ESRB advice to EIOPA on the criteria for identification of exceptional sector-wide shocks (Article 144 c (7))[1]

1. Introduction and summary

According to the new Solvency II Directive ("Solvency II" or "the Directive"),[2] the European Insurance and Occupational Pensions Authority (EIOPA) should consult the European Systemic Risk Board (ESRB) on a draft regulatory technical standard (RTS) regarding the application of supervisory measures during exceptional sector-wide shocks. Specifically, Article 144c(7) of the Directive requires EIOPA to consult the ESRB and develop draft RTS which specify criteria for the identification of "exceptional sector-wide shocks". The criteria would ensure consistent conditions for applying supervisory measures. These measures would preserve the financial position of individual insurers during periods of exceptional sector-wide shocks that could threaten the financial position of the insurer or the stability of the financial system. The identification of such "exceptional sector-wide shocks" would allow supervisory authorities to require insurers with a particular risk profile to restrict or suspend certain payments or distributions, such as dividends, share buybacks and bonuses.[3] EIOPA issued its consultation paper on 1 October 2024.[4]

This document is the ESRB's advice to EIOPA, reflecting the ESRB's macroprudential perspective. Insurance activities play a key stabilising role for the financial system[5] and the real economy when they work well. This implies, among other things, that insurance coverage is sufficiently available and that insurance companies can

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[1] See ***Consultation paper on the proposal for Regulatory Technical Standards to specify the criteria for the identification of exceptional sector-wide shocks***, EIOPA, 1 October 2024.

[2] **Directive 2021/0295(COD) of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macroprudential tools, sustainability risks and group and cross-border supervision.** The Directive also amends Directives 2002/87/EC and 2013/34/EU which will soon be published in the Official Journal.

[3] See Article 144c paragraphs 2 to 6 of the **amended Solvency II Directive**.

[4] See footnote 1.

[5] Research suggests that "the investment behaviour of insurance companies and pension funds can be a stabilizing force on capital markets". See Timmer, Y., "**Cyclical investment behaviour across financial institutions**", *Journal of Financial Economics,* Vol. 129, No 2, August 2018, pp. 268-286 and "**The importance of insurance companies for financial stability**", *Financial Stability Review*, ECB, December 2009.

act as long-term investors. During times of stress, however, insurance companies might also amplify stress owing to procyclical behaviour and may also be a source of systemic risk.[6] Therefore, the ESRB has repeatedly made calls to enhance the macroprudential perspective of Solvency II and to develop a recovery and resolution framework for insurers.[7] Against this background, this advice considers the draft RTS developed by EIOPA in relation to the requirements set out in the new Articles 144a to 144d of the new Chapter VIIa of the the Directive and their potential interaction with other provisions of Solvency II. The introduction highlights, among other things, the commonalities and complementary objectives embedded in Article 144b and 144c of the Directive. This fosters understanding of the macroprudential dimension of the requirements and the ESRB's holistic approach when responding to EIOPA.

The new Directive incorporates valuable requirements that support a macroprudential perspective. Unlike the previous Directive, insurers must now take a macroprudential perspective on pre-existing requirements (for example underwriting, investment and risk mangement activities[8]), as well as the new supervisory provisions of Article 144a to Article 144d. For instance, the Directive now requires: (i) insurers to keep up-to-date liquidity risk indicators and liquidity risk management plans (Article 144a); (ii) supervisors to monitor liquidity risk as part of the supervisory review process, where insurers must explain how material risks will be addressed if they are identified (Article 144b(1)). Furthermore, the Directive requires Member States to ensure that their authorities have adequate supervisory powers to remedy liquidity vulnerabilities in exceptional circumstances (Article 144b(2), Article 144b(3) and Article 144b(4)), as well as supervisory measures to preserve the financial position of insurers during exceptional sector-wide shocks (Article 144c). Similarly, the Directive mirrors these requirements for insurance groups (Articles 246a and 246b).

The new supervisory powers granted under Articles 144b and 144c have at least two key considerations in common. First, the new powers can be exercised where there **are exceptional circumstances** (i.e. "the event") affecting insurers. Article 144b(4) refers to exceptional circumstances affecting the whole or a significant part of the insurance market, while Article 144c(1) refers to exceptional sector-wide shocks in general. Second, supervisors need to consider in their assessment **the impact of the event** (for example,

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[6] See ATC Expert Group on Insurance, ***Recovery and resolution for the EU insurance sector: a macroprudential perspective***, ESRB report, August 2017, p. 10.

[7] Including ***Enhancing the macroprudential dimension of Solvency II***, ESRB report, February 2020; **ESRB letter to EIOPA on liquidity risks in the insurance sector**, ESRB, 8 June 2020; **ESRB response to European Commission on the Solvency II Review**, ESRB, 16 October 2020; and ***Recovery and resolution for the EU insurance sector: a macroprudential perspective***, ESRB report, August 2017.

[8] See preamble paragraph 21 of the **amended Solvency II Directive**.

whether there are material liquidity vulnerabilities or exceptional sector-wide shocks affecting the financial position of insurers) **against its potential to threaten** *the financial position of individual companies (including protection of policyholders) or the stability of the financial system.*[9] Article 144b(3) is specific about the *imminent threat to the protection of policyholders* and Article 144c(1) is more general and mentions the *threat to the financial position of the company*. Regardless, a threat to the financial position of the company could in many cases be a threat to the protection of policyholders and beneficiaries.

