The Solvency II 2020-review

Insurance & Pension Denmark

Overall goals for the Solvency II review process

What does Insurance & Pension Denmark propose?

Insurance & Pension Denmark supports the underlying principles of Solvency II. Insurance & Pension Denmark also supports the need to carry out a review of the regulation in order to ensure that it is up-to-date.

The upcoming changes to Solvency II stemming from the 2020 review should take outset in the following:

- They must be cost balanced, as presumed and formulated by EIOPA
- Elements of EIOPA's proposal that will introduce increased costs should not be included in the Commission's final proposal, except the element that relates to negative interest rate shocks in the standard formula
- EIOPA and the Commission shall publish a complete impact assessment of the costs that the individual countries will meet from the final proposal

The overall consequences of EIOPA's proposal will, if not amended considerably, be increased costs for consumers, fewer investments in companies, reduced levels of growth and a reduction in the amount of long-term sustainable investments.

What is the challenge?

EIOPA has delivered its advice on the Solvency II 2020-review, which is being presumed by EIOPA to be balanced in terms of solvency requirements. However, the proposal will have negative effects on solvency ratios and thereby in practice increase costs for European insurance and pension companies. Increased costs that in the end will influence consumers negatively.

Solvency requirements are made up of a number of different factors and especially two of the suggested changes will significantly increase solvency capital requirements. These are changes to the risk free interest rate curve and handling of shocks to negative interest rates.

These two changes are to some degree counter balanced by adjustments to the VA for euros, but not the VA for Danish kroner, and easing of the risk margin. However, based on EIOPA's own impact assessment, there will be an increase in capital requirements by 10 per cent for Danish companies. Consequently, Danish companies will need to set aside more capital to their solvency preparedness.

In addition, EIOPA's proposal includes a long list of new reporting requirements – declared as well as hidden – which will cause an increase in administrative costs. These will ultimately lead to increased costs for consumers without simultaneously bringing about an increase in consumer protection.

EIOPA has carried out two impact assessments on large parts of their proposal, but only at the end of 2019 and mid-2020. At European level, there are great differences in the impact from end-2019 to mid-2020.

Possible consequences

Insurance Europe has estimated the consequences at European level of EIOPA's proposal. Most likely the proposal will:

- Bind an additional 60 Bn. Euro in capital in insurance and pension companies. For Denmark, the proposal will bind app. 1.0-1.3 Bn. Euro.
- Increase administration costs for insurance and pension companies by app. 7-13 Bn. Euro.
- Reduce investments in shares by up to 170 Bn. Euro. In Denmark, investments in e.g. windmills and listed companies will be reduced by app. 3.3 – 4.7 Bn. Euro.

Apart from a reduction in the level of overall investment, EIOPA's proposal will also cause a lower rate of return for pension savers and consequently also a reduced basis on which to collect taxes for national governments.

Handling of shocks to negative interest rates

What does Insurance & Pension Denmark propose?

Insurance & Pension Denmark supports the underlying principles of Solvency II as a risk-based system that must reflect the actual risks companies face. The changes to the risk free rate as a consequence of negative interest rates is a sensible way to ensure the continued relevance of the Solvency II regime. Widespread negative interest rates did not exit 5-10 years ago and hence, their possible existence was not included in the development of the original Solvency II regulation.

One can question, though, the correctness of EIOPA's proposal to an interest rate shock at the part of the interest rate that is not market based (the extrapolated part after 20 years). This part of the interest rate is politically defined and consequently will not experience shocks from the financial markets. Insurance & Pension Denmark is of the opinion that the interest rate shock should occur at the part of the interest rate that is market based (for Denmark 20 years) and that it hereafter is extrapolated.

The suggested change by EIOPA will in effect cause extra capital bindings for the European insurance companies. These capital bindings will be of such a significant size that overall, the review will not be balanced for companies. Insurance & Pension Denmark believes that decisions regarding the final outcome of the Solvency II review must be taken while being aware of the extra capital binding and its consequences.

What is the challenge?

The current calculation method of the interest rate risk in Solvency II does not take into account that negative interest rates can fall even lower. However, reality has shown in recent years that it is indeed possible.

EIOPA suggests in their advice that the calculation method of the interest rate risk is changed in such a way that negative interest rates can fall even more (with a lowest level of -1.25 per cent).

