EIOPA-BoS-14/209
27 November 2014

Recommendations under Article 21(2)(b) of the EIOPA Regulation and Information Request under Article 35 of the EIOPA Regulation

EIOPA Stress Test 2014

Introduction and legal basis

1. During the course of 2014, EIOPA carried out a Union-wide stress testing exercise, EIOPA Stress Test 2014, 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') [1].
2. One specific module of the EIOPA Stress Test 2014 was a direct follow-up to the EIOPA Opinion on the supervisory response to a prolonged period of low interest rates, which was issued in March 2013 in accordance with the provisions of Article 29 of the Regulation.
3. The Recommendations contained in this document are being issued in accordance with Article 21(2)(b) of the Regulation in order to correct issues identified in the stress test.
4. This document contains a single set of overarching recommendations drawn from the findings of the EIOPA Stress Test 2014. Although the EIOPA Stress Test 2014 comprised two modules; a Core Module addressing market and insurance risks and a Low Yield Module, some common findings emerged in both modules. These common findings support a set of common recommendations to take appropriate supervisory action.
5. These recommendations have been framed in the context of the implementation on 1 January 2016 of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)[2] and the caveats surrounding the stress test exercise, in particular the fact that undertakings were required to utilise the Standard Formula and were not able to use Undertaking Specific Parameters. While submission of Internal Model estimates was welcomed they were not included in the comparative analysis.

[1] OJ L 331, 15.12.2010, p. 48–83
[2] OJ L 335, 17.12.2009, p. 1-155

6. The recommendations also recognise that insurance undertakings, national supervisory authorities and EIOPA are preparing for Solvency II implementation. EIOPA has published guidelines to support consistency in undertakings' and national supervisory authorities' preparations for Solvency II. The findings of the stress test exercise also underline the importance of the matters covered in the preparatory guidelines and the actions that undertakings, national supervisory authorities and EIOPA will take as a result of them. In that context, the recommendations are designed to be complementary to the preparatory guidelines. Moreover, the recommendations also take account of the transitional measures embodied in Articles 131 and 308(b)(14) of Directive 2009/138/EC.
7. In order to facilitate follow-up action to the recommendations, this document also contains an information request in relation to Recommendation 1. This request is made under Article 35 of the Regulation.
8. EIOPA will support national supervisory authorities and undertakings through guidance and other measures as needed.
9. In addition to addressing the findings of the stress test exercise, these recommendations should also be viewed as fulfilling the commitments set out in the EIOPA Opinion on the supervisory response to a prolonged period of low interest rates[3].
10. These recommendations will be published on EIOPA's website.

Context

11. The results and findings of the EIOPA Stress Test 2014 exercise are set out in detail in the report "EIOPA Insurance Stress Test 2014" published by EIOPA on 30 November 2014.
12. The stress test and report comprise two modules. The first, Core Module, addresses financial market stress scenarios, along with a set of insurance specific stresses and insurers' behavioural responses to a stressed market scenario. The market stress scenarios included in the exercise address some of the key risks to the insurance sector that EIOPA has been highlighting in its ongoing financial stability analysis. In particular, the Core Module assessed the impact of a "double hit" scenario of low interest rates and a sharp reversal in asset prices.
13. The second, Low Yield Module, is a direct follow-up to the EIOPA Opinion on the supervisory response to a prolonged period of low interest rates. In particular, this module addresses three key questions related to the impact of such scenarios:
    a. What is the <u>scale</u> of the challenge posed by such scenarios?
    b. What is the <u>scope</u> of the challenge posed by such scenarios?
    c. What is the <u>timeline</u> for serious problems to emerge?

[3] https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/opinions/EIOPA_Opinion_on_a_prolonged_low_interest_rate_environment.pdf

14. In both modules, as outlined in the stress test report, the reported stress test data suggests that in the Baseline (before any stress) a non-negligible minority of undertakings may have insufficient capital. This may be related to the stage of preparation for the implementation of Solvency II, but it is appropriate to pay special attention to the ongoing preparations of these undertakings. In the case of the Low Yield Module, underlying structural vulnerability to interest rate and yield declines was identified for some business types. These findings merit additional direct supervisory action.

15. In the stress scenarios tested in the exercise, their negative impact on parts of the European insurance sector was clearly demonstrated. In some instances this may reflect the manner in which undertakings manage their balance sheets, whereas in others it was also a reflection of the severity of the scenarios that were tested. Again the negative impacts are in certain instances sufficient to merit additional supervisory action, in the former case as increased supervisory interaction and in the latter case in relation, for example, to contingency planning. Moreover, during the preparatory phase, supervisory authorities are expected to ensure that undertakings take active steps towards implementation, so that when Solvency II is applicable, its requirements can be fully complied with.

