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Insurance – Regulatory Strategic News

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The insurance sector, like the rest of the financial system, remains under the regulatory microscope. However, policymakers' concerns are moving beyond the risk posed to the system to consider how the financial system can better serve the economy and citizens. In this issue, we explore how debates in relation to systemic risk within the insurance sector have developed, as well as how sustainability and long-term financing of the economy are being addressed through insurance regulation. Finally, we cast our eye over developments affecting the retail insurance market.

Systemic risk is back on the agenda...

The financial crisis of 2008/9 led to a complete overhaul of the financial regulatory framework globally. One of the lessons of the crisis was that microprudential supervision did not guarantee financial stability, and therefore regulators have increasingly been focusing on systemic risk and macroprudential oversight. The concern is particularly acute today. After years of quantitative easing and low interest rates fuelling search-for-yield behaviour by investors, there is increasing concern that the financial system is vulnerable to a sudden re-assessment of risk premia given stretched asset prices.

> Regulators have increasingly been focusing on systemic risk and macroprudential oversight

Approaches to macroprudential oversight are maturing and becoming more sophisticated. While the focus immediately after the crisis was on global systemically important institutions ("G-SIIs"), there is now a shift towards recognising that a system that looks at activities across the sector could be more effective.

The International Association of Insurance Supervisors ("IAIS") has therefore begun work on developing a Holistic Framework for Systemic Risk in the Insurance Sector, to replace the dreaded G-SII framework. The framework identifies two main sources of systemic risk in the insurance sector:

1. Knock-on effects from the failure or distress of an individual insurer
2. Contagion effect through the sector's collective risk exposure and response to shocks.

In particular, the proposed framework considers the drivers of systemic risk arising from liquidity risks, interconnectedness through common macroeconomic exposure or counterparty exposure, the lack of substitutability of critical functions, as well as other risks such as cyber risks.

IAIS proposes a policy toolkit including:

- **Enhanced supervisory measures to limit the build-up of risk,** including enhanced macroprudential surveillance, enhanced supervision and disclosure of liquidity risk management and enhanced scenario analysis and stress testing to assess the effects of macroeconomic shocks,
- **Enhanced supervisory powers of intervention to address risks that have materialised,** for example by making it explicit that existing intervention tools, such as restrictions on business activities and directions to reinforce the financial position, could also be used for macroprudential purposes. It is also proposing new tools such as large exposure limits, temporary freezes of assets and stays on surrenders, additional capital buffers and capping the maximum rate of guarantees. While not within the remit of insurance supervisors, a system-wide lending facility for market-wide liquidity issues could also be an option,
- **Global monitoring of risks to be conducted annually by IAIS,** to gather data on individual insurers' position and assess sector-wide trends.

The final framework is expected to be adopted at the November 2019 Annual General Meeting of IAIS and would be implemented in 2020.

Work has also been ongoing at the European level by the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB). In a paper on macroprudential provisions, measures and instruments for insurance, published in November 2018, the ESRB builds on the IAIS work and sets out options for improvements to the insurance

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regulatory framework in Europe. While the ESRB recognises that Solvency II and the Higher Loss Absorbency can act as a dampener to the build-up of risk, these frameworks were designed with microprudential supervision in mind and may not adequately address systemic risk concerns.

In its report, the ESRB recommends the introduction of a number of tools, including **enhanced reporting, an EU-wide insurance recovery and resolution regime and a macroprudential toolkit to target systemic risks.** Such a toolkit could include capital add-ons and dividend restrictions, symmetric capital requirements for cyclical risks, liquidity requirements and discretionary powers for regulator to intervene. **The issues raised in the ESRB's report have been included in the European Commission's request for advice to EIOPA in relation to the Solvency II Review (see below).**

While such changes will not bite for another few years, the insurance industry is likely to face enhanced scrutiny of its liquidity risk management systems. Concerns include whether sufficient liquid assets are being held to cover surrenders and margin calls to avoid the need to liquidate illiquid assets in stressed markets. There is also a renewed focus on derivatives transactions, given that derivatives positions can increase leverage, increase interconnectedness through counterparty exposure and affect insurers' liquidity positions through margin calls. Recent proposals relating to liquidity and leverage in the fund industry may serve as guidance on what the insurance industry might expect further down the line.

