SHOULD ACTUARIES CARE ABOUT MACROPRUDENTIAL POLICIES?

An overview of EIOPA's proposal

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EIOPA REGULAR USE

AGENDA

1. Introduction
2. Systemic risk and macroprudential policy in insurance
3. Solvency II tools with macroprudential impact
4. Other potential tools. EIOPA’s proposal
5. Should the actuary care about macro?

1. INTRODUCTION. THE RATIONALE FOR MACROPRUDENTIAL POLICY

- **Micro vs. macro**(*)

	Microprudential	Macroprudential
Proximate objective	Limit distress of individual institutions	Limit financial system-wide distress
Ultimate objective	Policyholder protection	Financial stability
Correlations and common exposures across institutions	Irrelevant	Important
Calibration of prudential controls	In terms of risks of individual institutions; bottom-up	In terms of system-wide distress; top-down

- **Why do we care about it?**
  - Lesson learned from the 2008 financial crisis -> Need to supplement the microprudential perspective with the macroprudential one
  - Several policy developments -> FSB Key Attributes, the IAIS ICP and the Holistic Framework for Systemic risk

(*) Based on Borio, C. (2003).

1. INTRODUCTION. EIOPA'S APPROACH

1) Does insurance create or amplify systemic risk?

Topic 1 : Systemic risk and macroprudential policy in insurance

2) What tools are already in place?

Topic 2: Solvency II tools with macroprudential impact

3) Are other tools needed?

Topic 3: Other potential tools

EIOPA's advice for the review of Solvency II / COM's proposal

Note: This work lead to three papers published in 2018. See "Relevant documents"

2. SYSTEMIC RISK AND MACROPRUDENTIAL POLICY IN INSURANCE

	Sources of systemic risk
Entity-based sources	➢ Deterioration of the solvency position leading to: • Failure of a G-SII, D-SII • Collective failures of non-systemically important institutions as a result of exposures to common shocks
Activity-based sources	➢ Involvement in certain activities or products with greater potential to pose systemic risk ➢ Potentially dangerous interconnections
Behaviour-based sources	➢ Collective behaviour by insurers that may exacerbate market price movements (e.g. fire-sales or herding behaviour) ➢ Excessive risk-taking by insurance companies (e.g. ‘search for yield’ and the ‘too-big-to fail’ problem) ➢ Excessive concentrations ➢ Inappropriate exposures on the liabilities side (e.g. as a result of competitive dynamics)

3. SOLVENCY II TOOLS WITH MACROPRUDENTIAL IMPACT

- Although Solvency II is not a macroprudential framework, it contains several elements that may have financial stability impact:

  a) The **design of the framework** itself

  - As a prudential framework, the main objective is ensure sufficient loss absorbency capacity and reserving

  b) The elements whose **impact is indirect**

  - For example: Capital add-on, ORSA, Prudent Person Principle, etc.
  - May have positive impact on one or more macroprudential objectives in an indirect way

  c) The elements with **direct macroprudential impact** -> *See next slide*

3. SOLVENCY II TOOLS WITH MACROPRUDENTIAL IMPACT

- Classification and mapping of main instruments

Tools	Sources of systemic risk	Operational objective(s)
➢ Symmetric adjustment ➢ Volatility adjustment ➢ Matching adjustment ➢ Extension of the Recovery Period ➢ Transitional measure on TP	• Collective behaviour by insurers that may exacerbate market price movements	• Limit procyclicality

- Although the tools may have limitations from a macroprudential perspective, they seem to work effectively
- Given, however, that not all the sources of systemic risks are covered, there is room for potential new instruments

4. OTHER POTENTIAL TOOLS. EIOPA'S PROPOSAL

- General elements of the Advice

  ✓ The macroprudential perspective should be incorporated into the current Solvency II

  ✓ The Directive should define the macroprudential objectives and refer to the need for supervisors to identify and measure systemic risk

  ✓ It should also broaden the toolkit of authorities with the additional tools and measures,

➢ COM's proposal published on 22 September takes most of EIOPA's Advice into consideration!

4. OTHER POTENTIAL TOOLS. EIOPA’S PROPOSAL

- Principles followed:
  - Avoid “copy-paste” from the banking sector
  - Ensure at least one tool for each source of systemic risk
  - “Rules vs. Discretion”
  - Proportionality
  - Principle-based proposal. Follow up work is needed

4. OTHER POTENTIAL TOOLS. EIOPA'S PROPOSAL

✓ = Included in COM's proposal
✗ = Not included

Capital-based tools	
✗ Capital surcharge for systemic risk	Impose a surcharge if an entity-, activity- or behavioural source of systemic risk is identified
✓ Additional measures to reinforce the insurer's financial position	Possibility of restricting dividend or other payments to shareholders and the possibility of restricting the purchase of the insurer's own shares
Exposure-based tools	
✗ Concentration thresholds	Grant NSAs with the power to define "soft" concentration thresholds for action at market level
✓ Expansion of ORSA and PPP	The proposal is to include the macroprudential perspective

