Financial Stability and Insurance Markets

Completing the European Insurance Regulatory Framework

Francesco Mazzaferro
Head of the Secretariat of the European Systemic Risk Board
ESRB

Dimitris Zafeiris
Head of the Risks and Financial Stability Department
EIOPA

Florence School of Banking and Finance

3 September 2019

Overview

1. How can insurance contribute to systemic risk
2. Elements of a comprehensive regulatory framework
3. Macroprudential policies and measures
4. Recovery and Resolution
5. Insurance Guarantee Schemes

Overview

Real-life examples

- **Liquidity stresses**, e.g. in the event that policy holders were to lapse in large numbers
  - **Ethias**, key player in Belgium
    - Total **withdrawals of around EUR 600 million** and at times EUR 50 million in single days
    - Emergency support measures were put in place and **recapitalisation of EUR 1.5 billion**
- **Failure of a dominant insurer**, resulting in unavailability of cover and price increases
  - **HIH Insurance**, second biggest insurer in Australia
    - Systemic under-reserving and under-pricing led to failure
    - **Taxpayers funded a scheme** of AUD 640 million (around EUR 400 million), **loss of policy cover**
    - Substitutability issues: **construction suspended** in several states
- *Other cases are described in the Report on systemic risks in the EU insurance sector – Annex 3, ESRB, December 2015*

Two key systemic risk types for insurance

Direct and indirect contagion

Build-up and transmission of contagion

Triggers
- Banking crisis
- Financial market shock (e.g. double hit, risk free rate shock, …)
- Reinsurance crisis
- Credit/real estate crisis
- Reputational issues
- …

Amplifiers
- Bank-like activities
- Procyclicality
- Common asset exposures and/or interconnections
- Mass lapses
- Number and pace of failures
- Size
- Insurance products with systemic features
- …

Transmitters
- Asset liquidation
- Exposures

Impact
- Impact on stable funding
- Impact on liquidity in the banking sector
- Contraction of credit supply
- Impact on the banking counterpart
- Contagion in the reinsurance market
- …

Vulnerabilities

Maturity mismatch, investment portfolio with poor credit quality, inadequate reinsurance structure, …

Systematic withdrawal or failure of insurance services

Build-up and transmission of a withdrawal/failure of insurance services

Triggers
- Pricing pressure in the (re)insurance market
- Business generating P&L losses
- Unfavourable macroeconomic conditions (e.g. low yield)
- …

Amplifiers
- Under-pricing
- Under-reserving
- Under-capitalisation
- Market concentration
- Size
- Number and pace of failures
- …

Transmitters
- Critical functions/ services

Impact
- Loss of (re)insurance cover
- Impact on business cycle
- Loss/reduction of (household) income
- …

Vulnerabilities

Maturity mismatch, mispricing, bad product design, …

Source: Macroprudential provisions, measures and instruments for insurance, ESRB, November 2018

EIOPA and the ESRB reach similar conclusions on systemic risk for insurance

- Extensive discussion in the banking sector. Debate now spreading over to the non-banking sector, including insurance
  - The debate is useful and necessary
  - Not much work (research, policy papers, etc.) available
- EIOPA and the ESRB seek to ensure that the debate takes into account insurance specific features
  - Business model
  - Specific risks
- Extensive work done by both institutions:
  - ESRB (2015): Report on systemic risks in the EU insurance sector
  - ESRB (2018): Macroprudential provisions, measures and instruments for insurance
  - EIOPA (2018a): Systemic risk and macroprudential policy in insurance
  - EIOPA (2018b): Solvency II tools with macroprudential impact
  - EIOPA (2018c): Other potential macroprudential tools and measures to enhance the current framework

Overview

A comprehensive regulatory framework should have many elements

- **Microprudential regulation** and **supervision** to protect policy holders and make individual insurers safer
- **Recovery and resolution regime** to provide legal certainty when an (re)insurer gets into trouble and ensure that failure is orderly
- **Insurance guarantee schemes** to ensure compensation for losses in the event of insurance insolvency
- **Macroprudential policy** looking beyond individual insurer(s) and deploying tools that target systemic risks

A macroprudential framework to complement Solvency II

- **Solvency II** reduces vulnerabilities **at the level of individual insurers**

- Solvency II contains **a few measures with macroprudential effects:**
  - Symmetric adjustment for equity risk and volatility adjustment target procyclical behaviour
  - Extension of the recovery period in exceptional adverse situation

- **Systemic risk cannot be addressed by microprudential regulation alone**: it stems from the collective behaviour of institutions and is endogenous to the system