Protection of policyholders and financial stability are two supervisory objectives that must be considered when applying the new supervisory powers under Articles 144b and 144c. The new powers under Article 144c enable supervisors to restrict or suspend certain payments or remunerations during periods of exceptional sector-wide shocks.[10] In addition, Article 144b allows the suspension of redemption rights of life insurance policyholders in the case of individual undertakings facing material liquidity risks.[11] These powers require supervisors to consider microprudential and macroprudential perspectives simultaneously (for example the objectives relating to whether there is an impact on the individual company or the stability of the financial system). Based on their assessment, supervisors can decide to address one or both objectives. This means that one event (or a combination of events) could lead to many individual companies being subject to the supervisory actions, enabling supervisors to apply measures across several insurers.

Given the interlinkages across Articles 144a to 144d of the Directive, EIOPA should ensure that draft RTSs with a macroprudential perspective are considered jointly. From the ESRB's perspective, there is a need to consider jointly how to bring in the new requirements that support macroprudential oversight (Articles 144a to 144d and Articles 246a and 246b). This would ensure a uniform approach to topics that are interlinked. Moreover, it will help build a comprehensive overview of macroprudential considerations not only for individual insurers but of the insurance sector as a whole. For further

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9 The legal text in the Directive uses the word "or" in both Article 144c and Article 144b. Similarly, EIOPA's draft RTS uses "or" in Article 1(1).

10 For instance, Article 144c(2) of the Directive states that "during periods of exceptional sector-wide shocks, supervisory authorities shall have the power to require undertakings with a particularly vulnerable risk profile to take at least the following measures:

(a) restrict or suspend dividend distributions to shareholders and other subordinated creditors;

(b) restrict or suspend other payments to shareholders and other subordinated creditors;

(c) restrict or suspend share buy-backs and repayment or redemption of own fund items;

(d) restrict or suspend bonuses or other variable remuneration".

11 See Article 144b(3) point (e) of the **amended Solvency II Directive**.

considerations, please refer to the fourth section of this document, specifically under the subheading “ESRB considerations on the new supervisory provisions of the Directive”.

The rest of the document is structured as follows:

- **Section 2** notes that the ESRB welcomes EIOPA’s work and considers aspects that would improve the application of the RTS. In particular, the ESRB commends EIOPA for developing criteria that provide authorities with the flexibility they need to take action. The ESRB acknowledges the challenges of developing such criteria. This advice points to areas where the RTS could be further developed to ensure they are interpreted and applied consistently. This includes clarifying that the criteria set out in the RTS are not a closed list, expanding the background on sector-wide shocks, considering transmission and amplification factors as part of the criteria for identification and providing background and clarification on key concepts that are not defined in the Directive (for example the insurance sector and financial position). Such elements, if not captured in the articles of the RTS, should at least be addressed in the preamble to guide supervisors. By expanding the preamble, EIOPA can clarify the objectives of the RTS, ensuring a clearer understanding of specific terms.
- **Section 3** considers opportunities to support the effective future application of the RTS and the new supervisory provisions more broadly (Article 144a to Article 144d). This includes the need to help authorities take action by issuing guidance and opinions, the importance of identifying and mitigating liquidity risks which helps preserve the financial position of insurers or the stability of the financial system and the importance of stress testing to inform such assessments. Section 3 also considers the need to build a dataset that helps monitor systemic risks arising from sector-wide shocks, including liquidity pressures.
- **Section 4** presents other considerations by the ESRB on Article 144a to Article 144d and includes advice for EIOPA on how to ensure that draft RTSs, guidelines and opinions with a macroprudential perspective are considered holistically. This will help build a comprehensive understanding of the macroprudential dimension and will ensure consistent application. It also points to the need to set criteria in a way that would not constrain authorities in applying the new supervisory measures granted under such articles.

2. The ESRB's considerations on effective application of the RTS on Article 144c(7) of the Directive

EIOPA's draft RTS will play an important role in ensuring that the new supervisory measures are implemented and monitored consistently and swiftly with clear communication channels. The Directive already provides a robust framework for supervision. However, cooperation and supervisory convergence have an important role to play in ensuring that the tools are effectively applied, and the supervisory powers deployed swiftly when required. Furthermore, when macroprudential and prudential authorities are not integrated, there should be clear communication channels to monitor and measure risks of stress transmission and amplification and to swiftly apply the supervisory measures provided for in the Directive.

2.1 The draft RTS offers flexibility given the uncertainty surrounding possible sector-wide shocks.

The ESRB agrees with the principle that the RTS should strike the right balance between flexibility and granularity to support consistent application and harmonisation. The ESRB acknowledges EIOPA's intention for the criteria to focus on the possible consequences of the shocks. This is a pragmatic approach, as it is not possible to foresee all sector-wide shocks that could occur. The ESRB also finds that the criteria developed by EIOPA for exceptional sector-wide shocks are not restrictive and would therefore, in most cases, not be difficult for most authorities to apply. The criteria generally give the authorities an appropriate level of flexibility. Nonetheless, EIOPA could consider the benefit of taking into account the items described in the following paragraphs and including them in the articles of the RTS and/or the preamble.