Insurance & Pension Denmark supports this necessary change.

It is, however, an expensive change in terms of capital requirements. So expensive that EIOPA in its impact assessments have calculated the consequences for the relation between the solvency capital requirement and the free capital (the SCR-ratio).

At the end of 2019, the change to the interest rate risk would according to EIOPA caused an independent decrease of approximately 5 percentage points in the SCR-ratio for Danish companies. This is even calculated on the basis of limited marked data, i.e. it is unsure if this is indicative of the effect for the entire insurance and pension market. Unfortunately, EIOPA has not publicized the effects on the Danish marked based on their market information from mid-2020.

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New reporting requirements

What does Insurance & Pension Denmark propose?

Insurance and Pension Denmark supports the underlying principles of Solvency II. However, EIOPA's proposal to both change existing and introduce new reporting and disclosure requirements are problematic. They are most likely to create only very limited added value for companies, increase their costs and are unlikely to lead to any real consumer protection.

Insurance & Pension Denmark does not support the proposed changes to existing reporting requirements, nor the proposed new reporting requirements.

Insurance & Pension Denmark is of the opinion that EIOPA and the national supervisory authorities must prove why they need new reporting data in addition to the already existing vast reporting requirements.

Insurance & Pension Denmark proposes that authorities become better equipped to extend the use of existing reporting data and increase consumer protection through the use of these data.

What is the challenge?

When introduced in 2016, Solvency II caused a significant increase in reporting requirements. Specifically:

- 3 new qualitative reports
- 6-11 new quarterly quantitative reports
- up to 26 yearly quantitative reports

The Danish insurance and pension industry has obviously adopted these requirements in order to abide by the Solvency II regulation. Insurance & Pension Denmark believes, however, that neither customers nor other stakeholders including national authorities does make much use of the new data supposedly being reported.

The Danish and European insurance and pension industry at large have a common wish to thoroughly have the existing reporting requirements evaluated instead of increased in level. Certain reporting requirements can also be reduced without harming consumers.

Both the proposed changes to existing reporting requirements and the proposed new reporting requirements by EIOPA will cause increased costs for companies. The industry therefore expects authorities to document how increased consumer protection and increased societal value will come about as a result of the increased reporting requirements.

Especially new reporting requirements concerning cyber crime and further product division of non-life insurances do not make much sense to the industry.

Another challenge is the "hidden" new reporting requirements proposed by EIOPA. These are hidden in the sense that they are not indicated by EIOPA as overall changes to reporting requirements. However, they are evident when going through the individual areas where EIOPA proposes further reporting.

Regardless of whether these new requirements are justified or not, EIOPA's methodology makes it hard for both decision makers and companies to get a complete overview of the combined effect of the new reporting requirements proposed by EIOPA.

Extrapolation of the risk free interest rate curve

What does Insurance & Pension Denmark propose?

Solvency II is and must in future continue to be risk based regulation. It is essential that the capital requirements of individual companies depend on their risk profile. Insurance & Pension Denmark is of the opinion that the Solvency II review must maintain to value this underlying methodology of the regulation.

Consequently, Insurance & Pension Denmark does not support EIOPA's proposal to change the calculation method of the risk free interest rate. This opinion is also a reflection of the fact that the proposal will increase capital binding for companies. In addition, the proposed gradual phasing in is very complicated and will increase the complexity of the risk management conducted by companies.

What is the challenge?

EIOPA proposes the so-called alternative extrapolation methodology, which has been tested in impact assessments in 2019 and 2020. EIOPA's proposal to change the extrapolation of the risk free interest rate curve is based on an assumption that the existing methodology cause companies to set aside too little of their obligations towards costumers while making it too difficult for companies to manage their risks.

Insurance & Pension Denmark does not agree with this assumption by EIOPA. Insurance & Pension Denmark finds that the opinion of EIOPA does not justify the proposed far reaching changes to the interest rate curve and its effect on capital requirements.

The new methodology proposes to start the extrapolation of the risk free interest rate curve from the point where the market is no longer able to deliver relevant input and data. This point is better known as the First Smoothing Point (FSP), as opposed to today, where extrapolation starts at a fixed point (20 years for Euro and Danish kroner). According to EIOPA, FSP would at the beginning of 2020 have been 20 years. It is EIOPA's intention that FSP is stable from year to year and only is changed when the market dictates it. The change from a fixed extrapolation point (LLP) to a market based (FSP) is in the opinion of Insurance & Pension Denmark sensible as it allows market data to be used to fix the interest rate curve for as long as possible.

