EIOPA insurance stress test shows industry resilience but also reliance on transitional measures

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The European Insurance and Occupational Pensions Authority (EIOPA) published today the results of its 2021 Insurance Stress Test in which it assessed the industry's resilience to a prolonged COVID-19 scenario in a "lower for longer" interest rate environment.

In the 2021 Insurance Stress Test, EIOPA conducted a capital and solvency assessment and, for the first time, also examined participants' pre- and post-stress liquidity positions. The test allowed participants to calculate their post-stress position using two distinct approaches: the fixed balance sheet approach without management actions and the constrained balance sheet approach, where reactive management actions were permitted. 19 participants opted to make use of such measures.

The prescribed shocks were modelled on prevailing risks to the financial system and are deemed to be severe but plausible. They include a so-called “double-hit” effect where the risk free rate and risk premia move in diverging directions, complemented by a set of insurance specific shocks stemming from the outbreak of the pandemic.

Results

Despite the grave economic and financial implications of the COVID-19 pandemic, the European insurance industry entered the stress test exercise with a strong level of capitalisation – evidenced by a solvency ratio of 217.9% at the end of 2020. This robust buffer in the solvency ratio allowed participants absorb the shock of the adverse scenario.

The capital component of the exercise confirmed that the main vulnerabilities for the sector stem from market shocks, and, specifically, from the decoupling of the risk free rate and risk premia, the so-called double-hit scenario.

In the fixed balance sheet approach, where no management actions against the prescribed shocks could be enforced, the aggregate solvency ratio decreased by 92.1pp to 125.7%, bringing 9 undertakings under the regulatory threshold of 100%.

Results improved when participants, under the constrained balance sheet approach, were allowed to take reactive management actions. The actions taken reduced the original drop seen in the fixed balance sheet approach by 13.6pp to an aggregate solvency ratio of 139.3% and helped 7 participants return their post-stress solvency ratios to above 100%. The insurance industry therefore demonstrated that it has tools at its disposal to cope with adverse market and economic effects.

Despite the material cut in excess assets over liabilities, none of the participants reported an Assets over Liability ratio below 100%, neither under the fixed nor under the constrained balance sheet approach. This confirms the industry’s ability to meet promises to policyholders amid severe adverse developments of the economy and the markets.

The LTG measures which are part of the Solvency II regulation helped absorb part of the severe but plausible shocks, limiting the drop in participants’ solvency ratio. Nevertheless, the stress test also revealed that a section of the market still heavily relies on transitional measures, which, unlike long-term guarantees, are to be phased out by 2032. Undertakings should take concrete steps toward reducing their dependence on temporary measures that were put in place to smooth the transition from Solvency I to the Solvency II regime.

The liquidity component of the stress test showed that the liquidity position of participants appears to be a less significant concern than solvency positions given the sector’s large holdings of liquid assets. Still, outcomes show that insurers cannot rely solely on their cash holdings to cover unexpected outflows.

Petra Hielkema, Chair of EIOPA said: *“The stress test has shown that European insurers can maintain their financial health even amid harsh economic conditions. I’m pleased that at no point did participants report a post-stress asset position in which insurers’ commitments to policyholders would have been jeopardised. Below the surface of these positive results, however, is an often heavy reliance on transitional measures, which are going to be phased out by 2032. In the months to come, we will turn our attention to the vulnerabilities that were brought to light in the exercise. We will also call on legislators to consider disclosures of individual results to become a legal requirement.”*

Next steps

The 2021 Insurance Stress Test exercise gives supervisors a valuable insight into the capital and liquidity positions of European insurers under a severe but plausible scenario. It also provides a useful basis for a follow-up dialogue between group supervisors and the participants to address vulnerabilities that came to light.

EIOPA and the National Competent Authorities will analyse the results further to gain a deeper understanding of the risks and vulnerabilities of the sector. EIOPA will also assess the need for issuing recommendations on relevant concerns identified in the exercise.

Background

EIOPA conducted a capital and solvency assessment, which, for the first time, was also complemented by an analysis of the liquidity positions of participants. 43 insurance groups and 1 solo entity participated in the exercise, representing approximately 75% of the European Economic Area (EEA) insurance market with an adequate level of national coverage.

Although the stress test has a primarily microprudential focus, the exercise retains the non-pass/fail nature of previous stress tests. EIOPA worked with aggregated individual post-stress positions to infer the overall resilience of the industry and to identify any sectoral vulnerabilities. For the first time, in the 2021 stress test participants could include reactive management actions in the calculation of their post-stress position, e.g. de-risking strategies.