Solvency II

MITIGATING LOW YIELD RISKS WITH HIGH-QUALITY RISK MANAGEMENT

Le superviseur européen surveille les risques qu'induit l'environnement de taux bas depuis 2011. Les *stress-tests* qu'il a menés en 2014 et qui testaient en particulier ce type de scénarios, ont montré la vulnérabilité de certains acteurs. Aujourd'hui, EIOPA travaille à la fois avec les superviseurs nationaux pour coordonner leur action et avec le Conseil européen du risque systémique pour une approche plus trans-sectorielle.

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Since 2011, EIOPA is observing the increasing risk of the protracted low interest rates environment for the European insurance sector. According to the latest EIOPA's forecast published in the recent Financial Stability Report[1], market growth for both life and non-life insurers is expected to be positive in 2016 and 2017. However, as a consequence of the increasing reinvestment risk implied by the current quantitative easing (QE) policy in Europe, their investment portfolios might be rebalanced towards more risky asset classes, whilst also further new growth opportunities in emerging markets are expected. Hence, the current macroeconomic reality put pressure on profitability and consequently also solvency position of insurers.

These observations were confirmed by the EU-wide Insurance Stress Test conducted by EIOPA in 2014[2]. The exercise demonstrated substantial vulnerabilities for some insurance companies. According to the low yield module of the stress test, 24% of companies would not meet their solvency capital requirements under the "Japanese-like" scenario (the scenario that foresees a long period of low interest rates). 20% would not meet this threshold under the "Inverse" scenario (the scenario that foresees an atypical raise in the shape of the yield curve). The latest stress test exercise further concluded that a continuation of the low yield conditions could see some insurers having problems in fulfilling their promises to policyholders in 8-11 years' time.

Regulatory response to the low yield environment

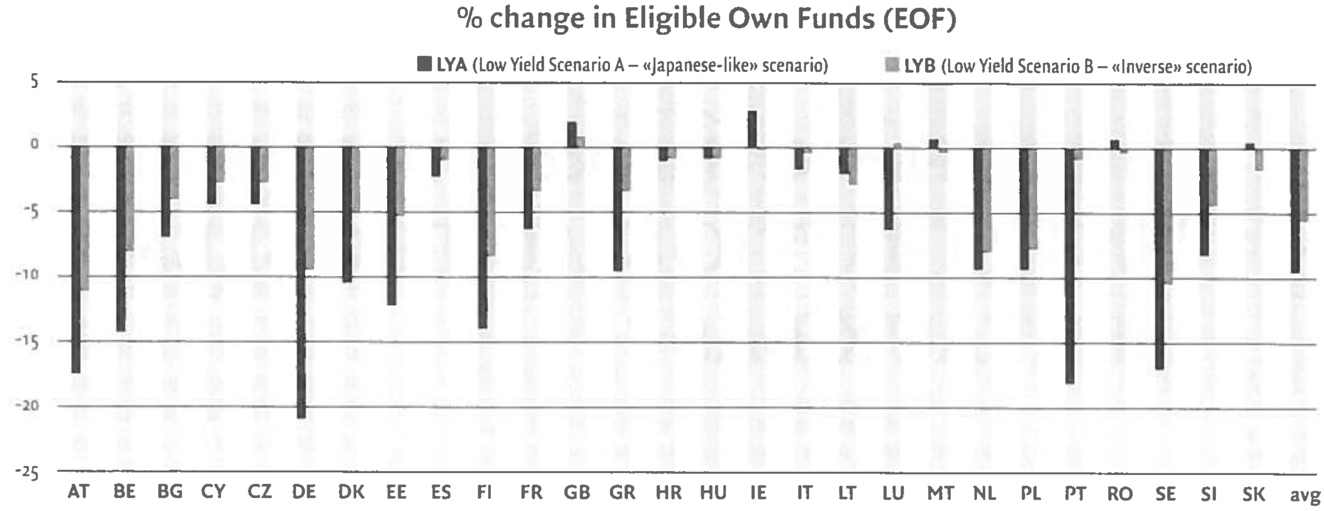
The vision of EIOPA is that the low yield environment should be addressed at the EU level in a consistent manner. To achieve this goal we have undertaken a number of regulatory steps.

