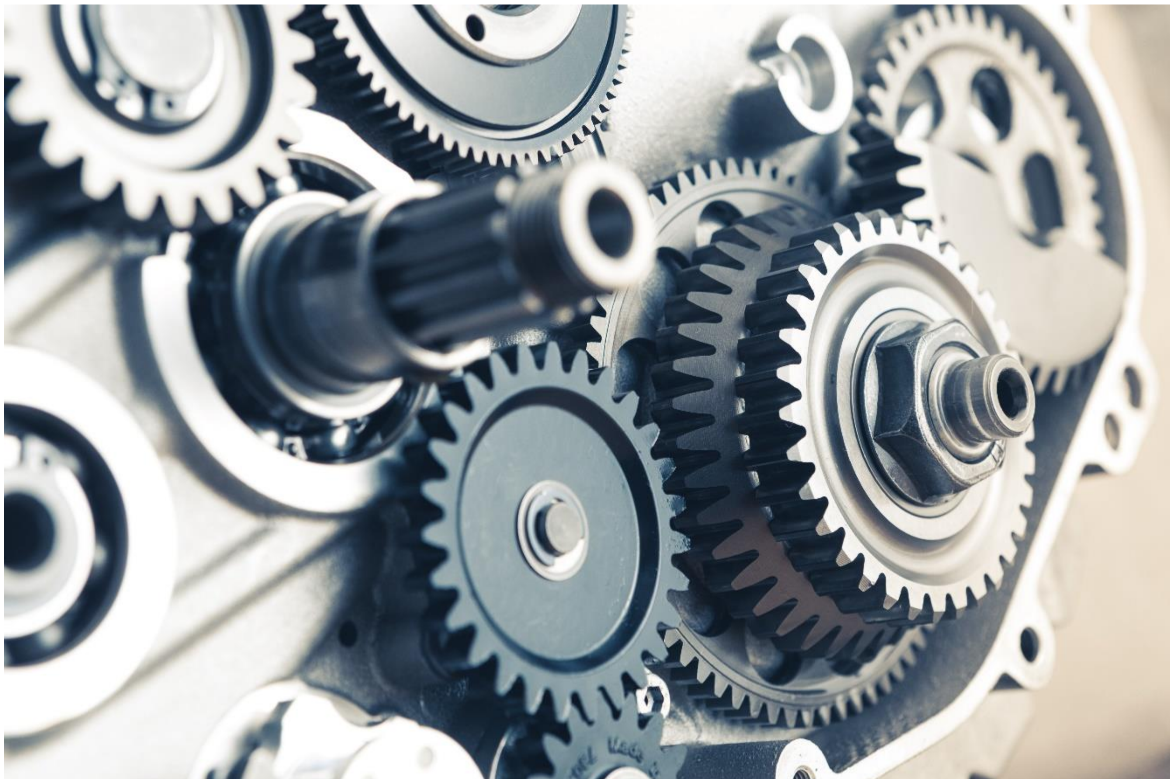
Position paper

Solvency II review: How to get the balance right



January 2021

DUTCH ASSOCIATION OF INSURERS

Key messages

Solvency II is already the most prudent regulatory regime for insurers in the world. The current high capital requirements are designed to make sure that insurers are able to fulfil their obligations to clients. The Dutch Association of Insurers sees no reason for further increase of the capital requirements. Imposing unnecessarily high buffers will lead to higher premiums for clients. Solvency II tries to exclude almost all possible risks by requiring insurers to hold (additional) (buffer) capital in the event of an (extreme) risk. But **increasing capital requirements** would result in additional costs, which, **ultimately would have to be paid by policyholders.** Instead, insurers should be enabled to offer their clients more long-term saving products and to invest the premiums they receive in green recovery of the European economy after the COVID-19 pandemic.

Solvency II, the European insurance regulation framework, is a modern, risk-based supervisory regime that was introduced in 2016 and is currently under a general review. The experience of the past years, including the COVID-19 crisis with its severe economic disruptions, has confirmed that **Solvency II is in principle effective**. With its high level of security it fulfils its purpose to protect the policyholders.

As such, the Dutch Association of Insurers sees **no reason for further increase of the capital requirements**. Instead, insurers should be enabled to offer their clients **more long-term saving products** and to invest the premiums they receive in **green recovery of the European economy** after the COVID-19 pandemic.

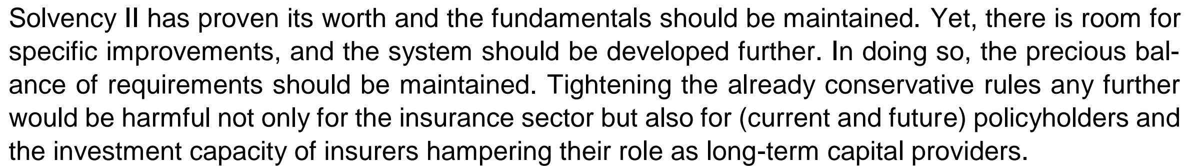
- In general, insurers are positive about Solvency II. The system helps insurers better identify and value risks. However, the Dutch Association of Insurers believes there is room for specific improvements. In short, the Association makes the following proposals:
- To avoid a distortion of competition, it is important that the objectives of the review are met both on a European level and for each type of insurer and each Member State. In particular, **it should be avoided that the review leads to a detrimental outcome for insurers offering long-term (risk) guarantees and long-term financing**. Both are urgently required to address the current social, economic and political challenges.
- The current Solvency rules do not sufficiently take into account the fact that life insurers hold the invested capital for a long period of time and therefore run less short-term risk. **Excessive artificial volatility could hinder insurers from offering products with long-term guarantees and from contributing to the long-term funding of the European economy.** The rules should reflect the actual risk profile of the insurers in a going concern. For this reason, improvements of Solvency II should include a more effective Volatility Adjustment. Insurers should be able to calculate this mechanism as much as possible on the basis of their own investment portfolio and the associated risks. This approach can help to **accelerate sustainable investments by insurers.**
- It is important to ensure that, insurance companies, do not face requirements that are disproportionate. Therefore, we propose introducing **a proportionality toolbox and individual proportionality measures**. This allows low-risk insurers to automatically apply (a list of) proportionate measures without an additional approval of the supervisor.

In this paper, we will provide more information about these and other issues within Solvency II.