EIOPA also proposes to change the extrapolation methodology from FSP to Ultimate Forward Rate (UFR). Insurance & Pension Denmark does not support this proposal.

EIOPA is of the opinion that the existing Smith-Wilson extrapolation and the alternative extrapolation method create results that are rather comparable. However, EIOPA has earlier published an effect evaluation based on end of 2019 data that shows a decrease in the SCR-ratio of 11 percentage point for Danish companies. The EU average was a decrease of 12 percentage points.

EIOPA proposes that this change is phased in gradually towards 2032, with a reduced speed in years where the interest rate in FSP is lower than 0.5 per cent. However, the proposal must still be fully implemented by 2032. At the same time, EIOPA advices companies not to use the phasing in methodology in their cover strategy. Insurance & Pension Denmark finds that this approach is unnecessarily complicated, as it depends on several factors (phasing out period and a given interest rate level) and is consequently burdensome and costly for companies to use in order to administer risk. Administration of risk is essential to ensure consumers as high a rate of return as possible.

Furthermore, EIOPA uses the gradual phasing in as an argument in favour of the entire Solvency II proposal being neutral and balanced in terms of solvency requirements. This is, however, not correct. At its best, the proposal is balanced in mid-2020. For the rest of the period towards 2032 and afterwards, the proposal is not balanced, as EIOPA also has documented in its impact assessment.

In conclusion, there seems not to be a valid reason to introduce such a complicated phasing in mechanism.

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Systemic risk

What does Insurance & Pension Denmark propose?

Trust is essential for the insurance and pension industry. The Solvency II regulation helps enabling the industry to handle even very large crises (the so-called 200 years events). Several elements in the existing Solvency II regime do also directly counteract what can be described as systemic risk.

In its review proposal, EIOPA discusses the issue of systemic risk, despite the fact that the Commission did not ask for advice on the topic.

The reason for EIOPA to include the topic of systemic risk may well be that systemic risk exists in the banking industry, where certain institutions are deemed to be systemically significant. However, there is a fundamental difference between the business models of bank institutions on the one hand and the insurance and pension industry on the other hand. EIOPA does also point to this in its own proposal.

Insurance & Pension Denmark opposes the introduction of regulation that is based on the assumption of systemic risk within the insurance and pension industry. Instead, Insurance & Pension Denmark suggests that authorities and the industry enter into a dialogue, both nationally and at European level. The purpose should be to consider how the national supervisory authorities can use the many existing tools within the Solvency II regulation that already works effectively and use these to target systemic risk.

Are insurance and pension companies not systemic?

There are essential differences between insurance and pension companies and banks:

- An insurance or pension company *receives* money through payments from customers and subsequently invest these money in e.g. shares, real estate and government bonds. Banks, on the other hand, *borrows money* from depositors and lends these to other customers.
- In Denmark, there cannot be ”run” on a pension company as is the case with a bank, e.g. with customers withdrawing all their deposits. Pension savers have long-term agreements and conditions. They cannot to the same extent withdraw all they assets from a pension company and in certain circumstances only while paying a fee.
- Insurance and pension companies are in their nature long-term with predictable cash flows. For pension savings, money is for example not paid out until the customer reaches a certain age and at that point the payment to the customer occurs over a number of years. For insurance companies, contracts are often signed for a one-year period.
- Risk spread is greater in the pension and insurance companies than in the banking sector thanks to the global reinsurance system.
- Investments by pension companies are divided into many different asset groups with a fairly large proportion of investments put into rather secure government and mortgage bonds.

A substantial examination by EIOPA of particularly problematic instances in the insurance and pension industry also showed that these were not due to liquidity and capital problems.

Existing regulation ensures that risk is under control – the industry is robust and invest in a diversified manner in order to minimize risk

Existing Solvency II regulation helps to ensure a robust insurance and pension industry with sufficient liquidity, both in the industry at large and in the individual companies. Ongoing stress tests are a good example hereof. And if a company’s solvency level is significantly reduced, while still abiding by its capital requirements, regulation already exists that gives national authorities the possibility to intervene. National supervisors can for example demand emergency capital plans to be prepared if these are deemed necessary.

