

2021 Insurance Stress Test Recommendations

Introduction and legal basis

1. During the course of 2021, EIOPA carried out a European-wide stress test in accordance with Article 21(2)(b) of Regulation (EU) No 1094/2010 of 24 November 2010 of the European Parliament and of the Council (EIOPA Regulation).
2. These Recommendations are issued in accordance with Article 21(2)(b) of the EIOPA Regulation in order to address issues identified in the stress test.
3. In view of the implementation of these Recommendations, EIOPA will support National Competent Authorities (NCAs) through guidance and other measures if needed.

Context

4. The results and findings of EIOPA's Insurance Stress Test 2021 exercise are set out in detail in the report "[2021 Insurance Stress Test Report](#)" published by EIOPA on 16th December 2021.
5. The stress test exercise focused on a prolonged COVID-19 scenario in a "lower for longer" interest rate environment and evaluated its impact on the capital and liquidity position of the entities in scope. The scenario identified a set of market and insurance specific shocks specifically constructed to reflect the EIOPA and ESRB assessment of prevailing systemic risks to the financial system at that point in time. A detailed description of the scenario can be found in Section 1.2.1. of the 2021 Insurance Stress Test report.
6. The scenario embodied the characteristics of plausibility and severity required by a robust stress test exercise. The set of shocks were economically and market consistent, hence plausible by construction. The overall probability of the market scenario placed the materialization of the events in the tail of the distribution and in line with the severity stipulated in Solvency II¹. The market shocks were complemented by a set of insurance specific shocks affecting all lines of business that were more exposed to the effects of the pandemic outbreak.²

¹ 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

² Further technical details on the scenario of the 2021 stress test scenario can be found in section 1.2.1 of the Report.

7. While maintaining its non-pass-fail nature, the stress test has the primarily microprudential objective of assessing the capability of the participants to sustain the adverse conditions depicted in the stress test scenario. The post-stress individual positions are eventually aggregated to infer the overall resilience of the insurance industry. The 2021 insurance stress test enhanced the macroprudential dimension of the exercise, complementing the standard fixed balance sheet approach with a constrained balance sheet approach where participants were allowed to apply reactive management actions in the calculation of their post-stress position. The results of these actions were used to identify potential spill-over effects on other markets.
8. The regular capital and solvency assessment, conducted in line with the Solvency II framework was complemented for the first time by the assessment of the pre- and post-stress liquidity position of the participants over a 90-day' time-horizon. The two components were based on a common narrative, scenario and set of shocks but were clearly separated in terms of the application of the shocks, data collection, assessment and disclosure.
9. The exercise covered a representative sample of 43 European insurance groups and one solo insurance undertaking registered in 20 EEA jurisdictions, representing 75% of the EEA market³. In the absence of a commonly adopted framework for the assessment and the consolidation of the liquidity positions at a group level, the participating groups were requested to provide the liquidity information for a significant subset of European insurance solo entities within the perimeter of consolidation of the group. Based on the defined threshold of 80% of group total assets, 117 solos were identified and included in the analysis.
10. Groups were requested to calculate their post-stress financial position by applying the same models used for their regular Solvency II reporting. The use of long-term guarantees and transitional measures was taken into account and the impact of these measures had to be reported separately.
11. The stress test results showed that European insurers can maintain their financial health even amid harsh economic conditions, while maintaining their ability to meet promises to policyholders. The exercise confirms that the main vulnerabilities stem from market shocks and more specifically from the decoupling of the risk free rate and risk premia, the so-called double hit scenario. However, most participants demonstrated under the constrained balance sheet scenario where reactive management actions are allowed, that they have the tools to cope with adverse market and economic effects. While long-term guarantees and transitional measures proved to be a robust buffer that allowed shock absorption, the exercise revealed the heavy reliance of participants on transitional measures which are to be phased out by 2032. Furthermore, 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.

³ In terms of Total Assets at Year End 2020.

- 12. As outlined in the Executive Summary of the 2021 Insurance Stress Test Report, further analyses of the results are required by EIOPA and the NCAs to obtain a deeper understanding of the risks and vulnerabilities of the sector.
- 13. In order to follow-up on the main vulnerabilities, EIOPA is issuing the following Recommendations.

Recommendations

- 14. The Recommendations relate to the findings of the EIOPA’s 2021 Insurance Stress Test, grouped into three different subject matters:
 - Recommendations on identified vulnerabilities;
 - Recommendations on availability of actions to manage adverse conditions;
 - Individual undertaking-specific recommendation.
- 15. The Recommendations contained in this document constitute the aggregation of the discussions and assessments of the individual stress test results of the 43 European insurance groups and one solo insurance undertaking that participated in the EIOPA’s 2021 Insurance Stress Test.
- 16. After analysis of the stress test results, EIOPA recommends a series of actions. First, EIOPA focuses on the need to decrease the dependency on transitional measures (Recommendation 1), the need to review the risk management process and ensure its adequacy where the stress test was particularly impactful (Recommendation 2), and the need for sufficient resources to properly assess non-Solvency II reported risks (Recommendation 3). Next, EIOPA calls for attention on the possibility to use management actions (Recommendations 4 and 5). Lastly, there is a recommendation concerning a specific undertaking (Recommendation 6).