Summary

This position paper represents the preliminary high level comments of the Dutch Association of Insurers. Due to the complexity of the matters addressed in the opinion and the extensive background documentation, we expect that we may have further detailed comments upon detailed analysis of the documentation. We stand available to discuss matters in more technical detail with the European Commission, as appropriate.

Dutch insurers are in favour of a good prudential regime that provides a clear balance between the interest of current policyholders (=assessing the risks on the balance sheet which could endanger these interests) and providing insurance solutions to future policyholders, or in other words, between hedging risks on the one hand and providing affordable products to clients on the other.



Solvency II has proven its worth and the fundamentals should be maintained. Yet, there is room for specific improvements, and the system should be developed further. In doing so, the precious balance of requirements should be maintained. Tightening the already conservative rules any further would be harmful not only for the insurance sector but also for (current and future) policyholders and the investment capacity of insurers hampering their role as long-term capital providers.

If it is done right, this review can also provide a significant economic stimulus. With their very long-term business model built on reliability, insurers are an anchor of stability in the financial world, which has incentives to be driven by short-termism. For their policyholders, insurers in general accumulate capital on a large scale and invest trillions of euros across Europe. The Solvency II review offers the chance to harness this huge potential even more by **supporting the Capital Markets Union, the European Green Deal, the enhancement of Europe's international competitiveness, the promotion of digital finance and the economic recovery after COVID-19**. If unjustified obstacles to investment are removed and the strict risk orientation is maintained, the Solvency II review provides a unique opportunity that should be seized. In order to keep their policyholders safe in adverse (economic) circumstances and to contribute to a future-proof Europe, the Dutch insurance sector recommends that the Solvency II review be guided by three basic principles:

- ✓ **Avoiding unjustified (artificial) volatility**
- ✓ **Reflect the actual risk profile of the insurers in a going concern**
- ✓ **Proportionality ensuring a balance between cost and benefit**

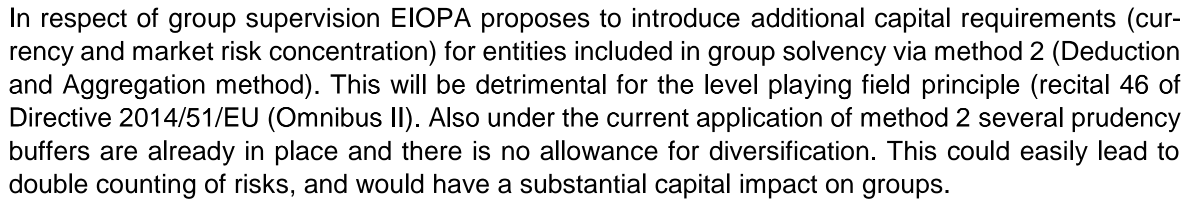
Besides this, the legislation should remain principle based and not become rules based.

The solvency position of insurers should be robust, now and in the future. There should be a kind of predictability in the development of the solvency position. For this, the solvency ratios must not be distorted by large short-term fluctuations. **Artificial volatility** of solvency positions could force insurers to act more pro-cyclically and short-term oriented, contrary to the insurance business model with its long-term illiquid liabilities. Generally, excessive artificial volatility could hinder insurers both from offering products with long-term guarantees for the sake of consumers and from contributing to the long-term funding of the European economy. These adverse effects need to be avoided.

Capital requirements should **reflect the actual underlying risks** of insurers realistically. A better quantification of actual risks could help make insurers more resilient to shocks. The quantitative requirements of Solvency II are assessed in a going concern situation. This implies, the insurer stays in business as an insurer. The balance sheet and the capital requirements are based on this assumption. Therefore, risks must be neither underestimated nor overestimated, because both cases could lead to wrong incentives and, as a consequence, to misallocations that endanger the security and the benefit of policyholders. Overestimation of risks could even hinder insurers from offering certain products and from investing in certain asset classes at all. Regulation that leads to excessive capital charges from an actual risk perspective and going concern perspective should, thus, be corrected or not be introduced in the first place.

The risk profile of an insurer also dictates the extent of supervisory attention and the ability to **apply Solvency II in a proportional manner**. Regulation costs money to implement and maintain and that needs to be proportionate to the risks and the level of policyholder protection that is demanded. If the risk profile of an insurer is lower, the requirements should be simpler while ensuring a same level of protection to policyholders.

To avoid a distortion of the competitive landscape in Europe, it is important that the objectives of the review are met both on a European level and for each type of insurer (Life/Non-Life/Health) and each Member State. In particular, it should be avoided that the review leads to a detrimental outcome for insurers with long term liabilities or insurers willing to provide these solutions to the consumers. These insurers provide long-term financing. Both are urgently required to address the current social, economic and political challenges.



In respect of group supervision EIOPA proposes to introduce additional capital requirements (currency and market risk concentration) for entities included in group solvency via method 2 (Deduction and Aggregation method). This will be detrimental for the level playing field principle (recital 46 of Directive 2014/51/EU (Omnibus II). Also under the current application of method 2 several prudency buffers are already in place and there is no allowance for diversification. This could easily lead to double counting of risks, and would have a substantial capital impact on groups.

Please note that the EIOPA impact assessment document mentions in paragraph 9.84 of the Background Impact Assessment document that on individual group level this consideration would not give rise to impacts of more than 5% point on the ratio. However we expect that this underestimates the impact, which is expected, in individual cases to be significantly higher. In the impact assessment that did cover group supervision (data call that was submitted January 2020), groups used qualitative fields to argue they are strongly against the introduction of these charges and did not necessarily submit the actual material financial impact it would have. As such the impact assessment does not appear to reflect the actual impact in reality.

An additional concern is that in the draft technical advice, EIOPA suggested to consider Expected Profits in Future Premiums (EPIFPs) as unavailable by default at group level. We believe this is inappropriate and does not reflect economic reality. The proposals in the EIOPA Opinion have improved somewhat. The assumption is no longer unavailability, but availability should be justified by the undertaking, We believe the current treatment as unrestricted tier 1 items should remain unchanged. The requirement to justify availability can lead to an inconsistent treatment of this item between member states, because it will be up to the local NSA to allow EPIFPs at group level.

According to chapter 7 of the EIOPA Opinion (paragraph 7.2) EIOPA proposes to subject the balance sheet of individual insurance entities, as well as the consolidated balance sheet of insurance groups to an audit requirement. We are concerned that in a group context this might subject subsidiaries that are not audited on a stand-alone basis indirectly to audit as well. This creates potentially substantial additional administrative burdens for such subsidiaries, compared to entities that do not form part of Solvency II groups in these jurisdictions. This is also contrary to the principle of equivalence.