Furthermore, the European pension industry generally has a very high level of solvency with an average of 259 percent (at the end of 2020). The Danish industry is particularly robust and has an average solvency level of 268 per cent (at the end of 2020) and consequently a higher level than the EU average.

If we take a closer look at the investments made by Danish companies, we will see that government and mortgage bonds make up close a third of all investments (32 per cent). Other types of bonds make up 18.5 per cent of investments. In comparison, global bonds in emerging markets make up 26.5 per cent, while shares in emerging markets only make up 2.8 per cent. In addition, investments in real estate, infrastructure and ownership of funds investing in unlisted companies are generally also part of investments portfolios. This type of diversification helps to reduce the exposure to some of the market risks or effects of events that EIOPA argues can cause systemic problems.

The consequences stemming from specific systemic risk regulation will be extra costs, which in the end will affect the pension savers. Regulation of systemic risk might also cause a "fire sale" of pension savers' assets, given that companies in the short term will need to release capital. For example, when share values fall – even in the case of short-lived falls – this can cause a need for companies to strengthen their solvency, which is why they need to sell shares at a time that is not favorable to pension savers. The consequence hereof is unnecessary loses as shares are sold at low value at a time when the market is in downturn.

The proposed regulation regarding systemic risk will in addition also lead to further demands for capital binding.

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Proportionality

What does Insurance & Pension Denmark propose?

Insurance & Pension Denmark supports Solvency II as a risk-based set of rules in which requirements to individual companies reflect the risk posed by the given company. Insurance & Pension Denmark welcomes that the Commission in its call for advice asked EIOPA to consider the issue of proportionality within Solvency II. EIOPA has included a number of proposals that improve proportionality, which is positive. However, Insurance & Pension Denmark believes that the Solvency II regulation will continue to impose a disproportionate amount of burdens and costs on small and less risky companies.

Insurance & Pension Denmark is of the opinion that the following adjustments must be incorporated into EIOPA's proposal:

- The limits for group 2 companies (that are not regulated by Solvency II but by national regulation) must be increased so the potential limit of 25 million Euro in premiums for non-life companies is established as a permanent limit for all European countries.
- Criteria number 2 in EIOPA's criteria for low-risk companies must be amended so that the combined ratio for non-life companies is defined including financial income or that the company's combined ration in at least 2 years in an on-going 5 year period is below 100. The current proposal states that the combined ration must by below 100 in 2 consecutive years.

Under criteria number 5 it is proposed that low-risk companies at a maximum level must underwrite 30 per cent of the yearly gross premium within shipping, aviation and transport or credit. Insurance & Pension Denmark believes that mutual companies within shipping should be except from criteria number 5 - several of the very smallest mutuals in Denmark underwrite insurances for fishery.

Furthermore, it should be voluntary for companies, small as well as large, whether to write their SFCR reports in their national language or in English.

What is the challenge?

The Solvency II regulation covers the vast majority of the European insurance and pension industry, from truly international companies, such as Allianz and Aegon, to the local insurance companies, such as the Danish companies Bornholms Brand and Vestjylland Forsikring. Only the very smallest companies have so far been except. Even though Solvency II is designed as a risk-based regime, a number of requirements exist – both regarding capital, reporting and construction of the company – that concerns all companies, even the very smallest.

Concerning capital, Insurance & Pension Denmark believes that all companies must hold sufficient capital to be able to ensure costumers and trust in the industry. However, it does not make sense to apply the same organizational and reporting requirements to a very small local company, as is applied to large and international companies. The difference in risk must be reflected in requirements to governance and reporting.

Possible consequences

EIOPA's proposals regarding proportionality is a step in the right direction, with its suggested easing of unnecessary burdens and costs. Insurance & Pension Denmark does, however, put forward a number of suggestions for improvements.

The existing Solvency II regulation continues to entail a large amount of costs for Danish companies. We specifically identify:

Listed companies are forced to publish a regulatory SFCR report both in Danish and English for analysts and investors.

Small local companies have disproportionately high reporting costs as a consequence of Solvency II. Some have had to hire people only to be able to meet these reporting requirements.