated Regulation are broadly effective and coherent, still highly relevant, neutral with respect to many digital developments, and bring EU added value. Nonetheless, a number of issues in the implementation of their principles (risk-based and market-based, proportionality), in the supervisory convergence process, and the implementation of their requirements limit their efficiency, and to a lesser extent their effectiveness, while some additional dimensions are missing that could enhance their relevance in the current environment. Specifically:

1. Effectiveness

The current risk-based, three-pillar approach of the Solvency II framework overall achieved progress towards its general objectives: to increase the EU insurance market integration, to enhance the protection of policyholders and beneficiaries, to improve competitiveness of EU insurers as well as to foster growth and recovery. It has significantly improved insurers' risk management and internal governance and thereby reduced the likelihood of an insurer to fail. However, **some of the numerous measures** aiming to facilitate an enhanced risk management (such as the **volatility adjustment mechanism**) **could be refined,** as they can give rise to insufficient or undesirable effects depending on the economic situation and/or on the specificities of the national markets.

The framework has also fostered transparency and strengthened supervisory cooperation and convergence, which in turn deepened the integration of the EU market and ensured a better level-playing field for EU insurers. Although all these benefits are largely acknowledged, the role of the insurers as institutional long-term investors or as "green" investors is still seen as unsatisfyingly discreet. Reasons can be found in socio-economic (policy) developments that were not foreseen at the time of the legislative process (such as the persisting low-interest-rate environment that renders some provisions or parameters outdated, insufficiently effective or even counter-effective). But they can also be found to some extent in the design of the framework and in its "principle-based" characteristic, which demands a very high level of clarity and cooperation to **avoid legal uncertainties and ensure sufficient supervisory convergence**. The needs for clarification evolve in turn with the implementation process, changing market conditions and new/emerging issues.

2. Efficiency

Due to the difficulties in obtaining reliable cost estimates and the lack of means to quantify the general benefits of the Solvency II framework, it has not been possible to carry out a quantitative assessment of its efficiency at EU level. The available evidence on compliance costs, however, suggests that the proportionality objectives have not been reached yet, and that insurers, the smaller ones in particular, spend significant financial resources to comply with the current regulatory requirements. The reporting requirements in particular seem to generate a cost that can appear disproportionate for smaller insurers, both in terms of reaching the specific audiences and in terms of frequency. **The assessment identified a number of areas where the supervisory reporting requirements could be better adapted to the size, nature and complexity of the insurance companies**. Therefore, the Solvency II framework is not as efficient as it could be. Both **updating and clarifying the application of the proportionality principle** could improve the general efficiency of the framework.

3. Relevance

The main objectives of the Solvency II framework – to deepen the integration of the EU insurance market while ensuring sufficient policyholder protection and financial stability, support the competitiveness of EU insurers and foster economic growth – remain highly relevant. However, the economic and financial conditions faced by insurers and reinsurers over the recent years and months (in particular in relation to interest rate risks and market volatility) significantly differ from those during which the Solvency II framework was designed. Therefore, some provisions and parameters now prove outdated and lead to insufficient or undesired outcomes. Likewise, it may also raise financial stability issues, and **the existing macro-prudential tools** already embedded in the framework **may not be fit to sufficiently allow addressing potential systemic risks** in the insurance sector. In particular, Solvency II does not provide a **framework for the coordinated resolution of insurers** when the disorderly failures of an insurer would lead to suboptimal outcomes for policyholders, the economy, financial stability and potentially taxpayers. Similarly, there is no harmonised and coordinated approach of safety nets in the form of **insurance guarantee schemes** that would protect policyholders and beneficiaries in case of failure. Another newly emerged objective is the role insurers are expected to play as institutional investors for a sustainable and green recovery, and into long-term sustainable investments in general. **The current framework seems to lack the necessary prudential incentives for insurers** to make long-term sustainable investments as well as **to manage and reflect climate and environmental risks in their risk management**. Reviewing the design of the capital requirements in order to better reflect the current (and foreseeable) (natural and financial) environment also highlights some additional objectives, or put even more emphasis on existing ones. As to the horizontal digital issues that can concern the insurance market, they are part of horizontal workstreams, and also subject to continued scrutiny and ongoing work, in collaboration with the ESAs.

