



Episode 6: Future changes to the Solvency II regime

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MIROSLAV KOTASKA: The extrapolation, together with interest rate risk, may create a huge impact on solvency ratios, and that's why there are some-- also the commission and EPA proposed some smoothing mechanism and a transition period for which these will be implemented.

SPEAKER 1: You're listening to (Re)thinking Insurance a podcast series from WTW, where we discuss the issues facing P&C, life, and composite insurers around the globe as well as exploring the latest tools, techniques, and innovations that will help you rethink insurance.

SINA THIEME: Hello, and welcome to (Re)thinking Insurance. I'm your host Sina Thieme, and today, I'm delighted to be joined by my guest Miroslav Kotaska. Hey, Miroslav.

MIROSLAV KOTASKA: Hi. How are you?

SINA THIEME: Good, Thanks. You're a consultant in Willis Towers Watson's Insurance Consulting and Technology Business in our Prague office. And I think, prior to working at Willis Towers Watson and KPMG, you worked at the Czech National Bank for seven years. And I think you drafted insurance regulations and took part in negotiations of Solvency II at the Czech national level but also at the European level.

And I think with your economics, and finance background, and your insurance regulation expertise generally, you're an excellent partner for today's discussion, which is on the proposed changes to the Solvency II framework, and before we get into that, I Googled your name and was like-- some Willis Tower Watson search results, I found Miroslav Kotaska, an actor who I think only played in a Czech cooking show in 2012 called the Down by The Water, if Google Translate isn't lying. Is that something that you wish people would find when Googling your name, or did you have other plans?

MIROSLAV KOTASKA: Well, honestly, I don't really care what people find about me on the internet, so obviously, this is not me because those people who know me, they know that I don't cook and I can't cook. So obviously, they know it's not me.

SINA THIEME: Fair enough. Great, let's move on to today's topic. In September of 2021, the European Commission published a proposal for the review of the Solvency II directive, and once the proposed directive has been agreed by all stakeholders, it will enter force in 2023 or 2024. And then

it would be another 1 and 1/2 years before they are applied in individual member states. Miro, can you just describe the process in a bit more detail and tell us where we are in that process?

MIROSLAV KOTASKA: OK, so what you mentioned, the commission proposal for the directive is somewhat halfway through, the whole process of Solvency II review, because the commission asked your part for its advice for this review early in 2019, I think, with about 19 topics to be done. And this review is happening basically for two reasons. First of all, the commission has a legal obligation to review the legislation after five years of being enforced, and there are several topics which the commission has in the legislation that it has to review, such as long-term guarantees, or group supervision, and so on.

And then there are also some market developments and other developments also political such as ESG, or sustainable finance, and that's what is taken into account in this review. So that was the call for advice, so-called request for advice for AOP. Then AOP worked on this advice, which took a little bit longer than expected because it's not that the topics were too technical, but we also got COVID. And we also got some changing situation on the market, so AOP did also some impact assessment on the proposals that they submitted.

The whole suggestion from AOP is going through public consultations, which also take time, and then the commission proposal in September last year is basically based on the advice from AOP and also from European Commission own consultations. So this is the half of the process, which we already know of, and now, we are looking ahead for the things to come. And in this process, we have the European bodies that need to find a compromise, and by the bodies, I mean the European Commission with the proposal. And then we have the council, and then we have the European Parliament, which they both studied the proposal by the Commission. They need to come up with their opinion on the commission proposal.

And once they have their opinions, the so-called trilogue begins between the Commission Council and European Parliament. And this is something which we can probably expect in the second half of this year because, as I was doing my study yesterday, I still haven't found any official document that the Council or the Parliament already reached a conclusion on their opinions. So this is something to look forward to, hopefully look forward to, and see how the Compromise will look like in the future. And once we have the Compromise with the trilogue, then, obviously, the member states need to have some time to implement in their legislation.

SINA THIEME: Right, and just to note that those proposed changes don't hold for the UK, right? I think the solvency regimes in the UK versus the rest of Europe seem to be rather diverging further with the EU proposal suggesting more rules and codification, and I think the UK is trying to really reduce those rules and codifications. But this is probably subject to another podcast unless you've got any thoughts on that, any inside knowledge.

MIROSLAV KOTASKA: No, you're completely correct, and I think it was just the last week or the week before when basically the British government or the Prudential Regulation Authority came out with the final proposal based on the consultation and also on the quantitative Impact Study. But the topics of the review are a little bit different in UK than they are in the European Union.

SINA THIEME: Right, OK, so what are the main areas of change in the EU proposal?

MIROSLAV KOTASKA: I think I mentioned already few because AOP and the regulators in the industry have been talking quite for some time about the long-term guarantee measures. Those are the measures that were put in place basically after the last financial crisis and its impact, so this was

something that was put into the proposal in 2012 to '14 such as volatility adjustment, matching adjustment, some transitional measures on the technical provisions and the yield curves. And this is a huge topic because this is something that was devised to help insurers to, let's say, smoothen the volatility of the short-term market fluctuations and these impacts on valuation of technical provisions of the insurance industry, which is much more long term than these short-term fluctuations.

And that's why this is being reviewed because the commission said, this is a big topic, and in five years, we shall review how these measures worked, whether they worked fine for the industry, whether they worked the way they were designed and helped to smoothen these fluctuations. And I think that they have proven somehow they work quite fine. Another big topic, which is something the industry has been calling for since Solvency II Life in 2016 is the risk margin, and here we see that we can expect some, let's say, decrease in the risk margin.

