



# SOLVENCY II REVIEW

*ANIA's views on the 2020 Solvency II Review*

Position Paper

## *Key priorities for the Italian Insurance Industry*

*The Volatility Adjustment needs to be fixed in its flaws, to become an effective countercyclical tool.*

*The RFR extrapolation methodology should be maintained as it is, avoiding additional complexity and volatility.*

*The Interest Rate Risk sub-module should have an explicit term-dependent floor to prevent a possible overestimation of risk.*

*The Long-Term Equity sub-module needs to appropriately recognise the fundamentals of long-term investments and better reflect the volatility in equity markets.*

*The Proportionality framework should ensure that insurers can avoid unnecessary costs based on the scale, nature and complexity of their activities.*

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# 1. Introduction

The **Solvency II regime has been introduced** in the EU legislation to **harmonise diverging local regulations**, align regulatory **practices** to the modern capital and risk management approaches **and guarantee that consumers are given consistent, high levels of protection**.

The introduction of Solvency II has therefore been strongly supported by the insurance industry and its economic, risk-based framework has proved its value since it was first applied in January 2016.

On the one hand, Solvency II has largely achieved its objectives, so what is required is **a set of focused changes**, on the other hand, if we consider the new challenges the European insurance industry is now facing, there is no doubt that **a new objective must be added to the old ones**.

As a matter of fact, the **Solvency II 2020 Review should now also pursue the reduction of undue requirements and constraints that may hamper long-term investments; this new objective can be achieved with targeted amendments that should lead to a better reflection of insurers' real risk**.

Solvency II is certainly the most sophisticated prudential framework in the world, but it is also the most conservative, creating **unnecessary costs and barriers**, which **have a significant impact on insurers ability to make long-term investments in the economy and offer long-term products**, already challenged by a negative interest rate environment.

**The insurance sector is key to achieving the objectives of the Capital Markets Union (CMU)**. As Europe's largest institutional investors, insurers have the financial strength to provide widespread benefits for the economy, acting in a countercyclical manner and investing with a sustainable, longer-term perspective.

The renewed framework will be required to consider new needs and properly respond to them. Moreover, the pandemic crisis is requiring to our industry a greater effort to support the achievement of the Commission targets of a greener, more digital and more resilient European Union.

**This is what makes Solvency II so important.**

**In aggregate, the impact of all changes should lead to a justified and needed reduction in capital requirements and volatility. This can be done safeguarding**, at the same time, the key objectives this legislation is aimed at, namely providing for equivalent protection for policyholders as well as robust prudential treatment in the perspective to preserve financial stability.

ANIA considers **the review of Solvency II to represent a key opportunity for policymakers to:**

- ✓ **deliver on the important European objectives** set out in the **Green Deal** and the **Capital Markets Union**, as well as support the **Next Generation EU** plans for the social and economic recovery of Europe. This would help insurers to: i) maintain their role as providers of long-term savings/pension

*The **Solvency II** framework has proved its value and largely **achieved its objectives**, since the entry into force in 2016.*

*The **Solvency II 2020 Review** should pursue the **reduction of undue requirements and constraints that may hamper long-term investments** in connection with **Green Deal** and **Next Generation EU**.*

products, which are key for the long-term well-being of European citizens, especially in light of ageing populations, and strained national budgets; ii) provide protection to individuals and businesses, and working with governments to close the protection gap, currently considered of paramount importance, given the challenges posed by climate change and iii) invest in the European economy, supporting the post-COVID-19 recovery and the transition to a sustainable economy;

- ✓ **support the competitiveness of the European insurance industry on the global stage**, and thus deliver on the EC ambition to strengthen Europe's leadership in the world.

In order to achieve the aforementioned objectives, it is crucial to focus the Solvency II Review on **improving existing instruments to fully take into account insurers' long-term business model, to mitigate artificial volatility and to reduce the unnecessary operational burden.**

**In particular, ANIA calls for:**

- ✓ **an appropriate valuation of insurance liabilities, which requires:**
  - **improving the Volatility Adjustment** to better mitigate market volatility, fully recognise country specific spreads within the eurozone and better reflect the spread above the risk-free rate that insurers can and do earn;
  - **maintaining the current extrapolation methodology**, avoiding additional complexity and volatility or, in alternative, to introduce the new methodology via a simple, predictable and mechanical phase-in mechanism in order to minimise the most critical elements and reduce unintended consequences.
- ✓ **an appropriate, risk-based capital treatment of assets, which requires:**
  - **fixing the design of the long-term equity** asset category;
  - **allowing for negative interest rates** in the capital charge calculation **with an appropriate floor.**
- ✓ **A proportionality framework working in practice**, to avoid unnecessary costs which ultimately would have to be borne by policyholders.

*it is crucial to focus the Solvency II Review on improving existing instruments to fully reflect insurers' long-term business model, to mitigate artificial volatility and to reduce the unnecessary operational burden.*

## 2. Italian priorities in the Solvency II Review

### 2.1 Volatility Adjustment (VA)

In general, **insurers have very stable balance sheets, based on long-term and predictable liabilities**, which enables them to take a long-term approach to investment. Given this long-term perspective, **they are generally less exposed to short-term market volatility and can play a countercyclical role in the financial markets.**

After a long debate regarding the assessment of long-term liabilities, on June 2013 the European Insurance and Occupational Pension Authority (EIOPA) introduced the so-called Long-Term Guarantee (LTG) package including a “countercyclical premium” (now known as the Volatility Adjustment and implemented as an additive correction to the risk-free interest rates term structure<sup>1</sup>).

According to Solvency II Directive (art. 77d), for each relevant currency, **the Volatility Adjustment shall be based on the spread between the interest rate that could be earned from assets included in a reference portfolio** for that currency and the rates of the relevant basic risk-free interest rate term structure for that currency, **reduced by the portion of that spread that is attributable to a realistic assessment of expected losses or unexpected credit or other risk of the assets** (i.e., the “risk correction”).

**For each relevant country, the above correction shall be increased** (in cases of localised exaggerations of bond spreads) **by an amount calculated in the same manner but based on a country-specific reference portfolio** (the so called “country or national component”).

The main objectives behind the design of this measure were to:

- ✓ **mitigate the impact of short-term market fluctuations** on own funds with respect to long-term insurance activities,
- ✓ **prevent pro-cyclical investment behaviour,**

The construction and calibration of such adjustment are therefore paramount when speaking of keeping the right incentives alive in insurance companies' investment strategies. **The Solvency II regime should not**, because of measurement flaws which do not currently reflect the real underlying risks and business model, **create artificial incentives for insurers to act in a procyclical way and inhibit their ability to play a countercyclical role.**

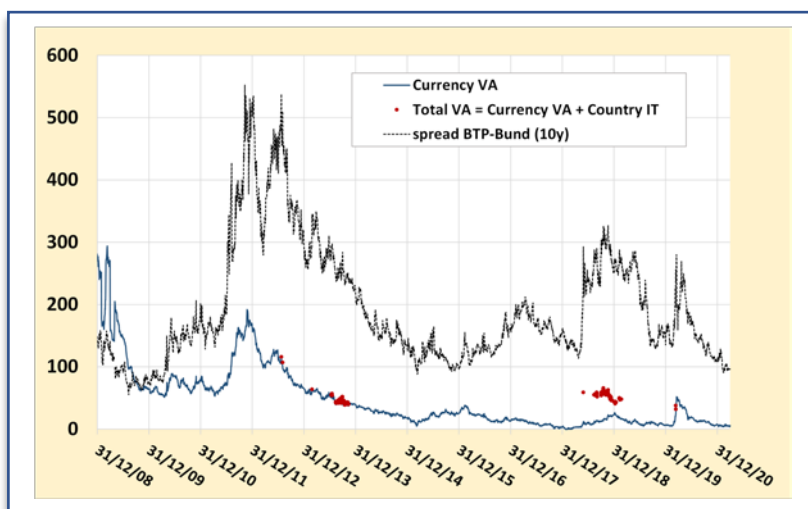
The extent to which a working and robust VA is needed has not been fully witnessed since the implementation of Solvency II. While some spread widening was experienced during the Covid-19 crisis, this was nowhere near the magnitude of 2008 or 2011 crises. On the other hand, significant spread widenings were witnessed in some national markets in 2008, 2011 and 2018 but backtesting analysis provided by ANIA shows that almost no relief was provided by the VA country component.

*Insurers are generally not exposed to short-term market volatility and can play a countercyclical role in financial markets.*

*Volatility Adjustment is aimed at mitigating the impact of short-term market fluctuations.*

<sup>1</sup> (RFR curve) Discount rates used to calculate insurance liabilities.

CHART 2.2.1: VOLATILITY ADJUSTMENT FOR ITALY



Source: ANIA elaboration on EIOPA and Refinitiv data; daily data; red dots indicate total VA for Italy when the country component activates.

*Significant spread widenings were witnessed in national markets in 2008, 2011 and 2018 but almost no relief was provided by the VA country component.*

With this in mind, ANIA appreciates the effort made by EIOPA in proposing some corrections and refinements to the existing VA framework aimed at addressing the most important shortcoming of the current VA - i.e., the failed activation of the national component in countries where market conditions were justifying it.

The pandemic, however, stressed the volatility of the current prudential rules but also how some other important elements concurring to it have not been properly addressed in the proposed VA solution.

As previously mentioned, the country component is particularly important for Italy, but it has not worked properly especially when it has been needed the most, namely in case of extreme volatility at national level, due to temporary circumstances reabsorbed in the medium term; these events expose Italian insurer's balance sheets and solvency positions to a high degree of so called "artificial volatility".

Moreover, it has proven once again how using punctual daily data to calculate Solvency II metrics, especially when calculating the VA, cannot be regarded as the optimal solution to measure volatility in financial markets, thus giving a wrong representation of the true risks to which insurers are exposed during a spread crisis.

The financial market turbulence caused by Covid-19 has shown that it is even more important than previously thought to have effective stabilising elements in the solvency regime. The solvency position of insurers should present a robust and reliable picture of their future prospects and must not be distorted by short-term fluctuations which might provoke pro-cyclical reactions that further fuel a crisis.

