EIOPA 16/297
15-12-2016

# EIOPA's Insurance Stress Test 2016

# Recommendations

## Introduction and legal basis

1. During the course of 2016, EIOPA carried out a European-wide stress test in accordance with Articles 21(2)(b) and 32 of Regulation (EU) 1094/2010 of 24 November 2010 of the European Parliament and of the Council (hereafter the 'Regulation').
2. The Recommendations contained in this document are issued in accordance with Article 21(2)(b) of the Regulation in order to address issues identified in the stress test.
3. In order to facilitate follow-up actions to the recommendations, this document also contains an information request in relation to Recommendation 3. This request is based on Article 35 of the Regulation.
4. EIOPA will support national supervisory authorities and undertakings through guidance and other measures if needed.
5. The present set of Recommendations is published on EIOPA's website.

## Context

6. The results and findings of EIOPA's Insurance Stress Test 2016 exercise are set out in detail in the report "2016 Insurance Stress Test Report" published by EIOPA on 15th December 2016.
7. In the first year of application of the Solvency II regime, this stress test was focused on the financial risks which were viewed as the biggest threat to the stability of the European insurance market, and with a large coverage of the market segment most vulnerable to these risks, namely solo undertakings offering life products with any kind of interest rate guarantees.
8. Two stress scenarios were tested in the 2016 exercise, i.e. a prolonged low yield (low-for-long) scenario and a double-hit scenario. A detailed description of both scenarios can be found in Annex I of the 2016 Insurance Stress Test Report.
9. The low-for-long scenario aims at emulating a situation of entrenched secular stagnation which drives down yields at all maturities.
10. The double-hit scenario was set-up by EIOPA in cooperation with the ESRB reflecting the risk of a sudden increase in risk premia combined with a continuing low yield environment.

11. EIOPA’s Insurance Stress Test 2016 is designed as a vulnerability analysis and does not attempt to assess capital requirements for the industry after the shocks. Furthermore, the ‘non pass/fail’ nature of the exercise allows departures from the strict application of the Solvency II regime. It also supports the testing of extreme albeit plausible scenarios.

12. The exercise was carried out with a sample of 236 solo undertakings from 30 countries. These undertakings were selected for participation as they were perceived as potentially more vulnerable to current market risks due to relatively long-term life business involving interest rate guarantees. Therefore, the sample consists mainly of life undertakings, or undertakings performing both life and non-life insurance activities. Overall, a market coverage of 77% in terms of the relevant business was achieved, consistent with the aim of performing a targeted exercise with significant market coverage.

13. From a regulatory point of view, the selected sample was adequately capitalized in the baseline scenario (market snapshot at reference date of 1 January 2016) and at European level. The overall surplus (i.e. eligible own funds in excess of the Solvency Capital Requirement) for the sample was reported at 280 billion euro, with an aggregate Solvency Capital Requirement ratio of 196%. The majority of the undertakings in the sample made use of the long-term guarantees measures as legally allowed under the Solvency II regime. The transitional measure on technical provisions was used by less than 20% of the sample, while only 1% used the transitional on interest rate.

14. The exercise highlighted the vulnerability of the insurance sector to the low interest rate environment. The materialisation of such a scenario exerts further pressure on business models offering long term guarantees.

15. Considering the above, EIOPA publishes a set of general Recommendations in relation to the vulnerabilities identified and the potential impact on the financial stability of the EU insurance sector.

16. National supervisory authorities are attentive to the challenging current financial environment and have taken actions to ensure smooth transition and adequate capitalisation in the first year of Solvency II implementation. Part of this effort was reflected in the follow-up of the Recommendations following the 2014 insurance stress test. The new set of Recommendations based on the results of the 2016 exercise aims at continuing and further enhancing the cooperation and coordination of actions at European level.

## Recommendations under Article 21(2)(b) of the EIOPA Regulation

17. The Recommendations set out in this document are addressed to all National Supervisory Authorities in the EU and EEA National Supervisory Authorities.

18. The Recommendations relate to the findings of EIOPA’s 2016 Insurance Stress Test as outlined in Section 3 of the 2016 Insurance Stress Test Report.

19. EIOPA will undertake a coordinating role in the follow up of the Recommendations.

## Recommendation 1

20. The stress scenarios indicate significant vulnerabilities for the sample. The double-hit results in a decline of total assets of almost 610 billion euro and a decline in liabilities of 450 billion euro. As a result, this scenario has a negative impact on the balance sheet of undertakings of close to 160 billion euro at EU/EEA level. In the case of the low-for-long scenario, the negative impact coming from an increase in liabilities of 380 billion euro is larger than the capital gains on the asset side, resulting in a decrease of assets over liabilities of about 100 billion euro.

21. As described in detail in Annex I of the 2016 Insurance Stress Test Report, the double-hit represents a plausible but extreme scenario and conclusions should be drawn under this prism. Nonetheless, results are not spread equally across the sample and there seems to be a number of conditions and portfolio structures that make undertakings more vulnerable to such an event.

