Position Paper

Response to ESRB report on macroprudential provisions, measures and instruments for insurance

Our reference:	ECO-19-010		
Referring to:	ESRB report on *Macroprudential provisions, measures and instruments for insurance* (November 2018)		
Contact person:	Alexandru Ciungu, Policy Advisor, Macroeconomics & Taxation	E-mail:	Ciungu@insuranceeurope.eu
Pages:	5	Transparency Register ID no.:	33213703459-54

Introductory comments

Insurance Europe supports an effective macroprudential framework that mitigates potential systemic risk in the financial system. However, given the limited potential for systemic risk to originate from the insurance industry, Insurance Europe does not believe that additional macroprudential measures are needed for the insurance sector. This is because a comprehensive macroprudential monitoring framework is already in place (ie, specific reporting requirements for financial stability, the European Insurance and Occupational Pensions Authority's (EIOPA) biannual financial stability reports, stress tests). In addition, the insurance supervisory system already includes many instruments with a macroprudential impact. The recently-implemented Solvency II framework represents a regime change in insurance supervision that also includes many elements that mitigate macroprudential risks, the impact of which will only become apparent over time.

The ESRB report complements the recent paper series by EIOPA on the same topic. Therefore, this response to the ESRB report should be read in conjunction with Insurance Europe's response to EIOPA's macroprudential work. In some areas, the ESRB reaches broadly similar conclusions and makes some of the same proposals. However, there are also substantial differences between the ESRB's and EIOPA's assessments regarding potentially suitable macroprudential tools.

As a general comment, Insurance Europe notes that any approach taken for the regulation of macroprudential risk in insurance should take full account of developments at international level and be globally-consistent.

Insurance Europe aisbl
Rue Montoyer 51, B-1000 Brussels
Tel: +32 2 894 30 00 • Fax: +32 2 894 30 01
E-mail : info@insuranceeurope.eu
www.insuranceeurope.eu

© Reproduction in whole or in part of the content of this document and the communication thereof are made with the consent of Insurance Europe, must be clearly attributed to Insurance Europe and must include the date of the Insurance Europe document.

Existing and pending provisions, measures and instruments with macroprudential relevance for insurance

The Higher Loss Absorbency (HLA) is referenced in some detail in the ESRB paper. Insurance Europe notes that the ESRB paper came out before the International Association of Insurance Supervisors (IAIS) Holistic Framework consultation paper; it would therefore make sense for the ESRB to reconsider this point, in light of the IAIS's intention to remove the HLA.

In Section 2.2 of the ESRB report on "Measures Available to Insurers", there are various comments on the Solvency II Matching Adjustment (MA) and Volatility Adjustment (VA). For the MA, in particular, the report does not accurately reflect its macroprudential benefits:

- On page 25 the ESRB report states that "the VA and MA typically do not add to the resilience of an insurance company". This assertion seems questionable and seems to be based on the view that insurers delay replacing assets. Insurance Europe's view is that the MA prevents insurers having to sell credit assets at depressed prices where they are only exposed to credit fundamentals, thereby avoiding value destruction and acting to improve the resilience of the insurer's balance sheet.
- At the bottom of page 26 / top of page 27 the ESRB report notes the key point that the MA helps prevent a fire sale of assets, but it does not go as far as noting that the MA only applies where an insurer has committed to hold assets to maturity and demonstrated the ability to do so.
- Page 47 of the Bank of England's November 2016 Financial Stability Report concludes that the MA is "beneficial from a macroprudential perspective by reducing potential instability across the financial system". This Bank of England paper is also referenced in EIOPA's second paper "Solvency II tools with macroprudential impact".

Where the ESRB states that "direct contagion could occur through […] reinsurance activities", Insurance Europe would point out that the IAIS concluded in its 2012 report "Reinsurance and financial stability" that traditional and finite reinsurance is unlikely to create systemic risk. As is widely accepted by regulators across jurisdictions, both conventional insurance and reinsurance are not in themselves systemic activities.