2.2 The ESRB believes that the criteria should not be understood as a closed list.

The ESRB advises adding the words "inter alia" to the factors listed in the criteria for identifying sector-wide shocks. This is to ensure that the criteria are not understood as a closed list. Article 1(2) of EIOPA's draft RTS sets out five factors or elements that authorities should consider when assessing the criterion for exceptional sector-wide shocks. Such factors are: (a) the nature, scale and scope of the event or events both in absolute terms and compared with any historical precedents; (b) the relevance of the insurer in the sector for financial stability; (c) the effect of the events on the insurance sector; (d) the declaration of exceptional adverse situations under Article 138(4) of the Directive; and (e) any measures which the supervisory authority has taken in accordance with Article 144b(3) of the Directive. However, these factors could be understood by some authorities to be an exclusive list (for example sub-paragraphs (a) to (e) might be considered as the only factors authorities can consider). Although the criteria should be definite, there should also be a margin of judgement for authorities. Therefore, the ESRB would advise including the word "inter alia" at the sub-level of Article 1(2) of the draft RTS so that any other factors or elements not explicitly listed but deemed important by the supervisor could also be considered in the assessment. Alternatively, EIOPA could, for example, consider including an additional factor "(f)" to Article 1(2) that would capture: "any other similar situation which demonstrably poses a significant threat to the financial position of the insurance companies, or financial stability, that is not already covered by the factors listed in points (a) to (e)".

2.3 The ESRB believes there is value in providing more background information in the RTS on sector-wide shocks and in including transmission and amplification factors in the criteria for identification.

The RTS does not limit the various events that could have a large and negative impact and result in a sector-wide shock. However, it should offer more background information in the recitals as presented in this paragraph. Exceptional sector-wide shocks impairing the financial position of an insurer or the stability of the financial system could initially be extraordinary but they could also turn out to be persistent. Moreover, various adverse events could also happen at the same time. A persistent, latent vulnerability could also turn into a critical event. These events might be localised to a specific country or region or they could spread across Member States. Past episodes[12] such as the 2008 financial crisis, the COVID-19 pandemic and the 2022 UK gilt crisis illustrate unforeseen events which could threaten the financial position of the insurer or the stability of the financial system (for example with material impact and spillover effects on the insurance sector). Including details on historical events would provide valuable context and guidance, although they would not constitute an exhaustive list.

Exceptional sector-wide shocks are not defined in Solvency II, and EIOPA could consider transmission and amplification factors and/or metrics in the criteria for identification. The ESRB agrees that defining exceptional sector-wide shocks could limit the range of potential sector-wide shocks that supervisors might be able to consider. Nonetheless, the criteria for identifying exceptional sector-wide shocks set out by EIOPA

[12] As the COVID-19 crisis deepened, euro area money market funds experienced outflows of nearly 8% of assets under management between 13 and 20 March 2020. See "**Recent stress in money market funds has exposed potential risks for the wider financial system**", *Financial Stability Review*, ECB, May 2020 and "**Interconnectedness of derivative markets and money market funds through insurance corporations and pension funds**", *Financial Stability Review*, ECB, November 2020. See also ***Financial Stability Report***, EIOPA, December 2023, pp. 12-26.

in the draft RTS should also consider transmission and amplification factors. Even one insurer may contribute to financial instability in one or more Member States, particularly if the insurer may be of large significance to the sector. The supervisory assessment of the criteria could be considered in the articles of the RTS or preamble, for instance, in terms of the size of the company's balance sheet, the volume of services provided, potential disruption of insurance services in the real economy, loss of consumer confidence, estimated impact on financial markets (including second-round effects) and other variables.

Macroeconomic and financial market conditions, as well as the impact of other sectors on insurers should also be considered in the RTS for identifying exceptional sector-wide shocks. A shock can be triggered by extraordinary events affecting other sectors with a potential spillover effect on the insurance sector. For instance, widespread defaults of external parties to which insurance corporations are directly or indirectly exposed can severely affect their financial position. This could compound existing vulnerabilities. The criteria should also give flexibility to authorities to consider macroeconomic variables that might help assess the potential severity of the shock.[13] This could mean that a material change in economic activity as a result of a shock (such as a pandemic or a financial crisis) could be sufficient for authorities to take supervisory action. Moreover, unexpected correlation of insured events could pose risks to the insurance sector or a segment of it. There could be unforeseen compounding effects interlinking different lines of business when a shock occurs (for example business interruption resulting from a natural catastrophe or pandemic). It would therefore be beneficial to include background information on exceptional sector-wide shocks in the articles of the RTS and/or recitals, as set out in Section 2.3. This would help ensure consistent application and guide authorities in applying the powers under Article 144c(7).

2.4 The RTS would benefit from clarification of the concept of the "insurance sector".

The draft RTS would benefit from the inclusion of context on what is understood as the "insurance sector" to ensure consistent application among competent authorities. In order to reduce ambiguity and help authorities apply the criteria for identifying exceptional sector-wide shocks, EIOPA should clarify in the preamble that the insurance sector, while not explicitly defined in Solvency II, can be identified by means of its subcomponents, i.e. by type of company (insurer and reinsurer) and by line of business (life and non-life). Thus, the supervisory analysis and assessment of the sector-wide shock

[13] For example, it is not clear that authorities will consider macroeconomic variables under a closed list approach.

could cover the whole sector (all subcomponents) or part of it. The RTS could include such contextualisation in the preamble. Furthermore, a reference to recital 68 of the amended Directive could help provide some background, for example: “adverse economic or market events affecting a large part or the totality of the insurance and reinsurance market, in order to protect policyholders and preserve financial stability”. It is also noted that the first paragraph of Article1(a) of the draft RTS adds the wording “of a sector” to “insurance and reinsurance undertakings”. Considering the wording and context of Article 144c of the Directive, the second use of the term “sector” could be ambiguous. Thus, deleting the addition “of a sector” is recommended.

