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ECB-PUBLIC
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Solvency II review

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Dear Vice-President Dombrovskis,

I am writing to you with reference to the consultation your services are organising on the review of Solvency II and am hereby transmitting to you the ESRB General Board's position on Solvency II.

Solvency II has contributed to make individual insurers safer and EIOPA has been central to making the new regime a success. Nevertheless, there are also gaps in the framework, and the forthcoming review of Solvency II is a unique opportunity to close these gaps in the years to come, or sooner if the situation requires so. Over the past few years, the ESRB has taken positions on topics it considered most pertinent with regard to their systemic relevance. They are the need to: (i) better reflect macroprudential considerations in Solvency II; (ii) establish a harmonised recovery and resolution framework across the European Union; and (iii) continue ensuring that risks are properly captured under Solvency II.¹ In addition, (iv) the recent events linked to the COVID-19 pandemic should be analysed and taken into account in the review as they shed a new light on the strengths and weaknesses of the insurance sector.

¹ Besides this letter, you may also refer to the [ESRB's response to the EIOPA's consultation on the Solvency II review](#), which provides an overview of the ESRB's work and position on the insurance sector.

(i) Better reflect macroprudential considerations in Solvency II

The ESRB believes that the review of Solvency II should result in a revised framework that also better reflects macroprudential considerations. The revised framework should thereby contribute to reducing systemic risk in the financial sector. The ESRB General Board has endorsed a report² that sets out three types of tools:

1. Solvency tools for preventing and mitigating procyclical investment behaviour of insurers. Existing anti-procyclicality mechanisms should be enhanced by a symmetric and transparent volatility adjustment which should form an additional own funds buffer and by addressing interactions with internal models.
2. Liquidity tools for addressing risks stemming from specific activities, such as hedging with derivatives and selling insurance products with consumer-friendly redemption features. The framework for liquidity risk should be enhanced by better reporting and measurement, stress-testing requirements and Pillar 2 provisions that enable supervisors to require those insurers that have been identified as having a vulnerable liquidity profile, to maintain a liquidity buffer.
3. Tools for addressing risks stemming from the provision of credit to the economy, e.g. when insurers originate mortgage loans or invest in corporate bonds. The treatment of the provision of credit should be enhanced by capital-based tools for (sub)sectoral exposures and by bringing insurers in scope of borrower-based tools, with a view to ensuring consistency in macroprudential policy across the financial sector.

In addition to these tools, the provisions of Article 138 of Directive 2009/138/EC on the extension of the recovery period could be clarified with respect to the role of the ESRB. Indeed, given that the ESRB is responsible for the macroprudential oversight within the EU, it would be more natural that the ESRB, where appropriate, was consulted by EIOPA before the declaration of an exceptional adverse situation.

(ii) Establish a harmonised recovery and resolution framework across the European Union.

Such a framework, together with additional harmonisation in the area of insurance guarantee schemes (IGS) to help maintaining public confidence and stability in the financial system, would contribute to adequately protecting policyholders as well as maintaining financial stability in the EU. Both objectives should be put on an equal footing. A harmonised recovery and resolution framework requires a broader set of tools than is

² [Enhancing the macroprudential dimension of Solvency II](#), ESRB, February 2020.

available in regular insolvency proceedings. This set of tools includes pre-emptive recovery and resolution planning, a set of preventive measures and resolution powers for authorities to intervene before solvency requirements have been breached, for example to allow the transfer or separation of all or part of the liabilities' portfolio and – as a measure of last resort and subject to adequate safeguards – to modify contractual rights.³

(iii) Continue ensuring that risks are properly captured under Solvency II

The ESRB sees the need to adjust the risk-free interest rate term structure, in particular given the persistent low interest rate environment. The last liquid point for the euro regulatory risk-free interest rate term structure should be moved to 30 years, the convergence period from the last liquid point to the ultimate forward rate should be extended from 40 years to 100 years and the extrapolated part of the curve should be blended with market data in order to avoid creating a cliff effect at the last liquid point.⁴

The ESRB considers it important that the resilience of the insurance sector to property risk is not weakened at the current juncture and welcomes EIOPA's analysis using recent empirical evidence. The ESRB identified vulnerabilities in both commercial real estate and residential real estate⁵, sectors which are important for financial stability given their size and strong interconnectedness with both the financial system and other parts of the real economy.

(iv) An update in view of the COVID-19 pandemic

While the impact of the COVID-19 pandemic is not yet over, the ESRB considers it important to draw first lessons. The ESRB General Board has identified five lessons that it would like to highlight. These lessons reflect the fact that supervisors and governments had to sometimes resort to ad-hoc solutions to support the insurance sector during the market turmoil. This situation is not satisfactory as it may lead to uncoordinated responses within the EU, ultimately undermining the smooth functioning of the internal market. The ESRB believes that these lessons highlight the need for Solvency II to be completed with new tools, so that the regulatory framework is comprehensive and helps ensuring that the insurance sector can fulfil its essential role, even during times of crisis.

