Amundi
ASSET MANAGEMENT

Solvency 2

Proposal approved by the European Parliament's Committee on Economic and Monetary Affairs

Nearly 2 years following the European Commission's proposal, a significant milestone was achieved in July, when the submitted project received validation from the Parliament's Committee on Economic and Monetary Affairs (ECON).

Key points of the Solvency 2 revision

- Several changes are underway in the quantitative pillar to **address what is perceived as unwarranted volatility of the solvency ratio**. These changes primarily focus on **enhancing the existing counter-cyclical mechanisms** that are already in place.
- To incentivize insurers to boost their involvement in financing a sustainable economy over the long term, the long-term equity investment scheme (LTEI) is undergoing a redesign. The aim is to **expand the scope of insurers' assets eligible for favorable capital requirements under LTEI**, allowing a larger portion to benefit from these advantages.
- The purpose of the revision is also to **more accurately reflect the interest rate environment, specifically addressing the occurrence of negative rate configurations** that were observed a few years ago.
- Risk management policies and tools must be able to integrate environmental, social and governance factors. In particular, **insurers will need to consider the implications of the net zero transition.** At this stage, the text does not mention any modulation of capital requirements based on whether financial assets meet specific social or environmental criteria, but EIOPA has initiated research on this topic.
- One of the main objectives of the revision is to **alleviate the regulatory burden imposed by Solvency 2 on smaller market participants and entities, which do not generate significant risk exposures**. Several amendments have been proposed to **extend the principle of proportionality,** which would streamline reporting and risk management processes or simplify the quantitative assessments for such entities.
- The review does not overlook the protection of policyholders and the overall stability of the financial system. On the contrary, it introduces significant enhancements in these areas. This includes **provisions to improve the monitoring of cross-border activities and the introduction of a dedicated chapter on preventing systemic risks.**

The revision does not entail a substantial overhaul of Pillar 1 but modifies the evaluation of specifics components of the Solvency 2 balance sheet and certain sub-modules of market risk.

Table below illustrates how the modifications to the quantitative pillar affect the volatility of the solvency ratio or its level:

Amendment	Reduced solvency ratio volatility	Change in solvency ratio
Change to the Risk Margin calculation formula	By reducing the impact of interest rate changes	↑ Increases Solvency 2 net assets
Widening of the equity shock dampener corridor	By reducing the impact of stock moves	↑ Reduces capital charge
Extension of long term equity investment		↑ Reduces capital charge
Revision of the Volatility Adjustment calculation method	Reduced impact of spread changes	↑↓ Impact varies across insurers' portfolios
Modification of the method for extrapolating the yield curve	Thanks to a better correlation between the EIOPA curve and the rates of securities in the portfolio	↑↓ Impact varies by level/shape of yield curves
Revision of the interest rate shock for the 'Standard formula' calculations		↓ Increases capital charge (in general)
Diversification between portfolio under Matching Adjustment and other activities		↑ Reduces capital charge

Risk margin: Parliament's proposal reduces the rate that models the cost of capital

The Risk margin calculation formula in Delegated regulation 2015/35 faced significant criticism due to several reasons. Firstly, the rate currently set at 6% to reflect the cost of capital is considered too high. Secondly, during the recent period of low or even negative interest rates, the discounted projected Solvency Capital Requirement (SCR) estimates did not adequately reduce the contribution of long-term liabilities over time.

Recognizing the need to reduce the risk margin associated with long liabilities, Parliament has adopted the Commission's proposal to incorporate an exponential time factor into the estimation of future discounted annual SCR amounts. This approach gradually lessens the impact of future SCR as the time horizon extends.

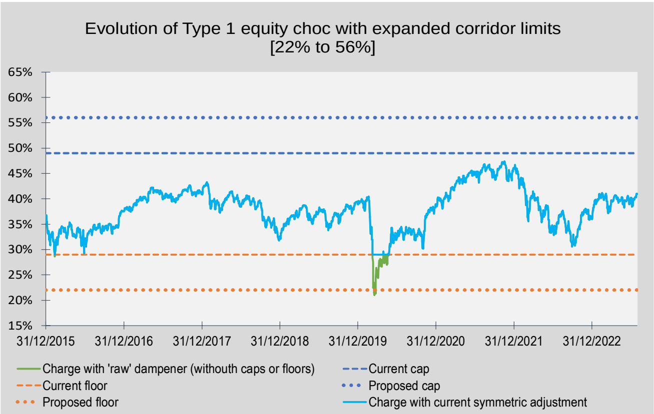
While the Commission suggested lowering the cost of capital rate to 5%, Parliament takes a more proactive stance by advocating for a rate of 4.5%.