- Need to **complement Solvency II with macroprudential measures**

Overview

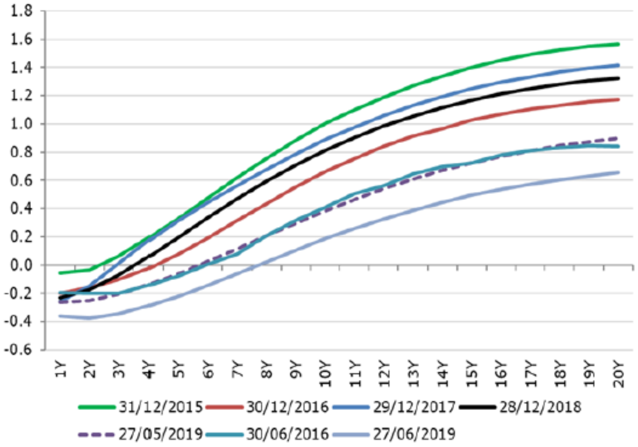
Options for macroprudential policies and measures by systemic risk type

- Need to have **tools** in place **to address sources of systemic risk,** such as:
  - Procyclicality and mass lapses
  - Deterioration of the solvency position leading to failure(s)
  - Under-pricing and under-reserving
  - Excessive levels of direct and indirect exposure
  - Risky behaviours, involvement in certain products and activities

- Several **tools and measures under consideration**, such as:
  - Capital-based tools (e.g. capital surcharges or dividend restrictions)
  - Liquidity-based tools (e.g. intervention powers in exceptional circumstances)
  - Extending Solvency II requirements (e.g. narrative reporting)
  - Recovery and Resolution framework (including pre-emptive planning)
  - Instruments targeting bank-like activities to ensure cross-sectoral consistency

EUR swap curve has flattened since the end of the last year

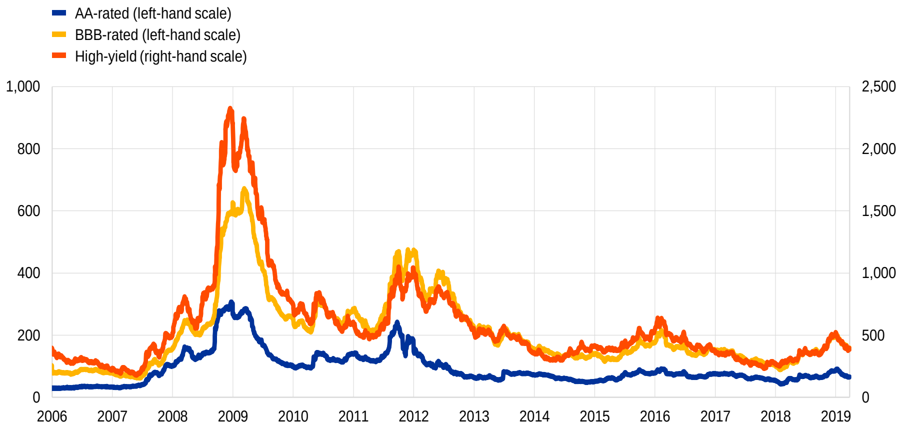
EUR swaps



Source: Bloomberg, latest observations are for 27 June 2019

Search for yield behaviour leads to compressed risk premia

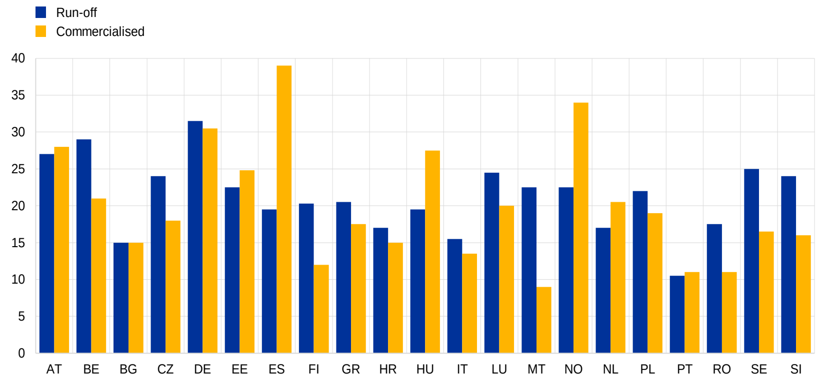
Corporate bond spreads



Source: Bank of America Merrill Lynch, latest observations are for 31 March 2019

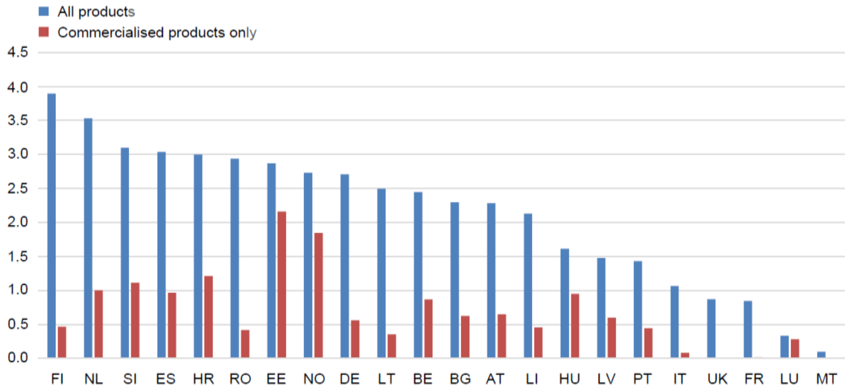
The low interest rate environment puts pressure on the profitability of life insurance companies, in particular those with guaranteed-return business models