2.5 The ESRB believes that the concept of financial position is relevant to the development and application of this RTS and that it should be clarified.

The concept of financial position is a broad concept which is not defined in the Directive. The assessment of the financial position should also include the insurer’s liquidity position. The criteria for identifying exceptional sector-wide shocks aim to ensure consistent conditions of application of supervisory measures to “preserve the financial position of individual insurers”. Considering that the insurer’s financial position can be affected by material changes to any of the component of its financial statements, the metrics on which the supervisory assessment is made should reflect such diversity. A narrow measure of the financial position of an insurance company would be its solvency position in relation to the Solvency Capital Requirement. The ESRB believes that a broader measure of financial position is warranted and that such a measure should also include the insurer’s liquidity position, which should also be monitored as a result. There are several reasons for this. First, from an economic point of view, measures in an insurer’s financial statement (for example balance sheet, profit and loss and cash flows) in relation to the insurer’s risk profile also matter for an overall assessement of the soundness of the insurer. Second, several passages in the Directive indicate that a broad interpretation is intended. For example, recital 45 requires that the assessment of the financial position of the insurer should use sound economic principles. Recital 109 considers the financial position of the insurer in terms of its susceptibility to risk concentration and intragroup transactions. Likewise, Chapter II of the Directive entitled “financial position” outlines different aspects of financial health ranging from solvency, risk concentration and intragroup transactions. Chapter II also outlines risk management and internal control. Additionally, paragraph 35 of Article 13 of the Directive distinguishes between solvency and the financial position in the context of concentration risk by stating that concentration risk includes exposures that could threaten either the solvency or the financial position of the insurer. Furthermore, recital 15 of the Directive[14] highlights the system of governance of an insurer as an important factor in ensuring that the insurer maintains its financial health. Furthermore, regarding the application of supervisory measures, Article 144c(4) of the Directive requires authorities to consider evidence from the supervisory process, and a forward-looking assessment of the solvency and the financial position of the insurer. This suggests a need for a comprehensive analysis that goes beyond solvency to include the broader financial position. Reflecting on this, EIOPA should ensure that the background on the concept of financial position is included in the articles of the RTS or the preamble. Furthermore, the impact assessment on the implementation of the draft RTS should not be limited to a single metric or variable but should consider the overall assessment of the insurer and the financial system as a whole.

3. Other considerations that will support the application of the RTS and new supervisory provisions of Article 144a to Article 144d more broadly

3.1. The ESRB recognises the importance of more guidance to support effective application of the new supervisory powers granted under the new supervisory provisions.

EIOPA will need to support the proposed draft RTS on Article 144c(7) through further guidance. The ESRB appreciates that the complex scope of the RTS may not be able to accommodate the needs of all stakeholders and encourages all authorities to apply the powers granted under Article 144c. The issues discussed in Section 2 (for example that the proposed criteria may not be sufficiently granular at RTS level and that some key terms are not explicitly defined in the Directive) can affect authorities that require a more guided approach to anchor the impact of the events to tangible situations. Such authorities may find clarification or more description of the issues in the articles of the RTS or preamble beneficial in exercising their new powers and managing litigation risk. Hence, EIOPA should make use of the opportunity to develop more guidance or other supervisory convergence tools available within its remit that promote the effective implementation and use of the powers granted in Article 144c.

[14] See footnote 2.

3.2 Identifying and mitigating liquidity risks helps preserve the financial position of insurers and the stability of the sector.

The ESRB has on several occasions highlighted the importance of strengthening supervisory tools to better address systemic risks, including liquidity risk. Further to the discussion in Section 2.5 on the concept of an insurer's financial position, liquidity is an important indicator of the insurer's financial position. Consequently, the ESRB reiterates the need to identify and mitigate liquidity risks in order to help preserve the financial position of insurers and the stability of the sector. Liquidity risk can stem from various sources (for example exposures to derivatives, margin call requirements, mass lapses, crystallisation of emerging risks and poor risk management). Appendix I highlights previous ESRB work on enhancing the macroprudential dimension of Solvency II, in particular with regard to liquidity risk management.[15]

Solvency II incorporates a new supervisory power to require insurers to reinforce their liquidity position. Liquidity risk is addressed under the Solvency II framework mainly in qualitative requirements (for example application of the Prudent Person Principle to investments, risk management framework and liquidity risk management plans). Furthermore, insurers must develop and keep a set of liquidity risk indicators to identify, monitor and address potential liquidity stress (Article 144a(2) of the Directive). Consequenly, liquidity risk appetites and liquidity risk management plans would capture insurers' liquidity thresholds, which serve as an early warning at entity level of a deterioration in liquidity conditions. Supervisors will monitor insurers to ensure they maintain adequate liquidity to settle their obligations even under stressed scenarios (Article 144a(1) of the Directive). If the liquidity position of an insurer deteriorates, authorities can make use of the supervisory power under Article 144b(2) of the Directive which allows supervisors to require insurers to reinforce their liquidity position when material risks or deficiencies are identified. The revision to Solvency II shows positive progress in making sure that insurers carefully monitor their liquidity as part of their financial position. To ensure consistent supervisory analysis and that insurers can meet liquidity needs as they arise, it would be important for insurers to clearly specify their liquidity needs according to time horizons (e.g. in the short, medium and long term) as well as possible triggers (for example variation margin calls, unexpected redemptions, etc.). This is as set out in the relevant RTS and submitted for consultation by EIOPA[16]

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[16] See ***Enhancing the macroprudential dimension of Solvency II***, op. cit., p. 109.

