European Commission - Questions and answers

Questions and Answers: Proposals for amendments to the Solvency II Directive and a new Insurance Recovery and Resolution Directive

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Why was there a need to review EU rules on insurance and reinsurance?

The Solvency II Directive (Directive 2009/138/EC) requires the European Commission to carry out a review of EU rules on insurance and reinsurance (i.e. insurance for insurance companies). But beyond this legal obligation, the review is an opportunity to reflect more broadly on the lessons learned from the first years of application of these rules, including during the COVID-19 crisis. As the (re)insurance sector (insurance and reinsurance) holds large volumes of investments, it could potentially make a significant contribution to Europe's recovery from COVID-19, the completion of the Capital Markets Union, and the European Green Deal.

Has the COVID-19 crisis impacted the insurance sector?

Overall, the financial position of insurers was not significantly affected by the COVID-19 crisis and, despite operational challenges, no major disruptions in the sector were observed. Notably, the sector remained well capitalised with an average solvency ratio of 235% at the end of 2020 according to data from the European Insurance and Occupational Pensions Authority. While that ratio is 7 percentage points lower than at the end of 2019, it remains well above the regulatory minimum of 100%.

Why are we reviewing Solvency II?

The aim of today's review is to strengthen European insurers' contribution to the financing of the recovery, progressing on the Capital Markets Union and the channelling of funds towards the European Green Deal.

Recent experience has shown that insurers improved their risk management during the first years of applying Solvency II rules. However, the COVID-19 crisis has also underlined that the risk of protracted low interest rates needs to be taken seriously. Addressing this risk was one of the objectives pursued by the Commission during the review.

Solvency II is a highly sophisticated set of rules that must be applied in a proportionate manner for smaller and less complex (re)insurers. The current high-level proportionality principle embedded in Solvency II did not produce the desired outcome and so more concrete rules are warranted to ensure that proportionality plays a greater role in the application of the rules.

The COVID-19 crisis has also highlighted the opportunity to enhance the supervisory and crisis management tools that are available in the context of economic distress, which may represent a source of risk for the stability of the financial system.

What are the next steps?

The European Parliament and the Council will now discuss the Commission's proposals.

In parallel, the Commission will launch the work on Delegated Acts supplementing the amendments to the Solvency II Directive. Today's Communication already sets out the Commission's intentions in this regard.

1. Proposal for amendments to the Solvency II Directive

What are some of the features of this review?

- Today's changes will better protect consumers and ensure that insurance companies remain solid, including in difficult economic times;
- Consumers ("policyholders") will be better informed about the financial situation of their insurer;
- Consumers will be better protected when buying insurance products in other Member States

thanks to improved co-operation between supervisors;

- Insurers will be incentivised to invest more in long-term capital for the economy;
- Insurers' financial strength will take better account of certain risks, including those related to climate, and be less sensitive to short-term market fluctuations;
- The whole sector will be better scrutinised to avoid that its stability is put at risk.

What will be the ultimate impact of the reform on capital requirements for (re)insurers?

Overall, the objective is to achieve a balanced review and to avoid a deterioration of insurers' solvency position at EU level. A tightening of overall capital requirements is not necessary in view of the already quite solid situation of the insurance sector in Europe.

The amendments making certain capital requirements stricter will be implemented gradually up until 2032. The Commission estimates that up to €90 billion of capital could be released in the short term at EU level.

However, certain (re)insurers or markets may face an increase in capital requirements. The progressive implementation of stricter capital requirements aims to facilitate (re)insurers' timely preparedness for the new rules.

Depending on financial market conditions, the Commission estimates that up to €30 billion of capital could be released in the long term at EU level. This should also help insurers increase their funding of the recovery.

Will the reform support the economic recovery?

The changes to the Solvency II rules will avoid an overall increase of total capital requirements across the EU (re)insurance sector in the long term. In the short term, capital of up to an estimated €90 billion could be released at EU level due to the phasing in of certain rules. This significant release of capital will help (re)insurers ramp up their contribution as private investors to the recovery from the COVID-19 pandemic.

How will this package contribute to the CMU?

In the 2020 Capital Markets Union Action Plan, the Commission committed to amend Solvency II to promote long-term investments without affecting financial stability and policyholder protection. The Action Plan pointed to the eligibility criteria for the long-term equity asset class, the risk margin calculation and the valuation of insurers' liabilities. With today's package, the Commission is delivering on these commitments. We want to avoid undue procyclical behaviours, while better reflecting the long-term nature of the insurance business.