The capital requirements under Solvency II form a solid protection against the failure of an insurance company. Should an insurer nevertheless become insolvent, there are various solutions for additional protection of the interests of policyholders. In the Netherlands there is a system of recovery and resolution (R&R) in place, designed to minimise any potential losses of policyholders in such a situation. Other member states have Insurance guarantee schemes (IGS) which serve a similar purpose. We believe **the leading principle should be that each member state has a system that protects the interests of consumers in case an insurer becomes insolvent**. This means that member states should be free to decide which tool is most appropriate for their market to deliver this protection. We believe that a recovery and resolution scheme is cheaper and more effective as a safety net for policyholders than an insurance guarantee scheme.

1. Quantitative requirements

- **The Dutch Association of Insurers sees no reason to increase capital requirements and further negatively impact the capital positions of insurers.**

Raising capital requirements, as several of EIOPA's proposals indicate, would have consequences for all stakeholders, especially the policyholders. Solvency II is one of the strictest regimes of capital requirements for insurers in the world and is designed to enable insurers to fulfil their obligations to policyholders. The regime ensures that insurers hold capital to absorb pre-defined 1 in 200 years events. Increasing capital requirements will have to be financed by the insurer. Depending on the type of insurer policyholders and/or shareholders will be impacted. This will lead to higher premiums for the policyholders, lower dividends for shareholders, issuance of additional share capital or bonds, de-risking and lower returns. From an investment point of view, the insurance sector will become less attractive to invest in (likely leading to higher costs of capital and thus likely leading to higher premiums), de-risking can also imply that insurers are less able to invest in new and sustainable products.

1.1. Extrapolation and the Risk-Free Interest rate

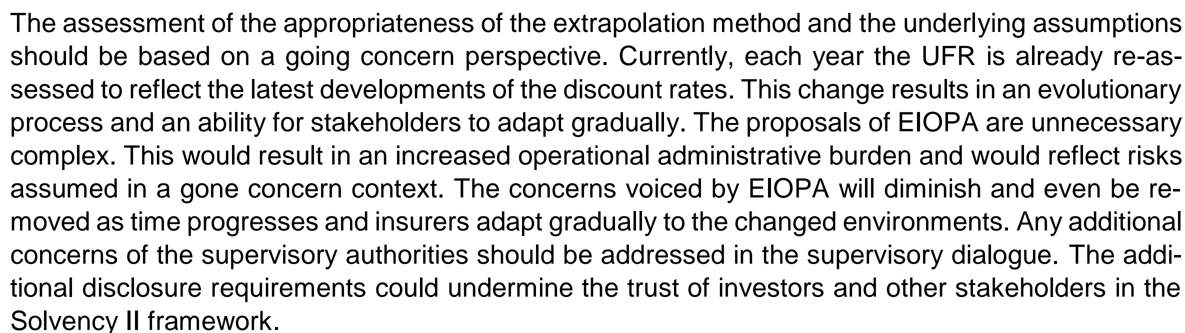
- **The current criteria for the Last Liquid Point are adequate.**
- **No change in the extrapolation method is warranted.**

For life insurers, which often have very long-term obligations, Solvency II's risk-free interest rate term structure is the main driver of their solvency position. This is also true for funeral insurers and disability insurers. Hence, in order to get robust solvency results, it is crucial that this yield curve is based on reliable data stemming from sufficiently deep and liquid markets. At the long end, where there are no longer sufficient volumes of transactions to find a market price based on bond/loan transactions, the curve must be extrapolated. For the euro, the last liquid point (LLP), where extrapolation starts, is currently at the maturity of 20 years. During the design of the Risk-Free Interest rate methodology, the European legislators required the extrapolation to be such that the longer term maturities were exempted from the short term market volatility. Changing the extrapolation should take this key element into consideration.

The insurers generally have an Asset and Liability Management (ALM) process in place. This ALM process ensures that the insurer has sufficient assets backing the insurance liabilities ensuring the interest of the policyholders are met. This is also a required by the Solvency II legislation. The constructions of the Risk-Free Interest rate currently matches these objectives by including the matching (sufficient bonds and loans available to back the insurance liabilities) and residual criteria (is there sufficient liquidity in the markets).

In the ALM, insurers already have to cope with a decreasing Ultimate Forward Rate (UFR). At the start of Solvency II the UFR was fixed at 4.2%. The calibration of Solvency II was based on an interest rate with a fixed UFR. EIOPA has changed the methodology to derive the UFR, as a result of which the UFR has been reduced to 3.75% (2020) and will be reduced even further to cope with the current low interest rate environment. The new methodology ensures that the UFR cannot change by more than 15 basis points per annum.

The advantage of this gradual change of max 0.15% is that insurers can gradually rebalance their capital to take account of the changes in the UFR. A faster, larger adjustment than this annual change would put sudden and high pressure on insurers as it would require them to rebalance the capital needs in a more dramatic manner resulting in more procyclical measures.
Currently, bond and derivatives markets both have to be deep and liquid. That is a legal requirement in Solvency II. For non-extrapolated maturities, insurers must be able to match their obligations with bonds. The main reference to the bond market best reflects reality and should definitely be maintained. In our opinion these criteria result in appropriate ALM and avoid an unnecessary reliance of derivative markets where this is not appropriate (risk management).



The assessment of the appropriateness of the extrapolation method and the underlying assumptions should be based on a going concern perspective. Currently, each year the UFR is already re-assessed to reflect the latest developments of the discount rates. This change results in an evolutionary process and an ability for stakeholders to adapt gradually. The proposals of EIOPA are unnecessary complex. This would result in an increased operational administrative burden and would reflect risks assumed in a gone concern context. The concerns voiced by EIOPA will diminish and even be removed as time progresses and insurers adapt gradually to the changed environments. Any additional concerns of the supervisory authorities should be addressed in the supervisory dialogue. The additional disclosure requirements could undermine the trust of investors and other stakeholders in the Solvency II framework.