[16] ***Consultation paper on the proposal for Regulatory Technical Standards on liquidity risk management plans***, EIOPA, 1 October 2024.

3.3 The ESRB highlights the importance of stress testing, and the need to build a dataset that helps monitor systemic risks arising from sector-wide shocks, including liquidity pressures.

To apply the criteria for exceptional sector-wide shocks, supervisors should build a dataset where stress testing results, macroeconomic conditions and financial market conditions are key components. Collating and processing data from the new supervisory tools in the Directive will take time. Considering that some of this data will be acquired through individual interaction with supervised insurers, authorities need to design tools that help them monitor the sector as a whole on a regular basis (in terms of liquidity trends and early warning indicators, for example). EIOPA's liquidity monitoring exercise[17] and other risk assessments[18] are a step in the right direction. In the absence of mandatory reporting templates, it is important that the process for applying the criteria to identify exceptional sector-wide shocks is structured in a way that it enables supervisors to monitor risks and take swift action if needed.

Enhancing datasets that allow authorities to assess the scale of potential sector-wide liquidity pressures of insurers and potential implications for financial stability is a priority. The ESRB has repeatedly flagged the lack of access to comprehensive and timely data for monitoring the magnitude of potential liquidity strains in the insurance sector and/or potential spillover from other sectors.[19] This involves both regular and ad hoc reporting requirements in times of stress, to allow for early identification of trends, risk levels and vulnerabilities, so that both insurers and authorities can act swiftly. The Solvency II reporting obligations on liquidity risk should provide useful data to this end. It is important that this monitoring and the results of the regular stress tests of the insurance sector inform each other.

Stress testing is a valuable supervisory tool to assess the resilience of individual insurers and the insurance sector to adverse sector-wide shocks, and liquidity should continue to be evaluated in such stress testing. Well-designed stress tests support authorities' work in assessing if insurers can withstand severe but plausible adverse developments of financial and economic conditions. The ESRB supports EIOPA in developing the EU-wide stress testing exercise by devising adverse scenarios. The results of the 2021 stress test exercise showed that the liquidity position of the insurers participating "appears to be a less significant concern than solvency positions given the sector's large holdings of liquid assets. Still, outcomes show that insurers cannot rely solely

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[17] EIOPA's Liquidity Monitoring Exercise is a sample-based exercise.

[18] See the **EIOPA Insurance Risk Dashboard** which includes an indicator on liquidity, the **EIOPA Insurance Stress Test 2024** and the **Methodological principles of insurance stress testing - liquidity component**, EIOPA, 31 January 2023.

[19] All aspects related to margin and collateral cash requirements.

on their cash holdings to cover unexpected outflows".[20] EIOPA's EU-wide stress test exercise for 2024 is ongoing, and the liquidity component follows the EIOPA methodological paper on stress testing.[21] The results of the exercise will be available by the end of 2024. The ESRB expects that liquidity risks will continue to be included in the supervisory stress testing.

4. ESRB considerations on the new supervisory provisions of the Directive[22]

4.1 General considerations on the new supervisory provisions not covered in the introduction.

The new supervisory provisions are part of a set of pre-emptive measures that help supervisors anticipate deteriorating financial conditions on a sector-wide level and manage their macroprudential impact. The preceding Directive contained several articles (Articles 137 to 144) that enabled supervisors to react when an insurer was in breach of regulatory requirements (for example, in cases of non-compliance with technical provisions and capital requirements). In contrast, the new supervisory provisions under Chapter VIIA of the amended Directive[23] introduce a pre-emptive scope, where supervisors have new powers to take action before an insurer reaches the point of non-compliance. Consequently, Articles 144a to 144d come into play before the potential application of Articles 137 to 140, unless an insurer reaches the point of non-compliance before pre-emptive action is taken. The new requirements in the Directive also consider the macroprudential perspective in the Own Risk and Solvency Assessment (ORSA)[24] and in applying the Prudent Person Principle on investments.[25] These serve further as an early warning mechanism to authorities when monitoring risks for individual insurers and developing national market-wide analysis. The various tools included in Solvency II will

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[20] See **EIOPA Insurance Stress Test 2021.**

[21] See **EIOPA Insurance Stress Test 2024.**

[22] See Articles 144a to 144d and Articles 246a and 246b of the **amended Solvency II Directive**.

[23] See Articles 144a to 144d and Articles 246a and 246b of the **amended Solvency II Directive**.

[25] See Article 45(1)d of the **amended Solvency II Directive**.

[26] See Article 132(5) of the **amended Solvency II Directive**

help authorities assess whether there are risks that could pose a threat to the insurer's financial position and/or the stability of the sector.

Powers granted to supervisors under Solvency II should be enforceable and applied consistently, and RTSs and guidelines should facilitate such objectives. It is crucial that supervisory measures are enforceable to mitigate the impact of sector-wide shocks that can jeopardise the financial position of insurers or financial stability of the sector. By using the powers available to them, authorities will help reduce the probability of financial distress and strengthen financial stability. Thus, it is important that supervisory powers and coordination among competent authorities are commensurate to the risk exposures. Such considerations should be emphasised in the draft RTSs and guidelines in order to enhance macroprudential supervision and ensure consistent application across jurisdictions. For example, the relevant authorities must have consistently harmonised mechanisms at their disposal, but these must allow the necessary flexibility to apply the new supervisory measures as effectively as possible.

