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EIOPA's Macprudential Framework

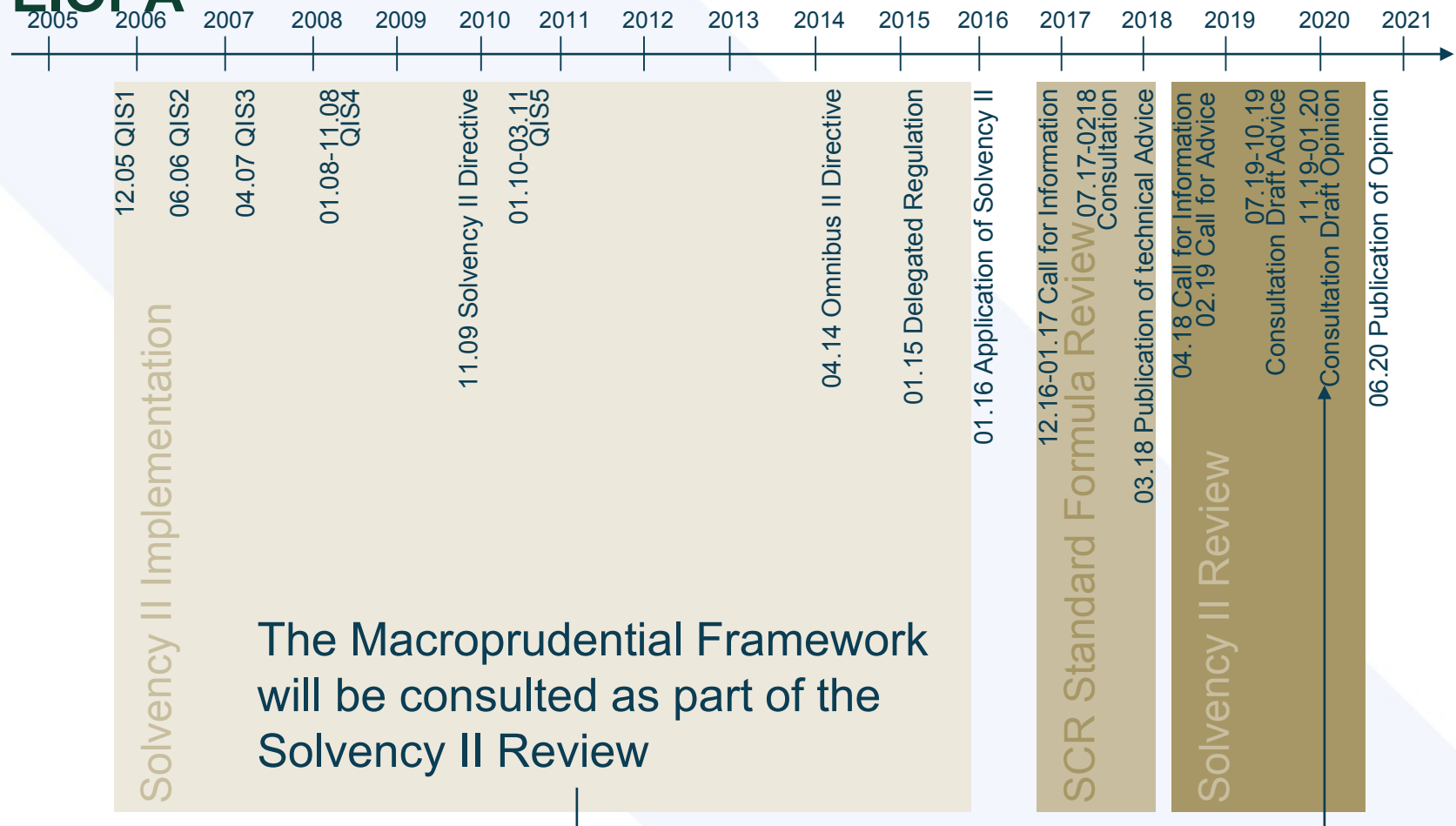
How to tackle the systemic risks of the insurance industry

