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Insurance Stress Test 2018
Frequently Asked Questions & Answers

1. What is a stress test?

A stress test is an important risk management and supervisory tool used by financial institutions, micro-prudential and macro-prudential supervisors to explore vulnerabilities and to assess the resilience of financial institutions (e.g. banks, insurers) and the entire financial systems (e.g. the banking sector, the insurance sector) to severe but plausible external shocks, such as sudden interest spike. Stress tests assess adverse outcomes under a variety of risks. They provide an indication of the impact and potential losses on materialization of these risks, and help to indicate areas where further supervisory actions are needed.

2. What are the objectives of this year's insurance stress test?

The objectives of the fourth EIOPA Insurance Stress Test are:

- **To assess vulnerabilities of the European insurance sector** to specific adverse scenarios with potential negative implications for the European financial markets and the real economy
- **To raise the awareness** of the potential **threats to financial stability** posed by the insurance sector at the European level
- **To increase transparency by requesting the individual disclosure of the results** to ensure a level playing field and to enhance market discipline among the stress test participating groups

3. What is the market coverage of the participating groups included in the stress test?

The target sample is composed of 42 insurance groups and results in a European market coverage close to 78% based on total consolidated assets according to the Solvency II Financial Stability reporting.

4. Why does this stress test focus on these specific insurance groups and not on solo undertakings as in case of the previous stress test in 2016?

The participating groups in 2018 were selected primarily based on size, European Union-wide market coverage from a financial stability perspective, business lines (life and non-life business) and involvement of a sufficient number of local jurisdictions. In the selection, the local market coverage was taken into account in a second stage.

This year EIOPA in coordination with the national competent authorities addressed the biggest European insurance groups identified as sufficiently prepared to undertake demanding endeavours like reassessing capital position post stress or publicly disclosing some of the stress test results.

In 2014, the stress test addressed solo undertakings as well as insurance groups, while in 2016 it addressed only solo undertakings. In both cases, the aim of including solos was to allow investigating at country level vulnerabilities posed by the persistent low yield environment on the specific firms' carrying long-term business as the type of business most typically exposed to that risk.

Given the need for a less demanding and more focused exercise in 2016, due to circumstances such as the first year of Solvency II implementation and the need to continue investigating on the effects of the low yield environment on the most exposed market segment, the exercise addressed solo undertakings only.

5. Who selects the participants for EIOPA's stress tests?

EIOPA in coordination with the national competent authorities selected the 42 participating insurance groups, which encompass the top 30 EEA (re)insurance groups in terms of total consolidated assets plus 12 additional (re) insurance groups and considering relevance for financial stability. The 12 additional (re)insurance groups were selected in order to extend the representativeness of the sample of group supervisors and jurisdictions represented in the exercise.

6. What are the scenarios tested in this year's stress test?

The Insurance Stress Test 2018 comprises the following three scenarios:

- **Yield curve up shock combined with lapse and provisions deficiency stress:** a sharp and sudden rise in interest rates triggered by both an upward shift in risk free rates as well as a significant increase in inflationary pressures.
- **Low yield shock combined with longevity stress:** a protracted period of extremely low interest rates.
- **Natural catastrophe scenario**: A series of natural catastrophes (e.g. storms, earthquakes, flooding) occurring in Europe.

Furthermore, the **exposure to cyber risk** and best practices in dealing with cyber risks will be assessed via a collection of information through a questionnaire.

7. What is the reference date for the Insurance Stress Test 2018?

31 December 2017.

8. How are the results of the stress test disclosed?

The participating groups are requested to consent for the disclosure of selected post stress results via their websites according to predefined templates (*See Annex 1 of the Technical Specifications*).

EIOPA will publish individual non-anonymous indicators represented in selected charts and tables.

9. **Which results will the participating groups be requested to disclose individually?**

The groups are requested to publish the impact of the scenarios on the group balance sheet including the excess of assets over liabilities with the impact of the Long Term Guarantee (LTG) and transitional measures.

The above mentioned results are identified in the templates for data collection and should be published in condensed versions of the standard Quantitative Reporting Templates (QRTs) together with a number of predefined indicators (*See Annex 1 of the Technical Specifications*).

