EIOPA-BoS-16/219-rev
25 October 2016

EC Consultation on the Review of the EU Macroprudential Policy Framework

-EIOPA Response-

Important note*: Please note that only responses received through the online questionnaire will be taken into account and included in the report summarising the responses (see http://ec.europa.eu/finance/consultations/2016/macroprudential-framework/index_en.htm). EIOPA will turn the approved document into the online questionnaire and intends to publish the document on the Website.*

1. In August 2016, the European Commission launched an open consultation for the review of the EU macroprudential policy framework (the 'consultation document'). The European Insurance and Occupational Pensions Authority (EIOPA) is responding to the COM consultation on the Review of the EU Macro-prudential Policy Framework under the provisions of Articles 23 and 33 of Regulation No. 1094/2010 of the European Parliament and of the Council[1] since the consultation document concerns issues related to EIOPA's area of competence.

Preliminary observations

Scope of EIOPA response

2. EIOPA welcomes the opportunity to contribute to the review of the EU Macroprudential policy framework. EIOPA has already done some work in this field. For example a recent EIOPA paper explicitly considered the macroprudential objectives in light of the current low interest rate environment.[2]

[1] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

[2] EIOPA (2016): *A potential macroprudential approach to the low interest rate environment in the Solvency II context*, published in March 2016. See link

3. EIOPA's response will focus on the insurance and Institutions for Occupational Retirement Provision (IORPs) related aspects, leaving aside other elements of the financial sector.

<u>Governance of and cooperation with the European Systemic Risk Board (ESRB)</u>

4. A fundamental element for developing a macroprudential framework lies on the identification and measurement of systemic risk. As stressed in Article 23 of EIOPA Regulation, EIOPA shall, in consultation with the ESRB, develop criteria for the identification and measurement of systemic risk and an adequate stress testing regime which includes an evaluation of the potential for systemic risk that may be posed by financial institutions to increase in situations of stress.
5. In this regard, EIOPA would like to stress its disposition to continue and further enhance its cooperation with the ESRB with respect to assessing risks and vulnerabilities beyond the banking sector. EIOPA's work could also be a useful supplement to the ESRB's work on macroprudential policy, particularly considering the holistic view that the ESRB has of the financial sector as well as the potential cross-sectorial implications.
6. Another general observation concerns the ESRB governance (questions 36 to 38). As the focus of the work of the ESRB could shift to include more activity on non-banking institutions, the technical and supervisory expertise of non-banks competent authorities– national competent authorities and ESAs alike – will be crucial. EIOPA sees a clear need to ensure adequate sectoral expertise in the discussions, particularly at the Advisory Technical Committee and General Board. It should be ensured that any potential expansion of the macroprudential framework beyond banking is discussed and agreed with an adequate involvement of the relevant insurance and occupational pensions' regulators including EIOPA in the decision-making process.

<u>Resources</u>

7. Finally, EIOPA is of the view that a new and extended EU macroprudential policy framework, covering the insurance and occupational pension sectors, would inevitably increase its involvement in the implementation of that framework. In this respect, additional resources to carry out implicit new tasks, such as gathering and processing additional data (which would then also be shared with the ESRB) as well additional analytical resources must be available. Thus, the issue of additional resources would not only affect the ESRB, but also the NSAs and ESAs.

Specific Questions Posed in the Consultation

8. EIOPA has identified section II.1.2 of the consultation document as the most relevant section for insurance and IORPs. In particular, Question 2 refers to expanding the macroprudential framework beyond banking, and is split into two sub-questions, posed in the following terms:

> *Q2: (a) Would you consider appropriate to expand the macroprudential framework beyond banking? [Please rank your answer from 1 (fully appropriate) to 5 (fully inappropriate), and explain your scoring.] (b) If*

deemed appropriate, what kind of systemic risks should be targeted and how?

Q2 (a) – Potential need to expand the framework beyond banking

9. EIOPA would rate the **need for an expansion** of the macroprudential framework to insurance and IORPs with the score 2. Further explanations distinguishing insurance and IORPs are provided below.