Options for additional macroprudential provisions, measures and instruments for insurance

The ESRB proposes the following measures:

- **Extension of Solvency II reporting requirements**

Insurance Europe understands the need for sufficient data to support an effective macroprudential supervisory process. However, Insurance Europe believes that a comprehensive macroprudential surveillance framework is already in place. The current reporting requirements under Solvency II (which include substantial data requirements that could already serve a macroprudential purpose) are extensive and already constitute a heavy burden for companies. Therefore, regarding any potential extension of reporting requirements, a detailed cost-benefit analysis is essential in order to ensure that it is necessary, proportionate and appropriately justified. EIOPA's recent call for input on reporting requirements signals an understanding of the importance of rationalising the current requirements, rather than expanding them, as proposed in this report.

In this context, Insurance Europe would point out that in Section 3.1.2 of the ESRB report, table 4b on page 42 notes that the extension of reporting requirements is assessed as high for "Ease of Operationalisation" with the comment "once established, it would not require much additional effort from authorities". Insurance Europe does not believe that it is a balanced approach to only consider the impact on the authorities, while failing to consider the impact in terms of extra reporting burden on insurers. Considering this, business practice has shown that reporting requirements in particular are associated with high implementation costs for insurers, as extensive IT and data-warehouse adjustments are usually required.

Another particular concern is the proposal to develop indicators for comparison of internal models. The comparison of internal models runs counter to the idea that such models are designed to reflect the particular business landscape of their users and their comparison would serve little benefit and may increase the risk that companies would be forced to make inappropriate model changes to address perceived gaps. Solvency II allows national competent authorities (NCAs) to effectively assess, authorise and monitor the appropriateness of internal models, including the plausibility of model reactions to macroeconomic changes.

- **Harmonised EU-wide recovery and resolution regime**. Insurance Europe would refer the ESRB to its response to EIOPA's consultation on potential harmonisation of recovery and resolution frameworks for insurers.

- **A macroprudential toolkit.** The ESRB considers the following elements promising for the creation of a macroprudential toolkit to target systemic risks for (re)insurers:

  - Power for authorities to impose entity-based and/or activity/behaviour-based market-wide capital increases and dividend restrictions in situations where insurance market developments could generate systemic risk.

Additional capital requirements cannot be the default response to potential systemic risks. Instead, where real systemic risk exists, better targeted mechanisms, such as ensuring supervisor oversight and good internal controls and risk management, are essential. Given the comprehensive nature of Solvency II, risks which could lead to systemic concerns (such as losses in asset portfolios or mass customer policy surrenders), are already covered. Therefore, it is unclear why there would be need for additional capital.

However, even if there could be a justification for specific situations where additional capital may play a role, Solvency II already allows for capital add-ons. These add-ons are allowed in cases where supervisors conclude that the risk profile of the insurer deviates significantly from the assumptions underlying its SCR calculation, or its systems of governance deviate significantly from the standards set out. It therefore already caters for eventualities where risks are not adequately reflected and does not limit the nature of those risks. Additionally, these capital add-ons are not permanent uplifts but need to be cancelled by the supervisor if the specific situation ends. Therefore, the supervisor must ensure ongoing control of the situation.

For financial conglomerates, it is important to consider how different buffers for banks and insurers interact; otherwise these buffers for conglomerates can become unreasonably large.

  - Power for authorities to intervene in exceptional circumstances, such as when policyholders terminate their insurance policies in large numbers.

Supervisory and/or management actions should be considered when faced with the extremely remote risk of mass surrender, as such actions can be effective in controlling liquidity risk. More specifically, in many cases insurers have the contractual ability to delay surrenders and/or resolution authorities have the power to apply temporary stays. In fact, it is no coincidence that in markets where products have flexible surrender options supervisors typically have the power to intervene. Such powers must be considered when assessing the actual systemic risk, because they serve as an important transmission blocking mechanism.

Therefore, Insurance Europe views the power of supervisors to temporarily freeze redemption rights as an important tool because it would address the (in Insurance Europe's view extremely remote) risk of mass surrender, preserving value and potentially preventing the need to use more drastic measures within the resolution toolkit. Besides, it could prevent the unequal treatment of customers who surrender their policy in a crisis and those who do not. In addition, this tool has proven its effectiveness in the few cases when it was used. Although mass lapses are extremely unlikely in practice, such powers would create an absolute limit to insurers' exposure to very significant forced "fire sales" of assets and contagion.

