



# A decade of Solvency II and the review underway

Since 2016, Solvency II has reinforced solvency, governance and supervisory convergence across the EU, but has also revealed procyclical pressures, an excessive compliance burden on smaller insurers, and constraints on the sector's capacity to finance long-term productive investment. The review now underway aims to correct these imbalances while preserving the framework's prudential foundations.

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**Abstract:** A decade after its implementation, Solvency II has consolidated itself as an international benchmark for risk-based regulation, having delivered higher average solvency, more rigorous internal governance, and greater supervisory convergence across the EU. Practical experience, however, has also exposed structural limitations: the framework's technical complexity has imposed a heavy regulatory burden, particularly on smaller insurers and notably in Spain, whose compliance costs are disproportionate to their actual risk profiles. The short-term sensitivity of the solvency capital requirement to market movements has likewise sat in persistent

tension with the long-term nature of insurance liabilities, generating procyclical pressures and constraining the sector's ability to channel savings into illiquid and long-term assets — precisely the kind of patient financing that Europe's green and digital transitions require. The review now underway addresses these imbalances along several axes: a recalibrated extrapolation of the risk-free curve, a redesigned and more entity-specific volatility adjustment, proportionality provisions for Small and Non-Complex Undertakings (SNCUs) and a reduction in the risk margin's cost-of-capital rate from 6% to 4.75%. The SCR itself is also refined, with preferential treatment for long-

term equity investments and a more accurate capture of interest rate risk, including negative rates. Complementing these technical changes, the reform formally embeds ESG and climate risks into governance and reporting, equips supervisors with new macroprudential tools, and updates the rules for cross-border groups. The intent is to preserve the prudential solidity the framework has built while removing the constraints that have prevented insurance from fully functioning as a stable, long-term source of financing for the real economy.

### Looking back at implementation of Solvency II in Europe and Spain

Implementation of Solvency II in January 2016 marked a structural shift in European insurance regulations. The new framework was designed to reinforce policyholder protection, improve financial stability and spur integration of the internal market, all of which underpinned by more realistic risk assessment, better aligned with economic principles.

In the last 10 years, the experience has been, on balance, positive. The regime has helped boost sector resilience, uplift the quality of internal governance and standardise supervisory standards in the EU. The application of market valuation principles and risk-adjusted capital requirements marked an improvement with respect to the outgoing Solvency I regime, which was far more static and reliant on fixed coefficients.

In Spain, the sector regulator, the DGSFP for its acronym in Spanish, maintains that Solvency II has been conducive to higher average solvency and more robust risk management. The sector has made strides in discipline, analytical capacity and supervisory comparability.

However, as with any complex prudential framework, accumulated experience has also revealed significant limitations. One of its most criticised aspects is the technical complexity of the framework, which has impeded its implementation and created a considerable regulatory burden.

Moreover, the sensitivity of the solvency capital requirement (SCR) to market movements has created a level of volatility that in certain contexts may not accurately reflect the long-term nature of the insurance business. In fact, the experience gained during its first decade of application has revealed a degree of tension between the long-term nature of the insurance business and short-term sensitivity to certain prudential requirements. Solvency II has strengthened the sector but has also evidenced that potentially conservative or pro-cyclical regulations can end up curbing one of its most valuable economic functions: acting as a stable institutional investor, capable of providing long-term financing and mitigating episodes of market stress.

### Rationale for the current review

After several years in action, both the European Commission and EIOPA noted that even though Solvency II had delivered its core objectives, the framework presented room for improvement. The revision underway, defined within a framework of recurring updates, seeks to adjust technical, operational and strategic aspects of the system without altering its general architecture. The main institutional and economic reasons for the review include:

1. *An environment of structurally low rates:* The original framework assumed an interest rate normalisation process that did not materialise for a long time.

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This situation affected the valuation of long-term liabilities in the life insurance segment in particular and often led to the overestimation of the capital requirement and excessive volatility in prudential metrics.

2. *The need to stimulate long-term investments:* The twin green and digital transitions, private sector innovation and reindustrialisation in Europe require stable financing channels. However, Solvency II has proven somewhat rigid in its treatment of certain illiquid or long-term assets, preventing the insurance sector from fully deploying its capacity to finance infrastructure, capital or other productive assets.
3. *Disproportionate regulatory burden:* Many insurers, particularly the smaller ones, as is the case in Spain, have had to bear a high regulatory and operational burden relative to their real risk profiles. This relative over-regulation has increased compliance costs without always bringing equivalent benefits in terms of stability or supervisory quality.
4. *Complexity and administrative burden:* Pillar III has proven particularly onerous. The volume of data, reporting frequency and technical documentation demands have put a strain on human and technological resources, particularly at firms with small operating structures.
5. *Resilience in systemic crises:* The COVID-19 pandemic and subsequent episodes of financial stress served as unanticipated stress tests. Although the framework responded well, it also revealed certain balance sheet instabilities tied to the sensitivity of the capital requirement and

certain valuation measures to abrupt and transient market shocks.

