German Insurance Association

SOLVENCY II

Position Paper

of the German Insurance Association (GDV)
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on the implementation of macroprudential provisions in the context of the Solvency II review

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1. Introduction

Against the background of the crises of the past years and structural developments that have increased systemic risk in the financial system, macroprudential policy has gained in importance, and the macroprudential framework in the European Union is under review. In the Solvency II review, macroprudential supervision of the insurance sector has been an important issue. The resulting amendments to the Solvency II Directive establish new macroprudential tools for the insurance industry. In addition, extensive macroprudential requirements are explicitly integrated into insurers' ORSA und investment strategies. Further specifications of the new macroprudential instruments and measures will be provided via regulatory technical standards and guidelines to be developed by EIOPA.

The insurance industry has shown its resilience during the shocks and crises of the past years. The existing regulatory and supervisory regime, which already contains various macroprudential elements (e.g. stress tests, volatility adjustment, risk dashboards and financial stability reports), has performed well. As there is limited systemic risk in the sector that remains to be addressed, it is crucial that the implementation of the new macroprudential tools and measures in Solvency II is well-balanced, risk-oriented and proportionate. They should also be consistent with developments and requirements of international standards, in particular with the ICP and ComFrame of the IAIS. Unnecessary burdens on industry and supervisors that do not lead to a commensurate contribution to financial stability should be avoided.

2. Macroprudential considerations as part of ORSA and investment strategies

Amendments to the Solvency II Directive

With the Solvency II reform, the integration of macroprudential concerns into ORSA (Art. 45) and prudent person principle (PPP, Art. 132) is explicitly prescribed, and minimum requirements are set. All insurers have to consider and analyse the macroeconomic situation and possible macroeconomic and financial markets' developments, including, e.g., inflation and interconnectedness with other financial market participants. Those insurers that are subject to a reasoned request by their supervisor have to consider and analyse wide-ranging additional macroprudential aspects in their ORSA and PPP. These include any macroprudential concerns and input factors the supervisor shares with the undertaking. Further, these undertakings have to consider and analyse the activities of the undertaking that may affect the macroeconomic and financial markets' developments and have the potential to turn into sources of systemic risk. This analysis also has to be incorporated as part of their investment decisions.

EIOPA is tasked with drafting regulatory technical standards (RTS) specifying the criteria to be taken into account by supervisory authorities when defining the insurers subject to the additional macroprudential requirements (Art. 144d).

GDV position

Macroprudential factors (e.g. interest rates, business and credit cycles) are material risks for the insurance sector. They have always been part of insurers' ORSA and investment strategies. The insurance industry welcomes the clarifications provided in this regard. However, in implementing the new requirements, a proportionate and risk-oriented approach is crucial. In particular, **application of the additional macroprudential requirements should remain limited to exceptional cases with a clear supervisory rationale.** E.g., a minimum market share would certainly not be adequate.

Given the very low contribution of the vast majority of individual insurers to systemic risk, the potential benefits of a broader application of the extensive macroprudential requirements to financial stability would be very small and do not justify the substantial costs involved. In any case, for the individual undertaking, it will be very difficult to determine its potential contribution to sources of systemic risk (e.g., because of interdependencies between actions of market participants) or to incorporate such considerations as part of their investment decisions, potentially resulting in conflicts with policyholders' interests. It is important that ORSA and PPP retain their character and are not over-loaded with additional goals that could impair their core purpose.

3. Liquidity risk management

Amendments to the Solvency II Directive

In view of the structural changes that have increased the importance of liquidity risk in the financial system, the amendments to the Solvency II Directive introduce new tools and supervisory powers aimed at liquidity risk. All insurers with the exemption of small and non-complex undertakings will have to draw up and keep up to date a liquidity risk management plan (LRMP) covering liquidity analysis over the short term, projecting the incoming and outgoing cash flows in relation to their assets and liabilities (Art. 144a). Those insurers subject to a supervisor request have to extend their LRMP to additionally cover liquidity analysis over the medium and long-term. EIOPA is tasked with developing RTS, firstly, on the content and frequency of update of the LRMP, and secondly on the criteria to be taken into account by supervisory authorities when defining the insurers which are requested to cover the medium and long term (Art. 144d).