4. Coherence

The interaction of the Solvency II framework with other parts of legislation is limited as Solvency II is self-standing and by itself replacing a patchwork of 14 former Directives. Further, while it focuses on the prudential dimension and policyholder protection by ensuring that insurers have sufficient capital to meet their obligations, the Solvency II Directive is very broad, encompassing also requirements for insurance groups. However, the current provisions of the framework do not seem to be effective in a way that corresponds to the objectives of the renewed Action Plan on the Capital Markets Union: issues of **insufficient volatility mitigation**, impacting the **insufficient effect of the framework on long-term investment** by the insurers. The same holds for "**green investment**" and the European Green Deal.

From an international point of view, Solvency II is one of the most advanced standards at international level, and several jurisdictions are in the process in incorporating (some of) the European rules in national legislations. On the other hand, the current lack of harmonised framework for coordination and management of crisis situations, including to address potential systemic risk, is not consistent with the objectives set at international level by the IAIS and the FSB.

5. EU added value

Overall, the Solvency II framework has clear added value by providing a harmonised and sound prudential framework for insurance and reinsurance companies in the EU, merging and harmonising the piece-wise regulation that existed before. Based on the risk profile of individual firms, it promotes comparability, transparency and competitiveness. Solvency II has significantly enhanced the protection of policyholders and beneficiaries, by limiting the likelihood that their insurer fails, as well as increasing transparency on the risks their insurer is facing. Under the coordination of EIOPA, Solvency II has also facilitated supervisory convergence within the Union and contributed to the integration of the Single Market for insurance services. However, the assessment suggests weaknesses in supervisory convergence and cooperation which clearly hinder the effectiveness of the framework in terms of competitiveness and integration of the EU market. It identified such issues related to insufficient supervisory convergence and cooperation in particular in the case of cross-border activities, and insufficient or unequal policyholder protection in case of failure. In particular, there is no harmonised and coordinated approach of safety nets in the form of **insurance guarantee schemes** that would protect policyholders and beneficiaries in case of failure.

There is no question about the need for the EU-wide Solvency II framework. Nonetheless, the assessment suggests that there is scope for improvement in a number of areas, identified in the above-analysis and listed below. The feasibility of specific policy actions, and the costs of any required changes, would be the subject of the back-to-back impact assessment.

7.2. Lessons learned

The following points summarise the lessons learned in this targeted evaluation in terms of the main areas for improvement in the Solvency II framework. These need to be understood within the above overall conclusion that the Solvency II framework is broadly fit for purpose, and generally acknowledged by all stakeholders as a well-functioning and robust regulatory framework. The risk-based framework has promoted comparability, transparency, enhancing risk management practices and competitiveness. It has therefore significantly enhanced the protection of policyholders and beneficiaries, also providing strong incentives for insurers to better measure and manage their risks, and to improve their internal governance. Under the coordination of EIOPA, Solvency II has also facilitated supervisory convergence within the Union and contributed to the integration of the Single Market for insurance services. The Framework has therefore achieved progress in the different specific (and operational) objectives, thereby contributing to the general objectives that had been set. The summary below focuses on the identified areas for improvement.

<u>Insufficient risk-sensitivity in the design of the capital requirements</u>

- Solvency II is a "risk-based" framework. It defines capital requirements based on quantitative evidence, setting the amount of capital resources that insurers have to set aside in order for them to be able to cope with very extreme adverse events. Higher capital requirements on investments are therefore applied to assets that are more volatile and/or riskier. This risk-based principle has significantly improved insurers' risk management practices.
- However, the framework needs to be regularly updated, so that it appropriately captures all the risks that insurers are facing. It is a necessary condition to maintain the reliability of the risk management as well as of the supervision, and to protect policyholders effectively.
- Indeed, current Solvency II provisions and parameters may not reflect key recent economic and financial trends.
- In particular, in the new economic environment characterised by compressed spreads and low yields, the level of capital requirements using **the standard formula may sometimes underestimate the risks insurers are actually facing**, in particular in relation to interest rates; Underestimation of interest rate risk can also have negative effect on investment behaviours and risk-taking activities by insurers, with potential side effects on financial stability. The calibration of the interest rate risk sub-module and the extrapolation of the risk-free interest rates are therefore not optimal.
- In addition, the current risk approach does not capture the possible risk differential between "green" and "brown" assets.