Dr. Frank Schiller, Vice Chair of the AAE Risk Management Committee

SAV Annual Meeting, 30 August 2019

Introducing and reviewing Solvency II

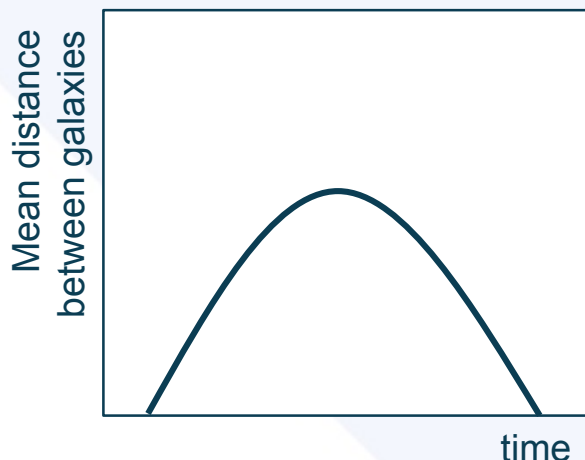
Reviews are an evolution not a revolution ... says EIOPA



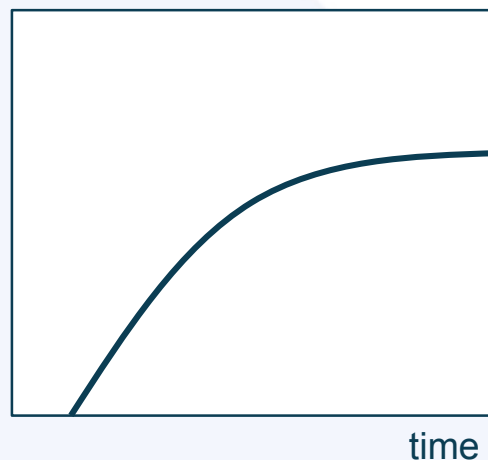
A brief history of time Solvency II

What kind of universe is Solvency II?

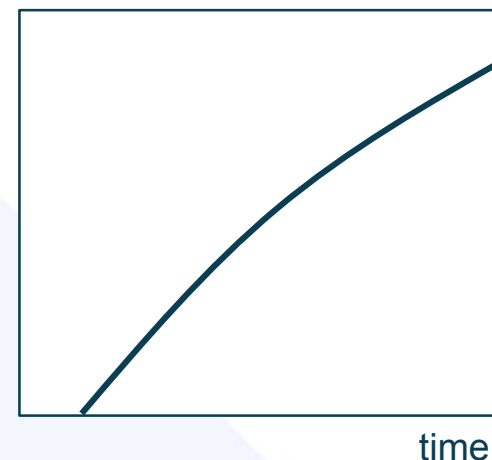
The Freidmann-Lemaître-Robertson-Walker-Model differentiates three classes:



Contracting universe:
After a Big Bang it will eventually **collapse again.**



Static universe:
The universe will **converge** to a stable size.



Expanding universe:
The universe will **grow without limitation.**

Sources: https://en.wikipedia.org/wiki/Expansion_of_the_universe, https://en.wikipedia.org/wiki/A_Brief_History_of_Time

What is a macroprudential framework?

Macro- vs. microprudential regulation – a short explanation

- **Systemic risk**
The risk of **disruption in the financial system** with the potential to have serious **negative consequences** for the **internal market** and **real economy**.
- **Financial stability**
The state where the **build-up of systemic risk** is prevented.
- **Macroprudential regulation**
A framework that aims at **mitigating systemic risk** (or its build-up) leading to **financial stability** and, finally, to **economic growth**.
- **Microprudential regulation**
A framework to **limit potential distress** of individual institutions and **ensure policyholder protection**.

What is a macroprudential framework?

And why is it relevant for insurers?

- Earlier systemic crises particularly impacted banks:
e.g. Savings and Loans Crisis, 1929 Wall Street Crash, Continental Illinois ('Too Big To Fail'), **2007-08 Financial Crisis**
- Insurers might create or magnify systemic risks:
 - AIG: **credit risk exposure** during 2007-08 Financial Crisis
 - ESRB December 2015 Report systemic risks in EU insurance sector: exposure to long-term interest rates "**low-for-long**" and "**double-hit**"
- Arbitrage between banks and insurers should be avoided
Consistency with ESRB and IAIS approaches important
- But insurance industry specifics need to be considered
Insurance is different with typical hold to maturity and long-term

Implement a macroprudential framework

The European Commission has requested a specific analysis as part of the Solvency II 2020 Review:

*“ EIOPA is asked to assess whether the existing provisions of the **Solvency II framework** allow for an **appropriate macro-prudential supervision**. Where EIOPA concludes that it is not the case, EIOPA is asked to advise on how to improve the following **closed list of items**:*