4.2 The scope of application of RTSs and guidelines derived from the new supervisory provisions should ensure adequate monitoring of the sector from a macroprudential perspective.

RTSs and guidelines should ensure a reasonable scope of application. The scope of application should ensure adequate monitoring of the sector from a macroprudential perspective. It is important for new RTSs and guidelines requiring a macroprudential view[26] to have a reasonable scope of application to achieve the objectives of contributing to financial stability and protecting policyholders. Thus, authorities should be cautious about setting criteria or granting exclusions that would restrict the application of supervisory measures. For example, setting criteria or thresholds that are too high could exclude a significant number of insurers and reduce supervisory efficacy in monitoring risks that affect the insurance sector and financial stability. It would also restrict the ability to build datasets that would support future supervisory analysis and projections. Thus, the ESRB highlights the importance of authorities using the newly acquired tools in a consistent manner to facilitate monitoring of macroprudential impacts of the sector and swift decision-making. EIOPA should use this opportunity to ensure that the scope of application of drafted RTSs and guidelines takes into account the fact that all insurers could be exposed

[26] For instance, RTS and guidelines related to maintaining liquidity risk management plans and liquidity metrics, carrying out additional macroprudential analyses in the ORSA and incorporating macroprudential considerations when applying the Prudent Person Principle.

to and impacted by risks, including liquidity risks, and that the size of insurers does not prevent transmission of risks to other actors in the sector.

4.3 The ESRB believes that RTSs and guidelines supporting the new supervisory provisions should be considered in a holistic manner to ensure consistency and facilitate an overarching view of macroprudential considerations.

The interlinkages across Article 144a to Article 144d of the Directive are important. As noted in the introduction, EIOPA draft RTSs and guidelines should assess such links simultaneously to ensure that they are applied consistently. A sudden or imminent liquidity deterioration of an insurer could trigger supervisory actions first under Article 144b and could subsequently trigger actions under Article 144c. Conversely, deterioration in the financial condition of an insurer or insurers under Article 144c could trigger material liquidity concerns. However, the supervisory powers granted vary according to the application of each article. For instance, Article 144b focuses on remediation of material liquidity vulnerabilities in exceptional circumstances and states that certain supervisory powers (suspension of redemption rights) could be applied as a last resort if this is in the collective interest of policyholders and beneficiaries of the undertaking. Furthermore, there is a need to consider both the new requirements on the ORSA and the application of the Prudent Person Principle to ensure an overarching view of the macroprudential considerations not only of one insurer but of the whole insurance sector. Therefore, it is advisable that EIOPA's draft RTSs, guidelines and opinions derived from Articles 144a to 144d of the Directive are developed in a holistic manner to ensure uniformity of approach on topics that are interlinked.

5. Conclusions

Monitoring systemic risks is essential to preserve financial stability, and the application of supervisory measures will help prevent or mitigate these risks. The ESRB mandate is the macroprudential oversight of the entire EU financial system, including insurance. As part of this, the ESRB seeks to prevent and mitigate systemic risks. Systemic risks can arise as a result of unexpected liquidity needs that may also affect insurers. Risks and vulnerabilities arising from such situations could have an impact on a market segment or a sector in a Member State or across Member States. A company failure could lead to other companies also suffering financial distress which could amplify the shocks to the rest of the financial system. For this reason, comprehensive monitoring and adequate microprudential and macroprudential supervisory measures can help reduce the frequency and/or impact of the financial distress of a market segment, sector or region.

This advice reflects the ESRB macroprudential perspective and it considers the RTS in relation to the requirements set out in the amended Directive. The ESRB believes that draft RTSs and guidelines supporting the new supervisory provisions of Articles 144a to 144d should be considered in a holistic manner to ensure consistency and facilitate a comprehensive view of the macroprudential considerations. The ESRB believes that the scope of application of RTSs and supporting guidance should ensure adequate monitoring of the sector from a macroprudential perspective. The ESRB also considers it important for the RTS on Article 144c(7) to include additional guidance in order to support effective application of the new supervisory powers granted under it. Such guidance could be included in the articles of the RTS or its preamble, or under supervisory tools available within EIOPA's remit.

The ESRB welcomes EIOPA's pragmatic approach to developing criteria as it is not possible to foresee all sector-wide shocks that could occur in the future. The ESRB also finds that the criteria developed by EIOPA on exceptional sector-wide shocks are not restrictive and would therefore, in most cases, not be difficult for most authorities to apply. The criteria give the level of flexibility that authorities would generally need.

The ESRB believes that the RTS could be enhanced to promote the consistent application of the new requirements laid out in Solvency II. The ESRB also acknowledges the challenges of developing such criteria. The ESRB provides considerations on: the need to clarify in the articles of the RTS or preamble that the criteria is not a closed list; the value of providing examples of possible sector-wide shocks; considering transmission and amplification factors and/or metrics as part of the criteria for identifying sector-wide shocks; and the importance of providing clarifications on key concepts not defined in the RTS or the Directive (for example insurance sector, financial position). This could help ensure consistency of interpretation and application and will allow authorities to be confident in using the new supervisory powers and to act swiftly.