10. **Which results will be disclosed by EIOPA?**

The EIOPA stress test report will analyse and disclose results on an aggregated and individual level. Among others, the report will include aggregated anonymised figures regarding an estimation of the group's capital position post stress while, for the information on which the written consent from participants was acquired, the report will include selected non anonymised charts and tables.

11. **Will the disclosure of the stress test results at individual participant level be compulsory?**

For EIOPA the increased transparency is key to ensure a level playing field and enhance market discipline among the stress test participating groups. At the same time, EIOPA is not empowered by its regulation to request obligatory the disclosure of the stress test results at individual participant level. Therefore, participating groups are explicitly asked for their consent on the individual disclosure during the first submission of the results and to confirm such consent after the data quality assurance process at national level conducted by the respective national supervisory authority and at the European level conducted centrally by EIOPA.

12. **Which positive side effects are expected from the individual disclosure of the stress test results?**

One of EIOPA's core responsibilities is to support the transparency of markets. Therefore, increased transparency in disclosing the results is key to ensure a level playing field and enhance market discipline among the stress test participating groups.

In addition to an overall better understanding of the resilience of different groups to adverse market developments, EIOPA expects several positive effects through the disclosure of individual stress test results, such as:

- **Improving market discipline** namely to increase the reliability of the analysis and conclusions and to ensure a better quality of the data and results.
- **Supporting the participating groups** in their follow-up to the stress test exercise recommendations and enhancing their abilities to compare their results with those of their peers to a set of common scenarios.
- **Providing participating groups the aggregated picture** presented by EIOPA's stress test report through the idiosyncratic perspective and by disclosing their own assessment of the results (including potential follow-up measures).

13. **To what extent is the stress test based on the Solvency II harmonised reporting requirements?**

The stress test templates reproduce to the extent possible the Solvency II regular templates used for the supervisory reporting purposes. The stress test templates and specifications explicitly identify the information additionally required for the purpose of the stress test. Information, which is required for the supervisory reporting purposes, but is either simplified or not required for the stress test is also identified in order to simplify the exercise.

14. **Why do the stress test technical specifications - with regard to the reconstruction of the balance sheets after the stresses – not exactly reproduce the Solvency II framework?**

EIOPA's stress test is not a pass-or-fail exercise. Its focus is assessing vulnerabilities and the potential systemic impact of shocks to the financial and economic environment. As such, given the different focus, some scenarios may include elements not prescribed in the regulatory framework for capital adequacy purposes but may be relevant for financial stability analysis purposes.

15. **How exactly did the European Systemic Risk Board (ESRB) contribute to the EIOPA Insurance Stress Test 2018?**

EIOPA discussed with the ESRB potential stress scenarios for the insurance sector based on their risk outlook. As a result, the two market scenarios, namely the yield curve up shock combined with lapse and provisions deficiency stress and the low yield shock combined with longevity stress were agreed – *see also question 6*. These two market scenarios have been calibrated using the European Central Bank's (ECB) financial shock simulator and consists of a set of prices' shocks for a large spectrum of assets triggered by simultaneous events.

16. **Why does the EIOPA exercise test a scenario based on an upward in interest rates?**

The risks of a sudden interest spike are highly discussed and identified as being key for the insurance undertakings. If interest rates were to return suddenly to the higher historical levels, many insurance undertakings could be negatively impacted with a scissor's effect: market values of assets could be reduced and the long-term value of claim increase faster than expected which could even potentially increase the value of the liabilities. In this regard, EIOPA needs to assess the potential outcome of such a scenario and the vulnerability of the participating insurance groups, should this risk materialise. Calibration of the different shock levels was performed in close cooperation with ESRB.

