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Insurance Sweden's response to the Better Regulation Consultation on European Commission's proposed amendments to the Solvency II directive

As a member of Insurance Europe, we (Insurance Sweden) overall share the views expressed in its response to the European Commission's (EC) proposed amendments in the current review of the Solvency II Directive. However, we wish to highlight and elaborate further on the proposal to widen the corridor for the symmetric adjustment to the equity risk charge by amending Article 106 (3). We would also like to clarify Insurance Sweden's strong position against such a change. In addition, we support Insurance Europe's view that the symmetric adjustment should be optional to apply. We also would like to express our strong objection against EC's proposal of how to divide SFCR into two parts by amendments to Articles 51 and 256, which we believe will only increase the burden of reporting without any tangible benefits.

Do not widen the corridor for the symmetric adjustment

An increased corridor to ± 17 percentage points will lead to higher volatility in the capital requirement for equities that will, among other things, result in unwarranted disincentives to equity holdings as well as negative implications for the policy-holders. A change of the corridor will have significantly larger consequences for insurance companies, such as the Swedish, with large holdings of equities.

The impact on long-term financing and green financing is strongly negative for Swedish insurance companies, contrary to EC's assessment of "+/-" in the impact assessment.[1] The proposed change is, thereby, in conflict with the ambition in the Capital Market Union to promote insurance companies' long-term investments in equities as well as the Green Deal's aim that insurance companies will support the transition to a green and sustainable economy.

Increased corridor for the symmetric adjustment has negative consequences for Swedish insurers due to large equity holdings

According to EIOPA, on average one third of Swedish insurance companies' assets consist of equities, which is the largest share of equity holdings among European insurance companies.[2] A change of the corridor will, therefore, have significantly larger implications for Swedish insurance companies than for most other European companies.

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[1] See page 180 in SWD(2021) 260 final

[2] See e.g. Figure 5.7 in EIOPA (2019), Financial stability report December 2019.

The composition of EIOPA's equity index used to estimate the symmetric adjustment and the actual equity exposure for an insurance company often differ materially and, thereby, distort the effect of the measure. This is a phenomenon which is often referred to as basis risk. This problem with the symmetric adjustment is also recognized by, among others, EIOPA.[3]

Swedish insurers' equity exposures differ from EIOPA's index in that a large share, above 60 per cent[4], of equity holdings is in Swedish equities, mainly to avoid currency risk. Even though the Swedish stock market has a relatively high weight (8 per cent) in EIOPA's index, the big difference between the actual holding of Swedish insurance companies of Swedish equities and the weight in the EIOPA index persists and creates basis risk.[5] The basis risk can be even higher for other European insurance companies, because many countries have higher home bias among their insurers.[6] On the other hand, the consequences of EC's proposals will probably be worse for the Swedish insurance companies because the majority of the equity holdings, including e.g. holdings belonging to unit-linked policies, are denominated in non-euro currencies due to the composition of the reference index.

A widening of the corridor will further increase this basis risk for Swedish and some other European insurance companies, which in turn can lead to unwarranted situations where the level of the capital requirement to a larger extent does not reflect the true risks of the company's equity exposure. This will have an even more substantial effect if the companies, as the Swedish, have large equity holdings. It is also important to remember that the symmetric adjustment is also applied to equity type 2 exposures, which often differ more from EIOPA's index in terms of risk and realized returns than type 1 exposure.

These effects are already present with a corridor for the symmetric adjustment of ± 10 %. However, the negative effects will become more severe if the corridor is widened to ± 17 %. This might not be a big issue in bad times (i.e. bear markets). However, there could be situations in good times (bull markets) where it could be a drastic increase of the symmetric adjustment and henceforth on the capital requirement, but at the same time very limited increase in the value of the company's holdings of equites. Thus, the SCR-ratio will go down in such cases and this peculiar effect will be even more pronounced if the corridor is widened to 17 %. A decrease in the SCR-ratio can lead to situation where the insurers may have to "fire sale" equities in good times, which will in the end have negative effects on, e.g. policyholders' pension savings. Thus, in contrast to what is stated in EC's impact assessment such a change will have negative implications for the policyholders, at least for the Swedish.

A situation with drastic increase of the symmetric adjustment, but at the same time limited increase in the value of the company's holdings of equites is highly plausible. The correlations among stock markets tend to increase towards +1

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[3] See e.g. EIOPA (2020), Background Document on the Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/749).