First, the Commission is amending the long-term guarantee measures, in particular the volatility adjustment. This will improve how the framework mitigates the effects of short-term market volatility, in particular during crisis situations. In addition, as part of the forthcoming review of the Solvency II Delegated Act, the Commission intends to revise the long-term equity asset class. We want to make it easier for insurers to benefit from the preferential capital treatment on equity investments. Finally, the Commission wants to revise the risk margin, to reduce both its size and its volatility, also as part of the forthcoming amendments to the Delegated Act.

How will insurers be encouraged to invest in equity?

With trillions of assets under management, the insurance sector remains a mainstay of the European financial industry. Due to the long-term nature of their liabilities, insurance companies can provide long-term capital funding to businesses. However, we note that they have been retrenching from long-term investments in equity over the past 20 years. Today's package will remove undue disincentives to long-term equity investments.

First, as part of the forthcoming amendments to the Solvency II Delegated Act, we will revise the eligibility criteria of the existing long-term equity asset class. This will make it easier for insurers to benefit from preferential capital treatment when providing long-term capital funding to the economy. Under a cautious scenario assuming that only 15% of additional equities would qualify as long-term, the reduction in capital requirements would reach approximately €10.5 billion. This would be a decrease of more than 6% compared to current levels for insurers. This money can be further invested in the economy.

In addition, for other types of equity investments, the level of the capital charge will be modulated depending on stock markets developments so that it becomes less expensive for insurers to invest in equity when equity markets are plummeting. This will reduce incentives for procyclical behaviours.

Second, the Commission's proposal is amending the framework so that short-term market fluctuations do not excessively affect insurers' solvency position. In particular, we are improving the functioning of the volatility adjustment. This will make it more effective in mitigating the effects of short-term market volatility.

We will revise other parts of the framework in the Delegated Act, for instance the risk margin. This will reduce the sensitivity of insurers' balance sheet to short-term market turmoil, thereby better reflecting the long-term nature of insurance business.

What does the proposal mean for smaller insurers?

The proposal puts forward a significant extension of the size thresholds determining the scope of application of the Directive. This means that smaller insurers will be excluded from the scope of the Directive and will fall under national regimes. That should result in lower compliance costs with EU law for smaller firms that do not wish to be subject to Solvency II.

In addition, in order to simplify rules for small and less complex insurers, a new category of low risk profile (re)insurers will be introduced. It relies on clear and transparent criteria. Insurers in this category will benefit from lighter and more proportionate rules. Other insurers can still benefit from proportionality measures, subject to prior supervisory approval.

How does the reform contribute to the European Green Deal?

This reform will strengthen (re)insurers' management of climate risks by introducing a requirement for a long-term climate change scenario analysis. This analysis will take into account climate change-related risks that may not always be captured when calculating capital requirements.

In addition to this, EIOPA will conduct centralised climate stress tests in the (re)insurance sector and the Commission will launch a Climate Resilience Dialogue and explore ways to improve the collection of insured loss data.

Today's reform also sets out the following two mandates for the European Insurance and Occupational Pensions Authority (EIOPA):

- to review new evidence on environmentally or socially harmful investments with a view to potential changes in the Solvency II standard formula and draw up a report at the latest by 2023;
- to regularly review the evidence on trends in the frequency and severity of natural disasters and EU (re)insurers' exposure to such disasters with a view to potential changes in the Solvency II standard formula catastrophe risk modules.

Does the reform address potential systemic risks in the (re)insurance sector?

The Solvency II framework relies on robust prudential requirements to preserve policyholder protection and financial stability, which focus on the supervision of individual (re)insurance companies. Some targeted improvements will nevertheless be introduced in order to further prevent the build-up of financial stability risks that may arise.

The development of targeted macro-prudential rules will avoid unnecessary costs for the (re)insurance industry when investing long-term. They will ensure that companies can continue to provide long-term services to policyholders, while allowing public authorities to identify promptly any source of systemic risk that may arise from (re)insurance activities. In addition, the new tools are consistent with the international standards on systemic risk developed by the International Association of Insurance Supervisors.

These targeted improvements to Solvency II will be reinforced by the parallel introduction of a new crisis management framework.

How do the changes improve the level-playing field between insurance groups headquartered in different Member States?

