

Gabriel Bernardino
Chairman



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EIOPA RESTRICTED USE

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Dear Mr Jones, *Dear Olav,*

Thank you for sharing the comments of Insurance Europe on EIOPA's communication of the 2018 Insurance Stress Test results. Our continuous constructive dialogue is key in achieving our common goal of promoting financial stability and further enhancing transparency within the insurance sector.

The observations stated in your letter are mainly related to some elements of the communication of the results and not to the technical elements of the exercise. I attribute this positive fact to the fruitful and extensive consultation with industry representatives during the design phase of the exercise.

As regards EIOPA's communication our aim is always to provide a balanced overview of the stress test results by presenting both the high resilience as well as the potential risks and vulnerabilities of the sector. To this aim, the report is kept factual and limited to the evidence that emerged by the application of the shocks. Furthermore, the non-pass/fail nature of the exercise as well as the simplifications applied to the recalculation of the post-stress capital position of participants are reported and both highlighted in the executive summary and explained in detail in the report. Therefore, any considerations on the potential misinterpretation of the necessary capital levels are not supported by EIOPA's communication.

Allow me to clarify some of your specific remarks:

Regarding the potential effects on financial stability, indeed the exercise revealed some vulnerabilities that may pose concerns for the financial stability of the European insurance sector. EIOPA's messages factually provide the overview of the findings based on pre- and post-stress balance sheet and capital positions at aggregate level. Figures are complemented by a description of the potential vulnerabilities, which again has been kept factual.

More specifically, on the figures assessed, the report follows a structured approach in presenting the results, based on the analysis of the Assets Over Liabilities (AoL) followed by the analysis of the capital position (SCR ratio) and of its constituents (e.g. Own Funds and SCR). The related communication adopted the same structure with a focus on the key indicator, namely the SCR ratio for the first time calculated in a post-stress situation. Given that the excess of AoL is the main constituent of the Own Funds, which is a key element of

the Solvency II framework, it is not surprising that this element is considered important by journalists, analysts, etc. Nevertheless, the numbers in excess of AoL are always complemented by the AoL ratios making a clear distinction between the two indicators. The correct interpretation of the results is related to the level of knowledge of the insurance business. Increasing the understanding of the fundamentals of the insurance business and of the Solvency II framework is another area that both EIOPA and industry should work on and join forces. Limiting the information provided to the public does not support that direction.

With respect to the communication of the results, both the report and press release communicate both Assets over Liabilities and SCR numbers and in this order. Hence, a primary focus on post-stress SCR positions cannot be inferred from EIOPA's communication. References to post stress capital positions do not suggest a pass-or-fail nature of the exercise. Although there are a lot of technical challenges in calculating SCR post-stress positions, this exercise provides the first important step to estimate post-stress capital levels, clearly stating all implied limitations. Two years after the full implementation of Solvency II, the evaluation of potential vulnerabilities of the sector cannot be limited to the comparison of the balance sheet position before and after stresses. In this respect, a full vulnerability analysis and assessment requires a reference to the capital position under the new circumstances. The aim is not to conclude on the current amount of regulatory capital or its sufficiency, but to anticipate potential management and supervisory actions that may contribute to avoid any potential systemic risk build-up in the future.

Stress tests are preventive exercises where different scenarios are tested and vulnerabilities assessed from a market stability perspective. The indicators used aim at assessing two fundamental questions in the event such scenarios materialise:

- Are insurers able to meet their liabilities from existing assets?
- Are insurers in a position to meet their solvency requirements?

From a market stability perspective, it is fundamental to understand the impact of the shocks to both these aspects and the potential gap. EIOPA's focus is identifying vulnerabilities and how to manage and mitigate them. We do not expect that insurers need to have sufficient capital to withstand all possible scenarios tested in a stress test exercise.

The scenarios tested reflect the key risks for financial stability of the insurance sector identified by EIOPA. The design of the scenarios and the calibration of the market shocks were prepared in cooperation with the ESRB, using the ECB's financial shock simulator. The tool defines the shocks to the markets by applying the concept of conditional expected shortfall to historical observations, hence preserving the market consistency of the scenarios. In this respect, the scenarios are severe but plausible. The same applies to the so-called insurance specific risks defined and calibrated in line with the narratives, specifically:

- The decrease of the UFR reflects the economic rationale to stress not only the short-term, but also long-term part of the risk free rate curve in line with the narrative of the YCD scenario. In the 2018 exercise, this approach was deemed a preferable alternative rather than using purely market rates for the long end of the curve in order to assess financial stability considerations.
- Consistent to the Stress Test framework, which is based on the concept of instantaneous shocks, any management action that was not in place at the reference date was not allowed in order to achieve comparability of the results. The assessment of possible management actions is an expected constituent of the follow

up actions to the stress test exercise and the dialogue between participating groups and supervisors.

Regarding the goal of increasing transparency of the results and of the sector as a whole, as known, Solvency II figures at the reference date shall be considered as the baseline, pre-stress situation. Our exercise assesses the situation that insurance undertakings would eventually face if certain severe scenarios materialised. For this assessment, the participants were required to recalculate their balance sheet and capital requirements taking fully into account the new changed circumstances.

More specifically:

- The Solvency and Financial Condition Report (SFCR) provides information under SII baseline scenario complemented by sensitivity analyses. These data are valuable from a micro-prudential perspective but do not provide sufficient information from a financial stability perspective. A meaningful assessment can only be done by the estimation of the impacts of common severe but plausible scenarios.
- EIOPA is well aware of the complexity of the assessment of the post-stress capital position and the challenges to ensure more consistency in its calculation. For that reason, and in order to avoid any misinterpretation of these results, EIOPA did not ask for their individual disclosure. The request for individual public disclosure was limited to balance sheet figures up to the AoL.
- LTG and transitional measures are part of the SII framework therefore the post-stress situations are always assessed taking them into account. However, from a pure economic perspective, the impacts of the prescribed shocks are assessed also without the measures thereof. Well aware of the permanent and temporary nature of the LTG and transitional measures, EIOPA disclosed the impact of the shocks individually identifying the effects of transitional and LTG measures.

Undoubtedly, EIOPA believes that transparency will increase market discipline, improve the level playing field and increase confidence in the exercise and most importantly in the sector itself. The lack of transparency on the individual results creates unnecessary uncertainty and clearly limits the market discipline objective that could result from a mature and open communication of the actions to mitigate potential vulnerabilities.

EIOPA remains committed to continuously enhancing its stress testing methodological toolkit. In this effort, we are looking forward to continue our fruitful cooperation. Besides hoping that the explanation provided helps clarifying EIOPA's position, I strongly believe that it can also serve as a basis for further discussion and mutual understanding.

Yours sincerely,



Gabriel Bernardino

Cc: Martin Merlin, Director for Regulation and Prudential Supervision of Financial Institutions, DG-FISMA, European Commission

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