22. The low-for-long scenario requires a different type of interpretation of the results and follow-up supervisory actions. The impact, although lower than in the double-hit, remains significant at the EU level. Furthermore, the debate over the future course of interest rates seems to indicate that the low-for-long scenario is more relevant and most challenging for undertakings than a scenario of raising interest rates. In this context, the realisation of a scenario where interest rates remain low for a prolonged period of time, especially for the very long maturities, cannot be ruled out.

23. National supervisory authorities are recommended to take the actions defined in points a) to c) below as short-term measures to ensure that undertakings align their internal risk management processes to external risks faced by these undertakings.

   a. Encourage undertakings, when relevant, to assess the risk of the prolonged low interest rate scenario and the risk of a sudden increase in risk premia in their forward looking analysis as part of their Own Risk and Solvency Assessment.

   b. During their normal supervisory process, assess whether undertakings, induced by the current low yield environment, are revising their risk appetite or are pursuing portfolio allocations that go beyond their risk bearing capacity.

   c. Assess the viability of business models that are more vulnerable to the low-for-long scenario. This assessment could take place within the Risk Assessment Framework, taking into account that the impact of this scenario is spread over a number of years that may well exceed the decade, but without neglecting the risks involved due to the slow burning nature of the scenario. In this process, the following measures should be considered:

      - requesting a reduction in the maximum guarantees or in unsustainable profit participations offered, in new business
      - requesting a cancellation or deferral of dividend distribution.

## Recommendation 2

24. In order to better reflect on the different balance sheet characteristics at the national or at the product type level, the 2016 Insurance Stress Test Report further elaborates the analysis of the liabilities in the low-for-long scenario based on the cash flows reported. The results on the average maturity of liabilities based on Macaulay duration are consistent with the results of the 2014 stress test. In order to analyse the sensitivity of the liabilities to changes in interest rates, an approximation of the effective duration was tested for the first time in the 2016 exercise in an attempt to take into account the optionality embedded in the insurance contracts. A significant number of assumptions considered in the valuation of the technical provisions needs to take into account the different optionalities embedded in the insurance products or stemming from management strategies. Those assumptions require supervisory assessment in order to assure their validity and the consistency of results across insurance undertakings and countries.

25. The results displayed in the 2016 Insurance Stress Test Report exhibit the importance of the diversification tools which can affect the best estimate. The projection methodologies can have important effects on the value of the best estimates, in particular, the ability to model the negative interest rates, the reliability of the economic scenario generators or the credibility of the future management actions used for all simulations.

26. National Supervisory Authorities are recommended, subject to the principle of proportionality, to take the actions defined in points a) and b) below as medium-term measures to ensure an appropriate balance between solvency and financial stability objectives and the policyholder protection.

   a. Review and assess undertakings' models regarding the behaviour of management and policyholders, including the legal capacity and willingness to take the decisions that are modelled. Particular attention should be given to those dynamic models that can have significant effect on the value of the best estimate of technical provisions.

   b. The clauses of the guarantees, their typologies, and the optionalities they carry should be analysed to assess the value of the guarantees which companies are exposed to, the associated risks and whether the valuation of the technical provisions can be considered proportionate and prudent.

## Recommendation 3

27. EIOPA's Insurance Stress Test 2016 is designed as a vulnerability analysis and it does not attempt to assess capital requirements for the industry after the shocks. In the first year of application of Solvency II the scope was limited to solo undertakings and no recalculation of the Solvency Capital Requirement or Minimum Capital Requirement post stress was required.

28. In order to provide an indication on how an adverse scenario affects the sector, the impact in the excess of assets over liabilities is assessed. In the double-hit, 104 companies, constituting more than 40% of the stress test sample would lose more than a third of their total excess of assets over liabilities. In the low-for-long scenario, 38 undertakings (16% of the stress test sample) would see more than a third of their excess of assets over

liabilities lost. These figures may pose noteworthy threats at group level as well. Although the stress test exercise refers to the single entity (solo) level, the potential consequences for the group should not be overlooked.

29. National Supervisory Authorities are recommended to take the actions defined in points a) and b) below as a short term measure.

   a. Assess the importance of the stress test impact for the group, based on the vulnerabilities (loss of excess of assets over liabilities) at the solo level. In this context, the measures that groups are able to take to support their related undertakings, should be assessed.

   b. As part of the work of the Colleges of Supervisors, collect information on the impact and potential support at group level, considering management actions as well as diversification effects. Group supervisors are recommended to apply the proportionality principle in deciding the scope of this assessment.

## Information request under Article 35 of the Regulation

30. In relation to Recommendation 3, National Supervisory Authorities responsible for group supervision are requested to inform EIOPA by 31 October 2017 on the impact that the results of the stress test participating undertakings would have at group level and the possible actions taken.