- *the **own-risk and solvency assessment**;*
- *the drafting of a **systemic risk management plan**;*
- ***liquidity risk management planning** and **liquidity reporting**;*
- *the **prudent person principle**.*

*This assessment should be based on strong supporting evidence, also assessing the possible impact of such additional specifications of **insurers' behaviour** and possible **interactions with other Solvency II instruments**.*

Implement a macroprudential framework

Route taken by EIOPA for the analysis and derivation of a proposal

1. Analyse how insurance creates or amplifies systemic risk.

EIOPA report 02.2018 “Systemic risk and macroprudential policy in insurance” ¹

2. What are the tools already existing in the Solvency II framework, and how do they contribute to mitigate the sources of systemic risk?

EIOPA report 03.2018 “Solvency II tools with macroprudential impact” ¹

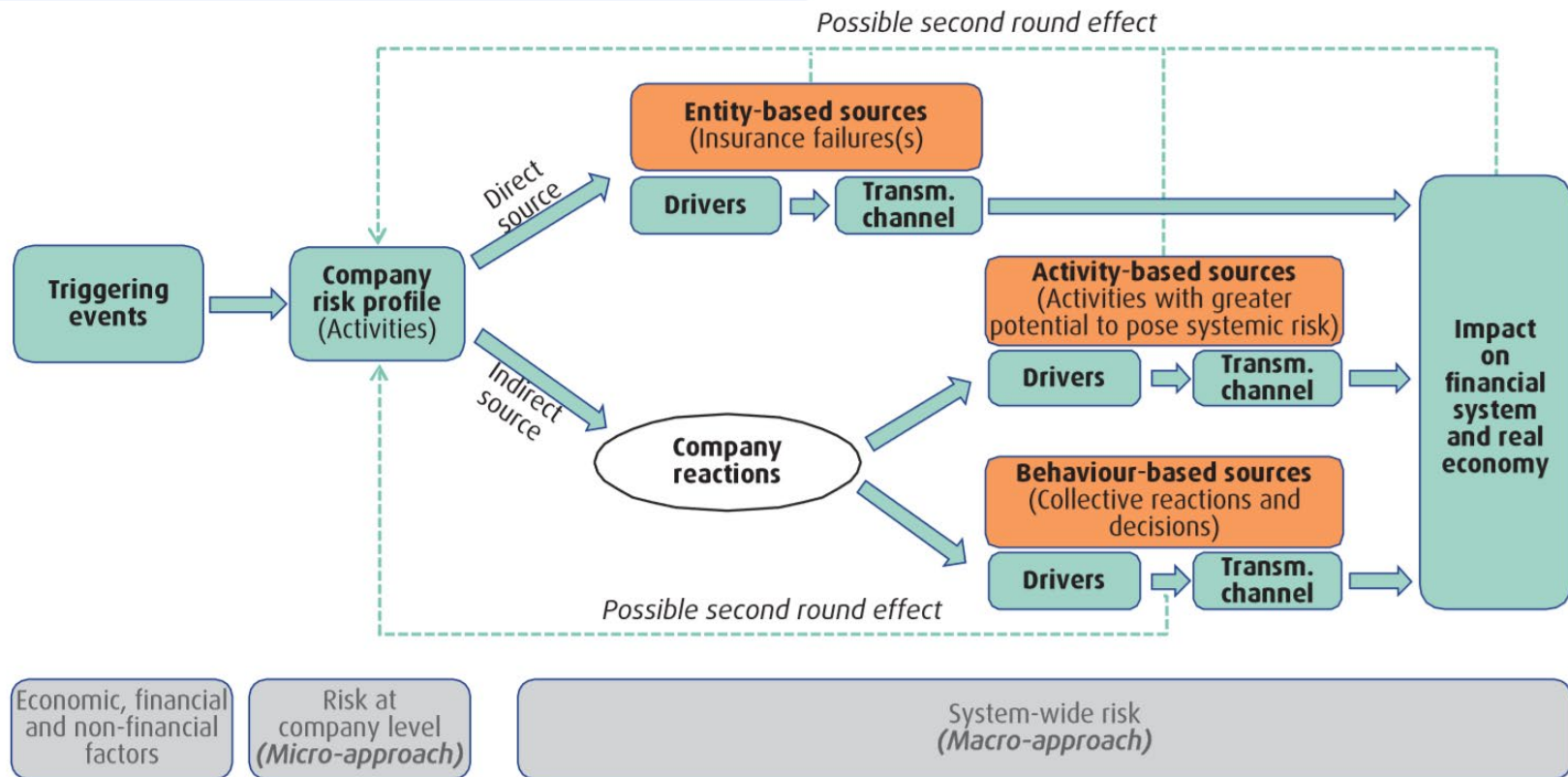
3. Are other tools needed, and which ones should be promoted?