<i>Recommendations</i>	<i>NCA(s) concerned</i>
Recommendations on identified vulnerabilities	
<p><u>Recommendation 1</u></p> <p>➤ <i>EIOPA recommends NCAs to consider whether undertakings still reliant on transitional measures are taking concrete actions to reduce their dependency on measures introduced only to smooth the transition from the Solvency I to the Solvency II regime.</i></p>	<p><i>All NCAs with undertakings relying on transitional measures</i></p>
<p><u>Recommendation 2</u></p> <p>➤ <i>EIOPA recommends NCAs to further assess if the exposure to the risks that cause either a large drop in Solvency Capital Requirement (SCR)-ratio or a (near) breach of SCR-ratio is adequately managed.</i></p>	<p><i>All NCAs with undertakings experiencing a large drop of SCR-ratio or a (near) breach of SCR-ratio</i></p>

<p><u>Recommendation 3</u></p> <p>➤ <i>EIOPA recommends NCAs to verify that undertakings allocate sufficient resources to ensure that their risk frameworks and models are sufficiently flexible to assess those risks that are not reported as part of the Solvency II reporting framework, particularly focusing on their ability to produce and process relevant data.</i></p>	<p><i>NCAs with undertakings that revealed more difficulties in retrieving and assessing the liquidity risk information needed.</i></p>
<p>Recommendations on availability of actions to manage adverse conditions</p>	
<p><u>Recommendation 4</u></p> <p>➤ <i>For undertakings that did not apply management actions, even though they were warranted, EIOPA recommends NCAs to further investigate the reasons for not applying management actions and if these undertakings have sufficient options to apply management actions in case of need.</i></p> <p>➤ <i>For undertakings that have applied management actions, EIOPA recommends NCAs to further assess the viability and reported impact of these management actions where the applied actions departed from what was discussed in the pre-validation phase. This applies specifically for undertakings that relied on intra-group support or where there is interconnectedness with the banking sector.</i></p>	<p><i>All NCAs with undertakings that did not apply management actions, even though they were warranted.</i></p> <p><i>All NCAs with undertakings that have applied management actions</i></p>
<p><u>Recommendation 5</u></p> <p>➤ <i>EIOPA recommends NCAs to assess the time it would take for participating undertakings to respond to adverse developments. This entails assessment of:</i></p> <ul style="list-style-type: none"> ○ <i>the decision-making processes;</i> ○ <i>the ability to gather the necessary information in a short timeframe;</i> ○ <i>the flexibility and adequacy of the models used by the undertakings to produce the required results.</i> 	<p><i>All participating NCAs</i></p>
<p>Individual undertaking-specific recommendation</p>	
<p><u>Recommendation 6</u></p> <p>➤ <i>EIOPA recommends supervisory actions, including on-site inspections, if needed, regarding one of the participants based on the information provided in the validation process.</i></p>	<p><i>NCA concerned</i></p>

Recommendation 1

- ***EIOPA recommends NCAs to consider whether undertakings still reliant on transitional measures are taking concrete actions to reduce their dependency on measures introduced only to smooth the transition from the Solvency I to the Solvency II regime.***

Background

17. The transitional measures on risk-free interest rates and technical provisions were introduced in 2016 and allowed insurance and reinsurance undertakings time to transition to Solvency II. These measures, however, are going to be phased out by 2032, which requires participants to be prepared.
18. The stress test has shown that undertakings have good buffers to honor their commitments with policyholders. Below the surface of these positive results, however, is an often heavy reliance on transitional measures. It is therefore important for undertakings to already start reducing the dependency on these measures to ensure compliance with the regulatory requirements at the end of the transitional period.

Recommendation 2

- ***EIOPA recommends NCAs to further assess if the exposure to the risks that cause a large drop in SCR-ratio or a (near) breach of SCR-ratio is adequately managed.***

Background

19. There are some undertakings that show a large drop in SCR-ratio, for instance, drops of more than 100 percentage points are observed. For other undertakings the stress test scenario causes the undertaking to breach or approach regulatory thresholds.
20. In both cases, this does not necessarily mean that risks are inadequately managed. However, as the impact of the stress test scenario is severe for these undertakings, it is important to verify this aspect to better understand the reasons for such a large drop.