Overall, these factors have prompted a technical revision of the regulatory framework with a dual objective: preserving the prudential solidity attained since 2016 while fine-tuning Solvency II to layer in a rationale more compatible with the economic function of insurance as a provider of protection and channel for long-term savings and institutional investment.

## Key aspects under review

### *Proportionality and small insurers*

One of the biggest changes ushered in by the reforms is the explicit acknowledgement that not all insurers are the same. A specific category is being set up for Small and Non-Complex Undertakings (SNCUs), which will be bound by simpler administrative and reporting requirements: shorter reports, less frequent internal risk assessments and simplified capital calculations when certain risks are relatively immaterial for the undertaking as a whole. The underlying rationale is clear: the level of requirements should be proportional to the size and complexity of each company, rather than being uniformly applied across the entire sector.

### *The cost of prudence: The risk margin*

All insurance undertakings must hold an additional financial buffer, beyond their technical provisions, calculated based on their best estimate of liabilities. This buffer is called the risk margin and its amount depends on a cost of capital, among other factors. The reforms reduce the cost-of-capital rate from 6% to 4.75% and also introduce a mechanism that progressively reduces the weight of risks further out in time. The practical impact is significant: insurers will be able to release capital which they can then earmark to growth or investments, without compromising policyholder protection.

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### ***Discount curves: How future commitments are measured***

Insurers assume very long-term payment commitments, for example annuities and life insurance. To calculate how much those future commitments are worth today, they use a risk-free interest rate curve, which provides the basis for the discounting exercise. The reforms introduce three changes in this respect:

- Firstly, they introduce new methodology for extrapolating that curve beyond the horizon for which there are reliable data, with a transition period extending to 2032. The goal is to make the curve smoother, more stable and more representative of the economic reality, particularly in times of low or anomalous interest rates.
- Secondly, the so-called volatility adjustment is getting a new design. This mechanism allows insurers to mitigate the balance sheet impact of sudden market oscillations that do not represent a real risk of default. The reformulated version will make this adjustment more entity-specific and harder to use in excess or disproportionately, so providing a fairer view of each undertaking's real financial situation.
- Thirdly, the reforms eliminate the restriction that limited recognition of the advantages of diversification for life insurers that manage long-term asset and liability portfolios together. Its removal corrects an unjustified penalty for this type of management.

### ***Mandatory capital: How much the insurers should set aside***

The SCR is the amount of capital an insurer must hold so as to be able to absorb unexpected losses and continue to protect its customers. The reforms introduce several changes to how it is calculated:

- With respect to long-term investments in equities, the methodology acknowledges that not all equity investments entail the same risk. If an insurer can demonstrate

that it will not be obliged to sell those investments if the market falls (recall that their commitments to policyholders are also long-term in nature), it can apply a lower capital requirement (22%) than the standard rate. This amounts to recognition that long-term management warrants differential treatment and also creates an incentive for insurers to take on long-term investments.

- As for interest rate risk, the new methodology improves the manner in which the standard formula captures the impact of sudden movements in rates, in either direction, even if rates are negative, correcting a previous design flaw conducive to the potential underestimation of this risk.
- Lastly, the SNCUs can use simplified calculation methods for risks that, individually or as a whole, represent a very small share of their total capital. This further cements the principle that prudential rigour should not require the same level of sophistication of all undertakings but should be flexible enough to allow for tailoring to reflect what really counts on a case-by-case basis.

### ***New tools for system stability***

The reforms give the supervisors new tools for acting if they detect risks that could affect the financial system as a whole. They can limit the payment of dividends or bonuses, require the undertakings to provide liquidity management plans and intervene preventively in the event of perceived systemic risks. These measures reinforce the supervisor's ability to take action in the face not only of individual problems but also threats of a broader nature.

### ***Sustainability and climate risks***

The integration of environmental, social and governance (ESG) factors in insurance management will no longer be a recommendation but rather a formal requirement. Insurers will be required to incorporate them into their internal

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governance structures, periodical risk assessments and the information they report to both the supervisor and the market. The reasoning is that climate and sustainability risks are real financial risks and should be treated as such.