ANIA believes EIOPA's proposal to change activation conditions of the VA country component<sup>2</sup> goes in this direction as it contributes to better reflect insurers' investment risk and eliminates current cliff-edge effects.

This important improvement is however strongly offset by some detrimental proposals such as the changes in the risk correction methodology and the introduction of a liquidity application ratio.

*ANIA appreciates the effort made by EIOPA in addressing the most important shortcoming of the current VA...*

*...however, important improvements in the new VA design are strongly offset by some existing structural inconsistency and by detrimental proposals.*

ANIA considers it is crucial that such modifications, which have a general effect, do not undermine the effectiveness of the redesigned adjustment, by introducing procyclical elements in a measure which should be anticyclical by nature.

ANIA strongly opposes EIOPA's hypothesis that the risk correction is currently misestimated and EIOPA's option of calculating the risk correction as a percentage of prevailing spreads. Its proposal would severely limit the ability of the VA to offset artificial spread volatility, making the VA less effective during a crisis, thus undermining the countercyclical effect of the VA – which is in contrast to the European Commission's request to assess the efficient functioning of the VA as a mechanism to prevent procyclical behaviour on financial markets and to mitigate the effect of bond spread exaggerations. (see more detail in Chapter 3 "[No need to change the risk correction](#)")

In support of its argument, EIOPA makes a comparison between historical spread movements and risk correction and asserts that this is evidence that the risk correction is not sufficiently sensitive to spread movements. However, the correct comparison which should be made to assess the effectiveness of the risk correction is between the risk correction and the losses which occur due to defaults.

EIOPA then states that the proposed changes to the risk correction are unanimously supported by the academic literature. **ANIA does not agree and considers EIOPA's references to academic literature incomplete and potentially misleading.**

According to findings from Amato and Remolona (2003)<sup>3</sup>, Alexopoulou et al. (2009)<sup>4</sup>, Fischer and Stolper (2019)<sup>5</sup>:

- ✓ under stressed market conditions liquidity risk is the main determinant of the credit spread movements.
- ✓ the portion of the spread reflecting credit risk fundamentals appears significantly less volatile than the entire spread, thus risk correction must be calculated as an absolute value and not as a percentage of the spread.

The above-mentioned findings confirm that **assuming a risk correction that moves proportionally with respect to the credit spread is to say the least questionable** (see more detail in Chapter 3 "[No need to change the risk correction](#)").

**ANIA, therefore, supports improvements to the Volatility Adjustment resulting in the following outcomes:**

- ✓ a general increase in the level of the VA to properly reflect the ability of insurers to earn returns above risk-free rates.
- ✓ an increased mitigation of artificial balance sheet volatility.

In ANIA's view, these improvements should consist in:

- ✓ The proposed VA mechanism<sup>6</sup> could be further improved by more properly taking into account the scale parameter in the activation of the macro-VA, as the proposed component  $\omega$  - designed to ensure a gradual and smooth activation of the country

*EIOPA proposal is in contrast with the European Commission's request to assess the efficient functioning of the VA...*

*...and with academic literature.*

<sup>2</sup> Defined as "macroeconomic component" in the EIOPA proposal.

<sup>3</sup> Amato J.D. and Remolona E. M. The credit spread puzzle. BIS Quarterly Review, December 2003.

<sup>4</sup> Alexopoulou I., Andersson M., Georgescu O. M. An empirical study on the decoupling movements between corporate bond and CDS spreads. European Central Bank (ECB). Working paper series n. 1085 / August 2009.

<sup>5</sup> Fischer H. and Stolper O. (2019). The nonlinear dynamics of corporate bond spreads: Regime-dependent effects of their determinants. Discussion Paper. Deutsche Bundesbank N. 08/2019.

<sup>6</sup>  $VA_{EIOPA} = 85\% * AR_4 * AR_5 * Scale_{curr} * risk\ corrected_{currency\ Spread} + 85\% * AR_4 * AR_5 * \omega * (Scale_{country} * risk\ corrected_{country\ Spread} - 1,3 * Scale_{currency} * risk\ corrected_{currency\ Spread})$



component and mitigating the cliff effect - is based on non-rescaled risk corrected spreads.

- ✓ **The general application ratio (GAR, increased by EIOPA from 65% to 85%) should be increased up to 100%.** Any haircut to the general application ratio intended to account for unquantified risks which are already largely dealt with elsewhere in the framework is considered to be technically unjustified and should be avoided.
- ✓ **There is not a prudential need to introduce liquidity penalties through the proposed “adjustment for illiquidity of liabilities” if GAR is set to 85%.** Such simultaneous haircuts are regarded to be too conservative and might imply double counting of risks. In any case, AR5 should be better addressed in Pillar II.
- ✓ **The risk correction should be based only on historical average default statistics, as it currently is.** Changing the risk correction to be a percentage of current credit spread embeds unjustified methodological assumptions and will paradoxically increase artificial volatility and pro-cyclicality. From an economic point of view, the risk correction should reflect the expected cost of default and downgrade i.e., be a realistic assessment of the costs incurred by holding a diversified portfolio of bonds over the long-term.

See Chapter 3 for further evidence and explanation on why no change in the Risk Correction is needed or justified. **If, notwithstanding our strong objections, EIOPA's new risk correction methodology would be considered further, then material changes to its proposed methodology would be needed to ensure the VA's ability to act as an effective countercyclical tool is maintained.** In ANIA's view, an improved calibration of the risk correction should imply a significant reduction of the parameters proposed by EIOPA (i.e., the percentages applied to the current and long-term portion of the portfolios spreads). Moreover, the improved calibration must be such that the Volatility Adjustment, calculated under the new framework, would bear – in particular for the currency component <sup>7</sup> – an average standard deviation at least equal to the VA currently in force; this would allow the VA to maintain its ability to act as a countercyclical tool preventing pro-cyclical behaviour in financial markets and mitigating the effect of temporary bond spread spikes (see more detail in Chapter 3 “[No need to change the risk correction](#)”).

*Important improvements to the current EIOPA proposal are needed in terms of:*

- ✓ activation of macro-VA
- ✓ general application ratio
- ✓ illiquidity ratio
- ✓ risk correction

*In particular, material changes to EIOPA proposed risk correction methodology would be needed to ensure the VA's ability to act as an effective countercyclical tool is maintained.*

## 2.2 Extrapolation of risk-free interest rates (RFR curve)

The Solvency II framework already captures long-term interest rate risks and the resulting discount rates used to calculate liabilities (“RFR curve”) are very low already, contributing to set proper risk management incentives for new business.

A number of elements are already in place to cover the risk that interest rates will stay low for a very long term and to ensure that companies and supervisors are well equipped to manage such an eventuality, such as the:

- ✓ **updated UFR methodology**, that will reduce the extrapolated rates every year,
- ✓ proposed overly punitive **interest rate down shock SCR**,
- ✓ low for long **stress tests carried out regularly** to increase the European companies understanding of the impact of such scenarios on their portfolios,
- ✓ **ORSA and the undertakings overall Solvency assessments**, which consider lower interest rates scenarios in their decisions regarding capital distributions.

*The Solvency II framework already captures long-term interest rate risks and cover the risk that interest rates will stay low for a very long term.*

<sup>7</sup> Defined as “permanent component” in the EIOPA proposal.



It is also important to note that **the current extrapolation method of risk-free interest rates** used to discount insurance liabilities has proven its worth: it **contributed significantly to the stabilisation of Solvency II results in 2020** and has proven its countercyclical nature during these years.

What EIOPA is proposing would shift extrapolated rates to a lower level, and this would result in a more punitive methodology. According to ANIA's simulations, the newly extrapolated curve would result approximately 25-30 bps lower than the current one. In other words, **EIOPA's proposal would contribute to increase capital requirements by decreasing own funds.**

CHART 2.2.1: ALTERNATIVE VS. SMITH WILSON EXTRAPOLATION METHOD (YE 2019)

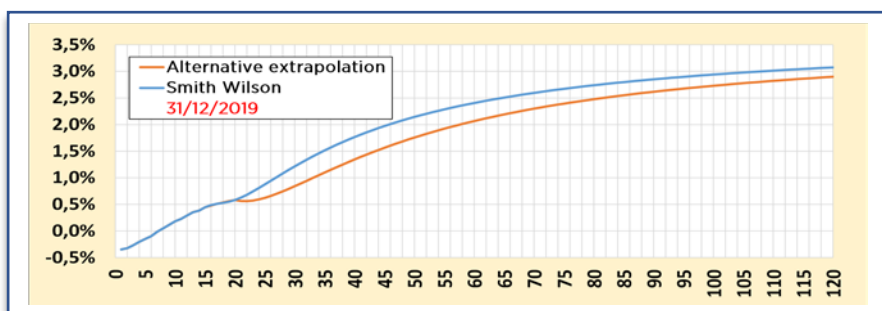
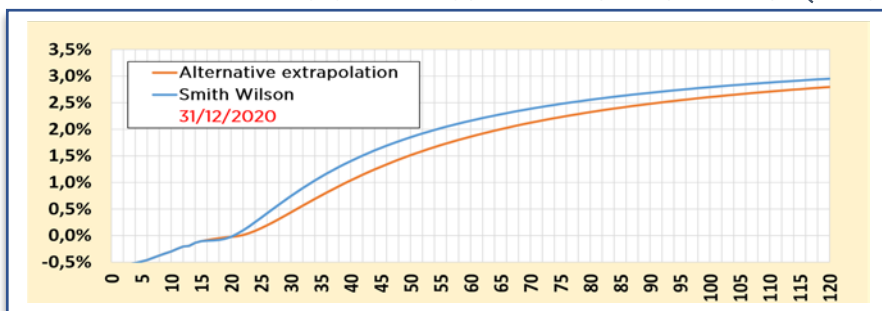


CHART 2.2.2: ALTERNATIVE VS. SMITH WILSON EXTRAPOLATION METHOD (YE 2020)



Source: ANIA elaboration on EIOPA and Refinitiv data.

To gradually introduce the additional requirements borne by the new extrapolation methodology, EIOPA has provided a transitional mechanism ("emergency brake"<sup>8</sup>) which will last until 2032.