³ [Recovery and resolution for the EU insurance sector: a macroprudential perspective](#), ESRB, August 2017.

⁴ [Regulatory risk-free yield curve properties and macroprudential consequences](#), ESRB, August 2017.

⁵ [Report on vulnerabilities in the EU commercial real estate sector](#), ESRB, November 2018 and [Follow-up report on countries that received ESRB warnings in 2016 on medium-term vulnerabilities in the residential real estate sector](#), ESRB, September 2019.

- First, the systemic importance of certain insurance activities for the functioning of the economy: The crisis highlighted that insurance activities and functions play a critical role in the good functioning of the economy. For example, the measures taken by governments to support credit insurance, the debates around the scope of the coverage offered by business interruption insurance or the extent with which health insurance should cover for pandemic claims highlight the important role that insurance plays in the economy. Strengthening the microprudential framework with a macroprudential toolkit would help to ensure the provision of critical insurance services as well as those insurance functions which might have a significant impact on the financial system or the real economy. It also shows that financial stability objectives can serve policy holder needs and that they should therefore be considered as important as policy holders' protection objectives in particular for the design of a recovery and resolution framework.
- Second, the need to build-up a buffer of capital ex-ante that provides additional resilience when needed: Insurers play a critical role for the economy not only via the services they offer, but also because as large asset managers they contribute to financing the economy. They need to be able to do so through the cycle, including during times of stress when losses materialise. This includes providing incentives to avoid procyclical behaviour such as insurers selling asset to maintain solvency ratios at a time when asset prices are falling.⁶ In some jurisdictions, supervisors gave priority and favourable consideration to new requests for applying the volatility adjustment and the existing transitional measures on technical provisions to smooth the impact of the crisis. Such transitional measures, however, were not designed for that purpose and can apply over more than 10 years. Countercyclical tools such as of capital buffers built ex-ante to cover for the potential materialisation of systemic risk would be more appropriate, as they can be released against losses during crises and provide valuable breathing space for insurers.
- Third, the power for supervisors to block distributions: At the onset of the COVID-19 pandemic EIOPA⁷ and the ESRB⁸ stressed the importance to restrict distributions during such a period of uncertainty. Many insurance supervisors, however, do not have the power to block or suspend dividend pay-outs or

⁶ According to ECB's Securities Holdings Statistics (SHS) and in net terms, the euro area insurance corporations sold securities (long-term bonds, investment fund shares and equities) worth more than EUR 70 billion in the first quarter of 2020.

⁷ [Statement on dividends distribution and variable remuneration policies in the context of COVID-19](#), EIOPA, April 2020.

⁸ [Recommendation of the ESRB on restriction of distributions during the COVID-19 pandemic \(ESRB/2020/7\)](#), ESRB, May 2020.

equivalent activities when insurers are not breaching their solvency capital requirements. Such a power – both at the level of individual insurers and across the insurance sector – should be considered during the review of Solvency II.

- Fourth, the volatility of the solvency ratio: With Solvency II being a mark-to-market regime, volatility in financial markets is reflected in insurers' solvency ratios. Existing tools, such as the symmetric adjustment for equity risk (SAE), the volatility adjustment (VA) and the matching adjustment (MA), attenuate this volatility, but the crisis highlighted certain shortcomings with some of them. In particular, during the large falls in equity markets in March 2020, insurers did not benefit as much from the capital relief of the SAE as they might have, because the SAE is capped at 10 basis points. This cap should be increased in a symmetric way, such that insurers automatically build up capital buffers during times when equity markets rise strongly and benefit from greater capital relief during times when equity markets fall sharply. The basis risk of the VA led to counter-intuitive results, with, first, the SCR ratio of some insurers increasing in the midst of the crisis.⁹ Second, while credit spreads of some countries increased in April for a short period of time, the country-specific add-on was not activated in a timely manner, which created volatility in some insurers' balance-sheets. These under and over-shooting effects of the VA should be corrected. Beyond these shortcomings, transforming the VA into a symmetric VA that would form an additional own funds item would also mitigate some of the credit spreads' volatility.
- Fifth, liquidity risk management requirements for insurers should be enhanced, there should be better liquidity monitoring and supervisors need the power to act on liquidity: The ESRB suggested to EIOPA to improve the monitoring of liquidity risks¹⁰ given the tensions observed in certain market segments, such as in the commercial paper and corporate debt markets, or the drying up of new business in some countries affected by lockdown measures, or the exceptionally large margin calls on derivative contracts.¹¹ The results of the ECB's Survey on credit terms and conditions in euro-denominated securities financing and over-the-counter derivatives markets (SESFOD) indeed suggest that some insurers faced strained liquidity situations linked to variation margins.¹² Moreover, variation margins

⁹ In several countries, several insurers recorded an increase in their solvency ratio of more than 30 percentage points between end of 2019 and end of March 2020. At the same time, the solvency ratio of some of the same insurers calculated without VA decreased significantly, in some cases by more than 40 percentage points.