EIOPA report 07.2018 “Other potential macroprudential tools and measures to enhance the current framework” ¹

¹ <https://eiopa.europa.eu/Publications/Reports/>

Step 1. Analysis of systemic risk in insurance

EIOPA's approach – a model of drivers and dependencies



Source: EIOPA report 02.2018 "Systemic risk and macroprudential policy in insurance", <https://eiopa.europa.eu/Publications/Reports/>

Step 1. Analysis of systemic risk in

	Systemic risk drivers	Transmission channels
Entity-based	Deterioration of solvency position leading to (collective) failures	
	<ul style="list-style-type: none"> • Size or global activity (G-SII and D-SII)* • Interconnectedness (counterparty & macroeconomic exposure) • Substitutability 	<ul style="list-style-type: none"> • Exposure • Lack of supply • Expectations and information asymmetry • Asset liquidation
Activity-based	Activities or products with potential for systemic risks and dangerous interconnections	
	<ul style="list-style-type: none"> • Derivative trading (non-hedging) • Financial guarantees (incl. monolines) • Asset and direct lending (e.g. securities) • Lapsable products 	<ul style="list-style-type: none"> • Exposure • Asset liquidation • Bank-like activities (maturity transformation and leverage)
Behaviour-based	Concentrations	Excessive risk-taking
	Inappropriate provisioning <ul style="list-style-type: none"> • Concentration of certain asset classes • Excessive risk taking <ul style="list-style-type: none"> – “Search for yield” – Too-big-to-fail / moral hazard • Heightened competition potentially leading to insufficient technical provisions 	Collective behaviour <ul style="list-style-type: none"> • Exposure • Asset liquidation

* FSB definition of G-SII: Global Systemically Important Institution / Insurer, D-SII: Domestic Systemically Important Insurer

Source: EIOPA report 02.2018 “Systemic risk and macroprudential policy in insurance”, <https://eiopa.europa.eu/Publications/Reports/>

Step 2. Tools existing in Solvency II

Solvency II as a microprudential framework itself has a positive effect on financial stability. Further direct impacts:

- **Reduce collective, procyclical behaviour of insurers:**
 - **Symmetric adjustment** to the equity risk charge (time and index averaging to reduce effects on extreme market price movements)
 - **Volatility adjustments** (reduce effect of market volatility and challenging environment – “low-for-long” and “double-hit”)
 - **Matching adjustments** (cushioning of market volatility by incentivising hold to maturity strategies)
 - Extension of **recovery period** in exceptional adverse situations (avoid collective behaviour after extreme market events)

Source: EIOPA report 03/2018 “Solvency II tools with macroprudential impact” <https://eiopa.europa.eu/Publications/Reports/>

Step 2. Tools existing in Solvency II

Direct macroprudential impact (continued):

- Restrict risk for activities or products with systemic risks and hence also restrict effects of interconnectedness:
 - Indirectly Solvency II related: EIOPA may temporarily prohibit or restrict certain **financial activities or practices for PRIIPs** * (only to address a significant investor protection concern)
- Reduce risks after breach of SCR
 - Only reactive measures, no possibilities to reduce risk before incidence
 - Cancellation or **deferral of dividends**
 - Requesting **recovery plans** and financing schemes

* PRIIPs: Packaged Retail Financial Products for Investors
Prohibit free disposal of assets

Source: EIOPA report 03.2018 “Solvency II tools with macroprudential impact” , <https://eiopa.europa.eu/Publications/Reports/>

Step 3. Proposed new tools and

measures

Tools to be considered during the Solvency II Review

Enhanced reporting and monitoring	
Capital and reserving-based	Leverage ratio
	Enhanced monitoring against market-wide under-reserving
Liquidity-based	Additional reporting on liquidity risk
	Liquidity risk ratios
Exposure-based	Enhancement or Prudent Person Principle
	Enhancement of ORSA
Pre-emptive planning	Recovery plans
	Resolution plans
	Liquidity Risk Management Plans (LRMP)
	Systemic Risk Management Plans (SRMP)
Intervention Powers	
Capital and reserving-based	Capital surcharge for systemic risk
Liquidity-based	Temporary freeze on redemption right
Exposure-based	Concentration thresholds

Capital and reserving-based tools

Objective: avoid (or provide early warning for) deteriorations of the solvency position in case of a shock.

