SPEECH

REVIEW OF SOLVENCY II: A BALANCED UPDATE

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Ladies and gentlemen

Thank you for inviting me to talk to you about Solvency II and our Opinion that we published at the end of last year.

It will be no surprise to you to hear me say that our approach has been one of evolution rather than revolution. This is a term that we have been using since we first started thinking about the review.

And this is because we firmly believe that the implementation of Solvency II has been a step change in how insurers approach their relationship to risk. Since its implementation some five years ago the insurance industry has better aligned capital to risk, uses a risk-based approach to assess and mitigate risks, which means that it can better price them. Insurers have also significantly strengthened their governance models and their risk management capacity.

The coronavirus pandemic has underlined this view. The crisis has shown us that Solvency II proved effective in protecting the sector from market turmoil.

Nonetheless, for a regulation to remain effective, it must also remain fit for purpose. And this means that we have to recognise that the situation today is much different to when Solvency II was conceived.

We have been in a low interest rate environment for many years now and this has an impact on the business model for many insurers. Climate change – while not new – has taken on a more urgent dimension, and – on top of all of this – we are still in the middle of the COVID pandemic.

These are the realities that have fed into our review.

Let's start with the low interest rate environment. Looking at the massive intervention measures from central banks as a result of the pandemic, it is clear that the 'low for long' scenario will continue for a long time yet.

The framework must take account of the economic situation, notably with respect to the capital requirement for interest rate risk. The current interest rate requirement does not reflect the steep fall of interest rates experienced during the last year and ignores the existence of negative interest rates. This should be corrected.

We are therefore proposing changes to the treatment of interest rate risk, as well as to discount curves used by insurers, in particular regarding extrapolation.

Insurers were able to withstand the shocks of the pandemic in part due to the work done during years following the implementation of Solvency II, entering the crisis with a robust capital position.

Looking beyond COVID, the insurance sector has an important role to play to play in supporting the economic recovery. Long-term investments – they type of investments favoured by insurers – are essential to foster economic growth, develop infrastructure and boost jobs.

Insurers should not be discouraged from investing in long-term assets or illiquid liabilities.

Our Opinion therefore takes into account the nature of the long-term insurance business, creating conditions for more long-term investment.

As part of our review, we are proposing the following changes:

- The volatility adjustment: the recalibration of application ratios so that insurers are rewarded for holding illiquid liabilities.
- The risk margin: reducing its size and volatility, especially for the long-term liabilities, based on the fact that there is diversification of risk over time.
- Equity risk: reviewing the criteria for the ability to hold equity long-term, by making a link with long-term illiquid liabilities and taking into account that equity investments are managed on a portfolio basis rather than on an individual asset basis.

All of these adjustments will improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments.

Let me also add something about proportionality, which has always been an important element in Solvency II. Looking at the experience in the practical implementation of the regime, we believe that we can increase the use of proportionality.

We are therefore recommending a new process for applying and supervising the principle of proportionality. This includes clear risk-based quantitative criteria to identify low risk undertakings eligible for applying proportionality measures. These will capture not only the size but also the nature and complexity of the different risks and will provide legal certainty regarding the application of the proportionality principle. Undertakings complying with such criteria will be able, after a notification, to apply automatically a number of proportionality measures that – in the main – focus on governance and reporting.

Finally, we need to supplement the current microprudential framework with the macroprudential perspective (including the introduction of specific tools and measures), as well as the need to develop a minimum harmonised recovery and resolution framework and achieve a minimum harmonisation in the field of insurance guarantee schemes.

We are not changing the fundamentals of the framework. That was never our intention. The regime works well, but if we are to emerge from this crisis with a strong insurance sector that fulfils its role in society, we have to make sure that regime continues to work well in the “new normal”.

Our view is that our Opinion proposes measures that will keep the regime fit for purpose by introducing a balanced update of the regulatory framework, reflecting better the economic situation and completing the missing elements from the regulatory toolbox.

At the end of the day, Solvency II is here to protect the consumer. In our review, it was important for us not to lose sight of this fundamental objective. Our balanced approach ensures that policyholders will remain protected in these challenging times.

Thank you very much.