Some of these RTS enhancements could take the form of:

- **Clarification that the criteria is not a closed list.** Although the criteria should be definite, there should also be a margin of judgement for authorities. This is to ensure that any other factors or elements not explicitly listed but deemed important by the supervisor could also be considered in the assessment. Therefore, the ESRB advises including the words "inter alia" at the sub-level of Article 1(2) of the draft RTS or adding a new factor "(f)" to Article 1(2) that would capture: "any other similar situation which demonstrably poses a significant threat to the financial position of the insurance companies, or financial stability, that is not already covered by the factors listed in points (a) to (e)".

- **Background information on exceptional sector-wide shocks to guide authorities in applying the powers under Article 144c(7).** Considering that exceptional sector-wide shocks are not defined in the legislation, there may be challenges for authorities that require a more granular approach towards more specific standards in order to avoid litigation risk and inaction bias. The ESRB believes that the RTS could include background information on exceptional sector-wide shocks to guide authorities in applying the powers under Article 144c(7) in the preamble. Past episodes[27] such as the 2008 financial crisis, the COVID-19 pandemic and the 2022 UK gilt crisis are examples of unforeseen events with a potential to threaten the financial position of the insurer or the stability of the financial system (for example in terms of material impact and spillover effects on the insurance sector).

- **Consideration of transmission and amplification factors.** The criteria should consider, among other things, that even one insurer may contribute to financial instability in one or more Member States, and that any such insurer may be of large significance to the insurance sector (for example in terms of the size of the company's balance sheet, the volume of services provided, potential disruption of insurance services on the real economy, loss of consumer confidence, estimated impact on financial markets, including second-round effects, or other variables). The criteria should also stipulate that macroeconomic and financial market conditions are duly considered in the assessment. These variables could be reflected in the articles of the RTS or preamble.

- **Clarification as to what is understood as the insurance sector.** In order to reduce ambiguity and help authorities apply the criteria for identifying exceptional sector-wide shocks, EIOPA should clarify this in the RTS, preamble, and/or other supporting guidance. While the insurance sector is not explicitly defined in Solvency II, it can be identified by its sub-components, and authorities could consider the whole sector or any part of it to inform their assessment when applying the powers granted under Article 144c(7).

- **Clarification that financial position is a broad concept and not limited to solvency and that the assessment of the financial position does not focus on a single metric.** The concept of financial position, which is mentioned but not explicitly defined in Solvency II, seems particularly relevant to the discussion of this RTS. Considering that an insurer's financial position can be affected by material changes to any component of its financial statements, it is advisable that the metrics on which the supervisory assessment is made are not restricted to or focused only on the solvency position of the insurer. EIOPA should clarify this concept in the RTS, preamble and/or other supporting guidance.

[27] As the coronavirus crisis intensified, euro area MMFs experienced outflows of nearly 8% of assets under management between 13 and 20 March 2020. See "**Recent stress in money market funds has exposed potential risks for the wider financial system**", op. cit.; and "**Interconnectedness of derivative markets and money market funds through insurance corporations and pension funds**", op. cit. See also ***Financial Stability Report,*** op. cit., pp. 12-26.

To support effective application of the RTS, the ESRB highlights important practical considerations, including interlinkages with other risks and the need to build up data. For example, it is crucial to:

- **Identify, monitor, and mitigate liquidity risk. This helps preserve the financial position of insurers and the financial stability of the sector.** As described by the ESRB on several occasions, liquidity risk may be pervasive. Further to the discussions in Sections 2.5 and 3.2 on the concept of financial position, liquidity risks can materialise quickly, which means that an insurer's current liquidity position may not fully reflect liquidity risk. Insurers that do not have a strong risk management framework are likely to fail to manage sudden liquidity demands. It is therefore important for insurers to regularly update their liquidity risk management plans and overall risk management and internal controls, and to consider how easily assets could be sold during times of market stress.

- **Build a dataset from previously available and newly reported data to monitor systemic risks arising from sector-wide shocks, including liquidity pressures and their impact on financial stability.** The ESRB acknowledges the challenges caused by authorities not having access to timely data and therefore welcomes the reporting obligations included in the amended Directive. It is clear that building datasets from newly reported data that allow authorities to identify exceptional sector-wide shocks and putting in place adequate risk monitoring will take time. However, authorities can lean on previously reported data and actively engage with insurers if they observe a deterioration in liquidity risk indicators either at idiosyncratic or market-wide level.

- **Use stress testing to assess the resilience of individual insurers and the insurance sector to adverse sector-wide shocks**. Well-designed stress tests support authorities' work in assessing if insurers can withstand severe but plausible adverse financial and economic developments. EIOPA's EU-wide stress test exercise for 2024 is ongoing and the liquidity component follows the EIOPA methodological paper on stress testing.[28] The results of the overall exercise are expected to be available by the end of 2024. The ESRB expects liquidity risks to continue to be included in supervisory stress testing.

[28] See **EIOPA Insurance Stress Test 2024**.

