ESRB response to the EIOPA Consultation Paper on the 2020 review of Solvency II

The ESRB welcomes the review of Solvency II and the EIOPA’s Consultation Paper. Given the importance of the insurance sector, a comprehensive regulatory framework is needed to help ensure that the sector can fulfil its essential role, even during times of crisis. Such a framework consists of a number of elements that complement each other: good regulation and supervision make individual insurers safer; recovery and resolution regimes provide legal certainty when an insurer gets into trouble, and they ensure that failure is orderly; and macroprudential policy looks beyond individual insurers and across sectors. Part of this framework is already in place. In particular, Solvency II has contributed to make individual insurers safer and EIOPA has been central to make 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. The ESRB therefore welcomes the review and EIOPA’s Consultation Paper (EIOPA, 2019).

The proposals set out in this response to EIOPA’s Consultation Paper reflect the positions that the ESRB has taken over the past few years. These proposals are grouped under three broad headings, which reflect the topics that the ESRB considers most pertinent with regard to their systemic impact. 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. While the ESRB’s mandate focuses on macroprudential considerations, the ESRB stands ready to support technical work at EIOPA to calibrate the tools set out under the first heading. This might include gradually phasing in some of the proposals made. In addition, the ESRB welcomes that EIOPA is giving ample consideration to the principle of proportionality in its Consultation Paper.

It would be important to consider the combined effects of these proposals and those of EIOPA as part of EIOPA’s impact assessment, in particular for the symmetric volatility adjustment. Some of the proposals set out below interact with those made in EIOPA’s Consultation Paper. To better understand this interaction, and to support the further calibration of the tools, it would be important for EIOPA to consider these proposals in its impact assessment. This is particularly relevant for the symmetric volatility adjustment, which can be integrated into EIOPA’s own proposals for this measure.
1 How to better reflect macroprudential considerations in Solvency II

1.1 Enhancing the macroprudential dimension of Solvency II

The EIOPA Consultation Paper states that a macroprudential perspective should be incorporated into the current prudential framework and that this would supplement the current microprudential approach in a consistent and coherent way.

The ESRB agrees with EIOPA that there is a need to complement Solvency II with tools that reflect macroprudential considerations. Solvency II was not specifically designed to address systemic risks. Current provisions therefore naturally lack the completeness and consistency of a macroprudential framework. The ESRB’s General Board has discussed macroprudential aspects of the insurance sector on a number of occasions and identified a broad set of possible tools in a report published in 2018 (ESRB, 2018a). Some of the more insurance-specific tools identified in ESRB (2018a) are considered in EIOPA’s Consultation Paper. The ESRB supports the inclusion of these tools in Solvency II and, reflecting its cross-sectoral expertise, focuses, in a second report approved by the ESRB’s General Board in 2019 (ESRB, 2020b), on other types of risk, including some that are not necessarily specific to the insurance sector. The review of Solvency II provides an opportunity to better reflect these macroprudential considerations in legislation.

This section sets out the solvency, liquidity and horizontal tools proposed by the ESRB to reflect the macroprudential considerations that have been identified in ESRB (2020b) as necessary to enhance Solvency II. ESRB (2020b) describes three types of tools that are designed to address procyclical behaviour and to ensure a consistent treatment of activities typically performed by banks. These tools are: i) solvency tools for addressing cyclical risks via symmetric adjustments to the solvency requirements of insurers; ii) liquidity tools for addressing risks from the asset and liability side of the balance sheet; and iii) horizontal tools for addressing risks stemming from the direct and indirect provision of credit to the economy.