[4] See e.g. Figure 5.14 in EIOPA (2019), Financial stability report December 2019.

[5] For a discussion about the weights in EIOPA's index, see, e.g. section 2.10 in EIOPA (2019), Consultation Paper on the Opinion on the 2020 review of Solvency II, EIOPA-BoS-19/465.

[6] See Figure 5.14 in EIOPA (2019), Financial stability report December 2019.

during a crisis, while the correlations during normal and good times are often significantly lower. In addition, the correlations between different stock markets and EIOPA's equity index can vary over time and also between different crises. Before an increase of the corridor is considered a thorough analysis of the correlations between EIOPA's index and insurance companies' equity holdings should, therefore, be conducted in both good and bad times, and not just in bad times as EIOPA has only analyzed.

Increased corridor will lead to overshooting and inconsistences

A corridor of ± 17 % will mean that the capital requirement for equities can deviate by nearly 50 % up and down from the default value (e.g. 39 % for Type 1 equities). Such large swings in the capital requirements can have large effects and contra-intuitive effects on the SCR-ratio. For example, the SCR-ratio might increase when there are large declines in the equity market. That can already happen with the current corridor. For example, the symmetric adjustment went from 0 % by the end of 2019 to – 10 % by the end of March 2020. This explain to a large extent why the average SCR-ratio for Swedish insurers increased from 261 % to 265 % during the first quarter 2020 in spite of the sharp fall in the equity prices, e.g., the Swedish stock market was down by around 20 per cent. [7] This is in sharp contrast to the average SCR-ratio of EU insurers, which during the same period fell from 259 % to 241 %.

It is counter-intuitive and inconsistent that the SCR-ratio for Swedish insurers increased in the midst of the COVID-19. However, this is just a consequence of the overshooting effect of the symmetric adjustment together with Swedish insurance companies' large holdings of equites. In fact, the overshooting would have been even larger if the symmetric adjustment would have not been limited to – 10 %. Then the symmetric adjustment would have been - 13,07 % at the end of March 2020 instead of - 10 %. Somewhat simplified calculations suggest that the average SCR-ratio for Swedish insurers would have been around 275 % Q1 2020 if the symmetric adjustment would have been – 13,07 %. A widened corridor would, thereby, have increased the SCR-ratio of Swedish insurance companies by around + 10 percentage in comparison to a symmetric adjustment of – 10 % during a period of large declines on the stock markets in Sweden and elsewhere. The EC's proposal to widen the corridor would lead to even more overshooting of the symmetric adjustment.

Thus, there will be a higher risk of overshooting from the symmetric adjustment and larger magnitudes of this phenomenon if the corridor is widened. With the current corridor there are limited consequences of this overshooting from the symmetric adjustment. But with an increased corridor there will most likely be severe consequences and more inconsistencies as the overshooting will be much larger. One pre-requisite for financial stability is to have consistent regulation for the financial system, including the insurance companies. Thereby, the proposed change of the corridor for the symmetric adjustment will in fact have negative consequences for the financial stability and not "++" as in EC's impact assessment.

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[7] From EIOPA's Insurance statistic.

That there are signs of overshooting during the spring of 2020 as a consequence of the symmetric adjustment has also been observed by EIOPA, but according to EIOPA this phenomenon was only observed for non-life undertakings. [8] However, In EIOPA's Insurance statistics the average SCR-ratio increased both for Swedish non-life and life insurance companies during this period. In EC's impact assessment this overshooting is not discussed and neither EC nor EIOPA have presented any other in-depth analysis, e.g. country specific analysis, of the consequences of a widening of the corridor.

Widened corridor will lead to specific problems for unit-linked and similar products

Insurers with mainly unit linked and depository insurance[9], i.e. products where the policyholders themselves decides on allocations between investment funds, must apply the symmetric adjustment. The objective of the adjustment, to reduce the volatility of own funds, is totally failed in such cases since the policyholders are not directly affected by any capital requirements, and totally unaffected by the symmetrical adjustment in their investment behaviour.

In fact, for insurers with mainly unit linked and depository insurance the symmetrical adjustment can lead to materially worsened solvency in good times (bullish markets), an effect that would increase if the corridor of the symmetric adjustment is increased.[10] Thus, for savings products where the policyholders decide on the allocations, e.g. unit-linked insurance, this adjustment has no effect on the insurance companies' investment behaviour and it substantially increases the Solvency ratio volatility. Therefore, we strongly support Insurance Europe's position that it should be optional for the insurance companies to apply the symmetrical adjustment.