1.2. Volatility Adjustment

- **The effectiveness of the Volatility Adjustment (VA) should be increased while minimising the artificial volatility.**
- **The VA should be calculated without unjustified deductions and be applied to all terms. We believe additional restrictions to the use of the dynamic VA in internal models are not required.**
- **A dynamic VA should be applicable to internal models and the standard formula.**
- **It should be allowed to calculate the VA on the basis of the own investments of the insurer.**

As stated in the recitals of the legislation which introduced the VA, the VA should mitigate the effects of short-term exaggerations of bond spreads. As bonds held to maturity are de facto only subject to some default risk, temporary spread fluctuations for other reasons must not be translated directly into artificial volatility of solvency positions.

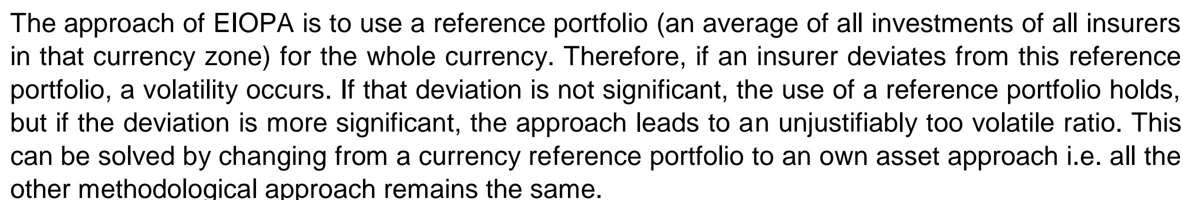
However, under the current rules, this is what happens. The VA is a function of the risk corrected spreads times an application ratio of 65% (= 65% of the outcome of the calculation is used, not 100%). If certain triggers are met a country adjustment kicks in. Since 2016, EIOPA submitted a report with respect to the functioning of the VA. In this report EIOPA mentioned that they did not witness any wrongdoings or strange behaviours of insurers due to the use of the VA. As part of the review 2020, EIOPA put forward some proposals for a change in the calculation method of the VA, to address some flaws.

EIOPA introduced a liquidity ratio, a duration ratio, a scaling factor, adjusted the risk corrected spread and adjusted the general application ratio upwards to 85%. The new approach of EIOPA was tested in two holistic impact assessments. From this assessment and the experience of the market behaviour following the COVID-19 crisis, it can be seen that EIOPA's proposals are actually **pro-cyclical and do not mitigate** the exaggeration of the spread movements, which is the objective of the VA. For Dutch insurers, EIOPA's current proposals **do not adequately reduce the artificial volatility** of the Solvency ratio. Dutch insurers were experiencing under- and overshooting.

Own asset approach within VA

EIOPA advises the European Commission to change the calculation of the VA into a sequence of multiple ratios. EIOPA's approach is more complex, does not result in a more effective measure for long-term insurance solutions, and is flawed with respect to some elements.

In the background documentation EIOPA lists various flaws which are addressed by their proposed formula but still insists that a haircut is needed in the form of the general application ratio. EIOPA introduced a liquidity ratio to reduce the benefits of using the VA. However, the issue is the ability to avoid forced sales in a "normal" situation as presented on the economic balance sheet. EIOPA changes the manner in which the risk correction is to be calculated. EIOPA introduces a dependency towards the movement of spreads. This introduction is actually contrary to the wishes of the European Commission to reduce reliance on credit rating agencies (see the External Credit Assessment Institutions regulation). Also the calibration of the approach of EIOPA is too conservative. The industry has provided evidence to this, which has been disregarded. In our opinion, the approach of EIOPA will not work in stressed circumstances.



The approach of EIOPA is to use a reference portfolio (an average of all investments of all insurers in that currency zone) for the whole currency. Therefore, if an insurer deviates from this reference portfolio, a volatility occurs. If that deviation is not significant, the use of a reference portfolio holds, but if the deviation is more significant, the approach leads to an unjustifiably too volatile ratio. This can be solved by changing from a currency reference portfolio to an own asset approach i.e. all the other methodological approach remains the same.

The Dutch Association of Insurers would prefer an approach in which the default is the currency reference portfolio and if appropriate a country adjustment. However, **if the deviation of the credit quality of the investment portfolio is too significant**, the insurer can, after agreement of the competent authority, use the **own assets** as the basis for the calculations ensuring a minimised artificial volatility and ability for a proper risk management and investment management according to the actual risk profile.

The formula to calculate the VA should reflect the ALM approach, the risk profile of the insurers in general, the long-term perspective of insurers (including going concern) and the ability to avoid forced sales.
In the methodology applied by EIOPA to determine the VA (current and proposal), sufficient acknowledgement should be given to the **risk properties of residential mortgage loans**. In the Netherlands, mortgage loans form a significant part of the investment mix backing the insurance liabilities. The risk properties are such that cash flows are have a high level of certainty. In the credit crisis, the euro crisis and the current COVID-19 crisis, the mortgage loans have performed quite well with **very low defaults**. In the current methodology, the mortgage loans are not treated as a separate class. The Dutch insurers are of the opinion that a separate class is needed. The data gathered by the European Central Bank could be used to construct an index for reference.
Thus, the Dutch Association of Insurers believes that insurers should, if they wish following their risk profile and after agreement with their supervisor, be able to calculate the VA as much as possible on the basis of their own investment portfolio and the associated risks, instead of that of the average European insurer in the currency zone. This allows insurers to compete on the basis of the quality of their investments. Of course, if there are no controls on this measure, insurers could “play the system” by intentionally investing in riskier assets, to increase their company VA. But fortunately, the Solvency II legislation has provided supervisors with a large number of powers to counter such an undesirable way of thinking and the introduction of a pre-agreement before introduction of the own asset VA would mitigate that risk fully.

Dynamic Volatility Adjustment
In line with article 105 (5)(d) of the Solvency II directive, the change in spreads has to be applied to the total balance sheet of an insurer. Therefore, if a VA is used, this should also be extended in the spread risk module i.e. the **introduction of a dynamic volatility adjustment** (DVA) for standard formula users, in the same way as it currently works for insurers which use an internal model. By the use of the DVA, the actual risks faced by insurers with respect to the bonds and loans is addressed, which is the default risk. An insurer does not maintain bonds and loans on its balance sheet as a (day) trader, but recognises these assets as part of its ALM.

Insurers using a dynamic volatility adjustment in their internal model have to demonstrate in advance that their model determines an appropriate solvency capital requirement with appropriate risk management incentives. The review and approval of these internal models by the national competent authorities provides assurance that these requirements are met. There is therefore **no need for additional restrictions such as the enhanced prudency principle to limit the effectiveness of the dynamic volatility adjustment**. Indeed, there is a possibility that internal models will not be adequate after the application of the enhanced prudency principle leading to unnecessary model re-developments or other unintended consequences.