The ESRB recognises that some of the parameters necessary to operate these tools need to be calibrated further and the impact of the tools needs to be assessed. ESRB (2020b) identifies the key parameters that would need to be calibrated to put the tools into operation. The parameters include the time period over which symmetric adjustments are calculated and the thresholds above which exposure to certain sectors of the economy can create risks that are deemed to require an additional capital charge. While the ESRB stands ready to provide further input, the need for institution-specific data means that EIOPA is best placed to undertake the calibration of the parameters and to assess the impact of the tools on the insurance sector.
1.1.1 Solvency tools for addressing cyclical risks via symmetric adjustments

Anti-procyclicality mechanisms should be enhanced by a symmetric and transparent volatility adjustment (VA) and by addressing interactions with internal models. Existing anti-procyclicality mechanisms in Solvency II do not cover all asset classes and some of them lack the symmetry needed to build insurer resilience during times of exuberance. Reflecting this, the volatility adjustment, i.e. the anti-procyclicality mechanism covering fixed income assets, could be enhanced in two ways. First, it should be made symmetric in order to ensure that insurers automatically build a buffer of own funds during times when risk premia on fixed income assets are excessively compressed. Second, the volatility adjustment should form an additional own funds item instead of affecting the technical provisions, in order to make the volatility adjustment more transparent and to ensure an unbiased valuation of insurance obligations. In addition, anti-procyclicality mechanisms should also apply to insurers when calculating their solvency capital requirement with an internal model since they cover roughly 40% of insurers' investments: the volatility adjustment should not affect the calculation of the solvency capital requirement since it already affects own funds; internal model users should also be required to adapt the symmetric adjustment for equity risk to their models. More generally, the ESRB also sees merit in applying the symmetric adjustment to other non-fixed income assets, to increase resilience during times of exuberance.

1.1.2 Liquidity tools for addressing liquidity risk arising from the assets and liabilities side

The framework for liquidity risk should be enhanced by: (i) better reporting and measurement; (ii) stress-testing requirements; and (iii) Pillar 2 provisions for liquidity buffers. As insurers receive premiums up front and pay out claims if and when they arise, the insurance sector is typically shielded from the liquidity risk inherent in the maturity transformation performed by banks. Depending on their activities and/or the redemption features of their products, liquidity risks can nevertheless arise on both the assets and the liabilities side of insurers' balance sheets. Reflecting this, ESRB (2020b) identifies three ways in which Solvency II should be enhanced to better account for liquidity risk. First, the information contained in the Solvency II quantitative reporting templates should be enhanced to enable supervisors to better assess the liquidity needs stemming from insurers liabilities. Second, the Solvency II provisions on managing liquidity risk should be reinforced, in particular with the requirement for insurers to perform internal stress-testing exercises. This should be complemented by supervisory stress tests incorporating liquidity risk. Third, Pillar 2 provisions in Solvency II should be enhanced to enable supervisors to require individual insurers with vulnerable liquidity profiles to hold liquidity buffers. This would be consistent with policy options set out in ESRB (2020a), which considers whether financial institutions that use derivatives should be required to hold a cash buffer to meet variation margin calls.
1.1.3 Horizontal tools for addressing risks stemming from the direct and indirect provision of credit to the economy

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. Insurers can conduct activities that are typically associated with banks, such as providing credit to the real economy either directly (e.g. by originating loans) or indirectly (e.g. by investing in corporate bonds). The different risk-bearing capacities of banks and insurers can mean that the same credit risk is reflected in different capital requirements. When these differences become large, they can provide incentives for regulatory arbitrage. Differences in the way in which the provision of credit is treated in bank and insurance regulations can also reduce the effectiveness of macroprudential measures. Reflecting this, ESRB (2020b) identifies two types of capital-based tools that authorities could use to set up additional capital requirements in order to increase the resilience of insurers to systemic risk stemming from a specific sector or sub-sector. First, a loss-given-default floor for residential mortgage loans, which authorities can increase during times of exuberance, should be introduced. This would also correct the inconsistency in the microprudential capital requirements between the insurance and the banking frameworks, while taking into account the risk-bearing capacity of the insurance sector. Second, a systemic risk buffer should be adapted to the insurance regulatory framework to allow targeting sectoral and sub-sectoral exposures. In addition to capital-based tools, insurers should be brought in the scope of borrower-based measures to ensure consistency across sectors in the treatment of the borrower’s credit risk. Authorities should be granted a power to impose public disclosure of certain exposures, thereby incentivising market discipline.