Weighted-average period for which interest rate guarantee is expected to apply



Source: [Report on long-term guarantees measures and measures on equity risk 2018](), EIOPA, December 2018. Latest observations are for December 2017

Average guaranteed interest rate for life insurance with profit participation

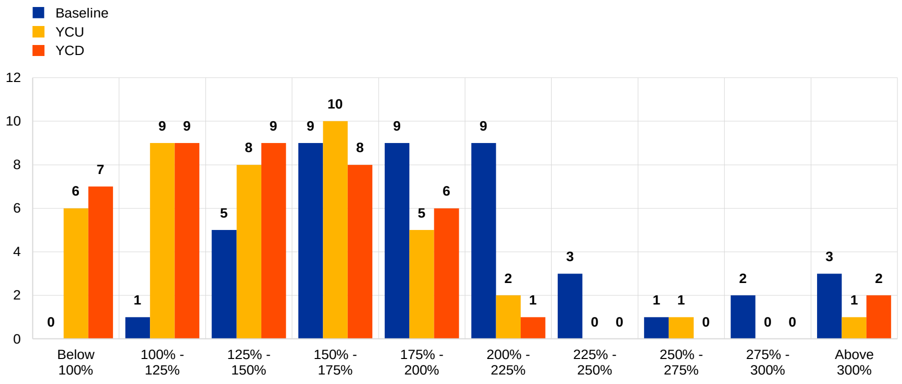


Source: [Report on long-term guarantees measures and measures on equity risk 2018](), EIOPA, December 2018. Latest observations are for December 2017

EIOPA stress-test scenarios highlight some of the main risks for the insurance sector (tested on 42 insurance groups, 75% market coverage)

- Risk of a prolonged low interest rate environment, which might increase concerns on the solvency of insurers
  - Need of appropriate risk measurement via a **more realistic risk-free rate term structure** using market-based inputs
  - **Recovery and Resolution regime**
- Risk of a Japanese-like scenario of increased surrenders if assets do not cover technical provisions
  - Tools to **assess and control liquidity risk**
  - **Discretionary intervention powers** in case of mass lapses
- Risk of increase in risk premia, e.g. on bonds
  - Need to **build-up reserves** on fixed-income instruments **that can be released in times of needs**

Distribution of solvency ratios in baseline, "yield curve up" and "yield curve down" stress-test scenarios



Source: 2018 insurance stress test report, EIOPA

Overview

Introduction

- **EIOPA published an Opinion** on the Harmonisation of Recovery and Resolution Frameworks for (Re)Insurers in the EU (2017)
- **ESRB published a Report** on Recovery and resolution for the EU insurance sector: A macroprudential perspective (2017)
- Both institutions advocate for a **minimum degree of harmonisation** in this field
- The lack of harmonisation makes **cross-border cooperation and coordination more difficult**
  - A patchwork of national rules cannot fully take account of the cross-border implications
  - Potential legal uncertainty, unequal treatment of policyholders, and potential spillover effects
  - Policyholder protection and financial stability objectives might not be met
- Work ongoing on **Call for Advice** on this topic

Areas for harmonisation

	Building blocks
Preparation and planning	1) Pre-emptive recovery planning
	2) Pre-emptive resolution planning
	3) Resolvability assessment
Early intervention	4) Early intervention conditions
	5) Early intervention powers
Recovery	*Solvency II ladder of intervention*
Resolution	6) Resolution authority
	7) Objectives
	8) Conditions
	9) Powers
	10) Safeguards
Cooperation and coordination	11) Cross-border cooperation and coordination arrangements

Scope should cover all (re)insurers subject to Solvency II, but…

…Proportionality is a fundamental principle

Both FS and policyholder protection objectives are relevant

Key messages

Subject to the **proportionality principle…**

- **Pre-emptive plans and assessments** (recovery planning, resolution planning and resolvability assessments) should be required

- A common set of **early intervention measures** should be in place, but no hard triggers

- Need to expand the **resolution toolkit** (incl. restructure of liabilities), but they should be exercised subject to strong safeguards

- Arrangements for **cooperation and coordination** for crisis situations (e.g. CMGs) should be established

- An effective RR framework should also consider the funding arrangements and, in particular, the **issue of IGS**

Overview

Insurance Guarantees Schemes

- **Significant differences** exist across Members States
  - Scope of coverage
  - Funding
  - Functions
- This **fragmentation creates particular problems** in the presence of failures involving cross-border business
- If IGSs are not properly equipped to compensate policyholders for their losses, **public trust** might also suffer
- **EIOPA has consulted** on its Advice on the harmonisation of national insurance guarantee
  - Consultation period: 12 July 2019 – 18 October 2019

Insurance Guarantees Schemes

- **The draft Advice addresses the following areas:**
  - Role and functioning
  - Geographical coverage
  - Eligible policies
  - Eligible claimants
  - Coverage level
  - Funding
  - Disclosure
  - Cross-border cooperation and coordination

Thank you for your attention