European Commission

| INCEPTION IMPACT ASSESSMENT | |
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| Inception Impact Assessments aim to inform citizens and stakeholders about the Commission's plans in order to allow them to provide feedback on the intended initiative and to participate effectively in future consultation activities. Citizens and stakeholders are in particular invited to provide views on the Commission's understanding of the problem and possible solutions and to share any relevant information that they may have, including on possible impacts of the different options. | |
| **TITLE OF THE INITIATIVE** | Review of measures on taking up and pursuit of the insurance and reinsurance business (Solvency II). |
| **LEAD DG – RESPONSIBLE UNIT** | DG FISMA – Unit D4 |
| **LIKELY TYPE OF INITIATIVE** | Legislative proposal |
| **INDICATIVE PLANNING** | Q3 2021 |
| **ADDITIONAL INFORMATION** | https://ec.europa.eu/info/business-economy-euro/banking-and-finance/insurance-and-pensions/risk-management-and-supervision-insurance-companies-solvency-2_fr |
| **The Inception Impact Assessment is provided for information purposes only. It does not prejudge the final decision of the Commission on whether this initiative will be pursued or on its final content. All elements of the initiative described by the Inception Impact Assessment, including its timing, are subject to change.** | |

## A. Context, problem definition and subsidiarity check

### Context

Directive 2009/138/EC (hereafter "the Solvency II Directive") entered into application on 1 January 2016, replacing 14 existing Directives. It introduces a modern and harmonised framework for the taking-up of business and supervision of insurance and reinsurance companies in the Union. Through the definition of risk-based capital requirements, stricter governance and risk management rules and enhanced supervisory reporting and public disclosure across all EU Member States, it allows for a risk-based regulation, contributing to the dual objective of protecting insurers' clients (called "policyholders") and preserving the stability of the financial system.

The Solvency II review clauses[1] provide that the Commission should assess and, where necessary, make legislative proposals for changes on four areas of the framework, namely:

- the long-term guarantees measures and measures on equity risk;
- the standard formula solvency capital requirements;
- the minimum capital requirements; and
- group supervision and capital management within a group of insurance or reinsurance undertakings, in light of new developments in various areas including early intervention[2] and resolution[3] frameworks, as well as insurance guarantee schemes (IGSs)[4].

Beyond that minimum scope, based on the experience gained over the first years of implementation of the framework, as well as on feedback from stakeholders, other parts of the Solvency II framework have been identified by Commission services as deserving an assessment. The Commission's call for advice to the European Insurance and Occupational Pensions Authority (EIOPA) covers 19 topics. The objective is to conduct a holistic assessment of the

1 See Articles 77f, 111(3), 128(5) and 242 of the Solvency II Directive.

2 Early intervention is a stage where the solvency position of an insurer starts to deteriorate and where it is likely that it will continue to deteriorate and fall below the regulatory capital requirements if no remedial action is taken. The Solvency II Directive already contains some provisions mandating the supervisor to intervene early when deemed necessary, notably at group level, but those provisions are defined in broad terms, and do not introduce a common set of early intervention powers.

3 Resolution of insurers that are failing or likely to fail involves ensuring the continuity of the insurance contracts and the continuity of payment to policyholders as well as the liquidation of non-essential or substitutable services in an orderly, cost-efficient and timely manner, in ways which avoid any systemic impact on the real economy and/or financial stability

4 IGSs provide last-resort protection to policyholders. When insurers are unable to fulfil their contractual commitments, IGSs offer protection against the consequences of a failure of an insurance company. They can offer protection by paying compensation to policyholders or by ensuring the continuation of insurance contracts. Not all Member States have created such safety net for the protection of policyholders, and the features of existing IGSs widely differ.

main components of the framework, without changing its fundamental principles, including the reliance on a market-consistent valuation and on risk-based capital requirements.

As some of those topics are addressed in the Commission Delegated Regulation (EU) 2015/35, the review of Solvency II will require considering amendments of both the Solvency II Directive and its Delegated Regulation.

**Problem the initiative aims to tackle**[5]

The economic and financial conditions faced by insurers and reinsurers over the recent years and months, in particular in relation to interest rate risks and market volatility, significantly differ from those during which the Solvency II framework was initially designed.