Widening of the symmetrical equity shock adjustment corridor

The symmetrical adjustment, also known as the dampener, operates in a counter cyclical manner. Its calculation is based on the deviation of a composite index[1] level from its historical average over the past three years. This adjustment then modulates the core equity shock[2], increasing it following a rise in equity markets and decreasing it after a downturn.

Under the existing Directive, the adjustment is limited to a minimum of -10% and a maximum of +10%. However, during the emergence of the Covid-19 pandemic in March 2020, the reduction in the equity shock was constrained by the -10% limit. To enhance the counter-cyclical effect, the proposed directive aims to broaden the range in which the symmetrical adjustment operates, extending it to [-17%; +17%].

As a result, the corridor within which the equity type 1 shock moves would shift from [29%; 49%] to [22%; 56%].



Source EIOPA - Amundi

[1] The index was constructed to be representative of the investments of European insurers

[2] 39% for equity type 1 (these are equities listed in an EEA or OECD country) and 49% for equities listed in other countries or not listed

In 2023, the International Association of Insurance Supervisors (IAIS) proposed a draft International Capital Standard (ICS) incorporating a counter cyclical regime similar to Solvency 2.

IAIS has just launched a final consultation to gather feedback from stakeholders before finalizing the standard to be applied to internationally active insurance groups (IAIG) in 2025.

While the exercises in recent years were based on ICS version 2.0, approved in November 2019, and which does not have a counter cyclical mechanism, a symmetrical adjustment is added to the specifications published for the year 2023:

- The corridor of [-10%; +10%] is maintained by the IAIS as well as the calculation formula and the duration of 3 years to calculate the moving average defining the market neutral level.
- But unlike Solvency 2, which determines a single adjustment, which is then applied to several equity types, the IAIS proposes to calculate an adjustment for 3 of the categories specified in the equity module: Equities listed in a developed country, equities listed in an emerging country, unlisted equities or hedge funds. For fiscal year 2023, the values to be used for each category were provided in the specifications.

In the consultation launched in July, IAIS seeks comments on the addition of this counter cyclical mechanism.

➲ Extension of the scope for Long term equity investment (LTEI)

Established in Delegated Regulation 2019/981[3], the concept of Long Term Equity Investments (LTEI), allows for a 22% shock to be applied in calculating the solvency capital required for equity investments, subject to certain conditions.

Parliament identified the need to incorporate provisions concerning LTEIs into the Level 1 text (Directive) and introduced a requirement for the insurance entity's governing body to approve the management policy for these investments.

Regarding the eligibility criteria, the Paliament's proposal generally relax the requirements. While the equity portfolio still needs to be clearly identified, there is no longer a mandatory contractual confinement. Additionally, the shares must be held on average for at least 5 years, and the entity must be able to demonstrate its ability to maintain the portfolio for this duration.

Two constraining conditions previously stated in the Delegated Regulation have been removed. Firstly, it is no longer mandatory that the technical provision the sub-portfolio is assigned to represents only a part of the total technical provision of the insurer.. Secondly, the demonstration of the entity's ability to avoid forced sale, at least over the next 10 years is no longer required.

Furthermore, while the Delegated Regulation originally limited the use of LTEI only to shares listed in a an EEA country and unlisted shares issued by entities within the EEA, Parliament has extended the scope to include shares listed in an OECD country and unlisted shares issued by entities located in an OECD country.

Equities held through UCIs or ELTIF type hedge funds can also be treated as 22%, with the holding period condition calculated at the fund level rather than the underlying assets.

➲ Approvals for 'Equity risk based on duration' system will be terminated

This system specifically applied to shares held to cover occupational retirement commitments and requires approval from the supervisory authority to achieve an equity SCR of 22%.

