ESRB
European Systemic Risk Board
European System of Financial Supervision

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Solvency II Review

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Dear Chair of the Council Working Party,

I wrote to you at the start of this year regarding the Solvency II review.[1] In that letter I highlighted where the EU co-legislators could strengthen and enhance the Commission's proposal to review Solvency II in order to better address systemic risks. As these considerations have so far not been reflected, the views expressed in that letter are still valid.

Today, I am writing to you after the ESRB General Board issued - for the first time - a general warning as risks to EU financial stability increased severely.[2] It is against this background that I would like to express my concern about some amendments to the draft proposals of the Commission, which the ESRB deemed to be a minimum of what is needed to help prevent or mitigate risks to financial stability and protect European citizens. In particular, I am concerned because some powers aimed at helping national authorities identify and mitigate liquidity risks are either insufficient, watered down or deleted.

I briefly elaborate on this below. In the annex to this letter, I am providing specific suggestions on the legal text under consideration regarding liquidity risk.

Providing supervisors with the tools they need to protect consumers and financial stability

Recent market developments in the United Kingdom should serve as a wake-up call. We acknowledge that those developments concerned the United Kingdom and in particular a different market sector, i.e. the pension fund sector. Nevertheless, these developments are relevant also for the EU insurance sector and the review of Solvency II, because of the following reasons:

- First: liquidity risk is pervasive. Even financial institutions that (i) do not engage in liquidity transformation as part of their business model, and that (ii) have long term liabilities and pursue liability driven investment strategies, can be exposed to liquidity risks. Widespread surrenders of life insurance contracts can be another source of liquidity risks.

[1] See Letter to Members of the European Parliament on the Solvency II Review and Letter to the Council Working Party on the Solvency II Review.
[2] See WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD of 22 September 2022 on vulnerabilities in the Union financial system.

- Second: prevention is more efficient and less costly than crisis management. Liquidity risk can materialise quickly and threaten financial stability with negative consequences for the real economy. It is therefore key that supervisors can act pre-emptively. When it comes to liquidity, powers that only apply in ‘exceptional situations’ are likely to be ‘too little, too late’.

Therefore, provisions regarding liquidity risks should be carefully considered within the ongoing Solvency II review. What is crucial is to enable supervisors to identify those insurers that might have a vulnerable liquidity profile and - if needed - to act before liquidity risk materialises.

This letter, including the suggestions in the annex, are consistent with the proposals the ESRB made in its response to the consultation of Commission services on the review of Solvency II.[3] It has been consulted with the Advisory Technical Committee of the ESRB. My staff and I are at your disposal to discuss these proposals.

I would like to take the opportunity and highlight that the focus of this letter on liquidity risk should not in any way be read as being at the expense of solvency. It would be detrimental to financial stability if capital requirements would be significantly lowered. Relatedly, the existence of a fully-fledged EU Recovery and Resolution framework in Insurance is necessary in order to safeguard financial stability and policy holder protection in a very important part of the financial sector.

Finally, please be informed that the same letter has been sent to the relevant Members of the European Parliament responsible for this legislative file. Both letters will be published on the ESRB’s website.

Yours sincerely,

Francesco Mazzaferro

Head of the ESRB Secretariat

[3] See Response letter to a consultation of the European Commission on the review of Solvency II.

ANNEX:

Explanatory notes:

The following takes as its starting point the text of the proposal of the European Commission (marked in grey).

Each article is preceded by a short paragraph setting out what the suggested drafting changes are trying to achieve.

Deletions relative to the text of the proposal of the European Commission, are indicated by ~~strikethroughs~~ and are marked in yellow; additions are indicated by *italics* and are marked in yellow.

Rationale and suggested changes

Ad Article 144a (1)

Art. 144a (1) as proposed in the text of the European Commission deals with liquidity risk management of insurance and reinsurance undertakings comprehensively.

Even liability-driven investors like insurance and reinsurance undertakings[4] can be subjected to liquidity risks. One reason is because insurers match their shorter-term assets and longer-term liabilities by investing in government bonds and interest rate swaps. Such duration matching helps insurers to immunize their balance sheets. But it exposes them to liquidity risk if they suffer mark-to-market losses on derivative positions and need to provide cash at short notice.

Therefore, the specification of ''stressed conditions'' should be preserved. Suggestions below are linguistic to enhance clarity.

Art. 144a (1): Member States shall ensure that *with regard to* the liquidity risk management, ~~of~~ insurance and reinsurance undertakings referred to in Article 44(2), point (d), ~~ensure they~~ maintain adequate liquidity to settle their financial obligation towards policyholders and other counterparties when they fall due, even under stressed conditions.

[4] For simplicity, the term “insurer” shall comprise insurers and reinsurers throughout the text.

Ad Article 144a (2)

Art. 144a (2) as proposed in the text of the European Commission contains an obligation for the creation of liquidity risk management plans and regulates an important part of liquidity risk monitoring.