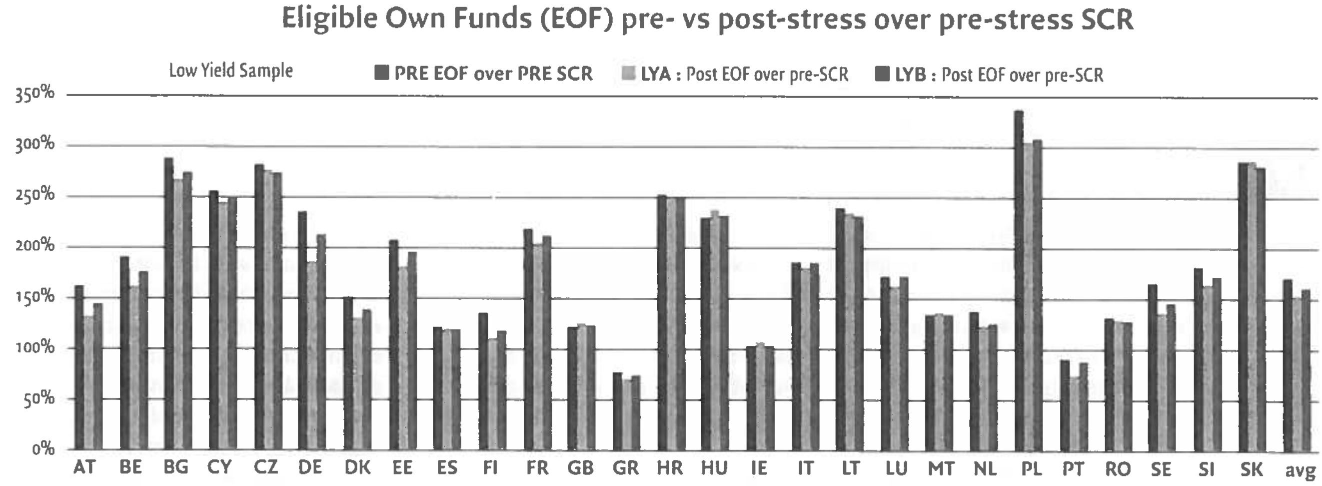
In 2013, EIOPA issued an Opinion[3] setting up a coordinated supervisory response that includes recommendations on enhanced supervision and promotion of industry actions (increase in reserving, product redesign...) to mitigate the low interest rate risk. In 2014, following on the stress test results, EIOPA issued the recommendations[4] to national competent authorities (NCAs), which aim to ensure that inter alia the low interest rates risk is addressed in a convergent way. EIOPA recommended NCAs to engage with undertakings and examine life insurers' asset/liabilities management and risk management strategies and practices and to ensure that they properly assess the sustainability of the guaranteed rates offered. In the course of 2015, EIOPA have been discussing the follow-up to its recommendations with the NCAs on a bilateral basis.

Certain work is being done in cooperation with the European System Risk Board (ESRB). Already back in 2013, EIOPA raised awareness about this potential risk of low yields at the ESRB level and as a result this risk has been included in the ESRB overview of systemic risks. In 2015, EIOPA and

1. https://eiopa.europa.eu/Publications/Reports/Financial_Stability_Report_May_2015.pdf
2. https://eiopa.europa.eu/Publications/Surveys/Stress%20Test%20Report%202014.pdf
3. https://eiopa.europa.eu/Publications/Opinions/EIOPA_Opinion_on_a_prolonged_low_interest_rate_environment.pdf
4. https://eiopa.europa.eu/Publications/Surveys/EIOPA%20Stress%20Test%20General%20Recommendations.pdf

2014 EIOPA stress tests – Low Yield Module results





Source: EIOPA Stress Test 2014, Press Conference, Frankfurt, 1st December 2014.

NCAs indicated that low interest rates have become a number one risk for insurers, which was reflected in the ESRB's annual working plan.

Within the ESRB, EIOPA took a lead in developing proposals for the regulatory steps that are necessary to mitigate this risk. By the end of 2015, we plan to finalise our suggestions. Furthermore, EIOPA is currently working on the methodology that NCAs should use in order to assess the low yield risk and the scope of the problems it creates. Looking forward, this methodology is supposed to become a very useful supervisory tool.

What impact Solvency II will bring?

On 1 January 2016, the new supervisory regime – Solvency II – enters into force. At first glance this creates pressure on solvency positions, because under the new regime capital solvency ratios will be lower than under Solvency I in most cases. Moreover, there will be also some companies which might be found undercapitalised and will need to deliver recovery plans to address this issue. However, Solvency II should not be blamed for that!

Under the previous regime (Solvency I) the risks to insurers remain the same, just they are hidden. Under the new framework, on the contrary, the low yield environment will be truly reflected in the final solvency ratio of insurance companies. The new fair value based and risk-sensitive regime will not create new risks, but will make the existing risks more visible and the situation of companies more transparent. And this is clearly an advantage for industry and supervisors alike.

We believe that Solvency II will bring a stabilizing element in the European insurance sector. Thanks to such an important risk management tool as the Own Risk and Solvency Assessment (ORSA), risk considerations and their capital consequences, will be explicitly taken into account in the strategic decisions of insurance companies. Furthermore, the companies will better understand the risks and will be prepared to take necessary actions in order to mitigate them. This will ensure an appropriate balance with the natural sales driven culture.

At the same time Solvency II will allow NCAs to properly review and evaluate compliance of insurers' strategies, processes and reporting procedures with the new framework. Supervision will become more forward-looking and risk-based, and NCAs will be working together with companies in order to reduce the risks of the low yield environment. ■