Supervisory Statement on inflation

1. LEGAL BASIS

1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Supervisory Statement on the basis of Article 29(2) of Regulation (EU) No 1094/2010[1]. This Article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union.

1.2. EIOPA delivers this Supervisory Statement on the basis of Articles 44, 45, 76 and 101 of Directive 2009/138/EC (Solvency II)[2].

1.3. This Supervisory Statement is addressed to the competent authorities, as defined in Article 4(2) of Regulation (EU) No 1094/2010[3].

1.4. The Board of Supervisors has adopted this Supervisory Statement in accordance with Article 2(7) of its Rules of Procedure[4].

2. CONTEXT AND OBJECTIVE

2.1. Higher inflation is persisting globally during 2022. This is having a material impact on the economy in general reducing growth forecasts and decreasing the purchasing power of consumers.

2.2. Central banks around the globe reacted promptly with monetary policy actions to tackle the inflation outlook through higher interest rates, ending the low-yield environment that has lasted for over a decade. It may be expected that inflation will get back under control and towards the target in the medium term, in the meantime vigilance is needed regarding the uncertainty around the future path of inflation.[5]

2.3. The most immediate impact of inflation on insurance business, is the increase on cost of claims (claim inflation) due to the increase on prices of the services, goods and expenses incurred in servicing insurance obligations. However, several additional elements should be considered such as future monetary policy reactions and their impacts on the valuation of technical

[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] 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 (OJ L 335, 17.12.2009, p. 1-155).

[3] Notwithstanding the fact that specific points of this Supervisory Statement describe supervisory expectations for insurance and reinsurance undertakings, they are required to comply with the regulatory and supervisory framework applied by their competent authority based on Union or national law.

[4] Decision adopting the Rules of Procedure of EIOPA's Board of Supervisors, available at: https://www.eiopa.europa.eu/sites/default/files/publications/administrative/bos-rules_of_procedure.pdf

[5] ECB has predicted an inflation level of 3.4% in 2024 while will be closer to 2.3% in 2025.

provisions, the impact on capital requirements and capital management tools, the impact on risk-management policies, the impact on the modelling choices and impact on consumers behaviour.

2.4. From the consumer protection point of view, the impact of inflation risks on insurance-based investment products was touched upon in the recently published EIOPA methodology for assessing value for money in the unit-linked market.[6] EIOPA's Supervisory Statement on the assessment of value for money of unit-linked insurance products under product oversight and governance[7] also highlights that product manufacturers should regularly monitor the products they brought to the market to identify events – including inflationary events – that may materially affect product characteristics. In addition, EIOPA is carrying out work with the other ESAs under the Joint Committee Work Programme for 2023 under a financial education initiative to assess the impact of inflation and interest rates on consumers in the three financial sectors.

2.5. Therefore, this Supervisory Statement addresses the main impacts of inflation on insurance and reinsurance undertakings, which may affect both life and non-life business. However, it should be noted that, due to its nature, long-tail non-life business is expected to suffer the most severe impact[8].

2.6. This Supervisory Statement is issued to support the end of the year Solvency II calculations. The impact of the inflation is undertaking specific, and this Supervisory Statement aims mainly to raise awareness about the relevant Solvency II provisions. With regard to the proximity of the end of the year, this statement is issued to foster convergence and consistent supervisory approaches across Member States.

3. SUPERVISORY EXPECTATIONS

Impact on technical provisions (best estimate evaluation)

3.1. Considering that during more than 20 years[9] inflation has remained low in most of the Member States of the European Union, the use of methodologies that do not explicitly adjust inflation has been frequently used, justified and considered proportionate, considering the simplicity of the approach and the lower probability of forecast error in a cost/benefit analysis.

3.2. However, the current inflation trend may lead to a risk to underestimate technical provisions if the same methodologies continue to apply. The impact of inflation can be usually more accurately and flexibly considered when modelled or adjusted explicitly. There may be a lack of historical data for high-inflation scenarios and the impact of inflation may not be reflected immediately on undertakings' claims experience for some lines of business.[10] Therefore, expert

[6] https://www.eiopa.europa.eu/media/news/eiopa-issues-its-methodology-assessing-value-money-unit-linked-market_en

[7] https://www.eiopa.europa.eu/document-library/supervisory-statement/supervisory-statement-assessment-of-value-money-of-unit

[8] Life insurance obligations are frequently nominal and therefore reasonably shielded against inflation. However, the impact on long-term life business may also be relevant due to an increase in expenses. Short-tail business does not include long term obligations limiting the impact of inflation, which can be factored in through repricing insurance products accordingly.

[9] https://www.ecb.europa.eu/stats/ecb_surveys/survey_of_professional_forecasters/html/table_hist_hicp.en.html

[10] As in cases where the cost of current claims may have been determined before the inflation spike, e.g., through court awards or based on fixed-price contracts with service providers.

EIOPA | Westhafen Tower, Westhafenplatz 1 | 60327 Frankfurt | Germany
Tel: +49 69-951119-20
info@eiopa.europa.eu | https://www.eiopa.europa.eu

judgement plays a relevant role also in consideration of the uncertainty of the potential range of outcomes considered in calculating the technical provisions and ensuring a prudent calculation.

3.3. As inflation rises, more granular considerations as breakdown of the types of costs (e.g. car parts, material goods for construction, court settlements, medical costs, etc.) or geographical considerations may be necessary to ensure an adequate level of technical provisions.