Over the recent years, in line with the objectives of the Capital Markets Union, the European Commission has made several amendments to the Solvency II framework, aiming to facilitate insurers' financing of the real economy. Preferential treatments have been introduced in order to remove barriers to investments in infrastructure, in high-quality securitisation, in privately-placed debt and in long-term equities. However, many insurance stakeholders claim that prudential rules (including capital requirements for market risks and the risk margin) still hinder insurers' ability to contribute to the long-term funding of the economy in the EU. This will also be important for the recovery from the economic impact of the Covid-19 outbreak.

Despite the existence of several regulatory mechanisms (the so-called "long-term guarantee measures and the measures on equity risk") aiming at mitigating the unintended pro-cyclical effects of market-consistent valuations[6] and of the one-year time horizon underlying the calculation of capital requirements[7], the solvency position of insurers may be subject to volatility. If that volatility becomes excessive, it may hinder insurers' ability to offer products with long-term guarantees and may incentivize them to largely shift the risk to policyholders (via the distribution of unit-linked or index-linked products). This could question the sustainability of the traditional life insurance business. The ongoing Covid-19 crisis has led to heightened volatility in financial markets, drops in stock markets, rising spreads, and a series of rating downgrades by credit rating agencies. Under the recent economic and financial conditions, insurers and reinsurers's levels of capital have decreased compared to 2019 and may have been more volatile. However, so far, despite the crisis, they remain on average well above what is required by Solvency II[8].

Furthermore, over the recent years, insurers have been facing an unprecedented protracted low – and sometimes even negative – interest rate environment. Such market conditions progressively deteriorate insurance and reinsurance companies' profitability, but also directly affect insurers' solvency position. The current prudential framework does not actually capture the negative interest rates environment in the standard formula capital requirements, hence possibly underestimating the actual risk faced by insurers.

In addition to those economic challenges, there are changes to the factors affecting the riskiness of insurers' investments and of their liabilities, due to accelerating climate change and environment-related risks. The underwriting activities of insurance companies can also help increase the Union's resilience to sustainability risks, in particular when it comes to the physical risks and damage arising from natural catastrophes. However, while insurers are exposed to risks related to unsustainable economic development, both on the assets and liabilities side of their balance sheets, the prudential framework may not appropriately reflect those risks, hence not providing the right incentives. The sector, with its high investment capacity, could also better support the green economic transition launched by the European Green Deal.

Besides, in recent years, several failures of insurers operating cross-border occurred. National recovery and resolution regimes are mostly incomplete and uncoordinated, and the patchwork of national IGSs can lead to gaps and overlaps[9]. All this has led to suboptimal outcomes[10] and revealed supervisory shortcomings in terms of preparedness

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5 The effects of the ongoing Covid-19 crisis cannot be fully assessed at this stage, and new developments in the coming months might allow identifying other issues and deficiencies of the framework, which would need to be addressed as part of the review of the Solvency II Directive

6 Including pro-cyclical behaviours that might be generated by periods of short-term volatility of bond spreads at country level.

7 The Solvency Capital Requirement is the minimum amount of capital that an insurer needs to hold to be able to meet its obligations over the next 12 months, even in the case of an adverse event that is likely to occur only once every 200 years.

8 The weighted average solvency ratio of insurers in the European Economic Area (EEA) was 227 % at the end of the third quarter of 2019, to be compared with a regulatory requirement to have a solvency ratio of at least 100 %. Estimates of more recent solvency ratios have been informally provided by supervisory authorities and insurance federations, or were disclosed by some insurance groups.

9 This may be due for instance to different geographical coverages. In some cases, a national IGS from Member State A will only cover policyholders residing in that Member and not those residing in Member State B, even if all policyholders are insured with the same local insurers from Member State A operating cross-border in Member State B. In other cases, a national IGS from Member State A will cover all policyholders whose policy is sold by a domestic insurer from that Member State, but will not cover local policyholders who are clients of a foreign insurer (from Member State B) operating cross-border, for the

for crisis situations and policyholder protection. These issues may affect citizens' trust in the single insurance market and several gaps and legal uncertainties[11] in the framework may have led to diverging supervisory practices, possibly affecting the level-playing field in the single market.