1.3. Risk margin

- **The inputs and the methodology of the risk margin should reflect the market circumstances and the risk properties.**

The industry has argued in the past why it is justified to reduce the Cost-of-Capital factor and adjust the formula to calculate the risk margin. In the calculation of technical provisions, a risk margin is added to the best estimate. The risk margin is included in the capital requirements to provide for easy transfer of the insurance portfolio to another insurance company, in case that insurance company gets into difficulties. It is a kind of dowry, which pre-finances any future capital requirements that follow from the best estimate of the insurance liabilities.

This additional buffer is rather high and contributes disproportionately to the volatility of technical provisions (due to the high sensitivity to interest rates) and own funds. The calculation is based on a fixed Cost-of-Capital factor of 6%, that is currently in the Solvency II directive. The Cost-of-Capital is based on the economic environment in 2006-2008 and has not been revisited. We are therefore of the opinion that the 6% is too high, no longer appropriate and cannot be substantiated.

In our opinion, the Cost-of-Capital factor should be reduced and if possible a procedure for adjustment of this factor should be designed. As a fallback solution, a reduction of the risk margin by EIOPA's lambda factor might be conceivable if its effect is strong enough and not capped for longer maturities. This approach reduces the interest rate sensitivity somewhat, which is preferred. See for other arguments also documents provided by Insurance Europe and the CRO Forum.

2. Accelerate sustainable investments

- **An own asset VA helps accelerate sustainable investments by insurers.**

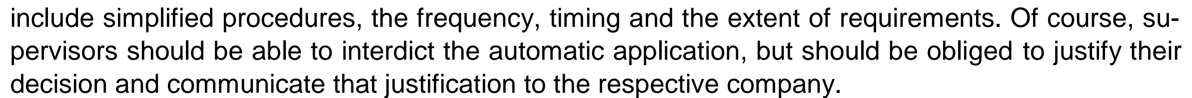
Insurers have the ambition to invest more and more in green investments. However, the speed of the increase of these investments could be enhanced by the proper treatment of these investments. The own asset VA mentioned earlier can be used to this end. Imagine how long it would take before green investments are a significant proportion of the VA reference portfolio across the currency zone, which, again, represents an average of all investments of all insurers. If an insurer decides to invest in green assets, this will therefore result in a **deviation of the individual insurer's investment portfolio from the reference portfolio**. This could deter insurers to invest sustainably, as the risk return of the reference portfolio is not properly reflected. This could be avoided with an own asset VA, which would allow for a proper inclusion of the green investments in individual insurers investment portfolios. This would remove a big disincentive for insurers to invest in green opportunities and contribute to the goals set out in the European Green Deal.

3. Improving proportionality

- **The application of proportionality should be partly automated via the proportionality toolbox.**
- **The quality of supervisory dialogue should be improved.**
- **The application of proportionality should be monitored and evaluated.**

A wider and more consistent application will generate advantages for policyholders (increased security, more diverse supply of insurance products), supervisors (stronger risk-sensitive approach) as well as insurance companies (reduced compliance costs and better future solvency). The basic conditions to realize these mutual gains are a risk-based approach, simple and clear regulations, and mutual accountability. In general, all companies should be able to apply proportionate measures based on their risk profile.

A toolbox should be introduced to automate the application of proportionality and reduce transaction costs and legal uncertainty for supervisors and insurers. Based on pre-defined risk-based criteria (such as the solvency ratio and its volatility as well as systemic relevance), **low-risk insurers should be allowed to automatically apply a non-exhaustive list of proportionate measures without an additional approval of the supervisor**. This list should cover all three pillars of Solvency II and



include simplified procedures, the frequency, timing and the extent of requirements. Of course, supervisors should be able to interdict the automatic application, but should be obliged to justify their decision and communicate that justification to the respective company.
While constructive supervisory dialogue is key to find individual solutions for proportionate measures, companies and supervisors occasionally report on difficulties. Hence, supervisors should establish clear and transparent procedures.

As a complementary action, regular evaluations will identify areas of improvement and initiate institutional learning. Thus, EIOPA's Advisory Committee on Proportionality should publish an annual report about the application of proportionality.

In this context we have developed the following proposals:

- Simplified standard formula. Reverse the burden of proof when applying the simplified standard formula and leave the choice up to the insurer. In the standard formula for calculating the Solvency Capital Requirement (SCR), EIOPA has drawn up a simplified formula for most risk modules. An insurer may currently apply this formula if it can demonstrate that the results do not differ materially from the standard formula. We want the supervisor to demonstrate the reverse.

- Exemption from quarterly and semi-annual reporting. Reverse the conditions for exemption from Quantitative Reporting Templates (QRTs) for quarterly and semi-annual statements: if the insurer is in excellent condition, an insurer does not need approval from a national supervisory authority to be exempt from the quarterly and annual QRTs.

- One report – one addressee. The Solvency and Financial Condition Report (SFCR) should be divided into a short report for policyholders ("Two-Pager") and a separate, purely quantitative report for the professional public. The SFCR in its current form, addressing user groups with completely differing requirements at the same time, is not expedient. We propose to follow the EIOPA's proposal to split the SFCR into a concise, easily understandable narrative report for policyholders (so called "Two-Pager") and a purely quantitative report for the professional public containing only relevant data. These data should only be based on the already published QRTs. The publication of additional quantitative data as well as a narrative explanation should not be required, as the professional public possesses the necessary expert knowledge to draw relevant information directly from raw data.

- Limited SFCR for unlisted insurers and captives. For insurers that do not operate in capital markets (i.e. they have not issued shares or bonds for public trading), the obligation to produce a professional SFCR should be cancelled. The document for policyholders does however, remain obligatory.

- An insurer with a low risk profile means an insurer who does not sell complicated products. By complicated products we mean mainly liability insurance.

- Simplified ORSA. Allow insurers with a low risk profile to fill out the ORSA using a set of questions formulated by EIOPA (following the example of the Irish supervisory authority).

- No actuary for short-term policies with a low risk profile. Non-life insurers with a low risk profile only need an actuary for policies with a term of more than four years.

- Extend reporting deadlines for insurers with a low risk profile. This will ensure that insurers with limited resources do not need to compete for expensive accountants and actuaries who are scarce within the reporting period.