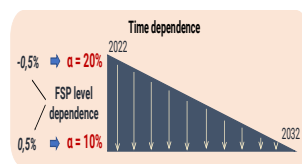
According to this mechanism, in fact, during the transitional period, the convergence parameter  $\alpha$  would be quantified using current 20y interest rates at future reference dates.

Although transition mechanisms are supported in principle, ANIA notes that dependency from interest rate levels and valuations dates used are shortcomings which make this proposal particularly unfit for its intended purpose; **its results would be very unpredictable and volatile, thus transferring these flaws directly into Solvency II balance sheets.**

It produces uncertainty on future levels of RFR curve, possible cliff-edge effect and it is not sufficient to alleviate the increase in capital requirements and volatility due to the RFR methodology change after 2032.

*The current RFR extrapolation method contributed significantly to a stabilisation of Solvency II results in 2020.*

*EIOPA's proposal would contribute to increase capital requirements and undermine stability in Solvency II results.*



*The "emergency brake" mechanism would produce uncertainty on future levels of RFR curve.*

<sup>8</sup> A transitional mechanism intended to mitigate the impact of the proposed alternative extrapolation method when interest rate levels are below those of 2019 (0.5% at 20y).

**ANIA, therefore, advocates for maintaining the current extrapolation methodology, avoiding additional complexity and volatility or, in alternative, for the introduction of the new methodology with a calibration parameter of 20% instead of 10%.**

**If there is a need for a transition due to the impact of changes, it should be based on a simple, predictable and mechanical phase-in mechanism in order to minimise the most problematic elements and reduce unintended consequences.**

This can be achieved by improving the model such as:

- ✓ **the value of convergence parameter is set to 20%** for the euro, which is consistent with the industry view that the current curves do not underestimate liabilities or are likely to cause financial stability issues.
- ✓ if an ultimate convergence parameter of less than 20% is foreseen, then this should be achieved by **decreasing this parameter by 1% each year**.
- ✓ there should be neither **permanent nor temporary requirement to report technical provisions, SCR and/or Own fund sensitivities** using any different alpha parameters.

## 2.3 Interest Rate Risk module (IRR module)

In recent years, economic conditions coupled with the liquidity measures taken by monetary authorities around the globe to contrast crisis situations have pushed interest rate levels into negative territory.

**ANIA recognises the need to properly reflect this new phenomenon in the insurance regulation, thus recalibrating the interest rate risk sub-module to reflect the low and negative yield environment.**

**However**, it should be acknowledged that this is the first time in history (not in 200 years) of negative interest rates and possibly that **financial markets will not work as we know it if rates should drop even further**, for example to the levels set by the new negative IRR shocks.

**Experience of interest rate changes in times of positive rates cannot be transferred mechanically to periods with substantially negative rates** without rethinking financial markets behaviour and, consequently, insurer's investment strategies. If interest rates were to fall too far and/or for too long below zero, insurers would have to retreat from fixed income investments and switch to a combination of investing more in real assets and/or holding more cash.

**In light of the aforementioned considerations, ANIA believes that a realistic and efficient interest rate negative shock should be calibrated including an explicit floor, which should:**

- ✓ **be representative of the EEA market as a whole,**
- ✓ **reflect the realistic extent to which yield curves can go negative,**
- ✓ **be term-dependent, to ensure its appropriateness for longer-term rates as well.**

EIOPA's final proposal on changes to the interest rate risk sub-module reflects a small improvement compared to previous versions. However, **the proposed interest rate still seems to overestimate the likelihood of low interest rates for the full range of maturities,**

*ANIA recognises the need to properly reflect negative interest rates in the insurance regulation...*

*...however, experience in times of positive rates cannot be transferred to periods with negative rates without rethinking financial markets behaviour.*

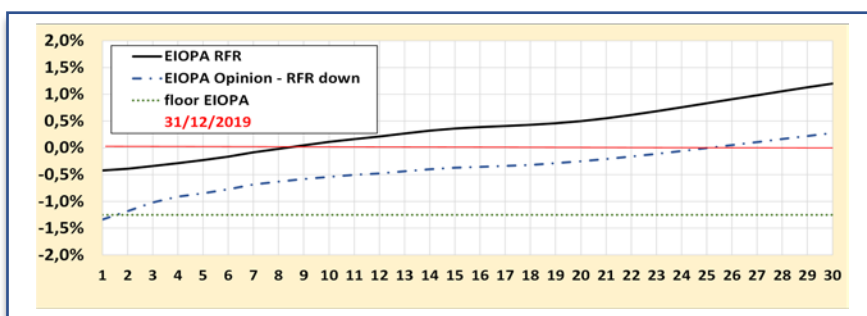
with a significant impact on solvency ratios and unnecessary increase in capital charges for many undertakings with long-term liabilities (see more detail in Chapter 3.1 [significant overhaul of the Solvency II framework](#))

ANIA appreciates EIOPA's acknowledgement of stakeholder feedback by recognising that the model should have an explicit floor to "prevent a possible overestimation of interest rate risk". However, as of today, the floor has been calibrated to -1,25%, based on historical interest rates in the Swiss Franc market<sup>9</sup> which does not appear to be sufficiently representative of the EEA-markets as a whole to provide an appropriate floor (only 0.16% of the liabilities in the EEA are denominated in Swiss Francs).

Moreover, the explicit floor has been designed to be fixed for all maturities, despite EIOPA itself observing<sup>10</sup> how the introduction of maturity-dependent shift parameters for the downward shock is "justified economically speaking".

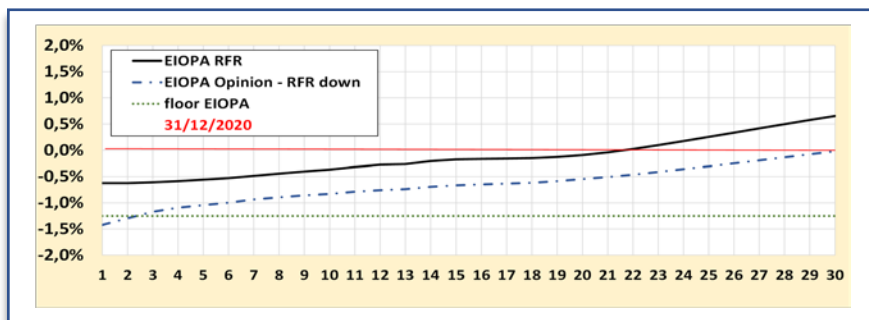
The following charts clearly show that the proposed floor works only for the first 1-2 years of the term structure, even if we consider a significant low yield environment as has been the one experienced at YE 2020, where rates were negative until the 21-year horizon.

CHART 2.3.1: EIOPA IRR SHOCK DOWN PROPOSAL (YE 2019)



Source: ANIA elaboration on EIOPA and Refinitiv data.

CHART 2.3.2: EIOPA IRR SHOCK DOWN PROPOSAL (YE 2020)



Source: ANIA elaboration on EIOPA and Refinitiv data.

A term-dependent floor - for example defined equal to  $-\theta_m s_m^{down}(\theta_m)$ , a factor used by EIOPA to define the shock<sup>11</sup> (see Chart 2.3.3) - would better reflect market reality.

An efficient interest rate negative shock *should be calibrated including a representative, realistic and term-dependent explicit floor.*

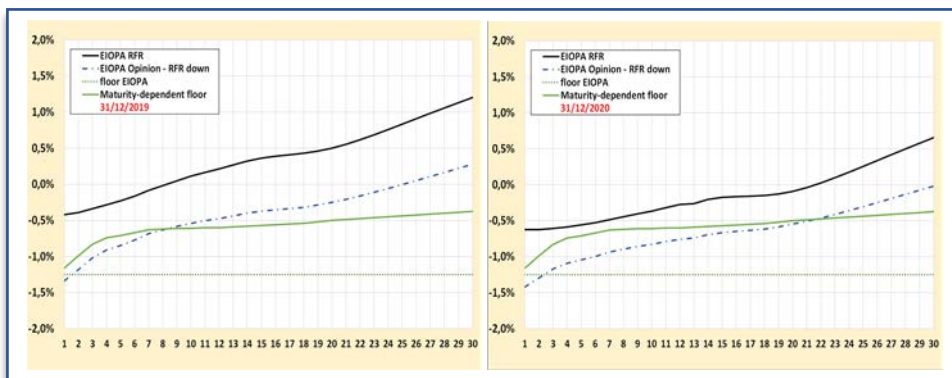
The floor proposed by EIOPA, calibrated based on the Swiss Franc market and designed to be fixed for all maturities, does not work.

<sup>9</sup> The calibration of the floor (-1.25%) was based on the lowest rates observed for maturities 1 to 10 years for EUR, JPY and CHF swap rates and for German government bonds until end of August 2020., observed for CHF swap rates (ranging from -1.217% for the maturity of 2 years to -1.131%).

<sup>10</sup> Second set of advice on the 2018 Review, par. 758.

<sup>11</sup> In EIOPA's proposal the down shock RFR curve is defined as:  $r_t^{down}(m) = r_t(m) * (1 - s_m^{down}(\theta_m)) - \theta_m s_m^{down}(\theta_m)$ .

CHART 2.3.3: A TERM-DEPENDENT FLOOR TO THE IRR PROPOSAL



Source: ANIA elaboration on EIOPA and Refinitiv data.

To limit the significant negative impact of the new proposal regarding the interest rate risk sub-module, EIOPA's final proposal introduces a 5-year phase in period.

ANIA welcomes EIOPA's proposal, and ideally would call for a longer phase in period, however, **introducing a phase-in mechanism is not sufficient to alleviate the increase in capital requirements due to the IRR methodology change.**

**Care must be taken also to the design of the phase in mechanism** to avoid the risk of a measure decoupled from the evolution of interest rates. For example, calibrating the interest rate risk down shock taking a 1/5th difference between the current stressed curve and the new stressed curve at a fixed date (i.e., the date of entry into force of the amendments) can have a very different and unpredictable impact depending on the reference date chosen for its calculation.