Finally, Solvency II proves to be a complex framework, with limited possibilities in practice for simplification or waivers, in particular for smaller insurers. This generates high compliance costs that may not be always justified. The Directive explicitly embeds an overarching principle of proportionality in the application of all Solvency II rules: it implies that the effective application of the requirements should be commensurate to the nature, scale and complexity of the risks of each insurer. This means that in some cases, simplified calculations may be acceptable, or that some requirements (for instance, the frequency and scope of reporting) may be less strict for insurance companies with low risk profile. However, there are only a few concrete provisions in the framework which clarify whether and how to implement the proportionality principle in practice. Therefore, its application highly depends on supervisory judgement and discretion, which is limiting its effective and wide use. In addition, the current levels of the threshold (based on size) for exclusion from the scope of the Directive have not been reviewed since 2009.

**Basis for EU intervention (legal basis and subsidiarity check)**

The prudential requirements for insurance and reinsurance undertakings are already dealt with at EU level. The legal bases are Articles 50, 53, 62, and 114 of the Treaty on the Functioning of the European Union[12]. The review aims to assess, update, and where possible simplify existing EU rules governing the prudential framework, taking into account the current economic environment within the EU. This can best be achieved at EU level rather than by different national initiatives. National measures would have a limited scope and would subject undertakings in the Union to different sets of rules. They would create fragmentation and would not be as effective in ensuring financial stability as EU rules, with detrimental effects also on the provision of cross-border services by insurance companies. Indeed, the experience gained during the first years of implementation of the framework has shown that national differences remain, leading to legal uncertainty, supervisory shortcomings and possibly affecting the level-playing field.

The possible introduction of harmonisation in additional areas – for instance, regarding IGSs – would however need to take into account the features of existing national schemes in order to minimise the administrative and regulatory burden of such harmonisation and identify whether some of the disparities between national schemes need to be removed to improve policyholder protection and preserve the integrity of the single insurance market.

## B. Objectives and policy options

The objectives of Solvency II are the adequate protection of policyholders and beneficiaries, as well as to ensure the financial stability of the Union and fair and stable markets. While ensuring to preserve those overarching objectives, and taking into account the need to incentivise appropriate risk management practices by insurers, the initiative pursues five main purposes:

1. in view of the new economic environment and the objectives of the Capital Markets Union and of the European Green Deal, mitigating the impact of short-term market volatility on the solvency position of insurers, facilitating their ability to offer long-term life and pension products with guarantees and to contribute to the long-term financing of the economy, but also accounting for the low-interest rate environment;
2. based on the experience gained over the first four years of implementation of the framework, expanding where appropriate, the effective application of the proportionality principle, in order to alleviate undue regulatory burdens for smaller and less complex insurers;
3. deepening and strengthening the internal market for insurance services, by improving the level-playing field, and enhancing policyholder protection in situations of a possible failure;
4. preventing the building-up of systemic risk and ensuring financial stability;
5. in view of the European Green Deal, ensuring that the framework provides appropriate incentives to address climate and environmental risks and opportunities in insurers' investment and underwriting activities.

For each of the five objectives, the baseline scenario is leaving the prudential framework unchanged. The following possible policy options will be considered in the impact assessment:

- in relation to the long term financing of the economy and the provision of long-term insurance products with guarantees, one possible option could be to only adjust parts of the framework while considering that the

same class of insurance contract. The coexistence of the two systems can lead to situations where some policyholders are covered by either no IGS at all, or by two different IGSs.

[10] Such as losses to policyholders, delays in payouts, diverging approaches between authorities and IGSs and loss of trust in the single market.

[11] For instance, in relation to the valuation of liabilities or group solvency calculation.

