EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

Macroprudential policy

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises the section of the consultation paper on Macroprudential policy. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting, public disclosure and Insurance Guarantee Schemes. Milliman has written briefing notes on each of these papers (available here).

On 15 October 2019 EIOPA issued a second wave of consultation entitled “Consultation Paper on the Opinion on the 2020 review of Solvency II” (the **CP**). This was accompanied by an impact assessment document including an assessment of the combined impact of the proposed changes. The CP is 878 pages long and covers a wide range of topics as follows:

- Long-Term Guarantee (**LTG**) and equity risk measures
- Technical Provisions
- Own funds
- Solvency Capital Requirement (**SCR**)
- Minimum Capital Requirement (**MCR**)
- Reporting and disclosure
- Proportionality
- Group supervision
- Freedom to provide Services (**FoS**) and Freedom of Establishment (**FoE**)
- Macroprudential policy
- Recovery and resolution
- Fit and proper requirements

Milliman has produced a briefing note giving a summary of EIOPA’s proposals in the CP (available here) and separate briefing notes covering each of these topics in more detail. This briefing note covers Macroprudential policy.

Background

The key focus of microprudential policy is the stability of individual entities. By contrast, macroprudential policy focuses on the stability of the financial system as a whole. EIOPA’s view is that, compared to the banking sector, macroprudential policies in insurance are much less developed and this represents a deficiency that could play a part in future financial crises.

At its heart, Solvency II is a microprudential regulatory regime and while it does have some direct and indirect financial stability impacts, in EIOPA’s view it lacks rigorous macroprudential tools and policies.

Elements of Solvency II with direct macroprudential impacts include long-term guarantee measures and the measures on equity risk. Furthermore, the Prudent Person Principle (**PPP**) and the Own Risk and Solvency Assessment (**ORSA**), having indirect macroprudential impact, could be used to a certain extent as instruments to mitigate systemic risk. In addition, there is a substantial emphasis on risk management in Solvency II, which in turn aims to discourage risky behaviour and excessive risk exposure concentrations.

However, in EIOPA’s view, there are still various areas of systemic risk that are not addressed sufficiently by Solvency II in its current form. EIOPA states that it is necessary to obtain a proper understanding of the sources of macroprudential risk for insurers, given that several studies have shown the potential impact of insurance business on systemic risk, and to then develop a macroprudential framework that addresses these sources.

Proposals

EIOPA has put forward various proposals to address these perceived deficiencies. These include the following:

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive

- Capital surcharges for systemic risk
- Concentration thresholds
- Expansion in the use of the ORSA report
- Expansion of the PPP
- Pre-emptive recovery and resolution plans
- Systemic Risk Management Plan (**SRMP**)
- Liquidity Risk Management Plans (**LRMP**)
- Temporary freeze on redemption rights

The harmonisation of macroprudential measures is a key consideration for EIOPA. The sharing of information between jurisdictions will help to achieve this aim, so that measures are appropriately coordinated across member states.

Each of these proposals are covered in more detail below.

CAPITAL SURCHARGE FOR SYSTEMIC RISK

Under this proposal, National Supervisory Authorities (**NSA**s) would have the power to impose capital surcharges to mitigate a specific systemic risk. The aim of this buffer would be to reduce the risk of failure of the undertaking in question, as the additional capital will provide an extra cushion against unexpected events. It can be used to address entity-based sources of systemic risk such as the failure of a systemically important insurer, as well as activity-based sources, such as selling a product with extremely high guarantees. It may also be used to discourage excessive risk taking, for example to combat the “too big to fail” mentality.

The NSAs would have the power to determine when surcharges would be applied, using relevant guidance from EIOPA in making their decision. However, it must be ensured that NSAs are acting consistently across EU states, so there is a level playing field for companies in each territory.

EIOPA believes that this capital surcharge complements the existing power of the NSAs to require a capital add-on where the standard approach does not reflect the undertaking’s risk profile.