Entities that have received approval for this system can continue to utilize it for designated portfolio, but new authorizations will no longer be granted. Since classifying equity as LTEI allows for the same shock of 22% there is no longer a need to a specific scheme for retirements commitments, while maintaining a separate system proved to be restrictive and saw limited usage, largely due to the requirement of commitments with an average duration of over twelve years.

➲ Accounting for Crypto asset risk

Parliament proposes amending the Directive to allow the Commission to include the risk generated by crypto assets within the market and counterparty risk modules used to calculate capital requirements.

➲ Volatility adjustment (VA)

The VA is a widely utilized component of the 'long branches package'. It is an adjustment of the risk-free yield curve used to discount the Best Estimate that mitigates the impact on the solvency ratio of asset market value fluctuations due to abrupt changes in bond spreads.

However, in its current definition of VA calculation does not adequately suit the specificities of insurers implementing it. An insurer could benefit from a high VA which is aligned with the average asset allocation of EU insurers, even though their asset portfolio may have limited exposure to spread variations and a lower proportion of fixed-rate assets compared to the reference portfolio. Additionally, the insurer's duration could be significantly lower than that of the reference portfolio.

To address this issue, Parliament's proposal, in line with the Commission's suggestion, introduces a factor that considers the mismatch in duration and/or volume between fixed-income investments and the provisions they cover.

[3] These Delegated Regulations amend Delegated Regulations 2015/35

VA is still calculated on a currency basis and its effectiveness is improved by increasing the general application factor from the current 65% to 85%.

$$VA_{Currency} = 85\% * CSSR_{Currency} * RCS_{Currency}$$

- The insurer's own $CSSR_{Currency}$ factor, ranging 0 and 1, considers the credit spread sensitivity of fixed income investments and the VA sensitivity of the best estimate of liabilities. The detailed calculation of this factor will be specified in the delegated regulation.
- The $RCS_{Currency}$ factor is the risk-adjusted spread of the reference currency portfolio.
- Parliament's proposal introduces the option to apply a multiplier adjustment specific to the insurer to the $RCS_{Currency}$ parameter. This adjustment is equal to a minimum of 125% and $RCS_{Ptf}/RCS_{Currency}$ where RCS_{PFT} is calculated in the same way as $RCS_{Currency}$ but using the weights and durations corresponding to the insurer's debt investment portfolio. The implementation of this option requires approval from the supervisory authority and compliance with certain conditions.

For the euro, an additional macroeconomic component, known as VA Euro-Macro, is included alongside the currency component.

However, if a specific risk-adjusted spread has been used for the VA Euro, the VA Euro-Macro is not applicable.

The purpose of the VA EuroMacro is to mitigate the impact of a widening of the spreads of a specific country within the euro-zone. It is an improvement over the existing VA country provision in the current regulations, as it avoids the threshold effects by activating in a smoother and gradual manner. The Euro Macro VA is defined by the product of the following factors:

- An overall application rate of 85%,
- The insurer-specific $CSSR_{€}$calculated for the Euro as described for $CSSR_{Currency}$,
- The difference between the risk adjusted spread of the representative portfolio of the specific country and 1.3 times RCS_{Euro} (which is the risk-adjusted spread of the total representative portfolio in euros),
- A Country coefficient, ranging from 0 to 1, designed to ensure smooth and gradual activation of the Euro-Macro component. The proposed definition aims to eliminate the threshold effects generated by the current formulation of the VA.

The use of the new VA provisions will be subject to regulatory approval, but entities applying the current system will be exempted from this requirement.

For currencies linked to the euro, the Parliament proposes calculating the same VA by including both the euro portfolio in euro and the related currency portfolio in the calculation.

➲ Extrapolation method of interest rate curves

The revision of the extrapolation method aims to increase the correlation between the risk-free yield curve, which is used to discount long-term insurance liabilities, and the rates observed on euro bonds. Indeed, the current method lacks the necessary correlations to effectively hedge long-term liabilities with conventional instruments and often requires the use of specialized derivatives.

The proposed approach retains the Commission's chosen method, which involves smoothing points. It extrapolates forward rates with a function that uses an Ultimate Forward Rate (UFR) [4] and forward rates computed on a set of smoothing points that correspond to maturities where there are market instruments that meet certain criteria, such as being deep, liquid, and transparent (DLT) [5].