*A term-dependent floor would better reflect market reality.*

*Introducing a phase-in mechanism is not sufficient to alleviate the increase in capital requirements due to the IRR methodology change.*

**In conclusion, ANIA would support a revision of the interest rate risk module provided it includes:**

- ✓ A negative interest rates shock with a floor calibrated on EEA interest rates,
- ✓ A term-dependent floor which would be able to work also for longer maturities,
- ✓ A phase in mechanism not depending on a fixed calculation date.

## 2.4 Long Term Equity module (LTE module)

Long term-investing is not simply about maturity or duration of assets or about restricting individual assets to be held to maturity or for a certain number of years. Instead, it is about the nature of the liabilities and the overall risk and investment strategy, which allows the insurer to hold its investment portfolio over a long-term horizon.

The ability and willingness to invest long-term is directly related to the nature of the liabilities of insurance companies and is not in contradiction with dynamic management of the investment portfolio in line with best risk management practices.

ANIA is a supporter of the Capital Market Union project since its inception and appreciates the EC's work in this area so far; the steps taken with the objective to improve the framework for long-term equity (LTE) in Article 171a<sup>12</sup> of the Delegated

*Long-term investing is about the nature of the liabilities and the overall risk and investment*

<sup>12</sup> Cfr. Article 171a of the Delegated Regulation. Introduced by the EC as result of the 2018 Review process, with the aim to recognise the long-term investments with appropriate capital requirements that reflect their long-term risks.

Regulation is considered to represent another building block towards the completion of the project.

**EIOPA itself has produced an appreciable effort for the 2018 Review in order to make the Long-Term Equity module more workable** and make the criteria prudentially sound by linking them to the illiquidity of long-term liabilities. This action would for sure go in the right direction when speaking of supporting the long-term investment capacity of insurance companies.

**Nevertheless, a decisive but major effort in further refining some of the eligibility criteria has to be done in order to better reflect market practices in the widest number of European countries.**

This would make the measure truly effective in supporting the Green Deal and the Capital Markets Union strategy.

As it is stated by the European Commission on its recent Communication on the CMU, “the participation of insurers in long-term investments, in particular equity, can be supported by ensuring that the prudential framework appropriately reflects the long-term nature of the insurance business and mitigates the impact of short-term market turmoil on insurers’ solvency”.

For all these reasons, **the LTE sub-module needs to appropriately recognise the fundamentals of long-term investments and better reflect the volatility in equity markets.**

According to academic literature (Mladina<sup>13</sup>, 2014) there is substantial evidence that asset risk for equity investments diminishes as the holding period lengthens (“equity returns show more volatility and tail risk at short horizons than at long horizons”).

In particular, regarding the criterion concerning life liabilities (criterion (g)<sup>1</sup>), the 10-year duration requirement for Homogeneous Risk Groups make the criterion hard to be fulfilled as it can only be met by few long-duration pension products. **The requirement should be lowered to 5 years, which is a time-period with about half of the volatility than a 1-year horizon.**

This would make achievable the LTE module in countries where business is characterised by lower durations such as Italy.

## 2.5 Proportionality principle

Changes in this area are necessary to ensure that any insurer can avoid, based on the scale, nature and complexity of its activities, unnecessary costs which ultimately would have to be borne by policyholders. **ANIA welcomes the Commission’s ambition to improve the application of proportionality in Solvency II.**

As a matter of fact, **the Italian market is characterized by many small and medium-sized enterprises.** At the same time regulatory costs, as of today, are not proportional to the size and complexity of the company; this puts smaller companies at a competitive disadvantage compared to larger or more complex insurers. Regulatory regimes should be fair for all market players; diversity in the market benefits consumers in terms of choice and price competitiveness.

*EIOPA has produced an appreciable effort to make the LTE module more workable...*

*...Nevertheless, a final refinement would make the measure truly effective in supporting the Green Deal and the CMU strategy.*

*ANIA welcomes the Commission’s ambition to improve the application of proportionality in Solvency II...*

<sup>13</sup> Mladina, P., “Dynamic Asset Allocation with Horizon Risk: Revisiting Glide Path Construction”, in The Journal of Wealth Management, Vol 16, No 4.

It is immediately understandable how fundamental this topic might be for the Italian market. Supporting further this statement is that in recent years Italy has been the only European country to implement proportionality measures in Pillar II requirements. **The absence, to date, of "practical application" rules has led the Italian Supervisory Authorities to draw up national regulations - IVASS regulation n. 38/2018 - aimed at improving certain areas for the application of the proportionality principle.** ANIA has played an important role in this process, asking for a dialogue with IVASS and stimulating the Italian authority to work on measures which would have set the basis for a regulatory environment based on proportionality.

In particular, **ANIA firmly believes that when designing the new European proportionality framework, extreme care must be taken to ensure that, by leveraging on national experiences, is able to avoid duplication or incoherence of eligibility criteria and requirements.** This is extremely important to avoid unnecessary costs for all companies but in particular for smaller companies, which are the ones that already suffer an unbalanced regulatory cost structure.

ANIA supports Insurance Europe's proposals on how EIOPA's proposals need improving.

## 2.6 Other EIOPA proposals

Other proposals from EIOPA are listed below.

ANIA supports the positions and counterproposals put forward by Insurance Europe on these and it is important that they be considered as part of the final compromise.

Reporting and Disclosure	Dynamic VA	Risk Margin
<ul style="list-style-type: none"> <li>• <b>SFCR</b>: amendments to the structure and content.</li> <li>• <b>RSR</b>: amendments to the frequency; elimination of some templates; revision of the existing risk-based thresholds.</li> </ul>	<ul style="list-style-type: none"> <li>• No dynamic VA allowed in the SCR standard formula.</li> <li>• <b>Enhanced prudency principle</b> where a dynamic VA is taken into account in internal models.</li> </ul>	<ul style="list-style-type: none"> <li>• Change to the calculation of the risk margin to account for the time dependency of risks.</li> </ul>
<b>Macroprudential Policy</b>		
<ul style="list-style-type: none"> <li>• <b>Power to supervisory authorities to:</b> <ul style="list-style-type: none"> <li>○ require a capital surcharge for systemic risk,</li> <li>○ restricting or suspending dividends,</li> <li>○ define soft concentration thresholds,</li> <li>○ draft recovery and resolution, systemic risk, and liquidity risk management plans,</li> <li>○ grant NSAs with additional mitigating measures for liquidity risk,</li> <li>○ impose a temporarily freeze on redemption rights in exceptional circumstances.</li> </ul> </li> </ul>		



<p><b>Correlation matrix</b></p> <ul style="list-style-type: none"> <li>• <b>Reduction of the correlation parameter</b> between the risk of falling interest rates and spread risk, in line with evidence from financial markets.</li> </ul>	<p><b>Transitional Measures</b></p> <ul style="list-style-type: none"> <li>• <b>Additional disclosure requirements</b> on the use of transitional measures.</li> <li>• <b>Restriction of initial application</b> to undertakings entering the scope of Solvency II and portfolios subject to transfer.</li> </ul>	<p><b>Group Supervision</b></p> <ul style="list-style-type: none"> <li>• <b>Policy proposals on the definitions applicable to groups</b>, scope of application of group supervision and supervision of intra-group transactions, calculation of group solvency.</li> </ul>
<p><b>Recovery and Resolution</b></p> <ul style="list-style-type: none"> <li>• <b>Minimum harmonised and comprehensive recovery and resolution framework.</b></li> <li>• Focus on request for <b>pre-emptive recovery planning</b> and the introduction of preventive measures.</li> </ul>	<p><b>Best Estimate of TP</b></p> <ul style="list-style-type: none"> <li>• <b>Clarification of the legal framework</b> on contract boundaries, definition of expected profits in future premiums and expense assumption.</li> </ul>	<p><b>IGS</b></p> <ul style="list-style-type: none"> <li>• <b>Introduction of a network of national Insurance Guarantee Schemes (IGSs)</b> that should meet a minimum set of harmonised features.</li> </ul>
<p><b>Symmetric Adjustment</b></p> <ul style="list-style-type: none"> <li>• <b>Widening of the corridor from +/-10% to +/-17%.</b></li> </ul>	<p><b>Matching Adjustment</b></p> <ul style="list-style-type: none"> <li>• <b>Recognition of diversification effects</b> in the SCR standard formula with regard to matching adjustment portfolios.</li> </ul>	<p><b>Cross-Border Business</b></p> <ul style="list-style-type: none"> <li>• Suggestions to support efficient <b>exchange of information among supervisors</b> during the authorization process.</li> <li>• <b>Enhancement of EIOPA's role</b> in the cooperation platforms.</li> </ul>
<p><b>Solvency Capital Requirement</b></p> <ul style="list-style-type: none"> <li>• No changes for the calibration of <b>property and lapse risk.</b></li> <li>• Removal of contingent capital instruments from the <b>definition of financial risk mitigation techniques.</b></li> <li>• Recognition of adverse development covers as a <b>risk mitigation technique.</b></li> <li>• Calculation of hypothetical SCR for <b>fire, marine and aviation risk.</b></li> <li>• Improvements in <b>counterparty default risk</b> module.</li> </ul>		<p><b>MCR</b></p> <ul style="list-style-type: none"> <li>• Update of the risk factors for <b>non-life insurance risks</b> in line with recent changes made to the risk factors for the SCR standard formula.</li> <li>• Clarification of legal provisions on <b>non-compliance with the MCR.</b></li> </ul>

## 3. Impact Analysis and main findings

### 3.1 A significant overhaul of the Solvency II framework

The nature of the Solvency II framework makes it highly dependent on spread movements and interest rates dynamics.

A comprehensive analysis of Solvency II proposed modifications needs therefore to take into account several factors, such as:

- ✓ financial market conditions at the time of the valuation,
- ✓ insurance business characteristics of the country we are focusing on.

In conducting its analyses, EIOPA performed **two different impact assessment exercises**:

- ✓ the **“Holistic Impact Assessment”, HIA** (from March to June 2020), requiring insurance companies to report on the combined impact of the EIOPA's proposals with a material impact on their solvency position with reference date end-December 2019 (corresponding to the calibration date of such measures);
- ✓ the **“Complementary Information Request”, CIR** (from July to August 2020), requiring undertakings to update data on the combined impact of proposals, similar to the information request for the HIA - but with a reference date of end-June 2020 – and to report specific data on the impact of the Covid-19 pandemic on the insurance business.