17. **Why does the EIOPA exercise test a scenario based on a downward of the yield curve?**

The concerns of the prolonged low-yield environment are still a major concern for the European insurance sector. This kind of scenario was already challenged in the 2014 and 2016 EIOPA stress tests and it is still viewed as one of the major threat in the insurance. Low-yields are damaging the profitability of some insurance undertakings and their ability to deliver certain level of guaranteed rates. All those concerns are well documented and justify a scenario, which tackles this aspect. Again, the calibration has been done in close cooperation with ESRB. A scenario-specific level of the Ultimate Forward Rate (UFR) has been set up to reinforce the consequences of such a scenario for the financial stability. However, the scenario does not pre-empt any changes in the regulation or regular methodology to determine the UFR.

18. **What is the rationale behind the natural catastrophe scenario chosen by EIOPA?**

Climate change is identified as a potential cause of reinforcing frequency or severity of weather-driven catastrophes. The focus of this year's scenario is on the European area and the different natural perils to which it is exposed, such as multiple cat events for windstorm, earthquake and floods perils. The calibration levels for those catastrophes have been done on an historical basis and the aggregate insured losses across all the events are expected to be within the range that could be expected from natural perils across Europe in an extreme year. In addition to this narrative, general insurers may also suffer from exhaustion of the reinstatement provisions of their reinsurance treaties.

19. **Why is the assessment of the cyber risk relevant for the insurance sector?**

Cyber attacks and cyber incidents are growing quickly and today the cyber risk can be considered as one of the most important operational risk to enterprises. A cyber attack or cyber incident can result in the interruption of business or service delivery but also in contractual failures, service delivery failures, failure in aging hardware, the loss of strategies or strategic/competitive advantages or the increase litigation exposure of the company. The cyber risk may be at the origin of lot of damage for an institution's reputation and brand (and with it, loss of customer confidence and trust). Moreover, the intellectual property can be impacted by this risk.

Insurance companies can be twofold affected as they typically face these risks directly as they also insure this kind of risks with large exposures. This makes it a very complicated to track this risk.

EIOPA is turning its focus on cyber risk, aiming at identifying the potential spill over effects of this emerging risk. This year's exercise will assess current practices and potential vulnerabilities of cyber threat and cyber insurance exposures by combining qualitative information with quantitative analysis provided by a questionnaire, part of the Stress Test package. The scope of participating groups for this stress test is large enough to be representative of the vast majority of the insurance market.

20. Why does the stress test require information on the impact of long-term guarantee (LTG) and transitional measures from participants?

Separate reporting of the impact of the LTG and transitional measures is key from a financial stability perspective for a meaningful assessment of the economic impact of the stress scenarios. This separated information is also part of the regular annual reporting. It is especially relevant under the prescribed stress scenarios to correctly identify the sectoral vulnerabilities. The use of the LTG measures has to be taken into account for the post stress estimations provided that they have been already approved by national competent authorities and are used for the baseline (pre-stress) situation. Particularly relevant for the adjustments derived from the transitional measures both on the risk-free interest rates and on technical provisions is that no change can be assumed to the amount used in the baseline. In other words, an approval of a new transitional amount cannot be taken for granted in the exceptional circumstances such as the stress scenarios.

21. **Does the stress test fully reproduce the Solvency II framework?**

The starting balance sheet of the stress test reproduces the Solvency II balance sheet in the pre-stress situation. Participants are requested to re-compute the initial balance sheet under the assumptions of the hypothetical adverse scenarios according to the specifications of the stress test.

In particular, it is more appropriate to use a different assumption for the UFR in the Yield Curve down scenario in assessing potential vulnerabilities at the European level. Consequently, the balance sheet after the scenarios, which is relevant from a financial stability perspective, is not fully appropriate to assess the compliance with the legally enforceable capital requirements under Solvency II.

22. **How are the reactions of the participating groups taken into account in the stress test? Are these reactions treated different from the regular Solvency II framework?**

EIOPA stress scenarios consist of instantaneous shocks to the regulatory balance sheet and related reported figures, such as the composition of assets and liabilities.