- Statistically non-significant insurers. Where small insurers' policies have no impact on industry results, their obligation to fill in data in the QRTs used only for statistical purposes can be cancelled.

4. Recovery and resolution

- **Minimum harmonisation of recovery and resolution regimes is an essential pre-condition to determine the need and design of insurance guarantee schemes.**

In regard to protecting clients in the event of an insurer's bankruptcy, we have taken an important step in the Netherlands in the past few years. The Dutch Recovery and Resolution (Insurers) Act stipulates that (subject to proportionality) every insurer that has to comply with Solvency II must draw up a preparatory crisis plan. This plan is subsequently approved by *De Nederlandsche Bank* (DNB). DNB also draws up a resolution plan for large Dutch life insurers. In this way, Dutch law already largely meets the objectives set out in the relevant proposals of EIOPA's technical advice. .

Preparatory crisis plan and resolution plan

A preparatory crisis plan ensures that in financially healthy times, an insurer assesses the measures which could be taken in case of a (threatening) breach of the SCR or the MCR to get the insurer back on track. The aim of the plan is to investigate and provide solutions for possible crises and describes the financial, operational and legal feasibility of these solutions. Proper preparation enables the insurer to immediately take measures in the event of financial problems. If the measures do not or insufficiently improve the position of the insurer, DNB takes the insurer into resolution or the insurer will go bankrupt.

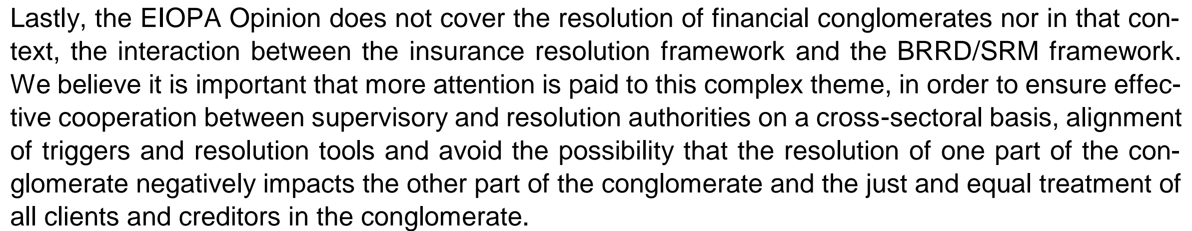
A resolution plan describes how DNB intends to orderly resolve an insurer or an insurance group instead of liquidate the insurer or insurance group in ordinary bankruptcy. It describes the instruments DNB intends to use in resolution and helps to identify which obstacles there are to the effective implementation of the resolution strategy. DNB assesses ex ante the resolvability of the insurer or insurance group and may require the insurer to take specific measures to remove obstacles that prevent effective resolution.

In its technical advice, EIOPA proposes to introduce a number of preventive measures, in addition to the recovery plan (preparatory crisis plan). We strongly doubt if this is useful and necessary. In case of a threatening breach of the SCR or the MCR, we believe the emphasis should be on the swift execution of the recovery plan by the undertaking, instead of other measures taken by the supervisory authorities in this phase or prior to that phase. We do believe that the execution of the recovery plan could already be triggered by a *threatening* breach of the SCR (in addition to an actual breach), which is earlier than provided for in the EIOPA Technical Advice.

Furthermore, EIOPA proposes to allow for resolution *before* an insurer becomes balance-sheet or cashflow insolvent. We believe this is not the correct trigger moment. We believe resolution should be seen as *an alternative* to liquidation in bankruptcy, for which the same trigger should be used. Moreover, we believe the notions of balance-sheet and cash-flow insolvency are primarily relevant for the resolution of other (non-insurance) entities in the context of insurance-resolution. We suggest to reword these conditions as proposed in appendix 2.

EIOPA distinguishes in the technical advice between rules-based and judgement-based triggers for recovery and for resolution. This creates the suggestion that rules-based triggers are necessarily 'automatic' and restrict supervisory discretion. We do not believe this is correct. A rules-based trigger such as 'failure or *likely to fail'* inherently includes supervisory discretion and provides sufficient room for supervisors or resolution authorities to act in a timely manner. Triggers should be clear for all stakeholders.

EIOPA lists a number of objectives for resolution, without ex ante ranking these objectives. We believe that, in line with recital 21 of the Solvency II Directive and articles 27 and 28, the objective of resolution should always be policyholder protection in combination with one of the other objectives (such as financial stability). We cannot imagine a situation where an insurer is resolved where policyholder protection is not the primary objective.



Lastly, the EIOPA Opinion does not cover the resolution of financial conglomerates nor in that context, the interaction between the insurance resolution framework and the BRRD/SRM framework. We believe it is important that more attention is paid to this complex theme, in order to ensure effective cooperation between supervisory and resolution authorities on a cross-sectoral basis, alignment of triggers and resolution tools and avoid the possibility that the resolution of one part of the conglomerate negatively impacts the other part of the conglomerate and the just and equal treatment of all clients and creditors in the conglomerate.

Safety nets to protect clients
At a European level, discussions are taking place about the possible minimum harmonisation of so-called Insurance Guarantee Schemes (IGSs). Such a scheme is a last possibility for consumers to receive payment when an insurer is unable to fulfil its contractual obligations.

According to the Dutch Bankruptcy Act, a trustee in bankruptcy uses the assets backing the technical provisions, as well as the remaining capital buffer to pay out policyholders and beneficiaries. before other creditors are being paid. , according to the Dutch Association of Insurers. It should be noted that an insurer fails when it breaches its MCR, which could well mean that the technical provisions are still fully covered by assets and there might even be a capital buffer above the technical provisions. This means that, even in a bankruptcy but certainly in an orderly resolution scenario policyholders have a good prospect to incur no or only limited losses.

Apart from this, the Dutch Association of Insurers believes that such a development should be seen in a broader context. Ultimately, what matters is how well clients are protected "below the line" with the help of the regular Solvency II. We are in favour of also including the recovery & resolution (R&R) framework in the discussion about an IGS. In our opinion, R&R and IGS are actually communicating vessels. If there is a properly arranged R&R (as is the case in the Netherlands) there is no reason for an IGS. A good R&R framework reduces the need for an IGS. In addition, an IGS is expensive, because insurers have to allocate capital for fund formation. This is reflected in the premium paid by the client. Furthermore, it is not necessary, because where insurers are concerned, the risk of a run on insurers is remote.