1.2 Extension of the recovery period under Article 138 of Solvency II

The EIOPA Consultation Paper considers clarifications to Article 138 of Directive 2009/138/EC, which establishes the rules and procedures in the event of non-compliance or a risk of non-compliance with the solvency capital requirement. Specifically, EIOPA’s draft Advice [2.1014] is to clarify the role of the ESRB such that, where appropriate, the ESRB would be consulted by EIOPA at an earlier stage of the process (i.e. before declaring an exceptional adverse situation).

The ESRB agrees with EIOPA’s draft Advice on how to amend the first two paragraphs of Article 138(4) of the Directive. Given that the ESRB is responsible for the macroprudential oversight within the European Union, it would be more natural that the ESRB, where appropriate, was consulted by EIOPA before the declaration of an exceptional adverse situation. Criteria that need to be assessed before declaring an exceptional adverse situation can be of a macroprudential nature, such as the possible procyclical effects of re-establishing compliance with the solvency capital requirement.
2 Establishing a harmonised recovery and resolution framework across the European Union

The EIOPA Consultation Paper states in its draft Advice [12.47] that a “minimum harmonised recovery and resolution framework for (re)insurance undertakings should be established”. It notes that “harmonised recovery and resolution rules contribute to adequately protecting policyholders as well as maintaining financial stability in the EU”.

The ESRB agrees with the draft Advice by EIOPA on the need for a harmonised recovery and resolution framework across the European Union. The ESRB’s General Board considered recovery and resolution of the insurance sector and published its views in a report in 2017 (ESRB 2017a). ESRB (2017a) states that the disorderly failure of an insurer or a group of insurers may pose financial stability risks, as the standard insolvency procedure might be unable to manage a failure in the EU insurance sector in an orderly fashion. Reflecting this, it concluded that a harmonised recovery and resolution framework across the European Union is needed. Such a framework should take a sectoral view, while allowing for the principle of proportionality.

ESRB (2017a) concludes in favour of a harmonised effective recovery and resolution framework for insurers across the European Union and sets out five points that such a framework should include. First, existing recovery and resolution frameworks should be evaluated and, if appropriate, enhanced and harmonised at the EU level. Efforts should also be made to ensure their consistent implementation. Second, the existing recovery and resolution toolkit should be expanded and multiple uses of its tools should be allowed. A majority of ESRB member institutions took the view that this should include giving resolution authorities the power to modify the terms of existing contracts as a measure of last resort, subject to adequate safeguards. Third, the recovery and resolution framework should cover the whole insurance sector, while allowing for proportionality. Fourth, the financial stability objectives of the recovery and resolution framework should be recognised, and a majority of ESRB member institutions took the view that it should be put on an equal footing with the objective of policyholder protection. The interactions of the resolution authority with the macroprudential authorities should also be clarified. Fifth, work on recovery and resolution frameworks should go hand-in-hand with a discussion on how resolution should be funded without having to resort to public funds.

ESRB (2017a) concluded that a harmonised recovery and resolution framework requires a broader set of tools than is available in regular insolvency proceedings. A broader set of tools is needed to enable authorities to be better prepared to deal with situations involving the distress and default of insurers. Specifically, ESRB (2017a) considers five tools that may be used at different stages of an insurer’s distress or failure: first, recovery and planning, including pre-emptive plans to increase awareness and support more decisive action by both insurers and supervisors; second, recovery measures and early intervention tools, which give the power to authorities to intervene before solvency requirements have been breached; third, commonly used resolution tools, such the use of run-off, which should be available across the European Union and should include solutions to address any funding shortfalls that might occur; fourth, resolution tools that allow the transfer or separation of all or part of the portfolio, which increase the resolution authority’s flexibility in identifying and separating viable business and/or vital economic functions.
Continuing to ensure that risks are properly captured in Solvency II

3.1 The risk-free interest rate term structure

The EIOPA Consultation Paper considers options for the calculation of the risk-free interest rate term structure. Specifically, the EIOPA Consultation Paper calls for views on the options on the last liquid point for the euro, including an alternative extrapolation method.