[12] Those four Article were the legal basis for Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 ("Omnibus II Directive"), which amended the Solvency II Directive.

current overall level of prudence is sufficiently high, even if this may imply underestimating some of the actual risks that insurers are facing in practice. Another possible option could be to make all the necessary technical changes, even if some of them may lead to an increase in capital requirements, but aiming to avoid that the cumulative impact of all changes results in an overall market disruptive deterioration of the average solvency position of insurers, which could unduly hinder insurers' contribution to the financing of the economic recovery in the aftermath of the Covid-19 crisis in line with the objectives of the Capital Markets Union and of the European Green Deal;

- in relation to proportionality, it coud be explored to introduce provisions that make the use of proportionate rules mandatory when certain clear criteria are met. Another approach could be to preserve the current proportionality framework, which is largely based on supervisory assessment, but further develop and clarify the areas where a more proportionate application of the rules have to be considered;
- in relation to the enhancement of the internal market for insurance services and policyholder protection, possible options could be to strengthen cross-border supervision and remove legal gaps that can hinder the level-playing field, to introduce an EU regime for recovery and/or resolution, to harmonise national IGSs, or a combination of the above;
- regarding financial stability, a possible option could be to introduce targeted measures that are limited to the areas listed in section 3.10 of the Commission's call for advice[13]. Another policy option could be to introduce new measures that also go beyond the scope defined in the call for advice, for instance on soft concentration limits;
- with regard to climate and environmental risks, a possible option could be to better integrate sustainability risks in qualitative requirements on risk management practices (including scenario analysis). Another option could be to look at how investments in sustainable assets could be supported by introducing lower capital requirements for "green" investments.

## C. Preliminary assessment of expected impacts

The effects of this initiative might also be dependent on future economic and financial developments stemming from the ongoing Covid-19 crisis, which cannot be fully anticipated at this stage.

### Likely economic impacts

The main stakeholders that would be directly affected by the initiative are insurance and reinsurance undertakings, competent authorities supervising them, and current and future policyholders.

Certain policy choices could lead to an increase in capital requirements (e.g. reflecting the risk of negative interest rates in the standard formula), whereas others could conversely reduce them (e.g. reducing capital requirements on long-term and/or green investments). The overall impact on capital requirements will depend on what the preferred policy options are, taking into account insurers' likely important contribution to the financing of the economic recovery of the European Union in the aftermaths of the Covid-19 crisis.

The initiative would address the potential obstacles that unduly prevent insurers from appropriately providing long-term products with guarantees and making long-term investments, and could therefore foster insurers' contribution to the long-term financing of the real EU economy , and in particular of small and medium enterprises, in line with the objectives of the Capital Markets Union. In addition, by possibly better reflecting the protracted low-yield environment in capital requirements, the initiative would allow insurers to better quantify and manage the risks to which they are exposed, and therefore to be more resilient to financial shocks, hence improving their ability to underwrite new business and invest with a long-term perspective. As on average insurers' levels of own funds are more than twice as high than what is required by the framework, the initiative should not generate significant and immediate capital needs in most cases. Therefore, the potential amendments to Solvency II are not expected to hinder insurers' contribution to the long-term financing of the economy.

Finally, by possibly introducing new measures in areas such as recovery and resolution frameworks, by strengthening the supervision of cross-border activities, and by aiming to foster supervisory convergence, the initiative can increase competition in the EU, contribute to the orderly and efficient functioning of the single market for insurance and reinsurance services and address potential financial stability concerns.

### Likely social impacts

The initiative can contribute to improving policyholder protection, by promoting sounder risk management practices by insurers. By ensuring that the insurance sector remains financially strong and supervised under an appropriate risk-based framework, the initiative can also facilitate insurers' actions to support the resilience of our societies[14]. In

[13] EIOPA is asked to advise on how to improve the following closed list of items: the own-risk and solvency assessment, the drafting of a systemic risk management plan, liquidity risk management and liquidity reporting, and the prudent person principle.

[14] In the context of the current crisis, insurers have taken several voluntary initiatives, such as extending insurance coverage beyond the contractual limits, accepting premium payment holidays, etc.

addition, the potential introduction of new provisions such as the harmonisation of national IGSs and harmonised regimes for recovery and resolution can further protect policyholders and taxpayers from the risks and costs incurred by the failure of insurance and reinsurance companies.

Solvency II was not intended to foster the transfer of risk and rewards to policyholders (via unit-linked or index-linked products). However, the risk-sensitive framework can still influence the design of insurance products offered, which is likely to further evolve in the context of the protracted low interest rates environment. The initiative might further affect the design of insurance products, including those with new combinations of features in terms of guarantees, liquidity and return offered, which are less capital-intensive from a regulatory standpoint. Such potential new products can still meet a likely growing consumer need for insurance coverage, in particular in the area of pensions, as the ageing of the European population may affect the need for additional personal savings for retirement.