In both exercises, **EIOPA tested two different scenarios**:

- **scenario 1**, corresponding to changes to the baseline<sup>14</sup> (i.e., Base Case) in accordance with EIOPA's advice;
- **scenario 2**: same as scenario 1, but with no change to the interest rate risk calibration of the SCR standard formula.

According to the results published by EIOPA, the impact of the proposals on the SCR ratio of the overall European insurance sector was, respectively, equal to -13 p.p. (from 247% to 234%) for HIA and -22 p.p. (from 226% to 204%) for CIR.

Holistic Impact Assessment (HIA)				Complementary Information Request (CIR)			
	Base case	Scenario 1	Scenario 2		Base case	Scenario 1	Scenario 2
<b>SCR ratio</b>	247%	234%	248%	<b>SCR ratio</b>	226%	204%	216%
<b>Change of surplus in excess of SCR</b>	/	-15 bn	+7 bn	<b>Change of surplus in excess of SCR</b>	/	-40 bn	-21 bn
<b>Change of SCR</b>	/	+25 bn	+2 bn	<b>Change of SCR</b>	/	+31 bn	+11 bn
<b>Change of own funds</b>	/	+10 bn	+9 bn	<b>Change of own funds</b>	/	-9 bn	-9 bn

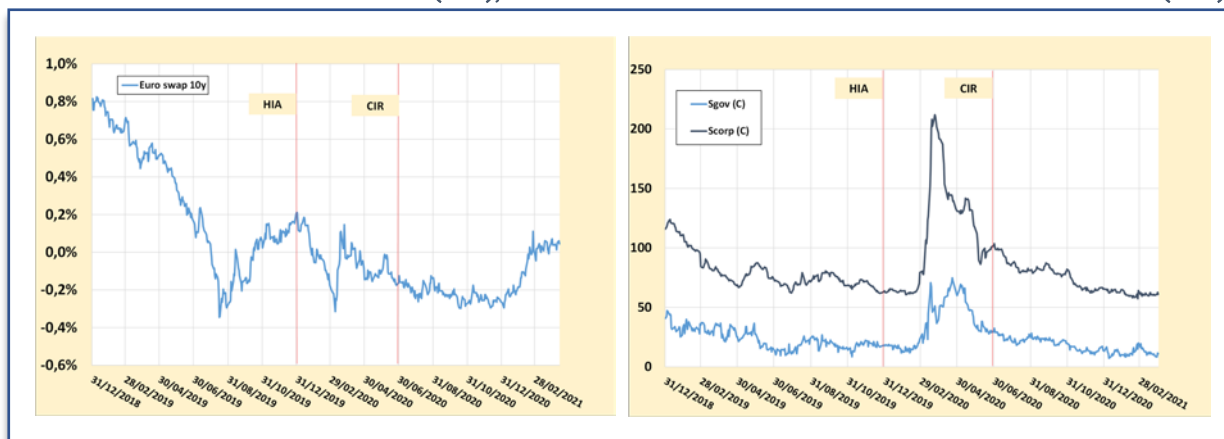
Source: EIOPA, Background document on the Opinion on the 2020 Review of Solvency II – Impact Assessment (pag.50).

The significantly higher impact on the Solvency ratio registered at end-June 2020 is mainly attributable to the **combined impact on the level of Own Funds<sup>15</sup> of both a sharp decline in 10y swap interest rates used to discount liabilities (from 0,2% to around -0,2%) and an increase in corporate bond spreads used to discount assets (approx. 40 bps) (see chart 3.1.1).**

<sup>14</sup> Scenario based on current Solvency II rules.

<sup>15</sup> Increase in Technical Provisions due to a decrease in interest rates and decrease in asset value due to higher spreads.

CHART 3.1.1: 10Y EURO SWAP RATES (LHS); BOND SPREADS FOR THE EUROPEAN INSURANCE SECTOR (RHS)



Source: ANIA elaboration on EIOPA and Refinitiv data. Daily data. Chart on the right is based on the government and corporate currency spreads calculated using EIOPA's VA portfolio.

These findings confirm once again the sensitivity of the proposed measures to financial market conditions. In affirming that the Review 2020 package is balanced, EIOPA should be aware that market conditions at the reference date of calculations play a crucial role in determining whether this statement is true or not.

ANIA's elaborations on these results show that the overall impact on solvency ratios from the baseline scenario of December 2019 to the revised scenario in June 2020 would be of approximately 43 p.p: 21 p.p due to different market conditions, 12 p.p due to interest rate module changes and an additional 10 p.p due to all other modifications proposed in the 2020 review process.

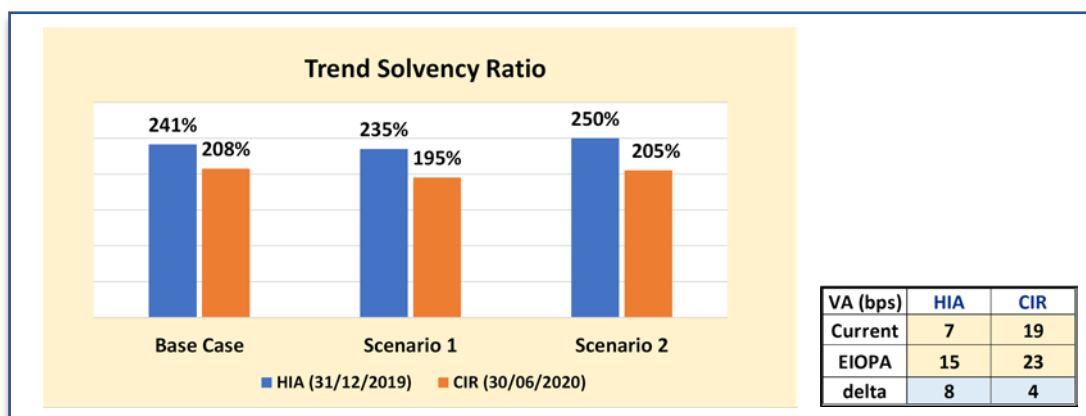
Thus, is quite evident that the proposal is not "balanced" in terms of SCR ratio.

### 3.2 The impact on the Italian Insurance industry

The results of HIA and CIR for a sample of Italian insurance undertakings are similar to the ones of the overall euro area average, although some important differences due to the peculiarities of the national business can be identified.

Chart 3.2.1 shows how the combined effect of EIOPA's proposals, coupled with the evolution of financial market conditions in the first half of 2020, would have determined a decrease of 46 p.p. in the average Italian Solvency ratio, from 241% (Base Case YE 2019) to 195% (Scenario 1 end-June 2020).

CHART 3.2.1: IMPACT OF EIOPA'S PROPOSAL ON THE ITALIAN INSURANCE INDUSTRY: SOLVENCY RATIO



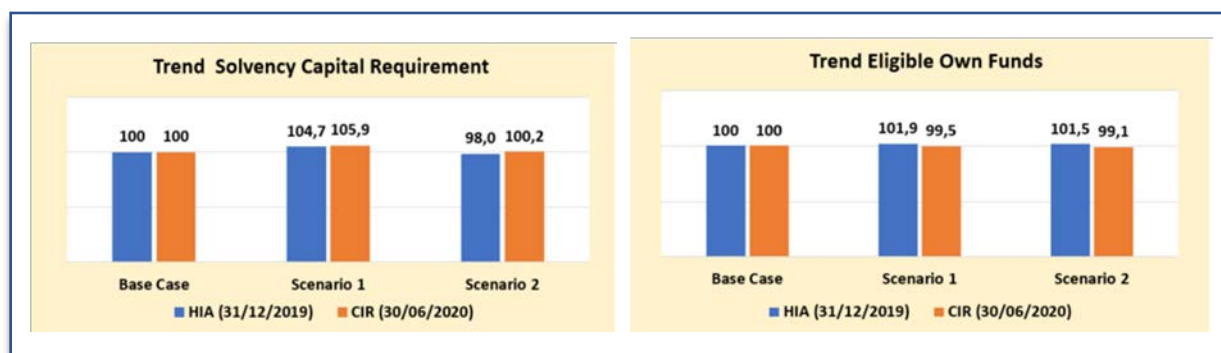
Source: ANIA. Aggregate data are based on a sample of undertakings participating to both HIA and CIR.

More in detail (chart 3.3.2), EIOPA's proposals (scenario 1) would decrease the average Solvency ratio (determined as Eligible Own Funds divided by the Solvency Capital Requirement) by:

- ✓ **-6 p.p. at YE 2019** market conditions (from 241% to 235%), resulting from an increase in Solvency Capital Requirement of +4,7% much higher than the increase in Own Funds (+1,9%).
- ✓ **-13 p.p. at end-June 20** market conditions (from 208% to 195%), resulting from an increase in Solvency Capital Requirement of +5,9% and a decrease in Own Funds of -0,5%.

A comparison between scenario 1 and scenario 2 (which includes all measures except IRR) provides an estimate of the impact of the proposed changes to the interest rate risk module. Considering YE2019 market conditions, **the impact of the IRR - the difference between scenario 2 and scenario 1 - is equal to 15 p.p.** (from 250% to 235%). In June 2020 it was equal to 10 p.p. (from 195% to 205%).

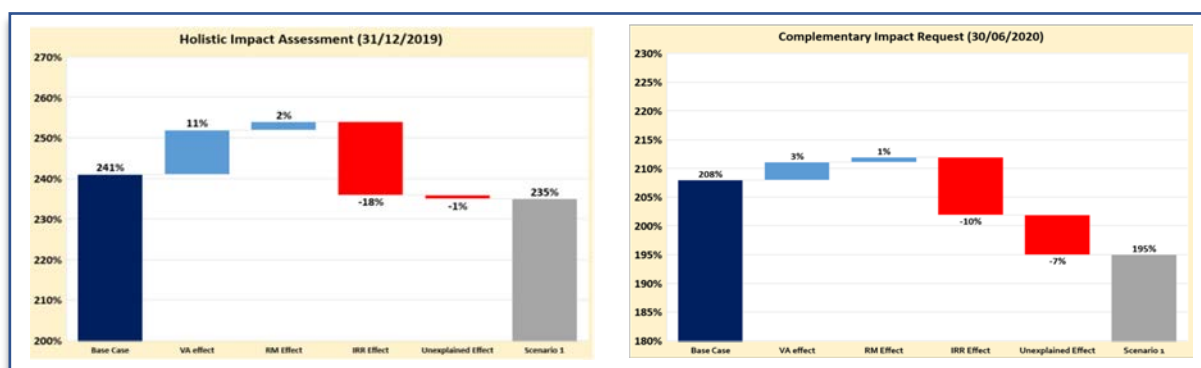
CHART 3.3.2: IMPACT OF EIOPA'S PROPOSAL ON THE ITALIAN INSURANCE INDUSTRY: SCR AND OWN FUNDS



Source: ANIA. Aggregate data are based on a sample of undertakings participating to both HIA and CIR.