Recommendation 3

- ***EIOPA recommends NCAs to verify that undertakings allocate sufficient resources to ensure that their risk frameworks and models are sufficiently flexible to assess those risks that are not reported as part of the Solvency II reporting framework, particularly focusing on their ability to produce and process relevant data.***

Background

21. The inverted production cycle that characterizes the traditional insurance business generates stable cash flows and makes undertakings less dependent on short-term funding. As a result, liquidity risk is generally less of an issue than in the case of banks. However, in times of crisis, uncertainty and/or distressed market periods, liquidity risk can have a potentially high impact on

undertakings. Although –as mentioned– the liquidity component of the stress test showed that participants' liquidity position appears to be less of a concern than their solvency position, undertakings should nonetheless have a proper liquidity management in place to fulfil both expected and unexpected funding needs in normal and distressed market periods.

22. Furthermore, given the absence of a commonly adopted liquidity framework in the European Union and the increasing consideration given to liquidity risk by the insurance industry and supervisors at European and global level, it is important for undertakings to pay the necessary attention to this risk.
23. In the stress test, EIOPA conducted a capital and solvency assessment and, for the first time, also examined participants' pre- and post-stress liquidity positions. While some undertakings were able to provide good quality and timely data for the liquidity stress test, others had significantly more issues in retrieving and assessing the information to assess the liquidity risk according to the proposed framework.
24. The issue can materialize for other risks or emerging risks which are not fully covered by the second pillar of Solvency II.

Recommendation 4

- ***For undertakings that did not apply management actions, even though they were warranted, EIOPA recommends NCAs to further investigate the reasons for not applying management actions and if these undertakings have sufficient options to apply management actions in case of need.***
- ***For undertakings that have applied management actions, EIOPA recommends NCAs to further assess the viability and reported impact of these management actions where the applied actions departed from what was discussed in the pre-validation phase. This applies specifically for undertakings that relied on intra-group support or where there is interconnectedness with the banking sector.***

Background

25. Participants were requested to estimate their position under two assumptions: a) fixed balance sheet, in which only the embedded management actions should be considered; and b) constrained balance sheet, in which reactive management actions could be considered.
26. The applied reactive management actions should be part of the governance framework adopted by the group (e.g. risk management plans, own risk and solvency assessment, investment strategies, and recovery plans) and not specifically defined and implemented for the stress test exercise. Reactive post-stress management actions also need to be realistic and proportionate and take account of the time needed to implement them.

27. The stress test revealed that several undertakings breached the SCR or were close to breaching the SCR and still did not utilise the possibility to use management actions. The reason for such decision should be further investigated.
28. Additionally, for the undertakings that applied management actions, in consideration of the material impacts that the enforced actions had on their post-stress Solvency position, EIOPA is of the view that, as a starting point, NCAs should consider the additional information available at their level on the governance and risk management framework of the participants. NCAs should only approach undertakings if the available information does not allow carrying out a thorough assessment of the capability of the companies to concretely apply such actions in terms of governance and operationalization.

Recommendation 5

- ***EIOPA recommends NCAs to assess the time it would take for participating undertakings to respond to adverse developments. This entails assessment of:***
- ***the decision-making processes;***
 - ***the ability to gather the necessary information in a short timeframe;***
 - ***the flexibility and adequacy of the models used by the undertakings to produce the required results.***

Background

29. Application of reactive management actions depends on the decision of the participants in the stress test exercise. While the application of the reactive management actions improves the solvency ratio, some participants did not apply them arguing that time was too limited to do so. However, in crisis situations, reactive management actions may have to be taken within a short time-frame to cope with the adverse situation. This also includes the need to produce the relevant information in times of stress.
30. The recommendation implies that all NCAs should assess whether the undertaking should have applied reactive management actions. This will require looking into the risk management framework of the undertaking. For example, an undertaking may not have breached the SCR, but it should perhaps have taken measures, according to its risk management framework.

Recommendation 6

- ***EIOPA recommends supervisory actions, including on-site inspections, if needed, regarding one of the participants based on the information provided in the validation process.***

Background

31. EIOPA puts significant resources to ensure the robustness and comparability of the stress-test results. This requires a comprehensive validation process that aims at evaluating the

simplifications and approximations applied by the participants, the robustness and appropriateness of their models used and, in turn, the quality of the data.

32. In the case of one participant the magnitude of the volatility of the results submitted during the validation process and the limited cooperation during the validation process raised EIOPA's concerns. Therefore, the NCA responsible for the supervision of that undertaking should further assess the case.

Follow-up by EIOPA

33. EIOPA has defined a series of follow-up actions and will undertake a coordinating role in the follow-up of the Recommendations with the aim of enhancing future stress test exercises and contribute to a more resilient insurance sector in Europe.
34. In addition, EIOPA considers that consistent and disciplined communication of the stress test results by participating entities would serve to limit distortions and contribute to a level playing field among insurers and also among other parts of the financial sector. To this end, EIOPA is considering possible measures to make sure the rate of publication will increase in future exercises.