Tools should not collide with existing Solvency II metrics.

- **Leverage Ratio:**

- Typical tool used in banking sector to monitor or limit the capital ratio or capital position.
- Reasonable definitions $OF/tot. \text{ assets}$, $ins. \text{ liab.}/OF$, $non-ins. \text{ liab.}/OF$ cannot be robustly calibrated for a European hard limit.
- Hence, proposed to consider as monitoring tool and early warning.

- **Capital surcharge for systemic risk:**

– Could be defined similarly to O-SII buffer in the banking sector

Capital and reserving-based tools

- **Monitoring against market-wide under-reserving:**
 - Additional QRTs required for detailed movement / variation analysis of TP to enable regulator to analyse in more granularity deviations of actuals vs. expected.
 - Can be used on entity and (as consistently defined) market level for an indication of under-reserving, i.e., not adequate best estimate assumptions.
 - Has to be designed properly to keep operational efforts manageable.

Tools from the banking sector like leverage ratio or capital surcharge cannot simply be copied. Insurance is too heterogeneous to effectively define hard limits or capital-add-ons. Approach would also contradicting the risk-based nature of Solvency II.

Consistent monitoring could provide insights and early warning for systemic risks. However, the current proposal from EIOPA is hardly suitable to achieve the intended

Liquidity-based tools

Objective: ensure that insurers meet their payment obligations even for assets invested more illiquidly or when extreme events occur.

Liquidity is only partially captured in Solvency II via PPP, ORSA or other qualitative requirements (Art. 44).

- **Additional reporting:**
 - Proportional reporting requirement, e.g., for G-SII and insurers involved in certain products / activities.
 - Not yet fully understood where to put focus, more analysis needed.
- **Liquidity risk ratios:**
 - Similarly to the Belgian example (in place since 2014), liquidity risks could be monitored based on certain KRIs and traffic lights system.

Liquidity-based tools

- Liquidity requirements:
 - Minimum liquidity requirements (e.g. similar to liquidity coverage ratio in banking sector) could provide hard but perhaps time-varying constraints to prevent pro-cyclical behaviour.
 - Can only follow after having established a stable liquidity risk ratio framework. EIOPA decided not to further consider this tool now.
- Temporary freeze of redemption rights:
 - May be applied in exceptional circumstances to restrict policyholders lapsing and thus enable institutions to react on extreme situations.
 - Might be conflicting to policyholders' interests

**Tools need more analysis and better understanding.
For small insurers proportionality has to be considered.**

Tools like the liquidity-ratio contradicting the risk-

Exposure-based tools

Objective: excessive concentration of exposures and interconnections have to be managed properly.

Solvency II already addresses concentrations by certain risk charges and in the PPP and ORSA.

- **PPP and ORSA:**
 - Extend requirements in the PPP to
 - ensure that no excessive level of direct or indirect exposure concentration occurs
 - discourage excessive involvement in certain products and activities.
 - Add consistent reporting requirements to the ORSA to enable supervisors to take market-wide perspective in risk analysis of excessive concentrations.
 - Additions should consider proportionality and not be prescriptive.

Exposure-based tools

- Concentration thresholds:
 - Excessive concentration in assets should be discouraged without jeopardizing the funding role of insurers needed in many markets.
 - What is a “normal” concentration varies materially in the different European markets.
 - At this stage only proposed to monitor asset concentrations.

Existing reporting requirements could be better utilized before adding new ones.

Rule-based requirements for reporting, monitoring or even limits would not help mitigating systemic risks. New exposure-based tools implemented in PPP and ORSA still need to follow the proportionality principle and leave enough freedom not to introduce new

Pre-emptive planning

Objective: minimize the risk of failures as well as the potential impact in case of materialized failures.

These tools should improve transparency on the future behaviour in extreme situations and can therefor reduce systemic risks.

- **Recovery Plans**

- Contingency planning of G-SII and D-SII for restoring their financial position after significant deteriorations.
- Should be seen as extension of ORSA and improves preparedness.