Further, new supervisory powers to address severe liquidity vulnerabilities are introduced, in particular, the power to temporary restrict or suspend dividend payments, share buybacks or variable remuneration, and the power to temporary suspend redemption rights of life insurance policyholders (Art. 144b). EIOPA is tasked with developing guidelines, further specifying the measures to address deficiencies in liquidity risk management and on the form, activation and calibration of powers that supervisory authorities may exercise to reinforce the liquidity position of undertakings when liquidity risks are identified and are not adequately remedied by these undertakings. In addition, EIOPA guidelines will further specify the supervisory power to temporary suspend policyholders' redemption rights, firstly, regarding the existence of exceptional circumstances that may justify this measure and secondly, the conditions for ensuring the consistent application across the EU and the aspects to consider for equally and adequately protecting policyholders in all home and host jurisdictions.

GDV position

Due to the specific characteristics of the insurance business – long-term orientation, stable financing of liabilities, pre-financing of insurance benefits through insurance premiums and the link of most insured events to external causes – liquidity risk in the insurance industry is much less pronounced than in some other sectors, e.g. banks or certain investment funds. **For most insurers, liquidity risk is very moderate.** Also, the current Solvency II provisions already require insurers to effectively manage their liquidity risks. This should be taken into account in implementing the new macroprudential provisions aimed at further mitigating liquidity

risk. An appropriate design of measures and tools is necessary that is aligned with potential systemic risk but is also cost-efficient and avoids negative side effects.

With respect to the content and frequency of updates of liquidity risk management plans, flexibility is needed, e.g., regarding the scope, form and granularity in order to align the LRMP with the actual liquidity risk of the insurer. Such a risk-oriented and proportional approach is also in line with the requirements of the IAIS (ICP 16.9.5 and ComFrame 16.9.b.2 and No. 1.4 of the "Application Paper on Liquidity Risk Management"). **Overly prescriptive requirements for liquidity risk management plans should be avoided**. Unlike solvency risks, liquidity risks are mostly characterised by their short-term nature. Therefore, **supervisory requests to cover the medium and long term in their LRMP should be limited to exceptional cases with a clear supervisory rationale**.

Regarding the EIOPA guidelines further specifying the new macroprudential tools to mitigate liquidity risk, a proportionate and risk-oriented approach is crucial as well. In particular, when considering additional tools to remedy severe liquidity vulnerabilities and their calibration a full cost-benefit analysis is necessary in order to avoid undue burdens on insurers and supervisors or negative side effects on policyholders and financial markets that might exceed the benefits to financial stability.

The new tool "suspension of life insurance policyholders' redemption rights" is rightly designed as a measure of last resort. Such a strong tool has to be handled with great care in order to avoid undesirable effects (e.g. an impairment of trust in private old-age provision). It should be prescribed clearly, that the application of this tool is limited to the manifestation of the (very remote) risk of mass surrender, with the aim of preserving value and potentially preventing the need to use even more drastic measures within the resolution toolkit. For this tail event, it would be a highly effective way of quickly controlling liquidity risk.

4. Restriction on distributions during exceptional sector-wide shocks

Amendments to the Solvency II Directive

Art. 144c introduces the supervisory power to restrict or suspend dividend distributions, share buy-backs and variable remunerations to preserve the financial position of undertakings with a particularly vulnerable risk profile during exceptional sector-wide shocks.

EIOPA is tasked with developing RTS to specify the criteria for the identification of exceptional sector-wide shocks.

GDV position

From the viewpoint of the insurance industry, supervisory powers to restrict insurers' distributions for macroprudential purposes are a very strong instrument with potentially very negative side effects on the financing conditions faced by insurers. In addition, it could easily prove counterproductive in a crisis and even increase systemic risk, e.g., because of the negative impact on investors' liquidity situation. For these reasons, **GDV very much doubts its suitability as a macroprudential tool for the insurance sector.**

Therefore, with respect to the RTS specifying the criteria for the identification of exceptional sector-wide shocks, a very careful and restrictive approach is needed. The empirical evidence from the crises of the past years (Covid-19 pandemic, Russia's attack on Ukraine) shows, that even during those severe shocks to the economy and the financial system such a measure was not needed to ensure the stability of the insurance sector. The stable and resilient financial position of the insurance industry under severe stress scenarios has also been demonstrated by EIOPA's insurance stress tests.

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