Expansion to insurance

10. Regarding insurance, three main issues need to be considered. First, Solvency II, the new prudential framework in the EU, has entered into force only recently (1 January 2016). This has two main implications:
    a) The industry and all relevant stakeholders (NSAs, policyholders, investors, etc.) are currently adapting to the new approach and to new requirements derived from Solvency II; and
    b) Although Solvency II was not designed as a macroprudential framework, it contains elements that may have a macroprudential impact. Among those, the following could be mentioned: the symmetric adjustment in the equity risk module, the volatility adjustment, the matching adjustment and the possibility to extend the recovery period, particularly in exceptional adverse situations.[3] Due to the recent implementation of Solvency II, the macroprudential implications of some of these measures as well as the potential impact on the behaviour of insurers cannot be fully foreseen at this stage.
11. Second, although the issue of systemic risk in insurance has been more extensively analysed than in the IORP sector, it is still far away from the existing knowledge in the banking sector. This issue will be further elaborated in the answer to Q2 (b).
12. Third, although the insurance sector appears to be more stable to the impact of the financial crisis than the banking sector in the short term, insurance is a key element of the financial system and, as such, may be considered within the scope of a possible extension of the EU macroprudential policy framework. Furthermore, the insurance and IORP sectors are also affected by severe challenges like the protracted low interest rate environment, which creates pressure particularly on certain business lines, such as those products offering guaranteed returns.
13. The above calls for an extended **timeline** to assess the need to recalibrate existing or to add additional new tools in order to properly avoid the build-up of systemic risk in the insurance sector. This would also be in line with the gradual approach taken so far to the development of the EU macroprudential policy framework. EIOPA is of the view that any potential additional macroprudential tools or policy should be discussed in the context of the Solvency II review. This would contribute to ensuring consistency and complementarity between both the macro and micro prudential frameworks.

[3] For more information, see EIOPA (2016), section 4.

14. Another fundamental aspect refers to the **approach** that needs to be taken when considering whether the EU macroprudential policy framework should be expanded to insurance. Three principles should be followed:

    - Any expansion to the insurance sector should be implemented in a way that fully takes into account its specific nature, which results from its business and funding models, as well as the risks that the sector as a whole poses to the rest of the financial system.
    - A proper balance needs to be struck between maintaining the stability of the financial system on the one hand and avoiding an overreaction that could be harmful for the sector and economy as a whole in the long-run on the other. Naturally, it would also need to be ensured that any instruments considered, effectively contribute to mitigating systemic risk and enhancing the stability of the financial system and not creating any unintended consequences.
    - The protection of policyholders should still be the primary objective resulting from the interaction between micro and macro prudential policies.

15. EIOPA (2016) approaches the issue of a macroprudential framework in insurance by applying a stylized framework that considers one final objective (i.e. the achievement of a stable financial system supporting a long-term economic growth), two intermediate objectives in which the final objective can be broken down (i.e. mitigating the likelihood and the impact of a systemic crisis) and several operational objectives. The operational objectives should be defined in a way that can be more directly achieved by macroprudential authorities by means of implementing or adjusting a set of properly calibrated instruments.

16. The definition of the operational objectives and instruments that are relevant for the insurance sector is a fundamental element. One possible approach is to consider the following operational objectives:[4]

    - Ensuring sufficient loss absorption capacity and reserving;
    - Avoiding negative interconnections and excessive concentration;
    - Avoiding excessive involvement in activities and products whose features may pose systemic risk (previously known as non-traditional or non-insurance activities);
    - Limiting procyclicality and risky behaviour as insurers collectively 'search for yield'; and
    - Avoiding moral hazard.

