Finance Watch
Making finance serve society

ECON Hearing Solvency II and IRRD - 21st March 2022

Finance Watch's introductory statement

Solvency II and IRRD:

Aiming for a strong prudential regulation for the insurance industry

to serve the European economy

Mrs. Chairperson, Mr. Rapporteur, Honourable members of the European Parliament, ladies and gentlemen,

It is an honour to be with you today to contribute to the reflection of your Parliament on the Solvency II and the Insurance Resolution and Recovery Directives.

Solvency II and IRRD have many dimensions, but given the limited time I have today I will focus my remarks on assessing the effectiveness of Solvency II as a risk-based framework and of IRRD as a credible mechanism to manage the possible failure of insurance undertakings.

1. Apprehending risk in a symmetric manner: where is the symmetry in Solvency II?

I have to confess that I am struggling to find symmetry in the Solvency II proposal on the table.

- Long-term investment:

  The proposed lower capital requirements for less risky long-term equity investment make economic sense, and Finance Watch supports the proposal everything else being equal. But everything else is not equal, in particular given the climate change context we live in. In that respect, we consider that riskier investments such as fossil fuel assets should be excluded from the list of eligible equity investments receiving a 22% capital requirement, as they should be from the Matching Adjustment, as those assets will be increasingly stranded and their value is doomed regardless of the scenario that will prevail in the coming years.

- <u>Volatility Adjustment:</u>

  The modification proposed to calculate the Volatility Adjustment can make sense, but we regret that the Commission decided not to follow the ESRB's recommendation to implement a symmetric Volatility Adjustment, we are worried that a General Application Ratio increased at 85% could lead to underestimating risk and that, contrary to EIOPA's recommendations, no definition or justification of underlying assumptions will be required from insurers, which opens the way to an "à la carte" application and therefore divergence between different companies and EU countries.

- <u>Risk Margin:</u>

  If the objective of taking into account the real value of long-term insurance business can only be supported, we question the decision of the Commission not to follow EIOPA's recommendation to adopt a floor, as such a floor could avoid situations where capital requirements reductions could go beyond what is justified by the reduction of risk.

  Most importantly, we also challenge the wisdom of reducing the cost-of-capital rate used in the Risk Margin calculation from 6% to 5% when the cost of capital derived from European equity markets prices ranged between 6% and 7% at the end of February 2022 (with risk free rates around zero at the time, i.e. before the invasion of Ukraine by Russia and the current upward trend on interest rates linked to the inflationary context).

2. <u>Solvency II capital requirements do not consider the biggest of all risks, i.e. climate change related risks</u>

Regulators and central banks throughout the world recognise climate change as one of the most important, if not the most important, risk incurred by financial institutions and therefore a prime source of possible future financial instability.

In a stranded assets context where there is no scenario under which fossil fuel assets can prosper in the now near future with a planet carbon budget equal to 8 years, the insurance industry will be seriously threatened by climate change unless we get our act together now and adapt insurance companies' capital requirements linked to fossil fuel exposures.

At the end of the day, this comes down to apprehending time horizons in a coherent manner in order to apprehend risk. As stated previously, if longer time horizons lead to a lower risk assessment, then capital requirements can be lower; but if they lead to a higher assessment of risk, then capital requirements should be higher. This has far reaching consequences both for the ability of the financial system to orient capital towards developing a sustainable economy (financiers' job is to put a price on a risk) and for financial stability.

Your Parliament has now the opportunity to adopt the Pillar 1 measures that will enable the European insurance industry to withstand the worst effects of climate change and therefore avoid adding a new financial crisis on top of the looming climate crisis. This must be done at Pillar 1 level as there is so much Pillar 2 measures can do, and climate scenario analyses, however useful, should be taken for what they are, i.e. analysis, not action.

3. IRRD should provide an efficient and credible mechanism to manage the possible failure of insurance undertakings

IRRD is a welcome development and provides the right tools to deal with an insurance undertaking if and when it becomes likely to fail. However, IRRD does not provide for the means of reaching the objectives it gives itself. This questions its credibility when it comes to protecting policyholders and taxpayers from the consequences of the failure of an insurance company whilst maintaining financial stability.

As pointed out in the impact assessment, "the balance sheet of an insurance company is essentially composed of liabilities towards policyholders (by opposition to equity or debt instruments), (and) past insolvencies of insurers have shown that policyholders need to absorb losses".

In the absence of the obligation for insurance companies to build-up a mattress of debt able to absorb losses, and in the absence of an insurance resolution fund and of a harmonised EU-wide insurance guarantee scheme, there is no doubt that the potential failure of an insurance company will be paid either by policyholders or by taxpayers, or by both.

Such a mattress can be easily created by inserting in IRRD an insurance equivalent of the banking Minimum Required Eligible Liabilities (MREL) contained in BRRD or of the Financial Stability Board's Total Loss Absorbing Capacity (TLAC). In essence, this would consist of making insurance undertakings issue loss absorbing subordinated debt (so-called bail-inable debt) that bond investors would buy. If we do not adopt such a mechanism, the risk will effectively be borne by policyholders and by society for free. It is not a question of applying mechanically banking regulation to insurers, which obviously would not be appropriate, but of who bears the risk.

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Importantly for our debate and drawing from experience, we should bear in mind that the existence of TLAC has not prevented banks throughout the world from conducting profitable business, that the impact on the weighted average cost of capital of insurance companies issuing the debt would be minimal, and that investors would be happy to invest in such higher yielding debt. The choice we are facing here is therefore between putting in place a sound financial mechanism or perpetuating moral hazard in our financial system to the detriment of society.

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