Increased corridor is in conflict with the ambition of CMU and the Green Deal

To sum up, there are several drawbacks with a widening of the corridor for the symmetric adjustment to the equity capital charge. In addition, we believe that there are other factors that are more important for insurance companies not to be forced to "fire sell" equites during market turmoil than the symmetric adjustment. Swedish insurers' strong solvency position before the COVID-19 pandemic is the main reason why the holdings of equities were more or less constant during the first quarter of 2020.

The higher volatility in the capital charge for equites that a widened corridor will imply, will make it more difficult to maintain the current equity exposure for

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[8] See e.g. EIOPA (2020), Background Document on the Opinion on the 2020 review of Solvency II (EIOPA-BoS-20/750).

[9] Here we mean what in Swedish is called depåförsäkring in Swedish, which is often also referred to as 'portfolio bonds'.

[10] A somewhat simplified simulation conducted by a Swedish insurer on its portfolio (mainly unit-linked) when it is assumed an initial situation with symmetrical adjustment of 0 % and an immediate stock market increase of 35% shows that 1. No symmetrical adjustment, the SCR-ratio will decrease by 10 percentage points, 2. A symmetrical adjustment with a corridor of ±10 %, the SCR ratio will decrease with about 20 percentage points, and 3. A symmetrical adjustment with a corridor of ±17 %, the SCR ratio will decrease with about 30 percentage points.

Svensk Försäkring

Swedish insurance companies and other insurance companies with large equity holdings. It will also introduce an obstacle to increase the equity investments for these companies. Thus, a widened corridor goes against the ambition to promote long-term investment by insurance companies in the Solvency II review, as stated in the EC's new action plan for the Capital Market Union.[11] It will also make it more difficult for insurance companies to increase their investment in sustainable companies and thereby contribute to a transition to a green and sustainable economy in line with the Green Deal.

Thereby, there are several reasons why the corridor should be maintained, but hardly any reason why the corridor should be widened as in EC's proposal. Instead, the corridor for the symmetric adjustment should be kept at ±10 %. In addition, the symmetrical adjustment should be optional for the insurance companies to apply in line with Insurance Europe's view in the response to EC's proposed changes of the Solvency II-directive in the review.

Do not implement EC's proposal of how to divide SFCR by amendments to Articles 51 and 256

The European insurance industry has previously argued for a split of the Solvency and financial condition report (SFCR) into two parts in order to make the content more accessible to policyholders while reducing the burden for the insurance companies. The part of the SFCR that will be addressed to policyholders and beneficiaries is in the EC's proposal to a large extent in line with what the industry has previously proposed.

The part that is addressed to other market participants, on the other hand, differ significantly from the industry proposal. In the industry's proposal that part only consists of information that is included in the ordinary supervisory reporting (the so-called QRT reporting), but is in the EC's proposal much more extensive with requirements for detailed descriptions of e.g. the business and methods used for valuation and risk calculations.

The differences in outline, content, and timelines of the two parts in EC's proposal will in reality mean that the insurance companies must have two separate SFCRs, one for policyholders and one for others. In addition, insurance companies currently have well-functioning processes for SFCR that would need to be altered, which will require significant resources and additional costs. It should also be added that the supervisory authorities already have access to the information in the SFCR, so for the supervisory authorities these changes of the SFCR will not have any significant consequences. In addition, no more information than from the QRT-reporting is necessary in the part to other market participants as these participants have industry expert knowledge as well as additional information in e.g. the financial statements (.i.e. the annual reports).

We believe that if the industry's proposal on a more limited part to other market participants is not implemented, the proposal to divide SFCR into two parts should not be pursued. Otherwise, these changes of the SFCR will add significantly burden

[11] Action 4 in European Commission (2020), A Capital Market Union for people and business – new action plan, COM (2020) 590 final.

and cost for the insurance companies without achieving the aims of streamlining the report and not have any significant benefits for the policyholders. Instead, it should be considered to keep the current format of the SFCR where the "short summary" (max 2 pages) could be improved/changed to be more policyholder friendly (in terms of content, language, structure etc.) The rest of the report should then be kept intact and unchanged to avoid unnecessary costs and burden for the insurance companies.