<u>Limited ability of the framework to mitigate short-term volatility of insurers' solvency position</u>

- The Solvency II framework also relies on full market-based valuation of insurers' assets and liabilities, which allows monitoring the impact of economic and financial conditions on insurers' solvency in real time and on an ongoing basis.

- Solvency II comprises several **regulatory tools aiming at mitigating the impact of short-term market volatility**, relying on this "market-consistent" valuation. Such tools currently **seem unable to avoid events of very volatile capital resources**, in particular under stressed situations.
- This remaining excessive short-term volatility poses a risk to the international competitiveness of EU insurers, by generating more uncertainty. This uncertainty can disincentivise insurers from further expanding their business and activities internationally.
- **It fosters short-termism in insurers' underwriting and investment activities**, divesting from real assets supporting the European economy, and thereby hinders the opportunities for the insurance market to fully play its role as institutional investor.
- It also makes it more costly for insurers to offer products with long-term guarantees, incentivising a shift towards unit- or index-linked products where a large part of the risk is transferred to policyholders.
- In addition, **the current mechanism can also lead either to insufficient adjustment or to unexpected stability or even improvements** (so-called "overshooting") in the solvency position of insurers, as observed during the Covid-19 outbreak. Such unintended situations raise supervisory challenges, as appropriate risk measurement may be hindered under stressed situations.

<u>Limited incentives for insurers to contribute to the long-term financing</u>

- Solvency II has enforced a "risk-based" principle which has significantly improved insurers' risk management practices.
- With regard to market risks faced by insurers, the risk-based approach implies that the definition of **capital requirements on investments only depends on the relative riskiness of each asset over a one-year time horizon, without taking into account other EU political objectives**.
- Consequently, **the quantitative rules on long-term investments in general are seen as very conservative** by stakeholders and the framework has not sufficiently contributed to foster long-termism in insurers' investment decisions, which could support the long-term funding of the real economy and the financing of the recovery from the economic impact of the Covid-19 outbreak.
- The Commission introduced changes in 2019 via the Solvency II Delegated Regulation, to ensure that investments in qualifying long-term equity are subject to a preferential prudential treatment. Feedback received after more than a year of implementation tend to establish that the conditions imposed for the application of that preferential treatment may be either too complex or difficult to meet.
- **Improvements could further facilitate long-term investment** and incentivise insurers to play their full part as institutional investor for the long-term financing of the EU economy.

<u>Insufficient contribution to the greening of the European economy</u>

- The greening of the European economy concerns the insurers' balance sheets on both sides: assets and liabilities.

- On the one hand, the risk-based approach implies that the definition of capital requirements on investments only depends on the relative riskiness of each asset over a one-year time horizon, without taking into account other EU political objectives. Therefore, it also means that **prudential rules do not take into account the brown/green nature of investments**. This may (at least partially) explain why insurers' investments in green assets remain a small share of their total investments, even though insurers are key institutional investors for the financing of the green transition, and despite the neutrality of the prudential framework with regard to investment in assets or activities that are either environmentally-sustainable or detrimental to the Commission's objective of a climate-neutral continent.
- In addition, while Solvency II contains a **general requirement on insurers to take into account all risks in their risk management, the Directive does not name explicitly climate and environmental risks** (although other particular risk categories are mentioned). Still, those risks would often materialise through other risk categories, e.g. market or underwriting risk. This may result in a lack of clarity as regards whether and where insurers are expected to reflect climate and environmental risks and, as a consequence, in insufficient management of those risks by insurers.
- Improvements in this area could build on integrating sustainability considerations in one or all of the three Solvency II pillars.