However, Parliament specifies that for maturities of at least 40 years after the first smoothing point, the UFR must account fort at least 80% of the weight.

It is worth noting that the financial environment has significantly changed since the Solvency 2 review consultations in 2019-2020.

In the case of the euro, there has been a significant decrease in the gap between the UFR and the rates observed on long-term market instruments due to a sharp rise in interest rated and a reduction in the UFR. On June 30, 2020, the gap between the UFR and the risk free rate[6] for the 20-year maturity was 3.78% (3.75% - (-0.03%)), but by July 31, 2023, it had narrowed to 0.62% (3.45% -2.83%).

As a result, the risk free yield curve extrapolated using the current methodology has moved closer to the yields of core euro area government bonds in the 20-40 year segment of the curve. It is expected that the impact of change in the extrapolation methodology will be significantly lower compared to what was observed in 2019.

The Commission will be responsible for specifying all the details of the new extrapolation method, including the parameters determining the speed of convergence and the DLT criteria.

➲ Interest rate risk: increased capital requirements for some insurers

The proposed amendment to the Directive does not provide detailed information on the calculation of required capital, as this falls under the purview of the Commissions' Delegated Acts. Nonetheless, Parliament's proposal confirms the revision of the interest rate risk module, with the aim of introducing a downward shock when risk-free rated are negative. The draft requires the introduction of a negative floor rate that varies based on the maturity of instruments.

[4] Since 2017, the Ultimate Forward Rate has been determined each year, using two components, the expected real rate and the expected inflation rate, while varying by no more than 15 basis points from one year to the next. For the euro, the UFR has been set at 3.45% for 2023.

[5] In 2019, for the euro, swap maturities meeting the DLT criterion were maturities of 12 years or less then 15, 20, 25, 30, 40 and 50 years.

[6] Risk free rate distributed by EIOPA incorporating risk-adjusted credit but without volatility adjustment.

In its December 2020 report, EIOPA introduced a new stress configuration designed to assess interest rate risk within a standard formula. As part of the proposed methodology, the minimum +1% shock in the rate hike scenario has been removed, and negative rates are emphasized in the rate cut scenario.

The configuration advocated by EIOPA was presented in the letter 'Revision 2020: EIOPA Recommendations', which was published in January 2021.

To ensure a smooth transition for insurers, a 5-year period has been planned to fully implement the new configuration of interest rate shocks.

➲ Diversification of risks between Matching Adjustment (MA) portfolios and other activities of the insurer

The MA allows for the consideration of fixed income investment returns in determining the discount rate on liabilities. However, it currently requires that the liability portfolio be managed separately from other activities and be assigned a portfolio of assets that have matching cash flows.

These conditions are quite restrictive. Additionally, the use of MA limit the benefit of diversification because under the current regulations, any diversification of risks between MA portfolios and other activities of the insurer is excluded in the Solvency Capital Requirement (SCR) calculation.

The proposed Directive remove this restriction for portfolios under MA.

➲ Modulation of capital requirements according to ESG factors: The prior analysis methodology is being developed

EIOPA (European Insurance and Occupational Pensions Authority) has been assigned the task of examining whether investments linked to environmental or social objectives should receive specific prudential treatment. If appropriate, differentiating between sustainable and non-sustainable investments would warrant tailored prudential measures, and EIOPA would provide an impact assessment of the proposed changes.

EIOPA has already begun its work and published a 'Discussion Paper' in November 2022 to gather feedback from stakeholders on the proposed methods for this analysis.

➲ Revision of Non-Life Disaster Risk settings

To effectively account for climate developments, EIOPA will be instructed to review the calibration of parameters for the non-life catastrophe submodule used in calculating the capital requirement under the standard formula at least every three years.

Integration of sustainability risk in the capital requirement calculation: EIOPA published a 'Discussion Paper' in late November 2022

- In its Discussion Paper, EIOPA proposes to focus on **analyzing the potential link between transition risks and the prudential risks of investments in equities, bonds or real estate.**

  EIOPA wants to carry out a retrospective assessment and to this end, it has considered several approaches aiming to classify securities according to their transition risks.