The ESRB welcomes the analysis by EIOPA, as it sees the need to adjust the risk-free interest rate term structure to better meet macroprudential considerations. The regulatory risk-free rate term structure has a direct impact on the behaviour of insurers. It affects their provisioning and may influence hedging and investments choices. As a result, its design and derivation from market interest rates are important. For longer maturities, swap markets and sovereign bond markets are less liquid. Solvency II takes this into consideration by using a hybrid of market interest rates up to a last liquid point and extrapolations from this to an ultimate forward rate. The setting of these parameters determines the regulatory risk-free rate term structure. Reflecting the importance of the risk-free interest rate term structure for correctly estimating insurers' solvency positions, the ESRB's General Board discussed the associated issues in 2017. It found that the setting of the ultimate forward rate, the last liquid point and the convergence period may underestimate insurers' liabilities and published it findings in a report (ESRB, 2017b).

ESRB (2017b) proposed that the last liquid point for the euro regulatory risk-free interest rate term structure should be moved to 30 years, possibly in combination with an alternative extrapolation method. ESRB (2017b) includes analysis of common liquidity measures. This analysis showed little difference in liquidity between euro swap rates at 20 and 30-year maturities, with the same holding for liquidity in euro sovereign bond markets. ESRB (2017b) also notes that the extrapolated part of the curve should be blended with market data, provided that sufficiently reliable market data are available. The motivation for such an approach is that the requirement to extrapolate the risk-free interest rate term structure from a last liquid point that is set at a single maturity can lead to excessive exposure to interest rate risk around that maturity. Furthermore, by creating a cliff effect at the last liquid point, it may necessitate a short-term realisation of unrealised losses when maturity buckets of liabilities approach the last liquid point over time.
ESRB (2017b) also considered extending the convergence period from the last liquid point to the ultimate forward rate from 40 years to 100 years and the adjustment of the ultimate forward rate. ESRB (2017b) favoured an extension of the convergence period, as this would reduce the weight of the ultimate forward rate and increase the weight of the liquid part of the regulatory risk-free interest rate term structure when deriving the illiquid part of the term structure. ESRB (2017) noted that a large majority of ESRB members favoured the reduction of the ultimate forward rate, which was implied in the methodology developed by EIOPA to derive the rate in April 2017. At that time, ESRB members observed that the transition appeared to be too slow, should a “low-for-long” scenario prevail over the next decade.

3.2 Real estate vulnerabilities

The EIOPA Consultation Paper considers how to better calibrate property risk. In its draft Advice (5.107/5.108), EIOPA notes that “given the scarce available data and the on-going analyses, [it] is, at the time of this draft opinion, not in a position to provide the European Commission with a definitive advice implying a change to the current approach” and that it “will continue its analyses towards a potential change to the capital requirement calculation method for this risk.”

The ESRB considers it important that the resilience of the insurance sector to property risks is not weakened at the current juncture. The ESRB welcomes the analysis by EIOPA, as both the commercial and residential real estate sectors are important for financial stability. This reflects their size and strong interconnectedness with both the financial system and other parts of the real economy. While the ESRB has no specific comments on the recalibration of property risk, the current juncture is one in which property prices are elevated in a number of jurisdictions. The ESRB considers it therefore important that the resilience of the insurance sector to property risk is not weakened as a result of the recalibration of the solvency capital requirement for property risk.

The ESRB identified vulnerabilities in both commercial real estate and residential real estate that should be considered in any recalibration of property risk. The General Board discussed vulnerabilities in commercial real estate in 2018 and approved a report setting out the analysis (ESRB 2018b). While this analysis was hampered by scarcity of accurate and comparable data, ESRB (2018b) found that one of the main sources of vulnerability relates to investors’ search for yield in the low interest rate environment, which has increased commercial real estate prices and, potentially, made them vulnerable to a repricing of risk premia. The General Board discussed vulnerabilities in residential real estate in 2019 and the ESRB issued five warnings and six recommendations on medium-term residential real estate sector vulnerabilities and set out its analysis in a report (ESRB, 2019). In many of the countries receiving warnings and recommendations vulnerabilities are related to the level of household indebtedness, the growth of mortgage credit and signs of loosening of lending standards. Some countries also have vulnerabilities related to house price growth or overvaluation of residential real estate.
References