CONCENTRATION THRESHOLDS

Undertakings with high concentrations of risks are a potential source of systemic risk, although it should be noted that in isolation, high concentrations do not necessarily mean there is a risk to financial stability, but they can be an alert to supervisors. There are various exposures that should be considered, including to certain asset classes, assets in emerging markets, exposure to certain sectors e.g. banking and derivatives.

Thresholds are a tool that allow the authorities to set limits on risk levels undertaken; they can be considered either hard or soft. Hard thresholds cannot be breached, and EIOPA notes they are not well suited to Solvency II as it is fundamentally a principle-based framework. In EIOPA’s view, soft thresholds by contrast are more suitable and can be used by NSAs as a monitoring tool allowing flexibility to intervene on a case by case basis when required.

EIOPA has proposed that NSAs should be granted the power to define soft concentration thresholds, and the ability to intervene accordingly. This should foster good risk management and enable entities to work alongside their NSA to take steps to manage their risk concentrations.

EXPAND THE USE OF THE ORSA TO INCLUDE THE MACROPRUDENTIAL PERSPECTIVE

The ORSA is an important element of risk management under Solvency II, although it currently focuses mainly on microprudential risk analysis. EIOPA has proposed that the ORSA should be extended, to include macroprudential factors in its scope. This would allow authorities to easily obtain the macroprudential information they require from the ORSA, which currently is either not readily available or only included by some firms. The supervisor can then compile this information, to form a view on market-wide macroprudential risk.

It would also be beneficial to insurers, as they could receive supervisory input that can feed back into their ORSA processes. This could include benchmarking their macroprudential risk levels relative to their peers and the market, to the extent this is relevant.

EIOPA notes that this extension of the requirements of the ORSA to explicitly consider the macroprudential perspective is not expected to be onerous for firms to implement. Indeed, as many firms carry out macroprudential analysis elsewhere in their risk management process, in EIOPA’s view the adaptation effort required shouldn’t be material.

EXPAND THE PRUDENT PERSON PRINCIPLE TO TAKE INTO ACCOUNT MACROPRUDENTIAL CONCERNS

The prudent person principle states that undertakings should only invest in assets whose risks they can properly identify, measure, monitor, manage, control and report as well as appropriately take into account in the assessment of their solvency requirements.

EIOPA has proposed that this principle should be extended to macroprudential matters. This would work through insurers’ investment strategies, as they would be encouraged to take into account macroprudential concerns when analysing their portfolio liquidity and diversification. An example of this that EIOPA has given is of management actions that may lead to procyclical behaviour, such as an action to sell equity holdings in an already falling market. This would also occur as part of the supervisory review process; NSAs determining whether firms comply with the PPP would also consider the macroprudential angle.

PRE-EMPTIVE RECOVERY AND RESOLUTION PLANNING

The deterioration of the solvency position of a systematically important insurer, or failures of insurers that collectively are systematically important, is a clear source of systemic risk. EIOPA believes that key objectives in combatting this risk are to ensure sufficient loss absorbency capacity, and sound practice in risk management. To help achieve these aims, EIOPA has proposed that pre-emptive recovery and resolution plans should be required, either by certain undertakings or all. A pre-emptive recovery plan involves the insurer detailing the steps it would take to restore its financial position following deterioration arising from potential stress scenarios. Resolution plans deal with how the NSA would resolve an undertaking, whilst avoiding systemic disruption and any loss to taxpayers. These options and EIOPA's advice are discussed in more detail in the Milliman's Recovery and Resolution briefing note.

SYSTEMIC RISK MANAGEMENT PLANS

Excessive involvement in certain activities or products, and possessing high concentrations of risk, are each potential sources of systemic risk. In EIOPA's view, such risk taking should be discouraged, to ensure the stability of the financial sector.