- **Resolution Plans**

- Roadmap provided by authorities to achieve an orderly process of resolution or liquidation.

Improves supervisors readiness to deal with crisis.

Pre-emptive planning

- **Systemic Risk Management Plans**
 - G-SII or D-SII should provide a risk assessment of how they contribute to systemic risks and how these can be managed, mitigated or reduced.
- **Liquidity Risk Management Plans**
 - Relevant institutions should provide a framework to assess liquidity risks and how to further manage, mitigate or reduce them.

Tools in pre-emptive planning should especially consider proportionality and a principle based approach. Only then it can be ensured that this is not a formal and potentially useless exercise but really adds value for tackling systemic risk.

What have we to expect next?

Status quo of discussion and possible implications

- **Review of the Macroprudential Framework**
 - First round of feedback already received on discussion paper (consultation 29 March – 26 April), EIOPA is analysing feedback
 - Update given by EIOPA on workshop 6 June
 - Consultation of Draft Opinion November 2019 – January 2020
- **Comments from EIOPA**
 - Solvency II is already a comprehensive framework:
The macroprudential framework should only extend and not duplicate
 - Plan to only integrate new tools in current prudential supervisory framework
 - Need to assess flaws and introduce meaningful changes of LTG measures

What have we to expect next?

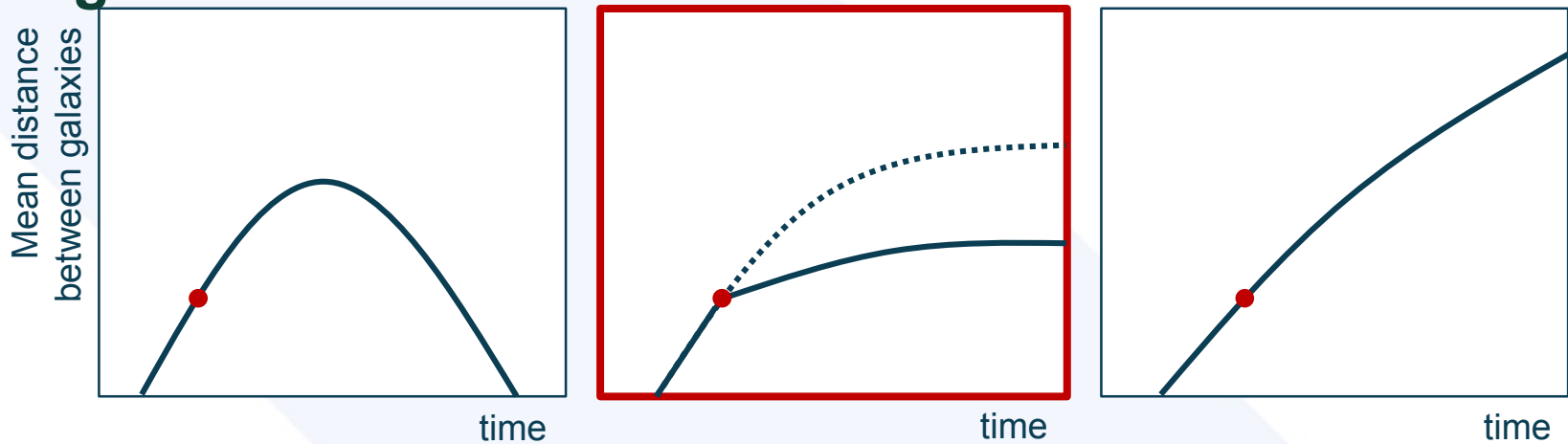
What does it mean for Switzerland?

- Most macroprudential requirements likely to be introduced for EU insurers are also likely to be part of the Solvency II Directive. Hence, due to **equivalence considerations** we believe that they will be relevant for Switzerland, too.
- Most requirements focus on **additional monitoring and reporting** and have currently no equivalence in the Swiss market. Additional reporting might also be required for Swiss insurance companies.

A brief history of time Solvency II

We are still rather early in time • –

Let's hope we live in a stable universe close to the target...



For a converging, stable Solvency II universe we have to

- keep track on all **interdependencies between the components**
- **avoid an overload** of the framework to keep it manageable
- strive for a **consistent interpretation** for all users and stakeholders, including the supervisors.



Thank you for your attention

Dr. Frank Schiller