Many (re)insurance groups operate in several Member States. The introduction of a harmonised recovery and resolution regime will further contribute to ensuring a sound and harmonised approach to supervision. Among other changes, clarifications will be introduced as regards the companies that should be included in group supervision, in particular with respect to holding companies, as well as regards the powers of supervisors in determining the scope of a (re)insurance group. Likewise, the rules will spell out in more detail how requirements defined at entity level can be applied at the level of (re)insurance group, including risks stemming from third-country subsidiaries.

Finally, the rules will further specify the powers and responsibilities of supervisory authorities over groups operating in the EEA but whose parent company is headquartered in a third country, so that all policyholders in Europe are equally protected regardless of the location of the head office of the group.

By clarifying the EU rulebook on group supervision, these updated rules will enhance policyholder protection, contribute to more supervisory convergence in Europe, improve the level-playing field between insurance groups and therefore enhance the single market for insurance services.

2. Proposal for the Insurance Recovery and Resolution Directive

Why is the Commission proposing a framework for the recovery and resolution of (re)insurers?

Insurance policies are essential for the daily life of Europeans and for Europe's businesses. They also include savings products, which will determine the long-term welfare of their holders.

A disorderly failure of (re)insurers can therefore have a significant impact on policyholders, beneficiaries, injured parties or affected businesses but also, in certain instances, amplify financial instability.

Today's proposal will help address the absence of harmonised procedures at European level, in particular in a cross-border context, for resolving (re)insurers and will improve (re)insurers and authorities preparedness for situations of financial distress.

What are the objectives of the proposal for the recovery and resolution of (re)insurers?

Today's proposal will ensure that (re)insurers as well as authorities have the means to intervene sufficiently early and quickly in a crisis situation, including across borders, to protect policyholders, while minimising the impact on the economy, the financial system and taxpayers. This proposal builds on the Bank Recovery and Resolution Directive (BRRD) and the Regulation for the recovery and resolution of central counterparties (CCPRRR), but reflects the specificities of (re)insurance activities and of the related prudential framework.

Why now?

Although the Solvency II Directive improved the resilience of the EU (re)insurance industry, situations of financial distress cannot be completely excluded. At present, there are no harmonised EU rules in the event of an insurer failing. It is therefore important to swiftly ensure that there is a framework in place to deal with a (re)insurer should things go wrong. This will improve the EU (re)insurance industry's resilience even further.

Why are normal insolvency proceedings often unsuitable for insurers?

In normal insolvency proceedings, the primary objective is to maximise the value of assets of the failed firm in the interest of creditors. However, the provision of insurance services will be discontinued and it may be difficult for policyholders to maintain their protection and immediately find substitute insurance services and products at a reasonable cost, which is a particular problem when it comes to life insurance. It may also take many years before the insolvency process comes to an end, which in the meantime leads to uncertainty, notably in relation to recoveries, with a knock-on effect on confidence. In addition, putting a cross-border group into insolvency in one Member States could have undesired consequences on other parts of the group in other jurisdictions. Finally, depending on the economic circumstances, the insolvency of a (re)insurer can cause or amplify financial instability and/or economic harm.

In contrast, the primary objective of resolution is to respond decisively, including in cross-border cases, to a situation of financial distress of a (re)insurer. The aim is to maintain critical insurance functions for policyholders and ensure a smooth transfer of their insurance portfolios, while achieving similar results to those of normal insolvency proceedings in terms of allocation of losses to shareholders and creditors.

What are the key elements of the Recovery and Resolution proposal?

The proposal lays out a comprehensive set of measures, which aim to ensure that:

- National resolution authorities are designated in each Member State. These could be national central banks, competent ministries, public administrative authorities or other authorities entrusted with public administrative powers;
- Preventive tools and powers, complementary to the existing Solvency II intervention ladder,

are clarified in order to ensure that national supervisory authorities are able to deal in an efficient manner with deteriorating financial positions or breaches of regulatory requirements of (re)insurers without introducing any new intervention threshold;

- (Re)insurers and national supervisory and resolution authorities are adequately prepared for any crisis;
- National resolution authorities have harmonised resolution tools and powers to take rapid and effective action when a (re)insurer's failure cannot be avoided;
- National resolution authorities cooperate effectively across borders, including with third country authorities.