To this end, EIOPA has proposed that certain insurers should produce a Systemic Risk Management Plan (SRMP). The undertakings in question will be those specified by the relevant NSA based on factors such as: size, extent of interconnectedness with the financial system, concerns around substitutability[2] as well as the nature, scale and complexity of activities. In these plans, the undertakings will detail the measures they will take to mitigate the systemic risk they pose to the financial system. These plans will inevitably require an additional commitment of resources for both the firms required to produce them and the NSAs, thus the proposal is to have only specific undertakings produce these.

LIQUIDITY RISK MANAGEMENT PLANNING AND REPORTING

Liquidity risk historically has been less of a concern for insurers than it has been for banks. However, in EIOPA's view, a market wide liquidity problem is possible and would certainly have a big impact on insurers. Liquidity risk, while an area listed in Solvency II to be addressed by risk management, does not have any specific quantitative requirements. Not only this, but NSAs find it difficult to monitor market wide liquidity risk, as information is not readily available from firms' reporting templates.

To address this gap in the current Solvency II regime, EIOPA considered various options. It has considered enhancing reporting and monitoring frameworks, as well as introducing binding quantitative liquidity requirements. EIOPA plans to develop a meaningful set of liquidity risk indicators, to facilitate liquidity risk monitoring. The liquidity of liabilities should also be better considered, for example looking at time to maturity, and product characteristics that affect the probability of lapse. For the time being at least, quantitative requirements are not proposed. However, EIOPA does feel that Article 44 of the Solvency II Directive should more explicitly refer to the need to have a liquidity risk management framework in place. Furthermore, EIOPA proposes that firms be required to produce a Liquidity Risk Management Plan (LRMP) which identifies potential liquidity stresses and how firms will address them. NSAs should have the remit to waive the LRMP requirement for certain undertakings less exposed to liquidity risk. This proposal will potentially result in extra work for insurers, however for insurers with good liquidity risk management it shouldn't be an onerous task. It should be noted that some NSAs, for example the PRA in the UK[3], have already put in place similar national requirements, however EIOPA's proposal would make such requirements consistent across all jurisdictions.

TEMPORARY FREEZE ON REDEMPTION RIGHTS

As part of liquidity risk management, EIOPA has proposed that NSAs should have the power to temporarily freeze redemption rights[4] in exceptional circumstances. This would be applied either to the whole or part of the insurance market~~,~~ and would allow undertakings enough time to put in place measures to reduce their liquidity risks, without affecting the stability of the financial system. This would help to limit procyclicality by reducing the risk of collective behaviour that can exaggerate price movements in financial markets due to, for example, fire sales of assets and which may result in detriment to policyholders.

EIOPA envisages that this measure would not replace the requirement under the standard formula to hold capital in case of mass lapses, but serve to supplement it, acting only as a last resort option where other measures have failed to be effective and where there felt to be a significant threat to policyholders or the stability of the financial system. EIOPA has also stressed that this should not also simply be a cure of symptoms, while underlying causes remain unaddressed, for example high guarantees that cannot be sustained need to be addressed. The rationale for the redemption freeze would need to be closely monitored and the freeze removed once the threat has passed. In EIOPA's view, there is a cross-border challenge associated with this proposal as policyholders who do not reside in the same country as the insurer should not be negatively affected if the insurer's home country puts a freeze on redemption rights in place.

[2] EIOPA sets out aspects for NSAs to consider in assessing substitutability for example whether the undertaking has a high or monopolistic share in one market

[3] PRA's Supervisory Statement (SS) 18/19 'Liquidity risk management for insurers'

[4] The right of policyholders to lapse or surrender policies

OTHER MEASURES UNDER CONSIDERATION

Other measures considered by EIOPA include enhancing the reporting framework currently in place, to help detection of potential market wide liquidity stress scenarios. Additionally, EIOPA believes that enhanced reporting is required in order to combat the risk of market wide under-reserving.

Milliman

CONTACT

LONDON

Jessica Crowson
jessica.crowson@milliman.com

MILAN

Nazario Cannarozzi
Nazario.Cannarozzi@milliman.com