Mr Alban Genais
Chairperson of the Council Working Party
Représentation permanente de la France auprès de
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14 Place de Louvain
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ECB-PUBLIC
ESRB/2022/0006

Solvency II Review

2 February 2022

Dear Mr Genais,

I am writing to you with reference to the proposal of the European Commission on the review of Solvency II.[1] Thanks to the work of the EU co-legislators and to the European Insurance and Occupational Pensions Authority (EIOPA) the market-based regulatory regime for insurers, introduced in 2016, has been a success in making individual insurers safer. To extend this success beyond individual insurers to the system-wide level, the European Systemic Risk Board (ESRB) has identified ways to enhance Solvency II in order to better address systemic risks. If left unaddressed, these risks could limit the insurance sector's contribution to sustainable growth in the European Union.

The ESRB communicated its views through its response to the consultation organised by the European Commission on the review of Solvency II.[2] In its response, the ESRB identified the following topics as the most pertinent with regard to their systemic relevance: the need to (i) better reflect macroprudential considerations in Solvency II; (ii) establish a harmonised recovery and resolution framework across the European Union; and (iii) continue to ensure that risks are properly captured under Solvency II. It also highlighted new insights from the events linked to the coronavirus (COVID-19) pandemic. It is worth noting that the ESRB and EIOPA's macroprudential considerations are broadly aligned, as shown in their respective responses to the Commission's consultation.

The proposal by the European Commission following this consultation is a good starting point, as it reflects many – albeit not all – of the elements that the ESRB identified to address risks to financial stability. It is important that these elements are not watered down during the legislative review since the proposal is deemed to be a minimum of what is needed to help prevent or mitigate risks to financial stability. I would also like to highlight points where the EU co-legislators could take the opportunity to strengthen and enhance the proposal.

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1 Proposal for a directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision, 22.9.2021, COM(2021) 581 final 2021/0295(COD).

2 The ESRB's response on the Solvency II review is on the ESRB's website available at: https://www.esrb.europa.eu/pub/pdf/other/esrb.letter201016_on_response_to_Solvency_II_review_consultation~8898c97469.en.pdf?acea8da5f1337e2ccd5eeff788656a17

Opportunities to strengthen the proposal to fully close important gaps in Solvency II

I would like to draw your attention to two important elements flagged by the ESRB in its earlier response and addressed to some extent by the European Commission in its proposal. The following elements require further strengthening.

- **Solvency risks** that arise from the low levels of interest rates and volatile capital markets. Failing to address these risks will result in solvency ratios being overstated, leading to fragile insurers with a higher risk of failure. The application of a more market-based method for deriving risk-free discount rates for insurers, which sets the last liquid point for the euro to 30 years and extends the convergence period from the last liquid point to the ultimate forward rate from 40 years to 100 years, is an important tool with which to address this risk.
- **Risks from distributions**, such as dividends or share buy-backs, can lead to a depletion of capital and insurers might try to conserve capital elsewhere by de-risking. Such de-risking strategies can amplify exceptional market-wide shocks. As distributions are also used as a signal of strength to the market, they could undermine the relative position of more prudent insurers, which may become stigmatised. Reflecting this, supervisors need powers to restrict distributions market-wide in exceptional circumstances.[3]

Opportunities to enhance the proposal to close further gaps that are currently not addressed

The proposal by the European Commission does not address some of the gaps highlighted in the ESRB's response. The following gaps are especially relevant in the context of low interest rates and sector-wide shocks.

- **Risks from mortgage lending** are closely related to real estate risks, and insurers in certain European countries invest up to 14% of their total assets in mortgage loans.[4] Despite continuing concerns about rising real estate prices in the European Union[5], insurers in many countries may engage in mortgage lending by applying lower capital requirements than banks. I therefore welcome the intention of the European Commission to better align the prudential treatment of mortgage loans in Solvency II with the credit risk framework for the banking sector.[6] However, the provisions for borrower-based measures for mortgage lending that apply independently of which part of the financial sector provides a loan are lacking. These measures are important to address the risks of residential real estate bubbles and rising foreclosures when the bubbles burst.
- **Risks from procyclical investment behaviour** can arise when insurers are forced to sell commonly held or correlated assets during times of stress. During the market turmoil in March 2020, insurance supervisors in some countries resorted to the existing transitional measures to smooth the impact of the sharp falls in asset prices. These measures, however, were not designed for this purpose, and this is problematic, as they will continue to provide capital relief for the next ten years. Improving existing mechanisms in Solvency II, including by making the countercyclical mechanism more symmetric, is therefore important.

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[3] See also Statement on dividends distribution and variable remuneration policies in the context of COVID-19, EIOPA, April 2020; Recommendation of the ESRB on restriction of distributions during the COVID-19 pandemic (ESRB/2020/7), ESRB, May 2020.

[4] See EIOPA Insurance Statistics, reporting template S.06.02 solo, Q2 2021

[5] See for example ESRB, 2019, Follow-up report on countries that received ESRB warnings in 2016 on medium-term vulnerabilities in the residential real estate sector

[6] See Communication from the Commission to the European Parliament and the Council on the review of the EU prudential framework for insurers and reinsurers in the context of the EU's post pandemic recovery, COM (2021) 580 final.

In the annex to this letter you find an overview table that summarises which of the elements set out in the ESRB's response to the European Commission's consultation on the Solvency II review were largely incorporated in the Commission's proposal and which of them were not or only partially.

My staff and I are at your disposal to discuss macroprudential elements in the review of Solvency II.

Finally, please be informed that the same letter has been sent to the relevant Members of the European Parliament responsible for this legislative file, and this letter will be published on our Website.

Yours sincerely,

Francesco Mazzaferro

Head of the ESRB Secretariat

Annex: Mapping of macroprudential measures for insurance advocated by the ESRB against the proposal by the European Commission

	Measures advocated by the ESRB	COM
Macro-prudential considerations	Liquidity tools for addressing risks stemming from specific activities	✓
	Clarification of the ESRB’s role in the declaration of exceptional adverse situations	✓
	Solvency tools for preventing/mitigating procyclical behaviour with a symmetric volatility adjustment	✗
	Tools (including borrower-based ones) for addressing risks stemming from credit provision	✗
Harmonised recovery and resolution	Recovery and resolution framework	✓
	Insurance guarantee schemes	✗
Properly capture risks	Adjustment of the risk-free rate	~
Resilience in crises	Ensuring the provision of critical insurance services	✓
	Correction of the countercyclical volatility adjustment for overshooting in crises	~
	Supervisory powers to block distributions	~

Note: A tick [cross] in the column headed ‘COM’ indicates that a measure advocated by the ESRB has largely [not] been reflected in the proposal by the European Commission. A tilde indicates that only parts of a measure advocated by the ESRB have been incorporated in the proposal by the European Commission and/or that their implementation should be enhanced.