16. National supervisory authorities are already aware of the challenges for some undertakings of meeting the requirements of Solvency II. They are actively engaging with these undertakings on their preparations for compliance with the Solvency II requirements and are making continued progress in this area. The recommendations support the continuation and even intensification of these interactions.

17. This, however, is not neutral for national supervisory authorities in terms of their resource needs and their own preparations for implementation of Solvency II. National supervisory authorities must also adapt their own processes, supervisory methodologies and resource allocation to the Solvency II environment. At several points, the recommendations call for national supervisory authorities to prepare themselves in good time to operate various elements of the Solvency II framework.

18. There is no categorisation of the recommendations by group or solo supervision. Rather, it is recognised that where the issues raised in the recommendations relate to groups then they will be dealt with by supervisors in the context of colleges of supervisors. Group supervisors are expected to take a lead and to facilitate full participation of solo supervisors in order to achieve a coordinated approach.

19. Overall, the samples of undertakings that participated in both elements of the stress test exercise accounted for more than 55% of the EU market on average. In the case of the Core Module, 167 entities covering 55% of EU premiums participated in the exercise, while for the Low Yield Module 225 entities representing 60% of EU technical provisions participated. The Core Module included both groups and individual undertakings, whereas the Low Yield Module was carried out on an individual undertaking basis.

20. EIOPA believes that the results of the exercise are therefore representative of the market as a whole and that the recommendations based on these results have more general relevance than for the sample undertakings alone.

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

21. The recommendations set out in this document are addressed to all EU national supervisory authorities.

22. The recommendations relate to the findings of the EIOPA Stress Test 2014 as outlined in Sections I.B and I.C of the EIOPA Stress Test 2014 report.

Recommendation 1

23. In the Core Module a non-negligible minority of undertakings reported that they would not meet the SCR threshold in the Baseline case, while a smaller subset indicated that they would not meet the MCR. After 1 January 2016, the Solvency II legislation would require direct supervisory action in both cases. Successful implementation of Solvency II requires intensive supervisory engagement with undertakings to ensure that they are properly prepared and, if they are not, that appropriate action is taken.

24. The Baseline conditions reported for the Low Yield Module sample of undertakings show a similar picture to that shown for the Core Module. A non-negligible minority of undertakings would be in breach of the SCR or MCR thresholds – a situation that would require action on the part of national supervisory authorities.

25. National supervisory authorities are recommended to take the following actions in advance of the application of Solvency II:

    a. Engage in a rigorous assessment of the preparedness of insurance undertakings to implement Solvency II, with particular emphasis on undertakings' planning of their capital, balance sheet management and their capacity to utilise all available features of the Solvency II framework;

    b. Put in place the necessary procedures within national supervisory authorities to operate the transitional provisions related to non-compliance with the MCR set out in Article 131 of Directive 2009/138/EC, including the measures to be taken under the second paragraph of that article; and

    c. Put in place the necessary procedures within national supervisory authorities to operate the transitional provisions related to non-compliance with the SCR set out in Article 308(b)(14) of Directive 2009/138/EC. This should include processes to deal with the second and third paragraphs of Article 308(b)(14).

Recommendation 2

26. In terms of the utilisation of the LTG and Transitional measures available as part of Solvency II, a clear difference between the behaviour of larger and smaller entities was observed in the stress test results. Smaller entities made relatively less use of the LTG and Transitional measures. This underlines the importance of preparation by undertakings to be able to utilise the LTG and Transitional measures.

27. National supervisory authorities are recommended to take the following actions in advance of the implementation of Solvency II:

a. Engage with insurance undertakings to ensure that they are able to make informed choices on the use of the LTG and Transitional measures and that they have the capacity to submit, in due time, the necessary information for national supervisory authorities to properly approve the requested use of LTG and Transitional measures. In relation to the LTG measures, attention should be paid to the asset and liability management (ALM) measures set out in Article 44.2a of Directive 2009/138/EC; and

b. Put in place efficient processes to support robust decision-making in relation to the use of LTG and Transitional measures.