#### **Supervision of groups and cross-border activity**

The reforms also update the rules applicable to insurance groups, *i.e.*, groups with more than one undertaking under the same parent and reinforces cooperation between the national supervisors across the different countries. Specific measures are being introduced to address broader cross-border activities, so acknowledging that the European insurance market is increasingly integrated and that its supervision must follow suit.

Taken together, these modifications seek to keep the framework robust but adapt it for an economic, technological and geopolitical environment in flux. The reforms do not seek to deregulate the sector but rather to better calibrate its prudential incentives so that the insurance business remains a solid sector and potential source of financing for the real economy.

#### **Challenges and opportunities for the insurance sector**

The Solvency II reforms mark the start of a period of transition which poses significant challenges as well as strategic opportunities for European and Spanish insurers. This time around. The debate is not limited to prudential concerns: it is directly linked to the sector's ability to channel stable savings into productive investments without compromising their role as insurance providers.

#### **Challenges**

- Technical adaptation for the new valuation parameters, particularly with respect to the rate curve, risk margin, volatility adjustment and rate risk treatment, which could require considerable adjustments to internal models, financial planning and asset and liability management.
- Management of the regulatory changes in a still-demanding environment in which practical implementation will require revising policies, internal metrics, validation processes and supervisor engagement mechanisms.
- Operational reorganisation to apply the proportionality principle, particularly at groups with multiple subsidiaries and different local frameworks, and reinforced analytical capabilities in order to justify the use of preferential or simplified treatments.

#### **Opportunities**

- By making certain requirements more flexible, the reforms may allow the release of some capital and foster the allocation of funds to productive investments, such as investments in infrastructure, the digital economy or the green transition, areas where the insurance sector may be able to provide stable financing that is hard to substitute with other sources.
- A more attuned prudential design could mitigate procyclical incentives and reinforce the sector's role as stabiliser during episodes of stress by reducing the sensitivity of the solvency position to short-term fluctuations, thereby easing the pressure to adjust portfolios during times of adversity.

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- The insurers that are quick to build climate, sustainability and liquidity risks into their corporate governance could improve their competitive positioning and credibility *vis-à-vis* the supervisor, while developing new capital allocation capabilities aligned with Europe’s strategic priorities.

For the national supervisor, the challenge lies with applying the proportionality principle without undermining prudential standards and ensuring that any capital released does not translate only into capital distributions but also leaves the sector better equipped to provide long-term financing and shore up business resilience and financial stability.

### **Insurers as institutional investors and macroeconomic buffers**

The regulatory reforms take on additional meaning through the prism of the economic role of the insurers’ capital. These undertakings manage stable, long-term and relatively predictable liabilities, putting them in a unique position to invest with long time horizons, absorb transient volatility and help fund projects that require “financial patience”. Against this backdrop, an overly rigid prudential framework not only affects the insurers’ profitability or capital usage, but also the financial system’s aggregate ability to channel savings into investments.

In that sense, the Solvency II reforms can also be seen as a correction of incentives. By reducing certain overly burdensome requirements and better recognising the economics behind long-term investing, the reforms align the prudential approach more closely with the real role of insurance in the economy: protecting households and businesses, shoring up confidence in adverse environments and acting as an institutional investor with a natural capacity to contribute to competitiveness, the productive transition and resilience of the business ecosystem.

### **Conclusions**

After a decade in effect, the Solvency II regime has earned credibility as an international benchmark for risk-based regulation, having reinforced the solvency of the European insurance sector and improved market transparency and discipline. However, its application in practice has also revealed certain imbalances and rigidities and excessive sensitivity to certain financial variables that needed correcting.

The review currently under way does not imply a break but rather a necessary evolution in order to align the existing framework with the latest challenges: sustainability, structurally different levels of interest rates than initially contemplated and a need for proportionality, macroprudential management

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and mobilisation of savings into more productive investments.

The key lies with preserving that which has worked well –prudential solidity, a risk–based culture and policyholder protection - while correcting the things that have curtailed the sector’s ability to fully deploy its economic function. The success of the reforms will hinge largely on this balancing act between prudence and macroeconomic utility.

If they are implemented wisely, the reforms could simultaneously achieve three objectives: more representative balance sheets for insurers, more proportionate supervision and a bigger role for the sector in providing stable financing to the real economy. That is, ultimately, the real purpose of the reforms: not watering down Solvency II but making the framework more compatible with the nature of the insurance business.

In sum, these reforms go beyond a regulatory framework update to redefine the insurance sector’s economic fit within the European financial architecture: as provider of protection, as taker of long-term savings and as stabilising agent in a context of productive, climate and geopolitical flux.

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