  - The index-based approach does not seem very appropriate because the indexes available are insufficient to conduct the analyses. The alternative approach consists of building three portfolios with different levels of transition risk exposure (high, medium or low) and analyze their respective returns.
  - Regarding the classification into these three categories, two options have been considered: the NACE code, which allows to determine the issuer's transition risk according to its economic sector or the exploitation of specific data relating to the issuer. In this second hypothesis, several metrics have been evoked but the intensity of greenhouse gas emission seems to be EIOPA's preferred option.
  - The sector approach is much simpler to implement, but it does not reflect the efforts of a company operating in a sector with high transition risks to reduce its greenhouse gas emissions. Regarding the second option, the main barrier is the availability of reliable data.
  - Beyond the difficulties regarding the selection of the indicator used to define the transition risk level, many other points need to be arbitrated including the consideration of a static or dynamic measure, the calculation method of change in the value of equity portfolios (taking into account dividends, reference currency, etc.) as well as the calculation method of the average spread for bond portfolios.

  As for the real estate, the proposed criterion for quantifying transition risk is the energy efficiency level of the building in question.

  EIOPA is considering to complement the retrospective analysis, based on historical data, with a forward-looking assessment..

  - EIOPA considers that the EU taxonomy is insufficient to assess companies' vulnerability to the energy transition as it provides only binary information. It proposes to adopt an approach incorporating factors of vulnerability to transition, quite similar to the method adopted for the Stress Test of the Financial System conducted in 2018 by the Bank of the Netherlands. Such method is based on a sector classification determined by NACE codes.
  - However, for its analysis, EIOPA would use the scenarios (orderly transition, disorderly transition, etc.) provided by the NGFS (Network for Greening the Financial System) as well as the NGFS's assessment to categorize transition risks (political reaction, technological change, etc.) into low, medium and high in each of these scenarios.

  Regarding the exposure of equity and bond investments to physical risk, EIOPA is not planning to take them into account in the immediate future because the data is considered insufficient.

- **Climate factors have a clear impact on the underwriting** risks of some insurance businesses. In 2022 EIOPA organized a data collection to gather information on climate change adaptation measures in pricing and non-life underwriting. EIOPA intends to use the approach defined for USP (Undertaking specific parameter) applicable to premium risk to carry out the analysis of the potential impact of adaptation measures and, depending on the conclusions, to change or not the parameters of the standard formula.

- As far as social **risks are concerned,** EIOPA has not undertaken any review of the Quantitative Pillar. The 'Discussion Paper' presents their inclusion within the context of pillars II (governance and risk management) and III (reporting).

Strengthening of the consideration of sustainability risks and the management of liquidity risk

➲ Integration of ESG-related risks and cyber security

The Solvency 2 article on risk management is amended to include the environmental, social and governance risks into the management process. The development of plans taking into account the goal of achieving climate neutrality by 2050 is also prescribed.

To manage sustainability risks and energy transition, insurers will need to rely on the information provided by the European Scientific Advisory Council on the Climate.

Short-, medium- and long term horizons will have to be considered and insurers will have to ensure consistency between the policies put in place to meet the Solvency 2 requirements and the elements communicated as part of the non-financial statement[7].

In addition, cyber security must be taken into account in the management of operational risk.

➲ Extension of the worst case scenarios for ORSA (Internal Risk and Solvency Assessment)

The draft Directive sets out a long list of economic and financial factors to be taken into account in ORSA and prescribes 2 global warming assumptions

The insurer must assess the consequences of adverse changes in financial markets such as adverse changes in interest rates, credit spreads and equity indices. Furthermore, insurers must also analyze the impact of inflation, the effects of interconnections with other financial market participants in adverse macroeconomic scenarios, and even assess the consequences of climate change, a pandemic or other large-scale events.

In addition, insurers are requested to assess whether their business can be a source of systemic risk.

However, the draft mentions that the analyses must remain proportionate to the scale and nature of the risks, as well as to the complexity of the insurer's activities.

Entities that have material exposure to climate change risk must assess their solvency at least every 3 years in at least 2 long term scenarios:

- A temperature increase below 2° C
- A temperature increase significantly above 2° C.

➲ A better assessment of the liquidity risk

The Directive is supplemented by new articles aiming to encourage insurers to improve their liquidity risk management and giving the supervisory authorities of the Member States the option to intervene in the event of a critical situation.