The contribution of the single EIOPA proposals on the overall variation of Solvency ratio can be summarised as follows:

CHART 3.2.3: CONTRIBUTION OF EIOPA'S MEASURES TO THE VARIATION OF THE SOLVENCY RATIO



Source: ANIA. Aggregate data are based on a sample of undertakings participating to both HIA and CIR.

If, on the one side, it's true that the contribution of the Volatility Adjustment in the HIA scenario was significantly positive (+11 percentage points), confirming the effectiveness of some of the changes proposed by EIOPA, on the other, it is also true that this contribution is significantly reduced in the CIR scenario (+3 p.p), when market spreads are higher.

The reduction of the effectiveness of the VA can be attributed to the introduction of procyclical elements such as the proposed modification on the risk correction.

Such a proposal, in contrast to the countercyclical nature of the VA, would contribute to introduce artificial volatility in a framework which is already prone to excessive volatility given the use of end-of month data.

### 3.3 No need to change the risk correction ... risk of undermining the countercyclical effect of the VA

EIOPA proposed methodology for the determination of the Volatility Adjustment (“EIOPA VA”<sup>16</sup>) includes a change in the calculation of the risk-correction as follows:

- For government bonds issued by EEA countries, the risk correction is determined as:

$$RC_{gov} = 30\% * \min(S^+, LTAS^+) + 20\% * \max(S^+ - LTAS^+, 0),$$

where:

- ✓  $S^+$  denotes the maximum between the average spread of government bonds<sup>17</sup> and zero;
- ✓  $LTAS^+$  denotes the maximum between the long-term average spread of government bonds and zero;

- For other fixed income investments in the representative portfolio, the risk correction is determined as:

$$RC_{corp} = 50\% * \min(S^+, LTAS^+) + 40\% * \max(S^+ - LTAS^+, 0),$$

where:

- ✓  $S^+$  denotes the maximum between the average spread of fixed income investments<sup>18</sup> and zero;
- ✓  $LTAS^+$  denotes the maximum between the long-term average spread of government bonds and zero.

The Delegated Regulation of Solvency II currently states that the risk correction should be calculated as a percentage of long-term average spreads (respectively, of government and corporate bonds).

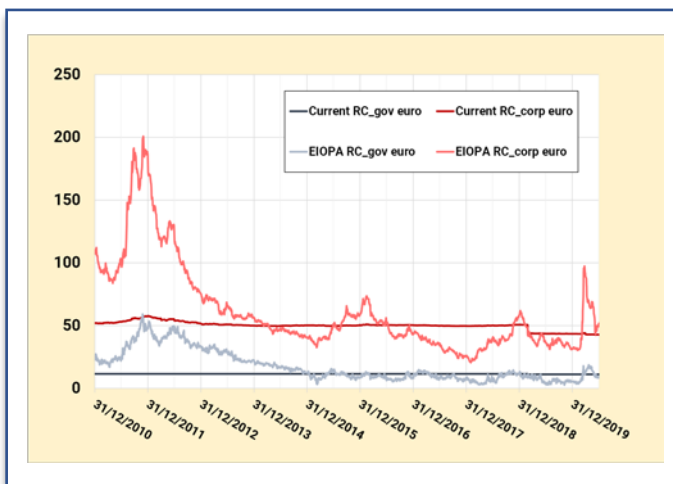
Chart 3.3.1 compares risk correction values for government and corporate bonds calculated using the current<sup>19</sup> and the EIOPA proposed methodologies.

The graph clearly shows that EIOPA proposal for the calculation of the risk correction, based on a percentage of the current spread, would make the risk correction highly dependent on the level of the current spread.

The procyclical behaviour arising from the proposed change in methodology will severely undermine the effectiveness of the measure itself and of the redesigned adjustment as:

- ✓ on the one side, it will restrict the level of the VA when the measure is most needed,
- ✓ on the other, it will provide additional relief when credit spreads are compressed.

CHART 3.3.1: CURRENT vs EIOPA RISK CORRECTION



Source: ANIA elaboration on EIOPA and Refinitiv data. Daily data. Euro currency. Government and corporate components.

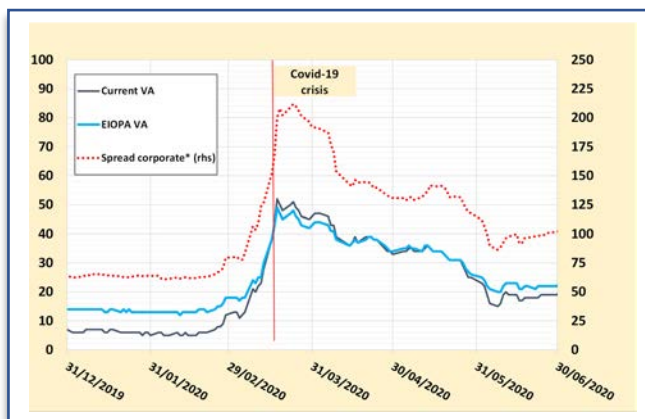
<sup>16</sup>  $VA_{EIOPA} = 85\% * AR_4 * AR_5 * Scale_{currency} * risk\ corrected_{currency} Spread + 85\% * AR_4 * AR_5 * \omega * (Scale_{country} * risk\ corrected_{country} Spread - 1,3 * Scale_{currency} * risk\ corrected_{currency} Spread)$

<sup>17</sup> In the respective sub-class of government bonds in the VA representative portfolio.

<sup>18</sup> In the respective sub-class of government bonds in the VA representative portfolio.

<sup>19</sup>  $RC_{gov} = 30\% * LTAS$ ;  $RC_{corp} = 35\% * \min(LTAS; PD + CoD)$

CHART 3.3.2: CURRENT VS EIOPA EURO VA



Source: ANIA elaboration on EIOPA and Refinitiv data. Daily data. Euro currency. Hp for EIOPA VA:  $AR4 * AR5 = 70\%$ . (\*) Based on VA portfolio.

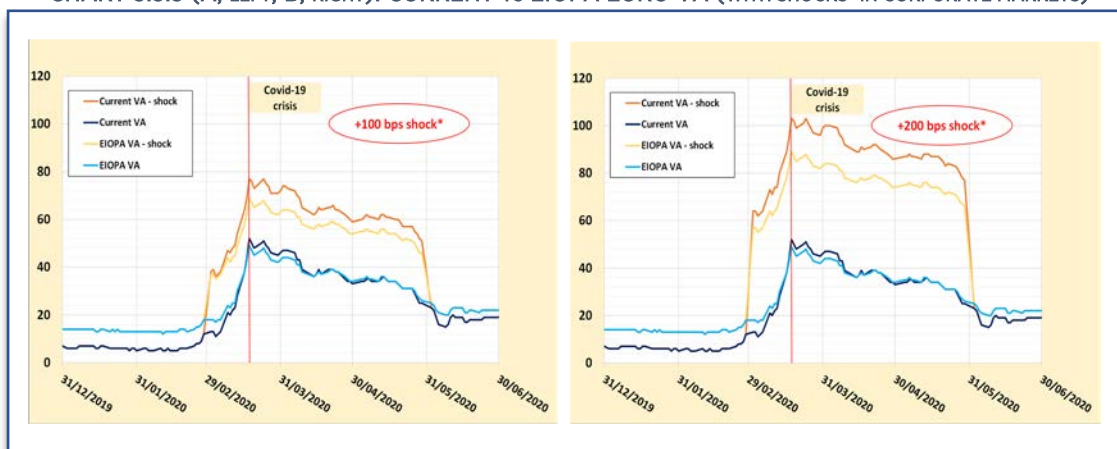
A concrete example of this behaviour is observable with the increase in euro corporate spreads experienced during the first months of the Covid-19 crisis.

Chart. 3.2.2 shows that EIOPA proposal would result in a lower VA with respect to the current framework, not working according to expectations.

To show the procyclical behaviour, two different scenarios can be considered (chart 3.3.3). This negative effect - measured by the spread between the orange (current VA with shock) and yellow (EIOPA VA with shock) line - increases when spreads rise sharply.

We assume a 100 bps credit spreads increase in Panel A and a 200 bps increase in Panel B (magnitudes comparable to those experienced during the 2008 – 2011 crisis).

CHART 3.3.3 (A, LEFT; B, RIGHT): CURRENT vs EIOPA EURO VA (WITH SHOCKS\* IN CORPORATE MARKETS)



Source: ANIA elaboration on EIOPA and Refinitiv data. Euro currency. Daily data. Hp for EIOPA VA:  $AR4 * AR5 = 70\%$ . (\*) shock applied to the VA portfolio corporate spreads.

The above results show that **changing the risk correction to be a percentage of current credit spread embeds unjustified methodological assumptions and will paradoxically increase procyclicality.**

Recital 30 of the Omnibus II Directive specifies that “the relevant risk-free interest rate term structure should avoid artificial volatility of technical provisions and eligible own funds and provide an incentive for good risk management”.

The procyclical behaviour of **the new risk-correction proposed by the regulator would severely limit the ability of the VA to mitigate the effect of bond spread exaggerations**, making it less effective when spreads increase sharply, thus undermining its countercyclical effect.



Assuming the risk-correction depending on a percentage of the current spread implicitly means assuming it is a volatile component of the credit spread. However, according to Solvency II directive<sup>20</sup>, the risk correction should be related to the portion of the spread corresponding to unexpected credit risk and expected probability of default and loss resulting from downgrade.