Obviously, the UK insurers who had annuity business and long-term liabilities towards their customers were most vocal about the risk margin, but we see that the development also in the EU states now is becoming in a way that the risk margin will be lowered, which will free up some capital for the insurance companies. And another big thing that is being reviewed, it's basically the capital charge for interest rate risk, and I think this is getting more and more attention. I think already in 2016 in their risk dashboard said that we are basically going through a long-lasting environment of low yields and basically what impact it has on insurance industry, in particular life insurance industry. And it's been five years, and the rates came even-- or even decreased over those five years.

So we are going really for 10 years with low interest rates, and the life insurers may have promised some significantly higher returns to their policyholders. So now, having in mind that the risk rates were so low and also became even negative, which was not foreseen when Solvency II was designed, now that the big change is basically changing the approach of how to calculate and how to account for this low interest rates and also for negative interest rates-- but unlike the risk margin, this goes the other direction. So basically, it increases the capital requirements for the insurers. I think these are the main topics of the review.

SINA THIEME: And so do you think the increase in the capital charge for interest rate, is that going to be the main concern for most insurers? Or are there other areas for concern?

MIROSLAV KOTASKA: I think so because AOP impact assessments proved that this has major impact on the solvency ratio or on the capital surplus. And also this needs to be somehow taken into account also with the extrapolation. Extrapolation may be seen as part of the long-term guarantee measures. AOP also just did some alternative method, and the extrapolation means that basically how to derive long-term curves to be used for discounting because these discount curves are derived from traded instruments on the financial markets.

And you know that beyond, let's say, 20 or 30 years the liquidity of these instruments is decreasing, and that's why the rates for such long-term outlook are not so, let's say, reliable. And that's why we need to extrapolate for this period. And this new method, again, brings some changes and brings some huge impacts on insurers balance sheets, basically, on valuation of the technical provision, in particular, again, for life insurers. So basically, the extrapolation together with interest rate risk may create a huge impact on solvency ratios, and that's why there are some-- also that the commission and EPA proposed some smoothing mechanism and a transition period for which these will be implemented.

So when we talk about the outlook that Solvency II review might come into force in the member states, let's say, in 2024 or 2025, then we'll have definitely additional years in which the companies should be preparing for this in basically smoothing the transition to the new calculations. And I think this transition period, as it is proposed, is until 2032.

SINA THIEME: OK, wow, OK, so in finding your period?

MIROSLAV KOTASKA: Yeah, exactly because the thing already now is I talked that they're in the long-term guarantee measures for which were included in the Solvency II directive, there are these transitional measures on technical provisions and on the risk-free rates. And these transitional measures were-- at the time Solvency II came into force were designed for 16 years, so they last until 2032, and that's why also now with the proposal for the new interest rate risk CR calculation, the transition period is also designed in a way that it finishes at the same time as those transitional measures that were in the directive originally.

SINA THIEME: Right, OK. Do you think any of these changes could support any business decisions in a wider sense? Or are they all rather, let's call them, technical parameter changes?

MIROSLAV KOTASKA: I think they will, a little bit at least. One thing that comes to my mind is this volatility adjustment, which, up until now, was basically prescribed by AOP. But now, with the proposed changes and the volatility adjustment, there are some application ratios which should account for the credit spread and so on. And this will be based more on the company's portfolios.

So in a way, how the portfolios, either did the liabilities and, in particular, how the asset side looks like, how liquid are the assets, what are the credit spreads for the assets the individual undertakings hold, then it may influence the size of the volatility adjustment the companies might be using to add to their risk-free rates, and they might be able to influence a little bit by their investments also how they discount for their liabilities. It's not so, let's say, dramatic or not so strong as for the matching adjustment, but still, this is something that the companies will need to take into account.

But also it's not just the relief for them. I think there are some stipulations proposed as for the risk management. So if you have some freedom to change how you calculate the volatility adjustment, you also need to ensure that your risk management procedures are in place that you can also identify, manage, and monitor the risks that come from Europe, from your investment.

SINA THIEME: Right. It seems like there's still quite a lot of time until changes come into effect, and it's still quite fluid what exactly is going to come into effect. So is there anything that you think insurers should prepare for right now?

MIROSLAV KOTASKA: I think it'll would be good to follow up on the developments, have some plans to implement. I think if we talk about volatility adjustment having some effect on what the discount rate will be, then it's definitely good to think about already whether they need some changes in their investment portfolios or not. So I think this is one way to think about how to prepare. Also looking at the interest rate risk and maybe, if they are reviewing the investments, they might to do also this taking into account basically the asset liability matching and the basically interest rate gap that they are getting from their portfolios, whether they can somehow eliminate or decrease the interest rate risk.

So this is one thing that comes to mind, and maybe what I haven't mentioned because this is a little bit on the side of solvency to review-- there's also a new directive proposed by the European Commission, which is part of the whole Solvency II review, and this relates to resolution and recovery planning. So this is something that the insurance companies should have in place, having in

place some plans what they will do if the financial conditions deteriorate, how they will restructure their business, and so on. So this is also something to already prepare for.

Probably the big companies, the big insurance groups, especially those that are identified as systemically important by IIS, they are already doing this work. But the proposed directive should cover most of the national markets, so definitely also the, let's say, middle ones or even smaller ones can be included, can be in scope of the resolution and recovery planning. So this is also to be pointed out.

SINA THIEME: Miro, thank you so much for your time and all your expertise on the topic.

MIROSLAV KOTASKA: No, thank you. It was a pleasure talking to you.

SINA THIEME: Well, thank you for listening to this episode, and if you find this interesting, then join us on future episodes of (Re)thinking Insurance.

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