<u>Insufficient proportionality of the current rules</u>

- The assessment and feedback show that Solvency II is a sophisticated framework, which provides good incentives for robust risk management by insurers. However, it can also prove to be very complex, and its implementation generates significant compliance costs. In some cases, these high compliance costs may outweigh the benefits of the application of the framework for the smaller insurers, and there is a general sentiment that proportionality is insufficiently implemented in the supervisory process.
- The implementation of the framework also relies on a "proportionality principle". First, as regards the scope of firms that are subject to the Solvency II requirements, current thresholds have not been updated yet, and may prove to be outdated.
- Second, the frameworks embeds an overarching principle of proportionality, which supposedly ensures that both the requirements imposed to companies and the intensity of supervisory activities by public authorities are commensurate to the "nature, scale and complexity" of the risks of each firm. **However, in practice, the framework does not fully specify the nature of such "proportionate measures"**. This overarching principle has proven to be too "abstract", resulting in legal uncertainties and, at this stage, **the implementation of proportionality has been insufficient to effectively reduce the regulatory burden for smaller insurers**.
- The supervisory reporting and disclosure in particular, being a pivotal component of the Solvency II framework, has at the same time significantly enhanced transparency and disclosure to all types of external stakeholders, and developed as a core compliance cost, in particular for smaller insurers.

- In addition, so**me characteristics of the reporting and disclosure provisions could be improved**, as they are sometimes reported as inadequate to the targeted audience or seen as unnecessarily burdensome and frequent in regard to the expected use of the information.

Regulatory and supervisory shortcomings in policyholder protection, including in the event of an insurer's failure

- The assessment shows that Solvency II has facilitated the integration of the Single Market for insurance services by improving the level-playing field and supervisory convergence. However, feedback and EIOPA's reports also point to issues of inconsistent application of some Solvency II provisions across the EU, and **due to legal uncertainties, several areas of the framework may not ensure a harmonised implementation of the rules by insurers and supervisory authorities**, in particular in relation to the supervision of internal models, and to the supervision of insurance groups.
- Indeed, **EIOPA's recently enhanced role may prove insufficient to ensure a high-quality convergent supervision across Member States, and closing gaps may not always be achieved solely through non-binding tools. In addition, the lack of data sharing between supervisory authorities may hinder the effective supervision of insurers operating on a cross-border basis**. This can also affect citizens' trust in the single market and is detrimental to the Single Market for insurance services.
- Recent failures of insurance companies, which operated mainly outside the country where they were initially authorised, have indicated that there may be a need to consider enhancements in quality, consistency and coordination of insurance supervision in the EU, including in relation to cross-border business and group supervision.
- The situation confirmed that **policyholders are not consistently protected across the European Union in the event that their insurer fails**, in particular in the cross-border context. **National resolution regimes are mostly incomplete and uncoordinated.** Further, although a majority of Member States have set up an **insurance guarantee scheme** for certain life or non-life policies, the approach they have followed for the design diverges quite substantially from each other. It results in a **patchwork of the national insurance guarantee schemes**, which are expected to act as a safety net to pay claims in the event of the insurer's insolvency. This can leave some policyholders without any protection.

Limited specific supervisory tools to address the potential build-up of systemic risk in the insurance sector

- Financial stability is a primary objective of the Solvency II framework.
- In line with most rules of the Solvency II Framework that are targeted to individual insurers (so-called "micro-prudential supervision"), some existing measures contribute to addressing potential systemic risk when it stems from large insurers. Other provisions of the framework also aim at addressing systemic risk stemming

from “pro-cyclical behaviours” by a large number of insurers, which may collectively act as an amplifier of market downturns or of an exogenous shock.

- However, these tools provided for in the Solvency II Directive have been thought through at a time where the insurance sector was still deemed protected from “domino effects” such as those that have been observed in the banking sector. **Interconnectedness with other market participants, intersectoral impacts and common risky (herding) behaviours among insurers may have been overlooked**.
- There may be a need to further assess additional “dedicated” macro-prudential tools that would be better fit for purpose and less narrow in terms of scope. They should vest supervisory authorities with sufficient powers to allow an appropriate macro-prudential supervision (i.e. a supervision of the whole insurance sector) and to effectively prevent a build-up of systemic risk in the insurance sector.
- In particular, there may be no sufficient toolkit for public authorities to monitor, avoid and handle failures of insurers, as regular insolvency procedure might be unable to manage a failure in the EU insurance sector in an orderly fashion. From a macro-prudential perspective, a patchwork of national recovery and resolution regimes and insurance guarantee schemes is not beneficial to the integration of the EU financial market.

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