Regarding the unexpected credit risk, it is already included in the SCR for spread risk. Consequently, references to this should be removed from Article 77d of the Directive as it leads to a double counting of risks between the valuation and capital requirements. In ANIA's view, **the risk correction should therefore reflect only expected probability of default and loss resulting from downgrade.**

Despite EIOPA's statements to the contrary, **EIOPA's hypothesis that expected losses are linked to the level of the prevailing spread does not seem unanimously supported.**

**According to Amato and Remolona (2003<sup>21</sup>), for corporate bonds, expected loss accounts for only a small fraction of spreads across all rating categories and maturities.** They also state that "In general, spreads magnify expected losses, but the relationship is not one of simple proportions" and that "a more relevant feature of the relationship between spreads and expected losses is that the difference between them increases in absolute terms as the credit rating declines."

**Alexopoulou et al. (2009<sup>22</sup>) decompose the observed credit spreads into the expected losses and the risk premium.** They proxy the market's perceived default risk by one-year-ahead expected default frequencies (EDF) provided by Moody's. By assuming a 40% recovery value (a standard assumption in literature) they derive the risk premium as the absolute difference between the observed level of CDS spreads and the expected loss. As stated by the authors "Two main features may be inferred from these decompositions. First, up until the turmoil got underway in the summer of 2007, both expected losses and the demanded risk premium hovered at relatively low levels (for both financial and non-financial CDS spreads). Second, the bulk of the sharp upturn in perceived credit risk since August 2007 seems to reflect a higher compensation".

**Fischer and Stolper (2019<sup>23</sup>), using data for the 2004-2016 period, find empirical evidence for corporate bond prices to be primarily driven by credit risk and interest rate risk during quiet market conditions. During more anxious and volatile markets, however, the impact of these two factors abates, whereas liquidity risk becomes the salient issue.** While representing a negligible factor during calm phases, market-wide illiquidity shocks appear to result in substantial and long-lived increases in risk premia on the corporate bond market when a bearish sentiment prevails. This considerable impact of illiquidity on corporate bond spreads has not been reported previously by similar empirical studies based on simpler models. The results – which are shown to be robust against various modifications of the model setup – suggest that in highly unstable times - like the global financial crisis - liquidity risk may supersede credit risk as the most important determinant of corporate bond spreads.

**From a VA perspective,** the main findings coming from the papers described above are the following:

- ✓ **risk correction must be calculated as an absolute value and should not depend on a percentage of the prevailing spread;**
- ✓ **the portion of the spread reflecting credit risk fundamentals appears significantly less volatile than the entire spread;**

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<sup>20</sup> Art. 77 quinquies, Reg. 2099/138/CE.

<sup>21</sup> Amato J.D. and Remolona E. M. The credit spread puzzle. Bank for International Settlements. BIS Quarterly Review, December 2003.

<sup>22</sup> Alexopoulou I., Andersson M., Georgescu O. M. An empirical study on the decoupling movements between corporate bond and CDS spreads. European Central Bank (ECB). Working paper series n. 1085 / August 2009.

<sup>23</sup> Fischer H. and Stolper O. (2019). The nonlinear dynamics of corporate bond spreads: Regime-dependent effects of their determinants. Discussion Paper. Deutsche Bundesbank N. 08/2019.

- ✓ under stressed market conditions, where the need for an effective VA increases, liquidity risk is the main determinant of the credit spread movements.

This confirms that assuming risk correction that moves linearly with respect to the credit spread is questionable and that **retaining the current risk correction methodology – based only on long-term statistics - would better reflect historical default rates, would provide more stable VA and would not bear procyclical effects.**

CHART 3.3.4: CURRENT vs EIOPA EURO VA (COMPARISON WITH PROPOSED AND CURRENT RISK CORRECTION)

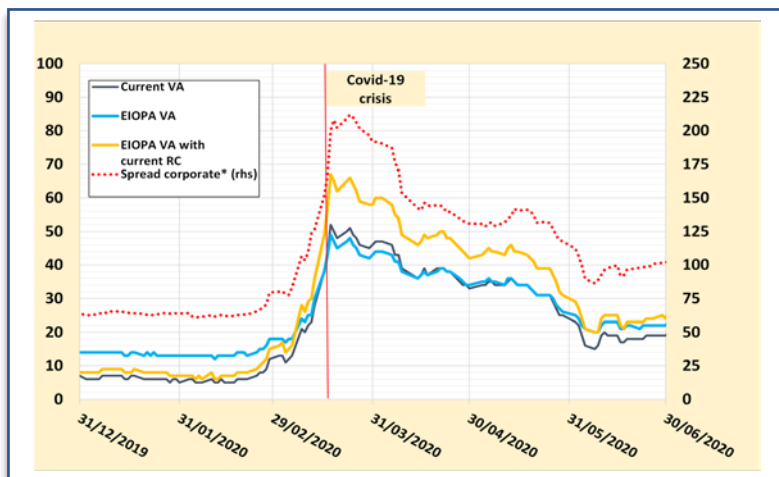


Chart 3.3.4 shows how the proposed EIOPA's approach would work without any change in the risk correction methodology.

Source: ANIA elaboration on EIOPA and Refinitiv data. Hp for EIOPA VA:  $AR4 * AR5 = 70\%$ . (\*) Based on VA portfolio.

Alternatively, **material changes to EIOPA's proposed methodology would be needed to ensure the VA's ability to continue as an effective countercyclical tool.**

**An improved calibration of the risk correction would imply a significant reduction of the parameters proposed by EIOPA (i.e., the percentages applied to the current and long-term portion of the portfolios spreads).**

This calibration must be such that **the Volatility Adjustment under the new framework should not reduce its ability to act as a countercyclical tool**, preventing procyclical behaviour on financial markets and mitigating the effect of exaggerations of bond spreads.

A valid proxy to measure such behaviour could be represented by the standard deviation of the VA daily changes variations against those of market spreads during the same period; this gives a picture of the variability of VA and market spreads compared to their means.

Defining  $c_{LTAS}$  the percentage applied to  $\min(S^+, LTAS^+)$  (in the EIOPA proposal equal to 30% for govies and 50% for corporate spreads) and  $c_{spread}$  the percentage applied to  $\max(S^+ - LTAS^+, 0)$  (in the EIOPA proposal equal to 20% for govies and 40% for corporate spreads), **we propose an "alternative risk correction"** in the following way:

- $c_{LTAS}$  equal to 30% (no change compared to EIOPA proposal) for govies<sup>24</sup> and 35% for corporates<sup>25</sup>;
- $c_{spread}$  equal to 10% for govies and 15% for corporates.

The rationale behind the proposed change in parameters aims to mitigate the unjustified impact of the new risk correction on the EIOPA VA in case of corporate spread shocks; **increasing the standard deviation of the VA would contribute to decrease the volatility transferred to the own funds.**

The "alternative risk correction" would therefore be defined as follows:

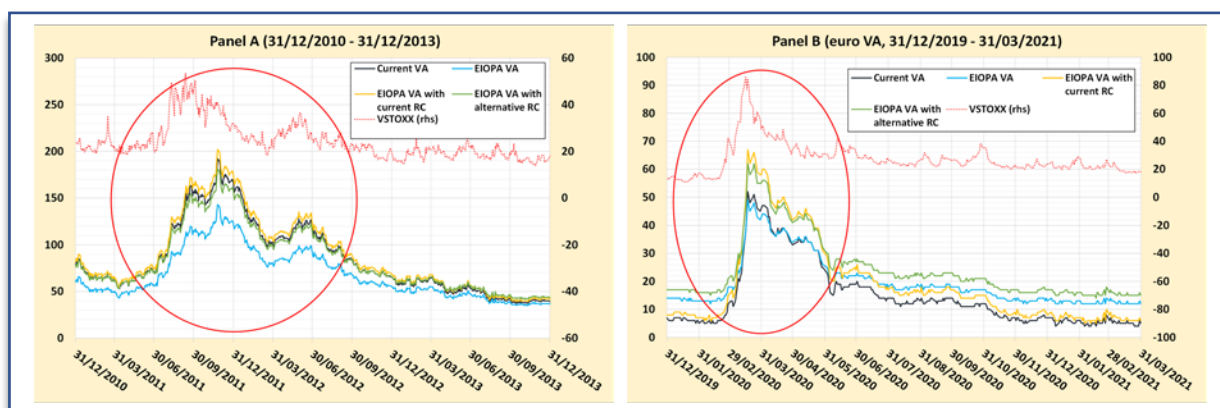
<sup>24</sup> Same value as for the current risk correction methodology ( $RC_{gov} = 30\% * LTAS_{gov}$ ).

<sup>25</sup> Same value as for the current risk correction methodology ( $RC_{corp} = 35\% * \max(LTAS_{corp}; PD + CoD)$ ).

- $RC_{gov} = 30\% * \min(S^+, LTAS^+) + 10\% * \max(S^+ - LTAS^+, 0)$ , for government bonds issued by EEA countries;
- $RC_{corp} = 35\% * \min(S^+, LTAS^+) + 15\% * \max(S^+ - LTAS^+, 0)$ , for corporate bonds.

According to ANIA's simulation (Chart 3.3.5), the VA obtained by substituting the “alternative risk correction” to the one proposed by EIOPA (from now on, “EIOPA VA with alternative risk correction”) will result in a **more reactive and effective VA compared to both the current and EIOPA VA**, in situations like the one experienced in 2011-2012 (Panel A) and in the more recent Covid-19 pandemic (Panel B).

CHART 3.3.5: CURRENT vs EIOPA EURO VA AND ALTERNATIVE PROPOSALS



Source: ANIA elaboration on EIOPA and Refinitiv data. Euro currency. Hp for EIOPA VA: AR4\*AR5=70%.

Moreover, Table 3.31 shows that during 2011-2012 crisis (when the standard deviation of absolute changes of total spread of European insurance companies' portfolios<sup>26</sup> was 4.0) the standard deviation of the EIOPA VA would be lower than the one calculated on the current VA (respectively, 2.0 and 2.6). Changing the parameters as proposed above would lead to a VA with a standard deviation equal to 2.4, ensuring at least a similar “degree of ability to offset exaggerations of bond spreads”.