17. In summary, EIOPA sees the merit of analysing the need to expand the current EU macroprudential framework to insurance, but this expansion should consider the specific nature of the insurance sector and define insurance specific objectives and instruments (i.e. not simply extending the approach developed for other sectors of the financial system). Furthermore, EIOPA suggests fully assessing the existing tools and pursuing the

[4] This approach goes along the lines proposed by Christophersen, C. and Zschiesche, J. (2015): "Macroprudential Objectives and Instruments for Insurance – An Initial Discussion", *EIOPA Financial Stability Report*, May, pp 72-90. See link

assessment of the need for further development within the Solvency II framework.

Expansion to IORPs

18. IORPs are usually considered together with insurance undertakings in any discussion on macroprudential policy concerning non-bank institutions.[5] This is explained by the common features of the insurance and occupational pension sectors, particularly with regard to the nature of assets and liabilities. An expansion of the macroprudential policy framework to IORPs is, however, even more challenging that for insurance for two main reasons.

19. First, the occupational pension sector in Europe is characterised by a huge heterogeneity across countries, both in terms of the different relative share of private and public pensions, and in terms of regulatory frameworks. Differences in national regulatory frameworks occur especially with respect to the valuation of liabilities, different IORPs' funding requirements and the available security mechanisms (essentially, the potential sponsor support and, in some cases, pension protection schemes).

20. Second, analysis on the systemic relevance of IORPs and the potential systemic risk arising from this sector is still in its early stages of development. More information on this particular issue is provided in the next section.

Q2 (b) – Systemic risk in the insurance and occupational pension sectors

21. On the second question, it should be stressed that while it is generally accepted that systemic risk is inherent in the banking sector, the issue is less generally accepted in the case of insurance and IORP sectors.[6] This is a key aspect, given that a proper understanding of the impact, sources and transmission channels, as well as the interaction with the overall economy is a prerequisite for the development of an effective macroprudential policy.

22. The following paragraphs just aim at providing a broad overview of the status of the discussion on the topic by briefly reviewing some of the most recent literature.

Systemic risk in insurance

23. EIOPA (2016) considers specifically the issue of systemic risk in insurance and discusses the potential need for a macroprudential framework. It is broadly accepted that the traditional insurance business model is generally less likely to become a source of systemic risk and that, although not immune to failures, insurers are also far less likely than banks to suffer a "run on the company".

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[5] See, for example, ESRB (2016): "Macroprudential policy beyond banking: an ESRB strategy paper", July 2016.

[6] In the context of this document, systemic risk is considered "a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy", see article 2 of Regulation (EU) No. 1092/2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board.

24. Recent empirical evidence further investigates the issue and confirms that the insurance sector plays a subordinate role in causing systemic risk compared to banks.[7]

25. Insurance undertakings exert systemic importance in a different way than banks. The analysis carried out by the IAIS in 2013 and updated in 2016 identified that the systemic significance of insurance arises from five categories, namely, size, global activity, interconnectedness (with two subcategories, i.e. counterparty and macroeconomic exposures), asset liquidation and substitutability.[8]

26. Furthermore, certain insurance product features underpin the provision and build-up of systemic risk and have a significant impact upon failure. The International Association of Insurance Supervisors (IAIS) has analysed the systemic risk from insurance related product features (previously referred to as "non-traditional non-insurance activities and products).[9] Two sets of risks are used to identify whether product features are likely to expose an insurer to greater degree of systemic risk: 1) the macroeconomic exposure, which captures the exposure transmission channel; and 2) the substantial liquidity risk, which, in turn, captures the asset liquidation transmission channel. Both sets of risks may lead through the indicated transmission channels to systemic risk events such as domino effects and loss cascades or policyholder runs and fire sales.

27. The International Monetary Fund (IMF) considers two dimension of systemic risk potentially triggered by the insurance sector, i.e. the risk of individual defaults and potential contagion and the systemic risk posed by common exposures across undertakings in the event of an adverse shock.[10] The former revolves around similar elements as the one highlighted by the IAIS, i.e. size, interconnectedness and integration, substitutability, leverage, funding liquidity risk, or complexity. In addition, a macroprudential scenario is also considered, in which higher correlations within the insurance sector and the market increases the likelihood of a common shock that may result in similar reactions with potentially detrimental effects for the market as a whole. An example could be the current prolonged low interest rate scenario.