However, the article does not identify the frequency with which liquidity risk management plans should be updated. As liquidity risk and capital market conditions can change quickly, management plans need to be periodically reviewed and kept up to date.

Therefore, the draft proposal of the European Commission, in particular the reference to liquidity risk indicators, should be maintained. It should also be strengthened by including a notion on the timely updates of liquidity risk management plans and indicators.

Art. 144a (2): For the purpose of paragraph 1, Member States shall ensure that insurance and reinsurance undertakings draw up and *keep up to date* a liquidity risk management plan projecting the incoming and outgoing cash flows in relation to their assets and liabilities. Member States shall ensure that insurance and reinsurance undertakings develop and *keep up to date* a set of liquidity risk indicators to identify, monitor and address potential liquidity stress.

Ad Art. 144a (5):

Art. 144a (5) as proposed in the text of the European Commission should combine insurers' liquidity risk management plans including those laid down in Art. 44 in respect to the long-term guarantee measures for effective liquidity risk management.

Therefore, this article should be kept as it is to ensure that liquidity risks can be adequately addressed.

Art. 144a (5): Member States shall ensure that, where insurance and reinsurance undertakings apply the matching adjustment referred to in Article 77b or the volatility adjustment referred to in Article 77d, they may combine the liquidity risk management plan referred to in paragraph 3 of this Article with the plan required in accordance with Article 44(2), third subparagraph.

Ad Art. 144a (6)

Art. 144a (6) as proposed in the text of the European Commission establishes an obligation on the part of EIOPA to draft regulatory technical standards to further specify aspects of the liquidity risk management plan.

The standardisation of liquidity risk management practises is important as it enables a sector-wide comparison of risks for supervisors across insurance and reinsurance undertakings. Such comparison requires that insurance and reinsurance undertakings would use homogeneous and conservative assumptions for macroeconomic variables when projecting expected cash in- and out-flows in the liquidity risk management plans.

Therefore, the draft proposal of the European Commission should be maintained and even strengthened by including underlying assumptions for macroeconomic variables in the content specification as well as the specification of the plan's format.

Art. 144a (6): In order to ensure consistent application of this Article, EIOPA shall develop draft regulatory technical standards to further specify the content *including underlying assumptions for macroeconomic variables, the format* and the frequency of update of the liquidity risk management plan. EIOPA shall submit those draft regulatory technical standards to the Commission by [OP please add date = 12 months after entry into force]. Power is conferred on the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1094/2010.

Ad Art. 144b:

The title of Art. 144b as proposed in the text of the European Commission ties supervisory powers to remedy liquidity vulnerabilities to the occurrence of exceptional circumstances.

However, the framework for insurers' liquidity risk management should be enhanced beyond vulnerabilities in exceptional circumstances. In addition, supervisors should be granted, via Pillar 2 provisions, the powers to act on liquidity.

Therefore, Art. 144b should not contain the restriction of exceptional circumstances.

Art. 144b: Supervisory powers to remedy liquidity vulnerabilities ~~in exceptional circumstances~~.

Ad Art. 144b (1)

Art. 144b (1) as proposed in the text of the European Commission establishes an obligation of supervisory authorities to monitor the liquidity position of insurance and reinsurance undertakings.

The ESRB considers it important that supervisory authorities have the powers to act on liquidity as indicated in its response to the consultation of Commission services on the review of Solvency II.[5] Given the margin calls and tension in the cash and derivatives market for fixed income, liquidity risk monitoring is important.

Therefore, Art. 144b (1) should be kept in its current form.

Art. 144b (1): As part of the regular supervisory review, supervisory authorities shall monitor the liquidity position of insurance and reinsurance undertakings. Where they identify material liquidity risks, they shall inform the concerned insurance or reinsurance undertaking of this assessment. The insurance or reinsurance undertaking shall explain how it intends to address those liquidity risks.

Ad Art. 144b (2)

Art. 144b (2) as proposed in the text of the European Commission defines the powers of supervisory authorities to address undertakings with a particularly vulnerable risk profile.

Liquidity risks can only be addressed if supervisory authorities are endowed with the power to remedy them.

Therefore, the article should be kept as it is.

Art, 144b (2): Member States shall ensure that supervisory authorities have the necessary powers to require undertakings to reinforce their liquidity position when liquidity risks or deficiencies are identified. Such powers shall be applied where there is sufficient evidence regarding the existence of liquidity risk vulnerabilities and the absence of effective remedies taken by the insurance or reinsurance undertaking. The measures taken by

[5] See Response letter to a consultation of the European Commission on the review of Solvency II.

supervisory authorities on the basis of this paragraph shall be reviewed at least once a year by the supervisory authority and be removed when the undertaking has taken effective remedies.

Ad Art. 144b (3):

Art. 144b (3) as proposed in the text of the European Commission provides supervisory authorities with the power to temporarily suspend redemption rights of policyholders on life insurance policies of undertakings facing significant liquidity risks.