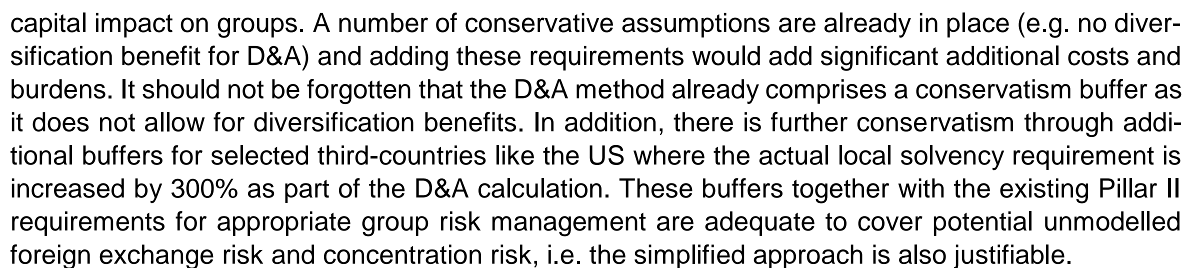
The Dutch Association of Insurers believes that, if a minimum harmonised framework for insurance guarantee schemes would be developed at European level, a fundamental discussion about the level of protection should be conducted. This is a complex discussion, but necessary to develop a fair system that safeguards a level playing field. The level of protection that a policyholder enjoys under an IGS depends for instance also on the manner in which an insurer is resolved.

Furthermore, the Dutch Association of Insurers believes that the funding of orderly resolution should be considered to be a full alternative to direct compensation of policyholders. For instance, the orderly run-off in resolution or a portfolio transfer could lead to better and more efficient outcomes for policyholders than directly compensating policyholders out of an insurance guarantee scheme.

We are surprised by the observation of EIOPA in paragraph 13.83 of the background analysis that funding costs of IGSs that directly compensate policyholders are lower than IGSs that facilitate portfolio transfers. This is not in line with our analysis because a portfolio transfer in resolution should prevent that losses to policyholders occur. We have some questions as well on the table on pages 707-708. Are the amounts and percentages mentioned in this table reflecting the guarantee of the total exposure of policyholders to the insurer (similar to a DGS, where a deposit is guaranteed up to 100.000 euro), or a guarantee of the loss to the policyholder?

5. Group supervision

In EIOPA's proposals (paragraph 9.50) the addition of currency and concentration charges on undertakings aggregated with the Deduction and Aggregation method (D&A) is concerning, as it appears to be adding prudence where several prudent buffers are already in place. This could easily lead to additional double counting of risks which EIOPA tries to avoid, and would have a substantial



capital impact on groups. A number of conservative assumptions are already in place (e.g. no diversification benefit for D&A) and adding these requirements would add significant additional costs and burdens. It should not be forgotten that the D&A method already comprises a conservatism buffer as it does not allow for diversification benefits. In addition, there is further conservatism through additional buffers for selected third-countries like the US where the actual local solvency requirement is increased by 300% as part of the D&A calculation. These buffers together with the existing Pillar II requirements for appropriate group risk management are adequate to cover potential unmodelled foreign exchange risk and concentration risk, i.e. the simplified approach is also justifiable.

In the draft technical advice, EIOPA suggested to consider Expected Profits in Future Premiums (EPIFPs) as unavailable by default at group level. We believe this is inappropriate and does not reflect economic reality. The proposals in the EIOPA Opinion have improved somewhat. The assumption is no longer unavailability, but availability should be justified by the undertaking, We believe the current treatment as unrestricted tier 1 items should remain unchanged. The requirement to justify availability can lead to an inconsistent treatment of this item between member states, because it will be up to the local NSA to allow EPIFPs at group level.

The proposed measures can have a material negative effect on group solvency and the group SCR while at the same time diminishing the risk sensitivity of Solvency II. EPIFPs are the result of a valuation based on economic principles. They are fully recognised as unrestricted tier 1 items, and there is no justification for any changes.

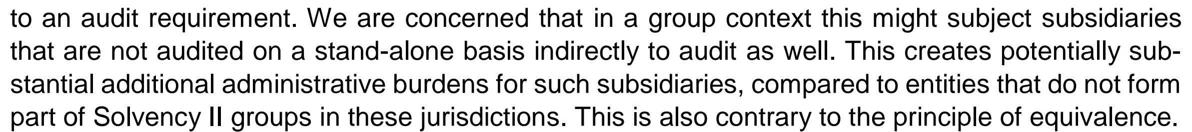
From an economic standpoint, the recognition of equity capital associated with future premiums on in-force business at group level is the natural consequence of their inclusion in the technical provisions and the build-up of an SCR to account for the associated risks. EPIFPs are an output of the economic valuation of the BEL (= the present value of expected future cash flows) and the level of EPIFP depends on each undertaking's risk profile. Uncertainties relating to future cash-flows are modelled in the best estimate and thus reflected in the amount of EPIFP. The best estimate is calculated based on an exit value notion. This suggests that the insurance contracts are transferred to a willing third party. The transfer includes all rights and liabilities of the relationship between policyholder and insurer. The third party will also assume the future premiums as part of the cash flows transferred. EPIFPs can be made available via several transactions. Moreover, unexpected events are already accounted for twice, in the risk margin and the SCR. There is no economic argument to go beyond the already high level of conservativeness included in Solvency II.

EIOPA advises (paragraph 9.101) to change the requirements with respect to the application of governance requirements to groups by no longer referring to the mutatis mutandis principle. The governance of a group is different from the governance of an individual insurance entity. In that respect we continue to believe that the mutatis mutandis principle provides the necessary flexibility to adjust the solo-governance requirements to the needs at group level. We doubt if the further articulation of group governance requirements at level 2 is helpful, due to the diversity of group structures, that might commend different solutions to group governance.

Financial conglomerates
Furthermore, we believe that Solvency II should refrain from setting specific and potentially diverging requirements in areas already covered by corporate law and general corporate governance requirements, for instance with respect to conflicts of interests, EIOPA advises the European Commission (paragraph 9.95) to clarify what should be included in the group solvency calculation as capital requirements for credit institutions, investment firms, and financial institutions. With respect to the requirements for credit institution pursuant to the Capital Requirements Directive and Capital Requirements Regulation, we believe the inclusion should be Pillar 1 and Pillar 2 required capital.

