EIOPA 2020 CONSULTATION ON THE REVIEW OF SOLVENCY II

Position with the comments of AEIP

27 March 2020

European Association of Paritarian Institutions- AEIP

Main messages

- The European Association of Paritarian Institutions (AEIP) believes that EIOPA’s proposals, resulting from the consultation of the 15th October 2019, lead to a significant increase in prudential requirements. We do not consider this increase in cost as justified with respect to personal injury insurance guarantees, which provide benefits in the form of annuities in the event of incapacity, disability, death or dependency[1].
- In most European countries, physical injury insurances make it possible to support public policies, in addition to the first pillar of solidarity, in order to meet the growing need for social protection linked to population ageing. It is therefore a priority to assess the prudential requirements of these guarantees "at the right price" so as not to unnecessarily increase their costs to beneficiaries.
- AEIP calls for better consideration, in the standard formula, of the specificities of long-term management of personal injury insurance policies offering benefits in the form of annuities in the event of accident, illness and dependency. These specificities require the standard formula to strengthen the mechanisms limiting excessive volatility from financial markets, particularly that volatility linked to interest rate changes. Similarly, the current low interest rate environment should be incorporated into the standard formula, without excessive caution, considering the long-time frame involved in managing these activities.
- AEIP would like to see better application of the principle of proportionality, avoiding unnecessary additional costs and complexities, in particular by simplifying or removing certain prudential statements, and leaving up to the organisations the choice of auditing their prudential statements, depending on the robustness of their process for preparing these statements as well as on the quality of their data.
- AEIP believes that the supervisor's current intervention thresholds lead, by their very construction, to a prudential level significantly higher than the SCR, closer to 130-150%. This state of affairs diverts the initial calibration of the Solvency 2 Directive and necessarily weighs on the cost of European insurance. It calls for the SCR to be considered as a target level, and not as a minimum, a role assigned to the MCR.

[1] These guarantees represent the second largest segment of European insurance, with more than €200 billion in annual premiums.

1. Introduction

AEIP, as a representative of provident institutions, insurance organisations specialising in health and provident insurance for private sector employees, is very committed to the defence of a Solvency 2 prudential regime adapted to the management of physical injury guarantees. It welcomes EIOPA's consultation to promote a constructive dialogue for the review of this prudential regime in 2020.

Physical injury guarantees, which include health, disability, death and long-term care insurance, constitute the largest insurance segment in Europe after life insurance, with more than €200 billion in premium income in 2018[2], far ahead of motor insurance.

They constitute a second pillar of social protection that complements national social security systems, offering income compensation through the payment of a compensatory annuity in the event of accident, illness or death of the beneficiary. It is in the interest of the European Union to promote the fair price of these guarantees, which, faced with the challenge of future demographic ageing, offers a response to the challenge of the sustainability of public systems.

The purpose of this note is to present AEIP's comments on the proposals made by EIOPA in the consultation carried out regarding the 2020 review of Solvency 2.

2. Promoted Objectives

In the context of the 2020 Solvency 2 review, AEIP is pursuing the following main objectives:

- **The specificity of the long-term management of personal injury guarantees** (incapacity, disability, death, dependency) **should be better recognised in the standard formula** in order to meet the needs of European social policies. **The calculation of the SCR should** therefore better **recognise** the long-term and non-redeemable nature of these guarantees in annuities, **and their lower exposure to market risks as calibrated at one year** in the current standard formula;
- **The complexity of implementation** by organisations, particularly medium-sized insurers operating within the same Member State, **should be significantly reduced, in order to avoid the additional implementation costs** that inevitably **weigh on the final consumer**;
- The revision of Solvency 2 should lead at the very least **to no increase in the solvency capital requirement**, and to no deterioration in the S2 coverage ratios of organisations. The current calibration of the standard formula is already very demanding in a low interest rate environment.
- **The SCR should be recognised as a target prudence level**, determining the action threshold for early action by the supervisor, **and no longer as a minimum threshold**, triggering remedial action, in order to respect the 99.5% confidence level one year from S2. The current design of the SCR as a minimum threshold, leads to requiring more than the S2 confidence level from insurance organisations.