... And the risk discussion is moving into sustainability and climate risk

Another type of risk that is gaining attention is sustainability and climate change risk. The Paris Climate Accord in 2015 put climate change, as well as broader environmental, social and governance ("ESG") issues on the map. Since 2015, we have seen the finalisation of the Task Force on Climate-Related Disclosures recommendations, the creation of the G20 Green Finance Study Group and the European Commission's Action Plan on Sustainable Finance.

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The insurance industry is considered to be on the frontline of these issues given its exposure to physical risks from extreme weather events but also from transition risks. The IAIS has been exploring how insurance companies and supervisors should respond to these challenges, including assessing the portfolio exposure to carbon asset risk and undertaking scenario analysis and stress testing for climate change factors. The European Commission has asked EIOPA to begin work, as part of the Solvency II Review in 2020, to consider changes to the framework to take into account sustainability risks, with a particular focus on climate change risk. **EIOPA will present its findings to the European Commission in September 2019 and will consider the impact on prudential rules on insurers' sustainable investments and how insurers incorporate sustainability in their underwriting practices.**

The European Commission Action Plan on Sustainable Finance, launched in March 2017, goes beyond climate change to consider sustainability risks, i.e. environmental, social and governance risks, more broadly. The Action Plan is multi-faceted and includes a number of interconnected actions to address sustainability across the financial system.

A proposal for a framework for sustainable investments, otherwise known as the "taxonomy" aims to define economic activities that can be considered as sustainable. The taxonomy defines six environmental objectives, including climate change mitigation, climate change adaption and healthy ecosystems. An expansion to consider social investments is foreseen at a later stage. While deliberations on the proposal by the European co-legislators have not come to fruition under this legislative cycle, a Technical Expert Group ("TEG") has been established to begin work on the technical criteria, starting with climate change mitigation and adaptation. Its first report is due in June 2019.

A second proposal on **disclosure relating to sustainability risks and adverse sustainability impact** by financial market participants is also on the table and, an agreement in principle was reached in March, subject to final approval by the co-legislators in April. The regulation will require financial market participants, including insurance undertakings and insurance intermediaries, to disclose to their clients how they take into account sustainability risks, i.e. the risk to the value of an asset from ESG factors, but also the impact of investment decisions on the environment and society. Such disclosures will apply to all entities and product providers, regardless of whether the product itself has a sustainability objective. The new rules will be phased in from 2021 onwards.

Finally, EIOPA has been asked by the European Commission to advise **on changes to Solvency II and the Insurance Distribution Directive ("IDD") to integrate sustainability risks and factors.** While EIOPA believes that sustainability risks are most likely to materialise through existing risk categories such as credit risk and property risk, the draft put out for consultation includes changes to the risk management framework and the investment section of Solvency II to explicitly require the consideration of sustainability risks by insurance undertakings. For insurance intermediaries, the draft changes to IDD would require firms to consider ESG factors in their product approval process and other product oversight and governance arrangements, whether or not the product is intended to be sold to customers with ESG preferences. EIOPA is due to provide its final advice to the European Commission by end of April 2019.

While the details of many of the initiatives above are yet to be defined, it is clear that, going forward, insurance undertakings will be required to have an enhanced focus on sustainability issues. This will include development of the necessary analytical capabilities to undertake stress testing and scenario analysis in relation to sustainability risk exposure, consideration of how to optimise strategic investment allocation to sustainable investments and the integration of ESG considerations across investment portfolios.

All of these issues are likely to be picked up in Europe through the Solvency II review

In addition to the themes of systemic risk and climate change, the review of Solvency II, which has governed the insurance sector in Europe since 2016, will also address issues such as improving proportionality of the rules, as well as lowering disincentives to insurers' financing the real economy as part of the Capital Markets Union project. This includes a review of the Delegated Acts originally scheduled for 2018 (the "2018 review") that seeks to fine-tune the technical details under Solvency II, to be followed by a full review of the Solvency II Directive in 2020 (the "2020 review").