This instantaneous shock approach entails a few important assumptions, which need to be taken into account when interpreting the stress test results:

i. Stresses are applied to the asset and liability portfolios effectively held by participants at the reference date, i.e. on 31 December 2017. When calculating the instantaneous stress impacts, participating insurance groups cannot assume new insurance business or alter their post stress asset structure. Future premiums on insurance business can be taken into account to the extent they fall within the Solvency II contract boundaries.

ii. EIOPA exercise is not a multi-period stress test exercise and, as such, does not include future rollover of the insurer's balance sheet.

iii. All future profits following the current asset and liability portfolio are taken into account when stressing the balance sheet as Solvency II values both assets and liabilities on a forward- looking market consistent basis. As the difference between the market value of the assets and the liabilities constitutes a material part of the own funds of the insurance undertakings, the actual impact of a particular stress scenario can, in this set-up, be better assessed by investigating the impact of the stresses on the assets, liabilities and own funds of the insurance groups.

iv. For the recalculation of the Solvency Capital Requirements (SCR) post stress, not allowing future management actions in the 12 months projection is a common practice introduced in the context of the stress test for the sake of comparability (i.e. allowing extracting conclusions on comparable grounds). EIOPA acknowledges that the calibration of the standard formula or internal models might not fit such extreme situations as the ones assessed in the stress test. Therefore, this aspect should be acknowledged when interpreting the results.

23. What is the probability of the EIOPA scenarios?

In line with the communicated objectives of the EIOPA stress test, which aims at assessing vulnerabilities rather than being a recapitalisation exercise, the combined probability of the scenarios is deemed less relevant and not computed.

24. Can the probability of the market scenarios be reliably estimated?

The probability of each market scenario is the outcome of the combination and correlation between the different triggering events included and its estimation necessitates methodological approximations. EIOPA does not compute the combined probability of market scenarios due to the significant shortcomings and the approximations required, which would affect the reliability of any estimation. The EIOPA market stress scenarios are the outcome of different simulations based on different sample of financial variables and selected triggering events. These selections as well as their probability levels have been chosen to reflect the main risks for the financial stability of the insurance sector and according to the general objective of the exercise as well as the methodology used. It should be noted that the probability of the triggering events (i.e. the originators of specific market distresses) does not necessarily coincide with the marginal probability of the shocks to the other variables (i.e. those variables affected by the spillovers of the triggers). The joint probability of the triggering events cannot be considered as the probability of the scenario as technically several combinations of triggering events might determine the same combination of responses observed in the chosen scenarios. Additionally to the market shocks, EIOPA includes some insurance specific shocks like the lapse or the provisions deficiency stresses in the yield curve up scenario or the longevity shock in the low yield scenario, for which a combined probability is not derived.

25. Is the severity of EIOPA market scenarios comparable to the stress scenarios used by the European Banking Authority (EBA)?

Further to the answer above, the severity of the EIOPA scenarios cannot be directly compared with the one of the EBA exercises, because the narrative is different and the shocks are applied differently. For example while in the EBA methodology the total effects are cumulated over 3 years, according to the EIOPA methodology, the effects are immediate. The current calibration takes into account the fact that shocks are applied as one-off shocks in the EIOPA methodology. Therefore, these shocks have to be more severe to compensate for the methodological differences. The sample used for the calibration and the percentile associated with the triggering event have been chosen in a way to satisfy the higher severity.

26. Did EIOPA consult external stakeholders in the process of designing the Insurance Stress Test 2018? To what extent were suggestions taken into account?

Relevant stakeholders, representing the stress test participants and the actuarial profession, have been consulted during the preparation of the stress test specifications. This time, given the complexity of the exercise, EIOPA engaged with the stakeholders at an earlier stage compared to previous stress tests, with the special focus on key elements like the individual disclosure of results and the post stress calculation of the capital position.

As an independent authority and to preserve the reliability of the exercise EIOPA does not discuss the severity of the scenarios or the level of the proposed shocks with the stakeholders but rather with the national competent authorities in cooperation with the ESRB.

Notwithstanding this fact, ahead of the launching the stress test exercise, EIOPA engaged in discussions with the stakeholders on the main components to ensure its feasibility and usefulness. EIOPA considered and took on board stakeholders' points, such as on the potential approaches for calculation of the balance sheet figures as well as the capital position post stress, the complexity of the stress scenarios, the indicators and stress test results to be publicly disclosed, the granularity of the data request, the timeline and the technical specifications.