4. OTHER POTENTIAL TOOLS. EIOPA'S PROPOSAL

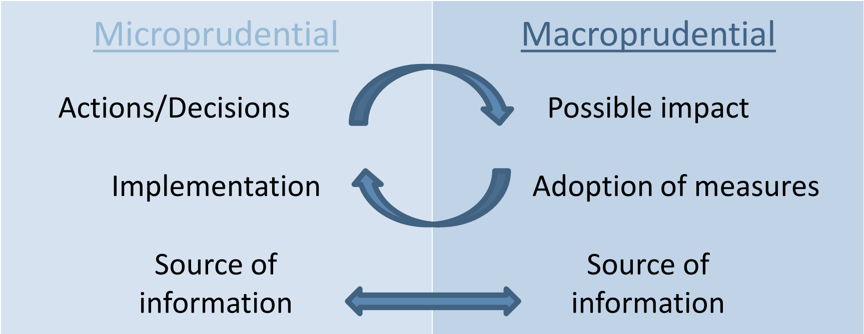
✓ = Included in COM's proposal
X = Not included

Pre-emptive planning	
✓ Recovery and resolution plans	Require RR plans to a very significant and significant share of the market respectively
X Systemic Risk Management Plans	Require SRMPs from a subset of undertakings
✓ Liquidity Risk Management Plans	Require LRMPs with possibility to waive undertakings
Liquidity-based tools	
✓ Liquidity risk framework	Comprehensive framework including mitigating measures
✓ Temporary freeze on redemption rights	Power to be used in exceptional circumstances, as a last resort and for a short period of time

5. SHOULD THE ACTUARY CARE ABOUT MACRO?

The macroprudential perspective is, in essence, out of scope of actuaries, but…

- ✓ Micro and macro are interrelated



- ✓ Actuaries can assess the design of macroprudential policies and support in its implementation

Let's address this in more detail…

5. SHOULD THE ACTUARY CARE ABOUT MACRO?

1) Does insurance create or amplify systemic risk?

Topic 1 : Systemic risk and macroprudential policy in insurance

- **Monitoring the insurance sector** (products, trends and PH's behaviour)
- **Contributing to mitigate (systemic) risks**. For example:
  - Ensuring well capitalised insurers
  - Considering potential sources of systemic risk related to new products
  - Designing sound models
  - Considering investment risk within the macroprudential context
  - Considering the selection of the reinsurer to cover the business
- Contributing to **public trust** in the insurance sector, supporting the "saving mobiliser" role

5. SHOULD THE ACTUARY CARE ABOUT MACRO?

2) What tools are already in place?

Topic 2: Solvency II tools with macroprudential impact

- Ensuring **compliance with the regulatory framework**
- Supporting in the correct **use of existing tools**. For example:
  - ✓ Providing scenarios, modelling and cash-flow projection for stress-testing
  - ✓ Identifying new risks as part of the ORSA process
  - ✓ Ensuring compliance with PPP
  - ✓ Drafting recovery plans in case of breach of SCR
- Assessing **potential limitations in the existing tools** with macroprudential impact

5. SHOULD THE ACTUARY CARE ABOUT MACRO?

3) Are other tools needed?

Topic 3: Other potential tools

- **Supporting the work of macroprudential authorities** by assisting in the technical work/discussions
- Ensure a **sound implementation of the potential new tools**. For example:
  - ✓ Liquidity Risk Management Plans
  - ✓ Pre-emptive recovery plans and resolvability of the insurer

IN SUMMARY

As we say in Spain:

"Let us not miss the forest for the trees"

- The added value of the actuarial function in terms of risk identification, measurement and mitigation is too relevant to restrict it to the microprudential sphere

- Actuaries have both, a stake and a very relevant role to play, and should therefore care about macroprudential policies

THANK YOU!

For more information visit:
https://www.eiopa.europa.eu

European Insurance and
Occupational Pensions Authority

RELEVANT DOCUMENTS

American Academy of Actuaries (2010): “Role of the Systemic Risk Regulator”, Public Policy White Paper, May 2010.

Borio, C. (2003): “Towards a macroprudential framework for financial supervision and regulation?”, BIS Working Papers No 128.

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EIOPA (2018c): Other potential macroprudential tools and measures to enhance the current framework, EIOPA, third paper on macroprudential policy in insurance.

EIOPA (2020): “Opinion on the 2020 Review of Solvency II”, Chapter 11, EIOPA-BoS-20/749, 17 December 2020.

ESRB (2018): “Macroprudential provisions, measures and instruments for insurance”, November 2018.

IAA (2013): “Actuarial Viewpoints on and Roles in Systemic Risk Regulation in Insurance Markets”, May 2013.

Thorton, P. (2010): “Financial stability, systemic risk & macroprudential supervision: an actuarial perspective”, Presentation to OECD Insurance and Pensions Committee, June 2010.