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From:	General Secretariat of the Council
To:	Financial Services Committee
Subject:	FSC 20.01.21 Item 3: Solvency II Presentation by the ESRB

ESRB
European Systemic Risk Board
European System of Financial Supervision

ESRB update on first lessons learned on COVID-19 for insurance

FSC

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Solvency II review

- Over recent years, the ESRB has developed policy proposals for the insurance sector
  - Solvency II and EIOPA made individual insurers safer
  - There is the need to have a comprehensive regulatory framework beyond microprudential policy to ensure insurance can fulfil its essential role even during crises
  - Complement Solvency II with recovery and resolution regimes
  - And with macroprudential policy looking beyond individual insurers and across sectors

- The COVID-19 pandemic is not yet over, but first lessons can be learned

- This helps to complement the policy proposals made over recent years

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Five first lessons learned from COVID-19 for the insurance sector

1. The systemic importance of certain insurance activities for the functioning of the economy
2. The need to build up a buffer of capital ex-ante that provides additional resilience when needed
3. The power for supervisors to restrict distributions
4. The volatility of the solvency capital requirements ratio
5. The enhancement of liquidity risk management requirements, better liquidity monitoring and the power for supervisors to act on liquidity

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1. 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 economy
  - Credit insurance is a good example as governments had to step-in during the crisis to support it

- Financial stability objectives can serve policy holder needs and should be considered as important for different frameworks, including recovery and resolution

- Strengthen microprudential framework with a macroprudential toolkit to ensure the continuity of insurance services and functions

2. The need to build up a buffer of capital ex-ante that provides additional resilience when needed

- Insurers need to be able to finance the economy through the cycle
- ECB statistics show that in net terms, insurers sold more bonds, equities and shares of funds than they bought in the first quarter of 2020
- To smooth the impact of fall in financial markets, new volatility adjustment and transitional measures were granted in some jurisdictions
- There are better countercyclical tools: capital buffers built ex-ante, as they can be released against losses during crises

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3. The power for supervisors to restrict distributions

- EIOPA and the ESRB stressed the importance to restrict distributions during such a period of uncertainty
- The power to restrict or suspend dividend pay-outs is lacking
- Supervisors need to have this power even when the SCR is not breached
- And across the insurance sector under clearly defined circumstances

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4. The volatility of the solvency ratio

- The volatility adjustment (VA) and symmetric adjustment for equity risk (SAE) attenuate solvency ratios volatility which is due to financial markets, but shortcomings were observed
- For the SAE: the 10 basis points cap should be increased symmetrically
- For the VA: over and undershooting effects
  - Counter-intuitive results due to basis risk: in some countries, insurers recorded a significant increase of their solvency ratio with VA
  - Timely activation of country component
- Transforming the VA into a symmetric adjustment applied on assets and forming a buffer of own funds would also mitigate credit spreads' volatility

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5. The enhancement of liquidity risk management requirements, better liquidity monitoring and the power for supervisors to act on liquidity

- Evidence of liquidity tensions in several market segments
  - Commercial paper and corporate debt markets
  - Drying up of new business in some countries affected by lockdown measures
  - Exceptionally large margin calls on derivative positions
- Liquidity poses two risks
  - Not being able to honour obligations in time
  - Forced to liquidate assets (spill-over risk), e.g. in money markets
- Exceptional and temporary monitoring by EIOPA: should be extended in time and scope
- Beyond monitoring, need for a liquidity framework adapted to insurance
- Including the power for supervisors to act via means of a liquidity buffer for insurers with a vulnerable liquidity profile

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To conclude

- Solvency II review is the opportunity to complement the framework from a macroprudential angle
- With new discretionary powers for supervisors – on liquidity, capital buffers and distributions
- With more symmetrical tools that are built in good times and released when needed

References:

- ESRB response to COM consultation
- ESRB recommendation on restriction of distributions
- ESRB response to EIOPA consultation
- ESRB letter to EIOPA on liquidity
- ESRB report on Solvency II review
- ESRB framework on macroprudential tools for insurance
- ESRB report on risk-free interest rate term structure
- ESRB report on recovery and resolution in insurance

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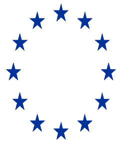

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Thank you

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