In the unlikely case of individual company mass lapses, supervisors are, in any case, able to intervene unilaterally after the SCR has been breached as part of the ladder of intervention. Before the SCR has been breached, intervention should only be possible if requested by the company. Insurance Europe would add that stay and suspension powers could not only be applicable to cashing out insurance policies, but also to switching. This is one of the very few areas where changes to the existing situation can be justified to ensure that all supervisors in Europe have the necessary stay and suspension powers.

- Symmetric capital requirements that help dampen procyclical behaviour during downturns and prevent the build-up of sectoral vulnerabilities during upturns.

Insurers have very different business models from banks, different product mixes and different assets and liabilities, which respond differently to economic and financial cycles. In particular, insurance companies are not closely linked with the credit cycle like banks are. Moreover, Solvency II already contains three permanent capital tools that have a countercyclical impact (volatility adjustment, matching adjustment and symmetric adjustment to the equity risk sub-module). The risk of overlaps between potential new proposals with these existing countercyclical features is high. Considering this and other operational issues and challenges, a countercyclical capital buffer is not an appropriate tool for insurance supervision. This was also EIOPA's conclusion in its recent report on "Other potential macroprudential tools and measures to enhance the current framework".

- Liquidity requirements for insurers with a vulnerable liquidity profile.

While liquidity risk is not one of the main risks that insurers face, Insurance Europe accepts that this type of risk can be relevant for certain activities and that supervisors may want to monitor these. In fact, Solvency II requires insurers to invest in a manner that ensures portfolio liquidity; there are already microprudential constraints on liquidity. Furthermore, Solvency II requires insurers to implement an effective liquidity risk asset-liability-management (Art. 44 2 lit b) and d) of the Solvency II-Directive). Mass lapse risk already measures a significant part of liquidity risk.

In order to avoid a considerable additional burden of liquidity risk reporting and ratios, a proportionate approach is essential. Any additional monitoring should be based on data that is already available and metrics currently used within companies, to avoid additional cost and strain on implementation capacity. The macroprudential monitoring of liquidity risk in addition to microprudential supervision should mainly be conducted for the insurance industry in aggregate; only when the market situation deteriorates or when systemic risks relating to the insurance industry become apparent, should regulators engage with insurers on an individual basis and/or support measures that would alleviate liquidity risk.

Insurance Europe also points out that insurance liquidity risk events do not generally occur instantaneously, unlike in banking. Solvency II's risk-based nature and its embedded capital buffers ensure that sufficient assets are available to cover liabilities. Similarly, companies have strong incentives for managing their liquidity to meet liabilities as they fall due. Within this framework of sound risk management introduced by Solvency II, (re)insurers have payment deadlines that do not make them immediately subject to liquidity events and give them the needed time to appropriately manage and mitigate any crisis situations. In light of limited liquidity risks in the insurance industry, liquidity requirements do not seem justified. This was also EIOPA's conclusion in its recent report on other potential macroprudential tools and measures.

- **Instruments to target bank-like activities** to ensure cross-sectoral consistency of macroprudential policy.

Insurance Europe agrees that a cross-sectoral and activity-based approach is an appropriate way to mitigate systemic risk and to prevent regulatory arbitrage. However, regarding any potential transfer of instruments from other financial sectors to insurance supervision, it is crucial to take the specificities of the insurance sector (eg, the diversification benefits from different business types, product mixes and different assets and liabilities) into account and to ensure a proportionate approach.

Insurance Europe also has some concerns related to the following instruments:

- Macroprudential tools on maximum duration of loans: insurers may issue loans because these may be a good match for long-term illiquid liabilities. Restricting the duration of the term of these loans would seem inappropriate in this context.
- Aligning capital treatment across sectors: page 53 gives an example where "changing the capital requirements of insurers should take into account the existing diversification benefits between the different SCR risk sub-modules". This approach appears focused on the standard formula only and would therefore not work for an insurer with approval under Solvency II to use an internal model.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of more than €1 200bn, directly employ over 950 000 people and invest over €10 100bn in the economy.