TABLE 3.3.1: STANDARD DEVIATION OF VA AND MARKET SPREADS (2011-2012)

EURO VA	Current VA	EIOPA VA	EIOPA VA with current RC	EIOPA VA with alternative RC	Spread govies	Spread corporate	Total spread
STANDARD DEVIATION	2,6	2,0	2,8	2,4	6,5	5,2	4,0

Source: Based on VA and spread daily changes. ANIA elaboration on EIOPA and Refinitiv data. Standard deviation a calculated over the period 31<sup>st</sup> Dec. 2010 – 31<sup>st</sup> Dec. 2012.

The same exercise on the more recent Covid-19 crisis would give a similar result (Table 3.3.2).

TABLE 3.3.2: STANDARD DEVIATION OF VA AND MARKET SPREADS (COVID-19 CRISIS)

EURO VA	Current VA	EIOPA VA	EIOPA VA with current RC	EIOPA VA with alternative RC	Spread govies	Spread corporate	Total spread
STANDARD DEVIATION	2,0	1,6	2,5	2,0	4,5	5,9	3,0

Source: Based on VA and spread daily changes. ANIA elaboration on EIOPA and Refinitiv data. Standard deviation a calculated over the period 31<sup>st</sup> Dec. 2019 – 30<sup>th</sup> June 2020.

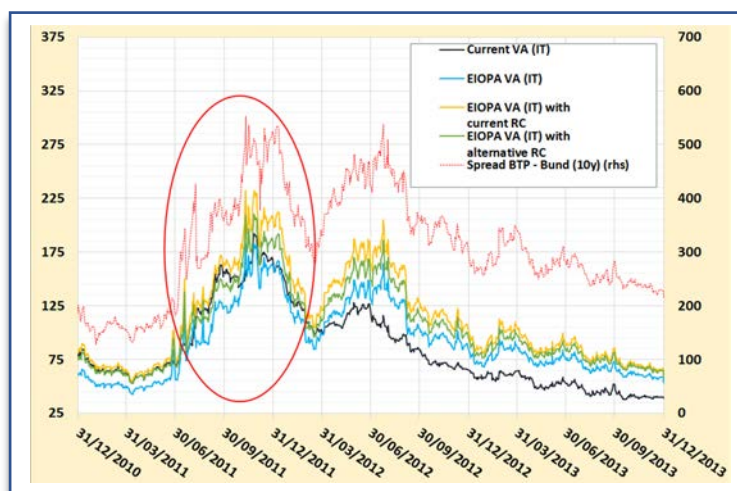
Looking at the total VA applicable for Italian insurance companies (Chart. 3.3.6) with a focus on the 2011-2012 crisis (when 10y BTP-Bund spread reached 500 bps), we recognise a similar detrimental effect of

<sup>26</sup> Based on VA portfolios, excluding risk correction.

the proposed risk correction and a more effective VA considering an EIOPA VA with the “current” (yellow line) and the “alternative” risk correction (green line).

CHART 3.3.6: CURRENT VS EIOPA ITALY VA (COMPARISON WITH PROPOSED AND “ALTERNATIVE” RISK CORRECTION)

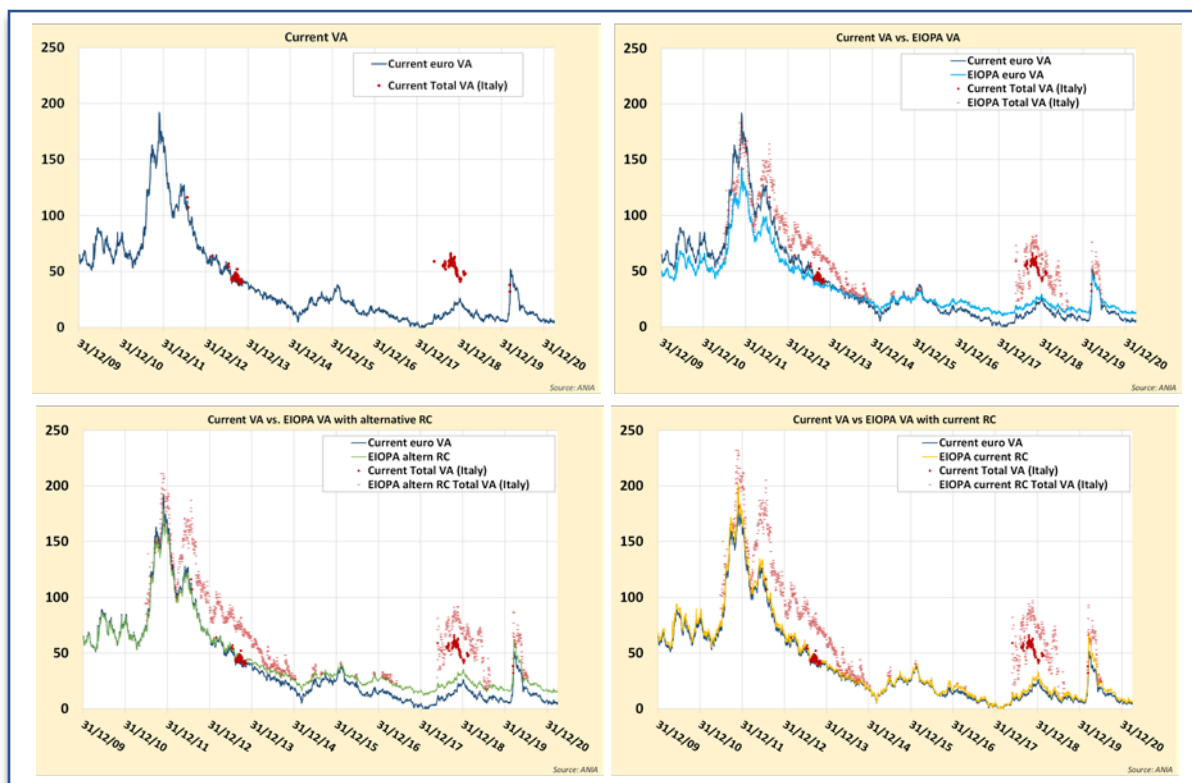
It may be observed that, despite some positive effect attributable to the above-mentioned proposed changes in the activation conditions of the country component (never triggered with the current VA methodology due to the cliff-edge effect), the EIOPA VA proposal would still lie below the current VA during the 2011 volatility spike registered for Italian government bonds.



Source: ANIA elaboration on EIOPA and Refinitiv data. Hp for EIOPA VA: AR4\*AR5=70%.

Chart 3.3.7 gives a final overview of the different VA proposals applied to an average Italian insurance company.

CHART 3.3.7: OVERVIEW OF THE VA PROPOSALS



Source: ANIA elaboration on EIOPA and Refinitiv data. Daily data. Solid lines represent euro VAs; red dots and dashes represent total VA when country component for Italy activates. Hp for EIOPA VA: AR4\*AR5=70%.

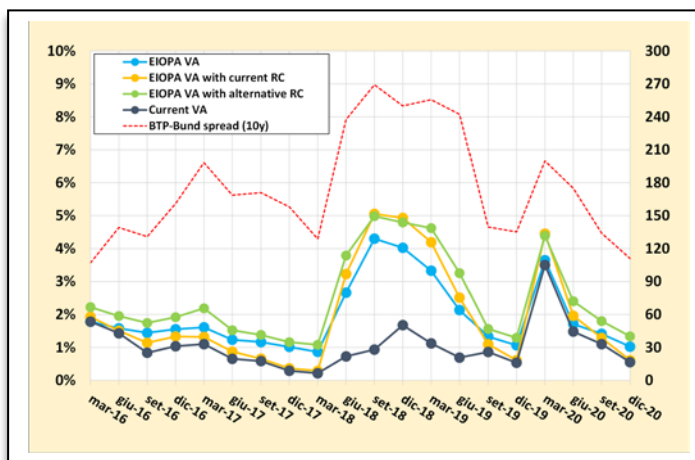
Both VAs proposed by ANIA, the one with the “current” and the one with the “alternative” risk correction, would not diverge substantially from the EIOPA proposed VA in terms of activation of the country component. Considering 2,851 daily observations (over the period 31/12/2009-31/03/2021), the

EIOPA VA with alternative risk correction would activate 1,338 times, EIOPA VA with current RC 1,202 while the EIOPA proposed VA 1,224 times (47% and 42% vs 43%).

Besides being more in line with bond spread movements - thus with the real risk faced by insurance companies - these proposals **would have a relatively limited impact on Technical Provisions compared to EIOPA's proposal**. *Chart 3.3.8* shows the impact on a simplified Italian insurance undertaking.

Source: ANIA elaboration on EIOPA and Refinitiv data. Impact calculated as % of the delta between present value of TPs using RFR with and without VA over the value of TPs.

CHART 3.3.8: % VA IMPACT ON TECHNICAL PROVISIONS



## 4. Conclusions

Overall, Solvency II framework has proven to be a highly sophisticated regulatory regime, and has proven to work reasonably well, since its entry into force in 2016.

Nevertheless, it has also been recognized as a regime which can be further refined in order to correct some flaws and to better enhance the role of insurance companies as long-term investors. Despite this widespread opinion, the Solvency II 2020 Review turned out to be the occasion to intervene in several elements of Pillar I.

**Enhancing the role of insurers as long-term investors should be the key objective of the entire Review.** The more so because the pandemic crisis is requiring to our industry a greater effort to support the achievement of the Commission targets of a greener, more digital and more resilient European Union.

**ANIA firmly believes that the 2020 Review should not bring additional capital charges on insurance companies; transitional mechanisms do not minimize negative effects in terms of solvency and have to be designed carefully in order to avoid undesirable side effects.**

At this stage, ANIA believes important elements still need to be reviewed in order to properly take into consideration prudential aspects in a market coherent context.

The suggestions made on the VA Risk Correction, on the RFR extrapolation methodology, on the floor to the negative shock in the IRR module and on the Long-Term Equity module may be read in this perspective.

**Taking these proposals on board would contribute to a more balanced regulatory framework, able to properly address the risk to which European insurers are exposed to and, at the same time, not to represent an obstacle to their capacity to invest in the real economy.**