The key elements of the proposal are:

- The framework will be based first on **prevention and preparation**. (Re)insurers (within the scope of Solvency II and proportionate to their potential risks) are required to draw up pre-emptive recovery plans to foster their preparedness and facilitate prompt remedial actions when faced with stress scenarios. Resolution authorities are required to draw up resolution plans on how to handle any form of financial distress which would exceed a (re)insurer's existing resources. If resolution authorities identify obstacles to resolvability in the course of the planning process, they can require a (re)insurer to take appropriate measure to simplify its structure to ensure that it can be resolved with the available tools in a way that does not involve costs to taxpayers.
- Supervisory authorities have the **powers to intervene at an early stage** (i.e. to deal in an efficient manner with deteriorating financial positions or breaches of regulatory requirements and prevent the escalation of problems). These preventive powers complement and are consistent with the existing Solvency II intervention ladder.
- The framework will provide national authorities with **resolution tools**. While minimising the impact of an (re)insurer's failure on the economy and financial system these tools will ensure the continuity of insurance protection for policy holders, beneficiaries and injured parties, transfer viable activities and portfolios of the re(insurer) where appropriate, without a need to bail-out and apportion losses in a manner that is fair and predictable.

How does the EU recovery and resolution framework square with the resolution regime adopted in some Member States?

Some Member States already have mechanisms at national level to resolve failing (re)insurers (e.g. the Netherlands, France and Romania). These regimes pursue the same objectives and are generally compatible with the proposed framework.

The proposed Directive sets out a minimum harmonised set of tools and powers, so that Member States will be able to introduce additional tools at national level to deal with crises, as long as they are compatible with the resolution objectives and principles set out in the proposal.

How will national authorities cooperate?

As some insurance groups are active on a cross-border basis and in some cases even globally, the proposal requires an appropriate coordination of resolution measures in a cross-border context to protect policyholders, the real economy and financial stability in all affected Member States and achieve the most effective outcome. Strong confidentiality requirements will have to be respected.

Resolution colleges will be established under the leadership of the group resolution authority and with the participation of EIOPA. EIOPA will facilitate cooperation of authorities, contribute to consistency and mediate if necessary.

What are the main resolution tools?

The main resolution tools include:

- **Write-down or conversion of capital instruments, debt instruments and other eligible liabilities (bail-in),** which aims to ensure that shareholders and general creditors take losses first and to facilitate the exercise of other resolution tools such as the solvent run-off or the transfer tools (sale, bridge or asset and liability separation tools).
- **Solvent run-off** whereby the authorisation of a (re)insurer to conclude new insurance or reinsurance contracts is withdrawn in order to limit its activity to the administration of its existing portfolio, thereby maximising the coverage of insurance claims by existing assets;
- **Sale of business** whereby all or parts of an (re)insurer's business can be sold on commercial terms, without complying with procedural requirements that would otherwise apply.

- **Bridge undertaking** whereby all or part of an (re)insurer's business can be transferred to a publicly controlled entity that will be eventually sold to a private purchaser when market conditions are appropriate.
- **Asset and liability separation** whereby impaired or problem assets and/or liabilities can be transferred to a management vehicle to allow them to be managed and worked out over time. In order to minimise competitive distortions and risks of moral hazard, this tool should only be used in conjunction with another resolution tool.

Will policyholders have to pay for saving (re)insurers?

The policyholder – business or individual – is at the heart of the EU insurance policy. The framework for resolution is not primarily designed to save (re)insurers but to maximise the protection of the insured by ensuring the continuity of their insurance cover. In addition, key safeguards will apply to ensure all parties are treated fairly. In particular, according to the "no-creditor-worse-off" principle no creditor, including policyholders, can be worse off in resolution than they would have been in an insolvency.

What are the conditions for entering into resolution?

An insurer or reinsurer will become subject to resolution when:

- it breaches or is likely to breach its minimum capital requirements or is likely to be balance-sheet or cash-flow insolvent;
- All other intervention measures (such as the preventive measures set out in this proposal or recovery measures set out in Solvency II) or private sector measures have been exhausted;
- Winding up the undertaking under normal insolvency proceedings would risk prolonged financial instability or a worse outcome for policyholders.

Entry into resolution will therefore always occur at a point close to insolvency, though authorities will have a degree of discretion to ensure that they can intervene, and sufficient equity is still available, before it is too late for resolution to meet its objectives.

Which (re)insurers would be covered by the EU regime?