**Likely environmental impacts**

The outcome of the review is also aimed to contribute to a better management and integration of climate and environmental risks into the financial system. First, by aiming at incentivising insurers to have a longer-term perspective in their investments, the initiative can enhance the contribution of the insurance sector to the greening of the economy and to the European climate objectives. Second, a better integration of sustainability risks in underwriting policies will help increase resilience to sustainability risks, in particular those arising from natural catastrophes.

**Likely impacts on fundamental rights**

The initiative is not expected to have a direct impact on fundamental rights.

**Likely impacts on simplification and/or administrative burden**

The initiative will aim to alleviate undue regulatory burden for small and less sophisticated insurers in two complementary ways. First, by potentially updating the thresholds, which trigger the application of Solvency II, the initiative may further exempt small insurers with simple risk profiles from the scope of the Directive. Second, it will seek to enhance the application of the proportionality principle in all areas of the framework, including in relation to reporting and disclosure, as well as pre-emptive recovery and resolution planning. However, this should not materially affect the level of protection of policyholders and beneficiaries.

## D. Evidence base, data collection and better regulation instruments

**Impact assessment**

The European Commission has asked EIOPA to provide technical advice for a comprehensive review of the Solvency II Directive. EIOPA will deliver that technical advice in form of an opinion in December 2020. Such an advice will provide input on individual policy measures and a holistic assessment of the combined impact of all policy recommendations, including the recent experience during the COVID-19 crisis. This will feed into the impact assessment that the Commission services will prepare from the fourth quarter of 2020 onwards to support the preparation of this initiative and to inform the Commission's policy decision making.

**Evidence base and data collection**

In view of the large number of topics that will have to be covered by the impact assessment, a significant amount of data is necessary. The assessment will rely on the data that have already been or will be collected at EU level, either as part of the regular supervisory reporting, or in the context of EIOPA's advice on the 2020 Review of Solvency II, which would not otherwise be directly available to the Commission. The Commission services will also rely on the various reports from EIOPA, including the yearly reports on the long-term guarantee measures[15], the opinion on recovery and resolution, IGSs, and on macro-prudential policy in insurance, the opinion on sustainability within Solvency II, the advice on potential undue short-term pressures from financial markets, and the report on insurers' asset and liability management. Financial stability reports from EIOPA, the ECB and the IMF, as well as European Systemic Risk Board (ESRB) reports[16], will also be taken into account. Finally, the Commission conducted a fitness check of supervisory reporting requirements in EU financial services legislation, mandated a study on the costs of compliance for the financial sector, and published two reports on group supervision in 2018 and 2019, which meet the review requirements set out in Article 242 of the Solvency II Directive.

Where available and to the extent possible, other public sources of information, data gathered from the industry and existing studies will also be used to enrich the analysis provided in the impact assessment. Any necessary additional analytical and technical work will be carried out by the Commission services and, where appropriate, with the support of members and observers of the Commission Expert Group on Banking, Payments and Insurance.

15 See the 2016, 2017, 2018 and 2019 reports on long-term guarantee measures and measures on equity risk.

16 In particular, between 2015 and 2018, ESRB published reports on systemic risks in the EU insurance sector, on regulatory risk-free yield curve properties and macroprudential consequences, on recovery and resolution for the EU insurance sector, and on macroprudential provisions, measures and instruments for insurance.

| Consultation of citizens and stakeholders |
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| Following the call for advice sent by the Commission in February 2019, EIOPA published three consultation papers: two in July 2019 covering the harmonisation of national IGSs and some topics related to supervisory reporting and public disclosure, the remaining one in October 2019 covering all the other items of the Commission's call for advice. EIOPA also conducted several stakeholder events and workshops on the Review in 2019. The outcome of such consultation activities will be part of the EIOPA technical advice.<br>In addition, the Commission will organise several stakeholder activities. In this respect, for instance, a conference on the Solvency II Review was already organised on 29 January 2020, involving panellists from the insurance industry, consumer associations, national supervisory authorities, Ministries of Finance, and Members of the European Parliament. The Commission will also run its own public consultation on the review. |
| **Will an implementation plan be established?** |
| An implementation plan will be established, foreseeing appropriate support actions by the Commission to Member States. |