In summary, AEIP notes that **the proposals put forward by EIOPA would lead to a net overloading of the capital required (SCR) and a significant drop in the coverage ratios of its members,** in

[2] OCDE insurance statistics 2018: https://read.oecd-ilibrary.org/finance-and-investment/oecd-insurance-statistics-2018_g2g9fad8-en#page1

particular due to a revision of the parameters on negative interest rates and the yield curve, but also to an increase in complexity. We therefore consider that **EIOPA's proposals need to be thoroughly reviewed** to meet the above objectives.

3. Comments on EIOPA Consultation

3.1. The standard formula should better recognise the long-term nature of physical injury guarantees (Accident & health)

► The last liquid point of the yield curve should be maintained at 20 years

Guarantees managed over the long term should be free of the volatility induced by very long-term interest rate variations. Therefore, the EIOPA curve was created with a last liquid point at 20 years. EIOPA's proposal to extend this last liquid point beyond 20 years (30 or even 50 years) would introduce unnecessary additional volatility into the calculation of the S2 coverage ratio, even though 20-year planning horizons are enough for these long-term guarantees.

AEIP is in favour of maintaining the last liquid point (LLP) of the curve at 20 years, considering that this avoids an unnecessary increase in volatility in the Solvency 2 ratios. The current yield curve thus gives a stable and fair representation of the technical provisions of insurance organisations.

► The correction parameter of the interest rate volatility should be strengthened in the EIOPA yield curve ("Volatility Adjustment" or VA) to neutralise the volatility induced in times of crisis

AEIP considers that it is necessary for the yield curve to further neutralise the short-term effects of interest rate changes, in order to capture in the standard formula only medium- and long-term developments. This is particularly true for long-term non-redeemable guarantees, whose exposure to long-term interest rate risk is managed over long horizons.

AEIP is in favour of introducing a specific volatility adjuster (VA) in times of crisis.

► The holding of long-term shares should be further facilitated as part of the effective implementation of the LTEI (Long Term Equity Investment) measure.

The new class of equity investments known as "Long Term Equity Investment" or LTEI, introduced in March 2019, on the occasion of the 2018 revision, promotes the financing of the European economy by reducing the solvency capital requirement to €22 per €100 invested instead of €39 for other types of shares.

However, we note that its effective application is made difficult because the measure is subject to restrictive conditions, sometimes incompatible with the management of portfolios of these long-term activities (average holding period of 5 years, backed by clearly identified liabilities and only composed of shares listed in the European Economic Area, etc.).

This measure presents a definite interest, but AEIP is still waiting for a reduction or simplification of the conditions for its implementation.

3.2 The low interest rate environment should be reasonably integrated into the standard formula so as not to lead to an increase in prudential requirements

► The interest rate shock in negative interest rate universe proposed by EIOPA is too demanding in terms of solvency capital and does not find compensation in EIOPA's other proposals.

EIOPA suggests inserting a rate shock in a negative interest rate universe in order to consider the current low interest rate environment in European markets. Without contesting the merits of a rate shock measured in a negative universe to better reflect current economic conditions, AEIP considers EIOPA's proposal to be largely disproportionate. According to our estimates, this proposal would lead to a maximum **100-point drop in the coverage ratio for physical injury or pension benefits, expressed in annuities.**

AEIP suggests limiting the scope of this shock over a horizon not exceeding 5 years, considering that it is not justified to include in the standard formula a lasting negative projection of the European economy. Moreover, insurance organisations managing long-term pension and retirement guarantees have room for manoeuvre to make planning decisions that guarantee their commitments and balances over the long term.

► The risk margin included in the valuation of technical provisions should be reduced to 3% to take account of the rate cut

Under the current rules, the risk margin can be calculated using a simplified method in the standard formula, by adding 6% to the amount of technical provisions valued on a best estimate basis. This 6% rate corresponds to the cost of capital fixed in Solvency 2 when it came into force in 2016.However, this rate has never been revised despite the continuous drop in interest rates since then.