Appendix I: the ESRB's key considerations on liquidity and insurers

Liquidity risk can stem from exposures to derivatives both in a limited manner through initial margin requirements and variation margins, or in an unlimited manner if no margin requirements apply. As stated by the ESRB, both the margin requirements and the clearing obligation for certain derivatives introduced via EMIR[29] have changed the risks associated with derivatives transactions from counterparty credit risk to liquidity risk. These may prove to be a challenge for some insurers.[30] Sudden and severe market price movements trigger the exchange of variation margins within a narrow time window, demanding adequate collateralisation and prudent liquidity management.[31] The collateral used in practice to meet variation margin calls is generally cash and cash equivalents. Based on past financial crisis and simulation analysis, cash runs short in a crisis.[32] Furthermore, central clearing counterparties (CCPs) increase their initital margin requirements if price volatility increases, triggering possible initial margin calls. As a substantial volume of initial margins are posted in non-cash collateral, volatility spikes can trigger additional liquidity needs because the value of the collateral might drop significantly.[33] The 2022 UK gilt crisis[34] is a recent example of how financial institutions can be suddenly exposed to liquidity strains to meet margin calls and then suffer financial distress, exhibiting procyclical behaviour in the form of spiralling disposal of assets to meet funding needs. This leads to severe market dysfunction where markets can become highly illiquid and volatile, which has an impact on financial stability.

The ESRB position on margin calls and liquidity applies to all financial sector players, including the insurance sector. The ESRB has considered the implications of significant margin calls from cash and derivative positions across the financial system.[35] It has highlighted the importance of monitoring the liquidity risks that arise from margin calls (and from derivatives more generally) and the need to design policy that enhances the preparedness of all market participants for potential future liquidity shocks.[36] Many of the recommendations addressed to competent authorities in the area of CCPs and relevant market participants also affect insurers. In particular, this would apply if insurers opted to become direct clearing members of CCPs. Furthermore, insurers that become direct clearing members

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[29] "European Market Infrastructure Regulation (EMIR), **Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories**" in *Official Journal of the European Union*, L 201/1, July 2012, p. 1.

[30] See **Enhancing the macroprudential dimension of Solvency II**, op. cit., p. 54.

[31] ibid.

[32] ibid., pp. 53-64. According to the simulated variation margin calls against liquidity position reported by the ESRB, 40 insurers, corresponding to 24% of the sample, would not have enough cash to meet variation margin calls following an upward parallel shift of 25 basis points in interest rates. The liquidity shortfalls observed within the sample can be driven by either a small amount of cash or a high IRS exposure.

[33] ibid., p.58.

[34] For details of the events and the Bank of England's intervention to support UK financial stability, see "**Financial stability buy/sell tools: a gilt market case study**", *Quarterly Bulletin*, Bank of England, November 2023.

[35] See "**Liquidity Risks arising from margin calls**", ESRB, June 2020.

[36] See Section 2 of ibid.

would reasonably need to assess the impact of direct exposures to CCPs[37] and how such risks would have an impact on their business model and financial position, including liquidity risk. Thus, it is paramount that exposures to derivatives are clearly considered as a potential source of liquidity constraints in the insurers' liquidity risk management plans and liquidity metrics.

Mass lapse risk, if not adequately monitored, could also negatively affect insurers' liquidity and their overall financial position in times of stress. Policyholders may be incentivised to lapse on their policies to address consumption or investment needs. The policyholder's appetite to surrender the policy depends on market conditions, product tax incentives, guaranteed rates, surrender penalties and personal preferences. In a recent idiosyncratic case in the European Union, policyholders exercised an early redemption of their life policies. Surrender penalties included in the life insurance policy mitigated lapses to a certain extent, but they could not prevent an increase in volume of redemptions. Thus, the concerned insurer experienced a significant volume of mass lapses that, combined with other idiosyncratic factors, led to its financial position deteriorating, to the extent that the competent authorities had to intervene to safeguard financial stability and protect policyholders. The ESRB has previously cautioned about the potential for mass-lapses to occur after an abrupt rise in interest rates, which could result in liquidity dry-up and recommended identifying insurers with a vulnerable liquidity profile and strengthening the requirements for such insurers.[38] However, one of the challenges in monitoring liquidity is the time lag that exists when reporting on a type of risk that can suddenly change.

Crystallisation of emerging risks can increase the impact on liquidity and the financial position of the insurance sector and could affect financial stability through different channels. Sustainability risks,[39] climate-related risks and cyber risk could also impair the liquidity and financial position of an insurer. It is therefore important that the insurance sector and authorities have a comprehensive view of the implications of such risks on the company's financial position, including liquidity, and consider the potential impact of such risks on financial stability. Materialisation of these risks could lead to forced sale of assets and affect broader financial markets. The ESRB's publications on these subjects reiterate the need for financial institutions, including insurers, to take steps that contribute to the mitigation of those risks, including the use of scenarios and stress testing to quantify such risks.[40]

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[37] See European Commission "**Request to EIOPA for Technical Advice on the Review of Specific Items in the Solvency II Delegated Regulation (Delegated Regulation (EU) 2015/35)**" in which the European Commission seeks EIOPA's technical advice on the standard formula capital requirements for exposures to central counterparties (CCP) when they become direct clearing members.

[38] See Section 2.2 of **Enhancing the macroprudential dimension of Solvency II**, op. cit., pp. 66-68.

[39] See recital 41c of **amended Solvency II Directive** where sustainability risk means an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential negative impact on the value of the investment or on the value of the liability.

[40] See **ESRB response to a consultation of the European Commission on the review of Solvency II**, 16 October 2020;.**ESRB response to the EIOPA Consultation Paper on the 2020 review of Solvency II**, 17 January 2020 and **ESRB Letter to EIOPA on Liquidity Risks in the Insurance Sector**; 8 June 2020.