28. The ESRB has also undertaken a significant amount of work trying to better understand the sources of systemic risk. Several scenarios where the EU insurance sector may have a systemic impact where identified:[11]

    - The involvement of insurers in non-traditional and non-insurance activities, such as variable annuities, certain types of guarantees and speculative derivatives transactions.

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[7] See, for example, Berdin, E. and Sottocornola, M. (2015): "Assessing Systemic Risk of the European Insurance Industry", *EIOPA Financial Stability Report*, December 2015. See link

[8] IAIS (2016): *Global Systemically Important Insurers: Updated Assessment Methodology*, 16 June 2016. See here. The asset liquidation channel was newly introduced as a fourth category, instead of the non-traditional and non-insurance category existing in the 2013 methodology. It refers to the liquidity of an insurer's invested asset with the aim of capturing how an insurer's failure could potentially transmit systemic risk to the global financial system.

[9] IAIS (2016): *Systemic Risk from Insurance Product Features*, 16 June 2016. See here

[10] IMF (2016): "The insurance sector: Trends and systemic risk implications", Chapter 3, Global Financial Stability Report (April). See here

[11] ESRB (2015): *Report on systemic risk in the insurance sector*, December 2015. See here

- Procyclical behaviours on the asset side, in their role as large institutional investors.
- Procyclicality coming from the liability side, i.e. in the pricing and writing of insurance related to economic activities such as credit and mortgage insurance.
- Common vulnerability to the persistent low interest rates combined with the uncertainties which could lead to the situation of an abrupt reversal of risk premiums when the value of assets decreases whilst the value of liabilities increases due to lower risk free rates - so called "double-hit" scenario, which may lead to collective failures.
- The lack of substitutes in vital lines of insurance business.

29. A recent trend observed in insurance is the increasing market share of unit linked products, in which individual policyholders directly carry the investment risk, whereas guaranteed interest rate products are becoming less prevalent. This trend may have wide macroprudential effects, given the impact on policyholders, which is not easily predictable.

30. Overall, EIOPA considers that it is very important to accurately define the operational objectives for a macroprudential framework for insurance. As an example, the ones proposed in the previous section seem to cover the most relevant sources of systemic risk identified in this section, and may therefore be used as a good basis for discussion. As such, Annex 1 summarises the following elements:

    a) Some possible operational objectives that macroprudential authorities may need to pursue *(as proposed in the previous section)*;

    b) The potential sources of systemic risk they seek to address *(following the elements identified in this section)*;

    c) Existing instruments and tools, mainly in the context of the Solvency II framework or compatible with it; and

    d) Other measures that could be envisaged.

31. EIOPA is of the view that there is still a substantial amount of work to be done in each of these four elements. Particularly on the last one, as mentioned throughout the text, it is premature at this stage to consider any additional measure. There should be a clear case and convincing evidence to recalibrate any of the existing instruments or to propose additional ones. This would imply 1) an analysis of the potential effectiveness of existing and additional instruments; 2) the consideration of the side effects and costs; and 3) an assessment of the consistency and complementarity between both the macro and micro prudential frameworks of any additional measure.

<u>Systemic risk in IORP sector</u>

32. In general, it is hard to find evidence that an idiosyncratic shock (i.e. the failure of a particular IORP) may be a source of systemic risk. Furthermore, it is sometimes considered that the IORPs sector as a whole may represent less of a systemic risk than the insurance sector. In large part, this stems from the way in which IORPs may absorb negative systemic effects.[12]

[12] Among the aspects that could be mentioned are the following: long-term investment horizons, potential support from the sponsors, the existence of pension protection schemes in some cases, the absence of liquidity

33. However, even if there is not much empirical evidence, IORPs may pose challenges in case of a common shock that affect several IORPs simultaneously throughout Europe. For example, EIOPA IORPs Stress Test Report 2015 exhibited that a prolonged period of low interest rates would pose significant challenges to the resilience of defined benefit IORPs[13] and concluded that further work needed to be done in order to analyse how prolonged adverse market conditions would affect the sponsors' behaviour and the possible consequences for financial stability and the real economy.