While the simplicity of its calculation is an advantage that should be retained, the 6% rate is, on the other hand, no longer representative of current market conditions. It is far too high and deserves to be revised downwards. We note that during the last stress test requested by EIOPA from European pension funds, in April 2019, EIOPA suggested to calibrate the cost of capital to 3%, applying a methodology similar to that of Solvency 2.

AEIP requests that the rate is revised downwards and proposes to retain a 3% risk margin rate.

3.3 Supervisor intervention thresholds should be lowered by considering the SCR as a target solvency level, rather than as a minimum

The current action levels provide for a trigger for remedial action by the supervisor if the SCR is lowered. EIOPA proposes to add early intervention measures by the supervisor, above the SCR, to anticipate a deterioration that could lead to a situation where the SCR is not covered by an organisation.

AEIP believes that this proposal amounts de facto to raising the solvency requirement to a level above one case of bankruptcy every 200 years (confidence level set at 99.5% for 1 year). However, the current rules for supervisory intervention already require stakeholders to have a S2 coverage ratio greater than 130-150%, to avoid any risk of intervention by the supervisor.

AEIP therefore rejects the proposal of EIOPA to add early action measures to a threshold higher than the SCR and believes that the SCR should remain the solvency objective to be achieved, since this requirement is sufficient. With this in mind, it would instead be necessary to reduce the threshold for triggering the recovery procedure to a level below the SCR - between the MCR and the SCR - and, where appropriate, to replace the current intervention thresholds with early intervention measures by the supervisor, if the SCR is lowered.

3.4 Simplify prudential reporting and eliminate unnecessary extra costs

AEIP has identified disproportionate requirements in relation to the size of the entities that should be reduced or removed:

- Quarterly reporting for the 4th quarter leads to work for justifying deviations from the annual statements, which are highly time-consuming and resource-intensive for little added value. We suggest abolishing it in favour of the annual statements
- Detailed information on the number of contracts and policyholders is time-consuming for the organisations
- The quarterly submission of the detailed list of investments appears costly and unnecessary, whereas a detailed submission on an annual or even half-yearly basis would be enough for small and medium-sized organisations
- The S2 statement of changes in equity, shown in statement "S.29", deserves to be simplified, as it is currently very complex to implement
- In the interest of streamlining, the RSR and the ORSA could figure in a single document. These reports are for the sole use of the supervisory authority and both provide a view of the organisation's solvency, one retrospectively through the standard formula, the other prospectively and more broadly than the formal framework of the standard formula. The implementation of the standard formula by the organisations should be simplified.

Finally, EIOPA suggests making the audit of certain prudential statements mandatory. AEIP is not in favour of this, given the additional costs that would result from it. The organisations should remain the decision-makers for carrying out targeted external audits, on a contractual basis, in connection with the requests of their auditors/supervisors, particularly regarding the reliability of the processes for preparing the financial statements and the quality of each agency's data. Indeed, Solvency 2 has organised in parallel the reinforcement of these processes of elaboration and data quality as well as of their controls (Actuarial report, key functions, etc.). The introduction of a mandatory audit may constitute an additional cost, which would also require double work, once the organisation makes the processes and data more reliable, something which would ultimately weigh on policyholders.

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The European Association of Paritarian Institutions – AEIP, founded in 1996, is a Brussels-based advocacy organization, representing Social Protection Institutions established and managed by employers and trade unions on a joint basis within the framework of collective agreements.

In the context of social protection, paritarism is a type of self-organization of social relationships which on the basis of equal negotiations, brings about agreements which are equally binding on both employers and employees. This kind of self-organization goes from the paritarism of negotiation to the paritarism of management and results in various types of agreements, from adhesion to a particular form of cover to the creation of a paritarian institution.

The Association has 20 Associate and Affiliate members - all leading large and medium-sized Social Protection Institutions, from 12 European countries, as well as 13 Task Force Members from 3 European countries. All AEIP members are not-for-profit organizations.

In particular, AEIP deals – through dedicated working groups – with EU coordinated pension schemes, pension funds, healthcare, unemployment and provident schemes, paid holiday and health & safety at work schemes. Complementary to their role as non-for-profit social protection providers, AEIP members are also long-term institutional investors.

AEIP represents its members’ values and interests at the level of both European and international institutions.

For more information: www.aeip.net