Liquidity risks can only be addressed if supervisory authorities are endowed with the power to remedy them.

Therefore, the article should be kept as it is.

Art. 144b (3): Member States shall ensure that supervisory authorities have the power to temporarily suspend redemption rights of policyholders on life insurance policies of undertakings facing significant liquidity risks that may cause a threat to the protection of policyholders or to the stability of the financial system.

Such a power shall only be exercised in exceptional circumstances, as a last resort measure. Before exercising such a power, the supervisory authority shall take into account potential unintended effects on financial markets and on the rights of policyholders, including in a cross-border context.

The application of the measure referred to in the first subparagraph shall last three months. Member States shall ensure that the measure can be renewed if the underlying reasons that justify it are still present and it is no longer applied when those reasons are no longer present.

Without prejudice to Article 144c (6), Member States shall ensure that the insurance and reinsurance undertakings concerned do not make distributions to shareholders and other subordinated creditors, and do not pay bonuses or other variable remuneration until the suspension of redemption rights is lifted by the supervisory authorities.

Member States shall ensure that authorities with a macroprudential mandate, where different from the supervisory authorities, are duly informed of the supervisory authority's intention to make use of the power referred to in this paragraph and are appropriately involved in assessing the potential unintended effects referred to in the second subparagraph.

Member States shall ensure that supervisory authorities shall notify EIOPA and ESRB whenever the power referred to in paragraph 3 is exercised to address a risk for the stability of the financial system.

Ad Art. 144 b (4)

Art. 144b (4) as proposed in the text of the European Commission establishes an obligation to clarify which authority should exercise powers that apply to all insurance undertaking operating in a Member State.

Therefore, the article should be kept, thereby ensuring that liquidity risks that affect the whole or a significant part of a Member State’s insurance market, can be adequately addressed.

Art. 144b (4): The power referred to in paragraph 3 may be exercised in relation to all undertakings operating in that Member State where the exceptional circumstances referred to in paragraph 3 affect the whole or a significant part of the insurance market. Member States shall appoint an authority to exercise the power referred to in this paragraph. Where the appointed authority is different from the supervisory authority, the Member State shall ensure proper coordination and exchange of information between the different authorities. In particular, authorities shall be required to cooperate closely and to share all the information that may be necessary for the adequate performance of the duties entrusted to the authority appointed pursuant to this paragraph.

Ad Art. 144b (5):

Art. 144b (5) as proposed in the text of the European Commission appropriately regulates Member States' obligation to inform EIOPA and the ESRB if market-wide supervisory measures related to liquidity vulnerabilities are taken.

However, the article fails to establish a timeframe for this obligation to inform. Therefore, the following addition should be made to ensure timely reporting.

Art. 144b (5): Member States shall ensure that the authority referred to in paragraph 4, second subparagraph, shall notify *without delay* EIOPA and, where the measure is taken to address a risk to the stability of the financial system, the ESRB of the use of the power referred to in paragraph 4. The notification shall include a description of the measure applied, its duration, and a description of the reasons and risks that motivated the use of the power, including the reasons why it was considered effective and proportionate in relation to its negative effects on policyholders.

Ad Art. 144c

Art. 144c as proposed in the text of the European Commission provides supervisory authorities with the power to take measures to preserve the financial position of individual insurance or reinsurance undertakings during periods of exceptional sector-wide shocks that have the potential to threaten the financial position of the undertaking concerned or the stability of the financial system.

Marked-wide shocks can make it necessary for supervisors to address risks to the financial position of insurers to mitigate amplification effects in crises. For example, dividends or share buy-backs can lead to a depletion of capital and insurers might try to conserve capital elsewhere by de-risking. Such de-risking strategies can amplify exceptional market-wide shocks. As distributions are also used as a signal of strength to the market, they could undermine the relative position of more prudent insurers, which may become stigmatised. Art. 144c suitably addresses the need to provide supervisors with the necessary power. Additionally, while Art. 144c does not address liquidity risks specifically, it addresses market-wide shocks that are intrinsically intertwined with liquidity risks.

Therefore, Art. 144c should be kept and should be reinforced to include measures that can be applied market-wide. To reflect this Art 144c (1) should be changed as follows – with equivalent changes introduced in Art 144c (2).

Art. 144c (1): Without prejudice to Article 141, Member States shall ensure that supervisory authorities have the power to take measures to preserve the financial position of ~~individual~~ insurance or reinsurance undertakings during periods of exceptional sector-wide shocks that have the potential to threaten the financial position of the undertaking concerned or the stability of the financial system.

Ad Art. 144b and Art. 144c

As a general remark, we would like to bring to the attention of legislators that the multitude in terminology (as e. g. in the case of “market-wide shocks’’ in the title of Art. 144c and ‘’sector-wide shocks’’ in Art. 144c (1) and (2) compared to ‘’exceptional circumstances’’ in Art. 144b) could lead to uncertainty of legal application.