3.4. The current inflation level may also have an indirect impact on the best estimate through other relevant assumptions as future management actions and policyholders' behaviour, which may be affected by the increased cost of living[11]. For example, the increased cost of living may be a trigger for lapses and surrenders of life insurance policies.

3.5. In this context and in line with Articles 29 and 30 of Commission Delegated Regulation (EU) 2015/35[12], undertakings should ensure that inflation is adequately considered according to the nature, scale and complexity of the risks, so that the level of technical provisions remains appropriate. This implies that undertakings re-evaluate whether their inflation expectations in the technical provisions are still realistic given current market circumstances. It should be noted that, while this may be relevant for a wide range of insurance obligations, long-term non-life obligations are frequently the most exposed to inflation risk.

3.6. On the other side, some inflation models are more reactive and the spike in inflation may be leading to significant increases on the level of technical provisions. While the current experience may also justify a review of such models, undertakings should ensure that any change in the modelling approach tempering the impact of inflation is properly substantiated and evidenced.

3.7. In the regular Supervisory Review Process, when assessing calculation of technical provisions, and following a risk-based approach, competent authorities are expected to monitor the insurance and reinsurance undertakings' assessment of the impact of the inflation and any measures taken as a follow-up.

Impact on investments

3.8. Inflation may also have an impact on the value of some assets, in particular those valuated using alternative valuation methods according to article 10(5) – (7) of the Commission Delegated Regulation (EU) 2015/35. The current inflation trend may lead to a risk to overestimate the value of assets if the same methodologies apply, especially those not considering inflation explicitly.

3.9. Undertakings using alternative valuation methods for investments exposed to inflation should assess whether the valuation methods and/or its parameters should be adjusted considering the

[11] For example, lower renewal rates, less business growth, higher prevalence of fraud or a reduction of the average cover per policyholder.

[12] Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

EIOPA | Westhafen Tower, Westhafenplatz 1 | 60327 Frankfurt | Germany
Tel: +49 69-951119-20
info@eiopa.europa.eu | https://www.eiopa.europa.eu

current inflation level to ensure the assets are valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction.

3.10. In the regular Supervisory Review Process, when assessing valuation of the assets and following a risk-based approach, competent authorities are expected to monitor the insurance and reinsurance undertakings' assessment of the impact of the inflation and any measures taken as a follow-up.

Impact on Solvency Capital Requirement

3.11. Inflation may also have an impact on the Solvency Capital Requirement (SCR), and some adjustments may be necessary, e.g., adjusting inflation-related parameters of internal models. Undertakings using internal models to calculate the SCR should assess the need to adjust any inflation-related parameters of their internal model to ensure it still provides the level of protection required by Article 101(3) of Solvency II.

3.12. Undertakings using the standard formula and having a risk profile exposed to inflation, should in particular assess whether the SCR calculation does not significantly deviate from their risk profile.

3.13. In the regular Supervisory Review Process, when assessing calculation of the SCR, and following a risk-based approach, competent authorities are expected to monitor the insurance and reinsurance undertakings' assessment of the impact of the inflation and any measures taken as a follow-up.

Other elements to be considered

3.14. A timely reaction to adjust future cost estimates may also be relevant for other functions beyond best estimate valuation. If and how inflation is reflected in pricing should be duly justified, evidence based and with robust governance. Moreover, it should be taken into account that the mitigating effect on non-life claims provision is probably limited. Outwards reinsurance assumptions may also need to be adjusted, as coverage levels or prices achieved this year may not be available for renewal.

3.15. In case the level and/or volatility of inflation remains high, a review of risk management systems may be beneficial in view of ensuring a comprehensive view of inflation. In particular, undertakings should consider whether the current calibration of the stress test scenarios remains accurate considering current economic conditions.

3.16. All relevant actions taken by the undertakings should be properly reflected in the own risk and solvency assessment (ORSA) to ensure continuous compliance with the requirements regarding technical provisions and the adequacy of the SCR as well as to adequately calculate the Own Solvency Needs where undertakings may need to consider inflation, interest rate, and correlations, if material, beyond the stresses in the Standard Formula as required by Article 45 of Solvency II.

EIOPA | Westhafen Tower, Westhafenplatz 1 | 60327 Frankfurt | Germany
Tel: +49 69-951119-20
info@eiopa.europa.eu | https://www.eiopa.europa.eu

3.17. Undertakings should ensure that inflation is comprehensively considered by all functions directly or indirectly impacted.

3.18. In the regular Supervisory Review Process, when considering the system of governance and assessing sound and prudent management of undertakings, including the review of the ORSA, and following a risk-based approach, competent authorities are expected to monitor the insurance and reinsurance undertakings' assessment of the impact of inflation on the risk management framework. This includes how the general impact has been reflected and evidenced in the ORSA report.

3.19. The participants of the Effective Dialogue between insurance supervisors and statutory auditors (EIOPA-BoS-16/071) should put inflation on the agenda. The competent authorities should communicate their expectations with regard to the auditors.

3.20. This Supervisory Statement will be published on EIOPA's website.

Done at Frankfurt am Main, on 20 December 2022 [signed]

For the Board of Supervisors

Petra Hielkema

Chairperson

EIOPA | Westhafen Tower, Westhafenplatz 1 | 60327 Frankfurt | Germany
Tel: +49 69-951119-20
info@eiopa.europa.eu | https://www.eiopa.europa.eu