While liquidity risk has been an integral part of the banking and asset management regulation for many years, it materialized in the UK pension funds scene last September 2022. To meet unusually large margin calls, which had been induced by the violent rate hike on government bonds, portfolios with high leverage to fixed-income exposure were forced to sell assets on a massive scale.

The proposed Directive requires Member States to ensure that insurance entities dispose of sufficient liquidity to meet their obligations to policyholders and other counterparties. To better understand liquidity risk, insurers will need to set up and update:

- A liquidity risk management plan incorporating the expected cash flows from their assets and liabilities;
- Indicators to identify potential stress.

In the case where the supervisory authority identifies a deficiency, it may require the insurer to strengthen its liquidity position.

In November 2022, IAIS published a paper presenting liquidity measures that could serve as an auxiliary tool in 2023-2025.

The IAIS combines an **Exposure** approach based on the calculation of the Insurance Liquidity Ratio (Source/Need) over one year and 3 month horizons with a **Projection** approach based on projected cash flows over one year, 3 month and one month horizons.

- The calculation of the two insurance liquidity ratios is based on balance sheet items. Coefficients are defined for the different categories of financial assets and different types of liabilities and these coefficients are modulated according to the horizon, 1 year or 3 months.
- The Projection method estimates a net cash flow by subtracting expected cash outflows over the reporting period, to expected cash inflows, first in the central scenario and then in a stressed scenario. In the case of negative net flows, the deficit is offset by the sale of assets whose prices are discounted by the application of the coefficients defined for the calculation of the liquidity ratio. IAIS recognizes the complexity of this approach and some parameters should be refined.

EIOPA is in charge of sending its recommendations on the content and frequency of the liquidity risk management plan update.

[7] Established by Directive 2014/95 amending Directive 2013/34 on annual financial statements, consolidated financial statements and related reports.

The deadlines for some disclosures are extended while the Solvency and Financial Situation Report (SFCR) reshaped.

Extension of the deadlines for some annual reports to the supervisory authority

Parliament does not amend the Commission's proposals on reporting deadlines.

The deadline for the submission of annual reports has been extended from 14 to 16 weeks, but the deadline for the submission of quarterly reports remains very tight and maintained at 5 weeks for individual entities. However, it is envisaged that, in the event of an exceptional situation (health emergency, natural disaster, etc.), the Commission may extend these deadlines.

The time limit for submitting the regular report to the supervisor (RSR) is 18 weeks.

However, quantitative reporting models will evolve starting 2024 following an amendment by an Execution Regulation published last April

Execution Regulation 2015/2450, which defines the models to be used for reporting information to the supervisory authority, was repealed by Execution Regulation 2023/894 of 4 April 2023.

The asset model (S.06/02) is evolving very marginally. In particular, it is supplemented by information on:

- Real estate investments, type of use and location of buildings (prime, non-prime, etc.),
- Crypto-assets,
- The application of the provisions on Long Term Equity Investments.

A template has been added to all annual communications (model S.06.04). Its purpose is to disclose to regulators the proportion of investments that are exposed to transition and physical risks from climate change.

A prospect of relief measures suggested by the Directive draft

EIOPA must transmit, within 2 years, a report on the steps to be taken to develop a more integrated data collection, which would avoid the production of redundant or potentially inconsistent information by the different categories of regulated players (banking, insurance, management companies, etc.).

The themes mentioned as priorities refer to the data relative to the investment fund and derivatives.

This standardization will facilitate the sharing of information between national and European supervisory authorities.

Reshaping of the SFCR

The proposal to split the SFCR into two parts is maintained and the Parliament has added information on sustainability and the consequences of climate change.

More particularly, the **section intended for policyholders and beneficiaries** must contain synthetic information on the entity's business and the risks to which it is exposed. The Parliament has added a description of the sustainability risks and principal adverse impacts of the insurance entity on sustainability.

Insurance or reinsurance captives are exempted from the production of this section intended for policyholders.

The **professional section** is quite similar to the current SFCR. It must include a description of the governance system, the valuation methods of the assets and the technical provisions including the MCR and SCR amounts. The risk profile and the management of capital requirements should be described, as well as the impact of the application of the Matching Adjustment or Volatility Adjustment if any of these provisions is used.

Entities considered important for the financial stability of the European Union, should provide information on sensitivity to market changes.