¹⁰ [ESRB letter to EIOPA on liquidity risks in the insurance sector](#), ESRB, June 2020.

¹¹ [Liquidity risks arising from margin calls](#), ESRB, June 2020.

¹² [June 2020 SESFOD](#) published on 21 August 2020.

received and paid by insurers and pension funds strongly correlated with in- and outflows from EUR-denominated money market funds during the March market turmoil, so that insurers and pension funds may have contributed to spill-overs across derivative and money markets.¹³¹⁴ EIOPA has put in place an exceptional and temporary monitoring of the liquidity of certain insurers¹⁵, without which assessing this risk would not have been possible at EU level. Besides the need to reinforce the risk management provisions of Solvency II on liquidity risks, a systematic reporting should be put in place, which should be proportionate to the risks and allow an assessment at individual, national and EU level. In addition, supervisors should be granted, via Pillar 2 provisions, the power to impose liquidity buffers for insurers with a vulnerable risk profile. This would enable them to act quickly and restore adequate liquidity positions if there were to be indications, for instance revealed by the application of stress tests, that certain insurers could face liquidity tensions.

Yours sincerely,

[SIGNED]

Christine Lagarde

Chair of the European Systemic Risk Board

¹³ Box [5] in Financial Stability Review, ECB, November 2020 (forthcoming).

¹⁴ Some financial entities also highlight this relationship. See '[Lessons from Covid-19: The Experience of European MMF s in Short-term Markets](#)', Blackrock, 2020.

¹⁵ [Statement](#), EIOPA, June 2020.

Annex: ESRB's response to the European Commission's consultation on the review of Solvency II – selected topics

In addition to the points set out in the main body of this letter, the ESRB hereby responds in this annex to some of the other issues raised by the European Commission that concern the ESRB's role in the prevention or mitigation of systemic risks to financial stability and the smooth functioning of the internal market.¹⁶

1. Long-termism and sustainability of insurers' activities and priorities of the European framework

The ESRB believes that the protection of policy holders and ensuring financial stability should be the primary objectives of Solvency II, as a prudential regime, albeit that two national supervisory authorities took a different view. In order to achieve these objectives, the ESRB believes that a risk-based approach is necessary. The ESRB believes that, subordinated to those primary objectives, Solvency II may have secondary objectives such as supporting the investment in environmentally-sustainable economic activities or in the real-economy and providing long-term financing for European SMEs, albeit that one voting member and one supervisory authority took a different view. Subordination to the primary objectives means in particular that the measurements of risks should not be distorted to achieve the secondary objectives. At the same time, a lack of investment in environmentally-sustainable economic activities or of the provision of long-term financing for European SMEs may in itself create risks to financial stability.

2. Proportionality of the European framework and transparency towards the public

The ESRB would welcome that insurers using an internal model be required to also calculate their solvency position using standard methods for information purposes and to disclose it to the public, albeit that two national supervisory authorities took a different view. It would indeed make it easier to monitor how divergent the risk profile of those insurers is to the European average and would help ensuring a level playing field between all players.

3. Improving trust and deepening the single market in insurance services

Insurance guarantee schemes (IGS) provide a minimum level of compensation to policy holders and/or allow the continuation of contracts and can therefore contribute to an orderly resolution. As such, they contribute to maintaining public confidence and stability in the insurance sector and in the financial system in general.

¹⁶ See Article 3 of Regulation (EU) No 1092/2010 amended by Regulation (EU) 2019/2176 for the ESRB's mission, objectives and tasks.

Furthermore, a patchwork of national recovery and resolution regimes and IGS would not contribute to financial integration in Europe and might create uncertainty for market participants over the level of policyholder protection and recovery and resolution tools that could be applied in the event of an insurer failing. The ESRB therefore favours that it becomes compulsory for all Member States to set up an IGS with some common elements agreed at EU level (minimum harmonisation).

The ESRB believes that public authorities should have the power to temporarily prohibit redemptions of life insurance policies and to reduce entitlements of a life insurer's clients in order to preserve financial stability and as long as policy holders are not worse off as a result of the action of public authorities than in the event of a failure.

4. Other risks

The ESRB recently published two reports on emerging risks: one on climate change risks to financial stability and one on systemic cyber risk.¹⁷ They highlight that new emerging risks could threaten financial stability in the EU and that financial institutions should take steps to contribute to the mitigation of those risks. The EU legislation should support those actions and require insurers to explicitly reflect climate change risks and cyber risks in their risk management practices. Scenarios to quantify risks would be useful for that purpose.

Another area in which risks are currently not adequately covered is the situation of negative interest rates. The current design of the standard formula of Solvency II leads to an underestimation of interest rate risk borne by insurers and has to be adjusted accordingly.

¹⁷ [Positively green: Measuring climate change risks to financial stability](#), ESRB, June 2020 and [Systemic cyber risk](#), ESRB, February 2020.