6. Audit of the SFCR information

According to chapter 7 of the EIOPA Opinion (paragraph 7.2) EIOPA proposes to subject the balance sheet of individual insurance entities, as well as the consolidated balance sheet of insurance groups



to an audit requirement. We are concerned that in a group context this might subject subsidiaries that are not audited on a stand-alone basis indirectly to audit as well. This creates potentially substantial additional administrative burdens for such subsidiaries, compared to entities that do not form part of Solvency II groups in these jurisdictions. This is also contrary to the principle of equivalence.

7. MCR

According to paragraph 6.9 of the EIOPA Opinion, EIOPA proposes that the *resolution authority* withdraws the license of the insurer in case of an irreparable breach of the MCR. In order to maintain consistency with ordinary bankruptcy proceedings, we believe it is more logical that the NCA withdraws the insurance licence, rather than the resolution authority.

Furthermore, EIOPA suggests that during resolution, the insurance entity remains subject to Solvency II requirements, without being specific about the requirements that the entity should continue to meet. It is unclear why the NCA continues to have a role in resolution, as opposed to ordinary bankruptcy proceedings and it is not clear which requirements the entity remains subject to. In any case it should be clear which requirements continue to be applicable in such a gone concern situation and we believe it would make sense to leave all activities in the resolution phase to the resolution authority.

Appendix 1
Solvency II: explanation of the European supervisory framework

Taking over risks from clients is the core business of insurers. A good understanding of the nature and extent of risks in order to know how much capital should be held to cover those risks is crucial for the adequate protection of insured parties. The European supervisory regime Solvency II provides an overview of risks and describes how insurers should take these risks into account in their balance sheet.

For the purpose of the Solvency II Directive (Directive 2009/138/EC), all risks were identified and assigned a weighting (risk premium). This risk premium determines how much capital an insurer must hold to be able to fulfil all its insurance obligations. In other words: is the insurer solvent (able to pay out amounts to its clients) or not? In addition, insurers must be able to cope with a "stressful situation", such as a financial crisis. As risk experts, insurers must be able to identify developments, explain them and adjust their policy where necessary. In short: Solvency II ensures that insurers look at future cash flows, events and market developments and take action for the benefit of the policy-holder/insured.

Risk-based

Solvency II aims to limit the risks in such a way that an insurer can only go bankrupt due to problems once every 200 years. Solvency II is based on all the relevant risks an insurance company may run, depending on the type of insurances. For a life insurer with long-term liabilities, these are, for example the longevity risk (the risk that an insured lives longer, than estimated on the basis of life expectancy) and the short-life risk (the risk that more insured persons die, than estimated on the basis of life expectancy). For a non-life insurer, these are, for example the risk of cancellation and the risk of disaster (extreme or unexpected events). In addition to industry-specific risks, there are more general market risks, such as interest rate developments.

ORSA: preparing for future risks

In addition, insurers must look ahead and make their own risk assessment, the so-called ORSA: Own Risk and Solvency Assessment. For insurers, ORSA means much more than just an assessment and a report. It is an integral process for the entire insurance business: line officers, risk managers, internal audit departments, legal & compliance, asset managers, and especially senior management. All risks are weighted, the risk profile and capital requirements are determined, as well as how the company intends to control the risks. In this way, the ORSA, just like the capital requirement, has an effect on product development, IT, pricing, the investment policy and so on. Insurers focus on all the relevant risks that may affect the insurer's business operations, the product range and the associated premium for clients.

Taking account of extreme peaks

The Solvency Capital Requirement (SCR) risk modules take account of pandemics, such as the influenza pandemic of 1918-1919, particularly relevant to, for example, the longevity and short-life risk modules. The other risk modules also provide for extreme, rare peaks in claims and are designed for the possibility of an insurer going bankrupt once every 200 years.

Glossary/list of abbreviations

ALM Asset and Liability Management

ECB European Central Bank

EIOPA European Insurance and Occupational Pensions Authority

DVA Dynamic Volatility Adjustment. An adjustment to the risk-free curve for illiquidity that is allowed to vary under stress (in contrast to VA).

LLP Last Liquid Point. From this point (currently 20 years), there is no longer a measurable market rate in a sufficiently liquid market and the "risk-free interest rate" is extrapolated to the UFR.

MCR Minimum Capital Requirement. This is 25 - 45% of the SCR. If this limit is undershot, the insurer is liquidated or sold by the supervisory authority.

ORSA Own Risk and Solvency Assessment, an ongoing assessment by the insurer of future risks related to the insurer's risk profile.

SCR Solvency Capital Requirement. This is the capital to be held by the insurer in order to continue to fulfil its obligations with 99.5% certainty within one year.

SFCR Solvency and Financial Condition Report. Insurers have to make this report annually and publish it. The report is based on the publicly available QRTs.

UFR Ultimate Forward Rate, the maximum risk-free interest rate. The UFR is calculated by EIOPA on the basis of the average capital market rate over the last 60 years.

VA Volatility Adjustment. A measure to ensure the appropriate treatment of insurance products with long-term guarantees under Solvency II. (Re)insurers are allowed to adjust the risk-free interest rate term structures to mitigate the effect of short-term volatility of bond spreads on their solvency position.

QRTs Quantitative Reporting Templates. Insurers have to use these to report data to their supervisor.

Appendix 2
Proposal for the conditions for insurance resolution

EIOPA proposal:

- The undertaking is in breach or likely to be in breach of the MCR and there is no reasonable prospect of compliance being restored;
- The undertaking is in breach or likely to be in breach of other prudential requirements (e.g. requirements on assets backing technical provisions), there is no reasonable prospect of compliance being restored and such non-compliance will likely lead to balance sheet or cash flow insolvency;
- There is a strong likelihood that a policyholders and/or creditors will not receive payments as they fall due.

Proposal Dutch Association of Insurers:

- The undertaking is in breach or likely to be in breach of the MCR, and/or in breach or likely to be in breach of other prudential requirements (e.g. requirements on assets backing technical provisions), there is no reasonable prospect of compliance being restored in such a manner that there are objective indications that this would justify a withdrawal of the insurance or reinsurance license in the near future;
- The liabilities of the undertaking exceed the assets of the undertaking or there are objective indications that the liabilities will exceed the assets of the undertaking in the near future that this will lead to balance-sheet insolvency;
- There are objective indications that creditors will not receive payments as they fall due.

This position paper can also be found on the website of the Dutch Association of Insurers:
www.verzekeraars.nl/dutch-association-of-insurers

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