The Parliament is willing to examine the results of the analyzes carried out under the two climate change scenarios, as well as information referring to the integration of ESG factors and convergence towards net zero by 2050 in the company's business plan.

The second change refers **to the audit requirement of the Solvency 2 balance sheet** included in the SFCR.

This requirement concerns both the entity scope and the group scope[8]. In addition, the auditor's report must be transmitted to the supervisory authority.

To take account of this additional requirement, the publication period has been extended and the SFCR publication deadline for an individual entity is set at 18 weeks following the end of the financial year.

[8] Insurance and reinsurance captive and entities identified as having a low risk profile are exempt

The extension of the proportionality principle reduces the burden on smaller and low-risk entities

➲ Review of the thresholds excluding small insurance companies from the scope of the Solvency 2 Directive

The Parliament's proposal is no different from that of the Commission and compared with the regulations in force:

- The threshold for annual gross written premium has tripled from 5 to 15 million euros
- The threshold for technical provisions has doubled from 25 to 50 million euros.

➲ Significant simplifications for low-risk entities

The Parliament is slightly changing the criteria for defining **'low risk profile** entities. The 20% limit on non-traditional investments proposed by the Commission is replaced by a limit on market risk. The Parliament's proposal is based on the new concept of Significant Cross-border Activities, which refers to entities that, under the freedom of establishment or freedom to provide services, receive more than 30 million euros in premiums or more than 15% of their total premiums in a host state.

The criteria depend on the type of activity:

Life insurance	Non life insurance
The basic Solvency Capital Requirement for interest rate risk is less than 5% of technical reserves (gross of reinsurance)	The combined ratio of the last 3 years is less than 100%
Premiums issued in Member States outside the country of residence do not represent a significant cross-border insurance activity	
Technical reserves (gross of reinsurance) are less than 1 billion euros	The annual gross premium is less than 100 million euros. The annual gross premiums for rail, air, marine, freight, credit insurance and guarantees cover less than 30% of annual premiums
Market risk represents less than 20% of total investments	
Less than 50% of premiums give rise to reinsurance	
No additional capital requirement under Article 37 of the Directive	

Entities with mixed activities must respect the limits for both types of activities.

All insurance and reinsurance captive entities are recognized as low risk profile.

Entities that believe they meet the criteria matching this profile and wish to benefit from the principle of proportionality, must notify their supervisory authority. However, the draft directive allows supervisory authorities to refuse the classification as a 'low risk profile' to entities that account for more than 5% of the national market.

The classification as a low risk profile significantly alleviates the insurer's obligations:

Simplification	· If the options and guarantees are intangible possibility of carrying out a cautious deterministic assessment of the life insurance commitments
Exemption	· Impact analysis of the ORSA climate change scenarios · Assessment of systemic risk generation · Elaboration of a liquidity risk management plan · Solvency 2 balance sheet auditing
Frequency spacing	· ORSA to be carried out every 2 years instead of annually · Report to the supervisor to be transmitted every 5 years instead of every 3 years · Written policies to be revised every 5 years instead of annually
Plurality of functions	· Possibility of assigning several key functions to the same person, with the exception of internal audit, provided that potential conflicts of interest are taken into account

Additionally, entities that do not qualify for a 'low risk profile' status may apply to obtain certain proportionality measures. They must specify the reason for their application and provide some explanation by exposing the nature, size and complexity of the risks inherent to their activity.

➲ Simplified calculation of the Basic Solvency Capital Requirement (BSCR) for risks that are immaterial

The Parliament does not amend the Commission's proposal to allow a simplified approach to assessing the capital required when the risk is immaterial.

This approach avoids the insurer from having to complete the calculation of a risk module every year, in the event this component should represent only a very marginal fraction of the entire BSCR.

If a risk is immaterial, for a period of 3 years following a 'classical' calculation of the capital required for this risk, the capital charge may be estimated by an evolution proportional to the change in the exposure to this risk. To be considered immaterial, a risk must not exceed 5% of the basic capital requirement (BSCR) and the capital requirement for all risks subject to a simplified calculation must not exceed 10% of the BSCR.