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34. Overall, EIOPA will continue to work on all these aspects related to systemic risk and macroprudential policy in the insurance and IORP sectors, with the aim of actively contributing to a debate that is gaining prominence in the recent years. Furthermore, EIOPA has also initiated some work in the field of recovery and resolution for insurance, which may contribute to the stability of the financial system to the extent that companies may suffer from similar vulnerabilities and be exposed to common risks (such as the protracted low interest rate environment). As such, EIOPA is willing and stands ready to support any work the European Commission might undertake in these fields.

risks as members and beneficiaries are usually not allowed to withdraw their accumulated capital, the possibility of changing the scheme designs (e.g. restructure the benefits or closing the scheme to new members), or risk sharing with scheme members (such as investment volatility, inflation risk, longevity risk, and annuitisation risk).

[13] EIOPA (2016): "IORPs Stress Test Report 2015", January 2016. See here

Annex 1: Potential sources of systemic risk, possible operational objectives and instruments in insurance

Operational objectives	Potential sources of systemic risk addressed	Existing instruments and measures with macroprudential impact	Other potential instruments and measures (*)
Ensure sufficient loss absorption capacity and reserving	• Exposure to common shocks and vulnerabilities (such as a prolonged low interest rate environment or a double-hit scenario) leading to a generalised deterioration of the solvency position.	• Increase in capital requirements (e.g. capital add-on under specific circumstances) • Cancelling or deferring dividend distribution • HLA for G-SIIs • Review of the ultimate forward rate • Own Risk and Solvency Assessment (ORSA) • Requesting a reduction in the maximum guarantees offered (currently possible in few countries only)	• Introduce leverage ratio • Request additional buffers (e.g. countercyclical capital buffers) • Strengthening and harmonising the recovery and resolution framework in the EU
Avoid negative interconnections and excessive concentration	• Potentially dangerous interconnections (e.g. by selling certain products such as CDS protection) or excessive concentrations (e.g. by means of intra-financial holdings) that might have spill-over effects in case of a shock.	• Solvency II prudent person principle • Prohibit or restrict certain types of financial activities • Own Risk and Solvency Assessment (ORSA)	• Establishing limits, capital requirements or otherwise provide disincentives for excessive concentrations (e.g. for sectoral exposures)
Avoid excessive involvement in activities and products whose features may pose systemic risk	• Involvement in certain activities or products not directly connected to traditional insurance, which may involve maturity transformation and leverage and generate systemic risk by means of domino effect or fire sales.	• Prohibit or restrict certain types of financial activities • Own Risk and Solvency Assessment (ORSA)	• Request of higher (quantity and/or quality) loss absorption capacity

Limit procyclicality	• Potential collective behaviours by insurance companies that may exacerbate market price movements, such as herding behaviours, “search for yield” or fire sales.	• Symmetric adjustment in the equity risk module • Volatility adjustment • Matching adjustment • Extension of the recovery period	• Allow regulatory capital requirements to fluctuate over the cycle (e.g. countercyclical capital buffer)
Avoid moral hazard	• Excessive risk-taking by insurance systemically important institutions under the assumption of being “too big to fail”	• Solvency II as a risk-sensitive capital requirements framework • HLA for G-SIIs • Own Risk and Solvency Assessment (ORSA) • Request of additional reporting and disclosure requirements	• Request additional capital buffers (e.g. systemic risk buffers) • Strengthening and harmonising the recovery and resolution framework in the EU

(*) This should by no means be interpreted as a proposal for new instruments, which would be premature at this stage. EIOPA is of the view that the rationale for any additional instrument or measure, the potential effectiveness, the side-effects and costs, as well as the consistency and complementarity between both the macro and micro prudential frameworks of any additional measure should carefully be analysed.