Recommendation 3

28. The stress scenarios in the Core Module demonstrated the vulnerability of the sample of participating undertakings to reversals of market values and a downward shock to interest rates. EIOPA in its regular Financial Stability Reports has highlighted such market reversal scenarios as a key risk for the insurance sector. The stress scenarios in the Low Yield Module of the stress test demonstrated the vulnerability of the sample of undertakings to a prolonged period of low yields (Japanese scenario) or a short term reversal in yields (Inverse scenario). In both the Core and Low Yield modules, regardless of whether the impact is considered in terms of available assets, eligible own funds or the ratio of eligible own funds to an SCR, the estimated impact of the stress scenarios is significant for a notable proportion of the undertakings in the sample.

29. Entities falling below the MCR or SCR thresholds in the first year of application of Solvency II would be covered by the provisions of Articles 131 and 308(b)(14) of Directive 2009/138/EC.

30. The materialisation of such risks could therefore put national supervisory authorities in a situation where they might need to request and assess progress reports submitted by undertakings in accordance with Article 308(b)(14) of Directive 2009/138/EC.

31. National supervisory authorities are recommended to take the following actions as a medium term measure:

a. Engage with relevant insurance undertakings as part of the supervisory processes described in the EIOPA Preparatory Guidelines to ensure that they have a robust system of governance in place, including the capacity to prepare meaningful adjustment plans, as well as progress reports as defined in Article 308(b)(14) of the Directive 2009/138/EC; and

b. Put in place efficient processes for robust decision-making in relation to the assessment of adjustment plans and progress reports mentioned in sub-paragraph a.

Recommendation 4

32. The market stress scenarios in the Core Module of the stress test demonstrated the vulnerability of part of the sample of undertakings to simultaneous reversals of market values and a downward shock to interest rates.

33. Exposure to these risks is a function of undertakings' approach to ALM and the choices that they make in relation to balance sheet structure. Undertakings have been shown to have significant market risk exposures encompassing interest rate and spread risk in particular.

34. National supervisory authorities are recommended, where entities are exposed to the risk mentioned in paragraphs 31 and 32, to take the following actions in advance of the implementation of Solvency II:

a. Engage with insurance undertakings to ensure that they have a clear understanding of their risk exposures and the vulnerability to given stress scenarios as a result of this; and

b. Engage with insurance undertakings to ensure that they have the capacity to take recovery actions to deal with those vulnerabilities.

Recommendation 5

35. The results of the Low Yield module analysis suggest that some undertakings are operating with considerable duration and/or internal rate of return mismatches. In some cases this is mitigated by relatively high capitalisation, but this does not remove the underlying vulnerabilities created by such mismatches.

36. The cashflow analysis contained in the Low Yield Module, although with known limitations, in particular the limited range of asset cashflows modelled, suggests that there may be some time before vulnerable undertakings could face net cash outflows. While this is a welcome result in one sense, it should not be taken as a signal for undertakings and national supervisory authorities not to take action to address such potential outflows. Rather, it underscores the need for national supervisory authorities to further scrutinise undertakings' cashflow analysis in terms of sustainability, with particular attention being paid to assets with cashflows that are difficult to model.

37. It is important to recall in this context the transitional measures embodied in the Solvency II framework that allow, under certain conditions, for undertakings to gradually apply the Solvency II requirements over time.

38. National supervisory authorities are recommended, where these vulnerabilities are relevant, to engage with undertakings to address the following issues:

a. Assess their ALM and Risk Management strategies and practices in terms of sustainability and the degree to which underlying risks are addressed; and

b. Ensure that undertakings properly assess the sustainability of the guaranteed rates that are offered. This should be reflected in the undertakings' policy on risk management and its risk appetite as approved by its administrative, management or supervisory body (AMBS).

39. National supervisory authorities are also recommended in the context of a low yield environment to take supervisory measures to deal with undertakings deemed to be operating unsustainable business models. Such measures should require submission from the undertaking of plans to put

their business on a sound footing. In this context, supervisory judgements should be informed by the full Solvency II framework as noted in paragraph 37.

40. Where undertakings do not provide or implement the plans mentioned in paragraph 39, national supervisory authorities are recommended to take the necessary action to protect policyholders.

Information Request under Article 35 of the EIOPA Regulation

41. In relation to Recommendation 1, national supervisory authorities are requested in accordance with Article 35 of the Regulation to submit to EIOPA by 30 September 2015 a report on the number, size and market significance of those undertakings that are not expected to meet the MCR or SCR requirements of Solvency II from 1 January 2016 without use of Articles 131 or 308(b)14 of Directive 2009/138/EC.

Done at Frankfurt am Main, 27 November 2014.

[signed]

Gabriel Bernardino

Chairperson
For the Board of Supervisors