The proposed Directive creates a crisis management framework (i.e. preventive powers, pre-emptive recovery planning and resolution regime) in relation to all (re)insurers established in the EU that are subject to the Solvency II framework. In addition, as the failure of an entity affiliated to a group can impact the solvency and the operations of the whole group, a consistent approach to groups, in particular in a cross-border context, is also proposed.

Should all (re)insurers develop pre-emptive recovery plans and be subject to resolution plans?

In line with the proportionality principle, not all entities will be subject to planning requirements. The proposed Directive establishes criteria that will be assessed by supervisory and resolution authorities. The authorities can also apply simplified obligations for recovery and resolution planning. However, to ensure an adequate degree of preparedness across the EU, (re)insurers that account for at least 80% of a Member State's market should be subject to pre-emptive recovery planning requirements and for at least 70% of a Member State's market should be subject to resolution planning requirements. Low-risk undertakings are exempt from these planning requirements.

Will the resolution framework be capable of addressing situations of extreme economic distress?

In situations of extreme economic distress, the resolution of a (re)insurer may still require the intervention of specific national schemes, such as an insurance guarantee scheme or a resolution fund where they exist, or, as a last resort, extraordinary public financing to provide for complementary loss absorbing and restructuring resources. These elements will be subject to the safeguards introduced by the framework and the relevant State aid rules. In any case, the write down and conversion tool should be applied before the use of any extraordinary public financial support in order to achieve the principle of burden sharing underlying any resolution regime. A specific requirement to create additional internal loss-absorbing capacity in the form of bail-in-able instruments that (re)insurers would have to issue and service was regarded as disproportionate and has therefore not been proposed.

What is the role of the European Insurance and Occupational Pensions Authority (EIOPA)?

Today's proposal is based on the preparatory work of EIOPA, in particular its July 2017 Opinion. EIOPA published a second Opinion in December 2020 on the review of the Solvency II Directive following the Commission's "Call for Advice" of February 2019. EIOPA will play a strong coordination role, aiming to reinforce convergence in the field of prevention and resolution, notably through its participation, and potentially mediation, in resolution colleges and the set-up of an internal Resolution Committee. EIOPA will receive clear and decisive mandates in areas where consistent rules and practices are key, while avoiding any duplication in the tasks of national authorities responsible for day-to-day supervision and resolution. EIOPA is also mandated to work out agreements with third-country authorities that would serve as a template for bilateral agreements for national authorities in the area of insurance resolution.

Resolution measures may interfere with the rights of shareholders and creditors. How is this dealt with?

In addition to strict conditions to resolution, in particular a demonstration that resolution would actually be in the public interest, the proposed Directive incorporates adequate safeguards to protect the interests of stakeholders affected by resolution measures. Notably, this includes the principle that no creditor should be worse off under resolution than it would have been had the (re)insurer been wound up under applicable insolvency law proceedings.

How does this proposal relate to work undertaken at international level?

At international level, the Financial Stability Board (FSB) developed, in October 2014, Key Attributes (KA) on effective resolution regimes for the insurance sector. This was targeted at any insurer that could be systemically significant or critical if it fails. The FSB released complementary guidance on developing effective resolution strategies and plans in June 2016 and in its KA Assessment Methodology in August 2020.

In parallel, the International Association of Insurance Supervisors (IAIS) adopted in November 2019 a set of Insurance Core Principles for all insurance and reinsurance undertakings as well as a Common Framework for Internationally Active Insurance Groups (IAIG) detailing standards for pre-emptive recovery planning.

The Commission's initiative is aligned with these developments.

Why is the Commission not putting forward a proposal to harmonise Insurance Guarantee Schemes?

Insurance Guarantee Schemes (IGSs) use contributions raised by the insurance industry to provide last-resort protection for policyholders, beneficiaries and injured parties when their insurers cannot meet their contractual commitments in case of failure.

There is currently no harmonised framework for IGSs in the EU.EIOPA, in its opinion on the 2020 review of Solvency II, recommended aligning national guarantee schemes. Creating consistent last-resort safety nets could promote trust in the Single Market for insurance.

However, introducing a minimum common framework for IGSs might entail significant implementation costs for insurers, in particular for Member States that do not currently have such a scheme, or where changes would need to be made to existing schemes to comply with the new framework.

The Commission assessed all these impacts and considers that, given the economic uncertainties created by the COVID-19 pandemic, as well as the need to focus on economic recovery, action to align rules for IGSs is not appropriate at this juncture. However, the Commission is committed to reassessing the appropriateness and timing of alignment in the future.

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