Several amendments aim to strengthen the protection of policyholders and to preserve the stability of the financial system

➲ Strengthening of the power of the supervisory authorities in case of events likely to constitute a systemic threat

In the event of an exceptional sectoral shock, the draft Directive gives the supervisory authorities the power to temporarily restrict or suspend the distribution of dividends, the payment of coupons on subordinated debt, the payment of bonuses or other variable remuneration.

The same type of measure may be imposed on an insurance entity that bears an acute liquidity risk or is likely to breach solvency requirements in the near future. As a last resort, the supervisory authority may suspend redemption rights on life insurance policies.

EIOPA is in charge of drafting the appropriate guidelines including the clarification of exceptional circumstances.

➲ Improved supervision of cross-border activities

Bankruptcies involving entities engaged in cross-border insurance activities have highlighted deficiencies in the system of supervision of insurance or reinsurance activities based on the freedom to provide services or the freedom of establishment.

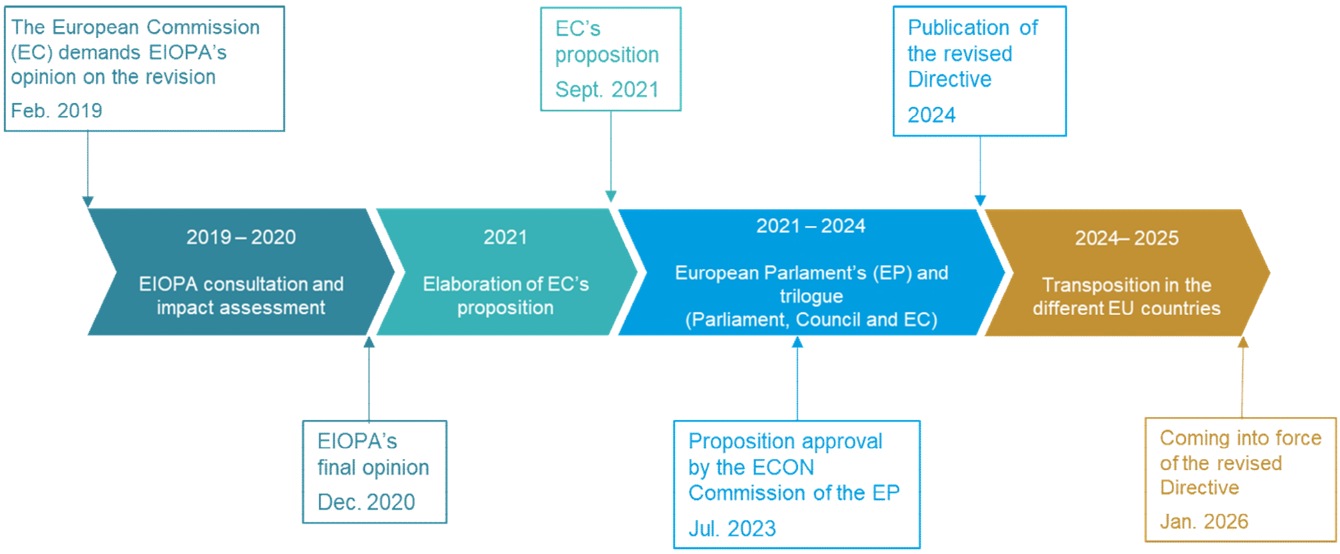
This is the reason behind the amendments that are being made to the Directive. The goal is to increase the exchange of information and cooperation between the supervisory authority of the host State and the home State authorities.

➲ Revision of Group Rules

The proposal for a directive adds several provisions extending the definition of insurance groups, clarifying the rules for calculating the group solvency ratio and improving the overall group supervision.

Next steps

The Directive draft approved by the Committee on Economic and Monetary Affairs provides for transposition by the Member States by June 30, 2025 at the latest and for application at the beginning of 2026. However, the timetable is also subject to discussion and the trilogue negotiation phase between the European Parliament, the Council of the European Union and the European Commission is only just beginning and it could lead to an agreement before the European elections in June 2024.



SOURCES:

EUROPEAN PARLIAMENT – July 27, 2023: proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138

OJ – December 17, 2009: Directive 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of November 25, 2009 on the taking up and pursuit of insurance and reinsurance activities (Solvency II)

EUROPEAN COMMISSION – September 22, 2021: Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138

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IAIS – November 18, 2022: Auxiliary indicator liquidity metrics - Level 2 document

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