In March 2019, the Commission unveiled the changes to the Solvency II Delegated Acts. Based on detailed input from EIOPA, the new rules include:

- **Measures to facilitate financing of the real economy,** in particular in relation to unrated debt and unlisted equity investments. This includes the creation of a new long-term equity category that would be subject to the same 22% capital charge as strategic participations for Type 1 and Type 2 equities, as well as qualifying infrastructure equity and qualifying infrastructure corporate equity,
- **Measures to enhance the proportionality of the framework** and simplify elements of the capital requirement standard

formula, for example a carve-out from the mandatory application of the look-through in investment funds and certain risk elements,

- **Measures to harmonise the treatment of deferred taxes to absorb present losses,**
- **Measures to fine-tune the calibration and risk sensitivity in certain areas,** such as updating the parameters for non-life premium and reserve risk, health and non-life catastrophe risk, and refining the treatment of risk mitigation techniques and group solvency calculation.

While many of the changes have been broadly welcomed by policymakers and industry alike, there remain key areas where stakeholders' views diverge.

In an exchange of letters to the European Commission prior to the adoption of the new rules, the European Parliament commented that the conditions attached to the new long-term equity class – the need for such investments to be ring-fenced and held for an average of 12 years – would make the proposals unworkable. While the final rules have reduced the average holding period to five years, this is still likely to make the new equity class cumbersome for insurers to make use of. The European Parliament also called for changes to the risk margin and the national component of the volatility adjustment. The European Commission's response signalled that the latter two issues would be dealt with in the 2020 Review and EIOPA was instructed to begin work on the volatility adjustment on 7 February.

> EIOPA advocated for changes to the interest rate module to take negative interest rates into account.

In its advice to the European Commission, EIOPA advocated for changes to the interest rate module to take negative interest rates into account. This was the subject of considerable concern to the insurance industry and was not included in the final rules adopted by the European Commission. In a letter to the European Commission, EIOPA expressed disappointment that this issue had not been addressed and also took issue with the introduction of the lowered equity risk charge of 22% until further work has been undertaken. EIOPA underlined that it was still carrying out work on how best to take into consideration illiquid liabilities backed by illiquid assets, and that any changes should be postponed until this work was finalised.

The rules must now be signed off by the European Parliament and Member States. However, given the imminent European elections, ratification may be delayed until later in 2019. Once finalised, these changes should reduce the burden and complexity for insurance undertakings to calculate their capital requirements, including when investing in funds, as well as open up new investment opportunities in unrated debt and equity instruments. However, as the proposal currently stands, firms may find it challenging to make use of these new rules due to the complexity of the conditions attached to their use.

Despite the 2018 review only just being finalised, attention is already turning to the 2020 review, where much weightier issues will be re-opened, including re-assessing the rules around long-term guarantees and equity risk. The European Commission issued its call for advice to EIOPA in February 2019, with EIOPA asked to provide its response by June 2020. In its request, the European Commission asked EIOPA to provide advice on 19 topics, including:

- Matching adjustment and volatility adjustment,
- Risk margin,
- Macroprudential issues (including recovery and resolution),
- European insurance guarantee scheme.

In preparation, EIOPA is expected to launch consultations on different aspects of the review in summer/autumn 2019. This review could therefore spell a significant change to the Solvency II framework and the broader insurance regulatory framework in Europe.

Meanwhile, the European Commission is looking again at transparency and the costs of retail products

> EIOPA concluded that further work was necessary to better define cost definitions and to develop common standards and methods for calculating comparable data on returns.

As part of preparations for what we expect to be a big agenda item for the new European Commission, EIOPA published in December 2018 its first report on costs and past performance of retail insurance products. The report concluded that there are significant data quality and comparability issues in the insurance retail market, which led to only 20% of the sample being included in the final study. EIOPA concluded that further work was necessary to better define cost definitions and to develop common standards and methods for calculating comparable data on returns.

Part of the issues is linked to the availability of data under the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs), which it has been announced will now undergo a full review in 2019. The co-legislators also agreed to extend the exemption for funds that are classified as Undertakings for Collective Investments in Transferable Securities ("UCITS") from being required to provide PRIIPs Key Information Documents ("KIDs") until 2022. The Joint Supervisory Committee of EIOPA, ESMA and the European Banking Authority had conducted a consultation last autumn on quick fixes to the PRIIPs KID, in particular around the presentation of performance scenarios. The three supervisors announced in February that, in light of the full review to take place this year and significant negative feedback to the consultation, they had decided not to suggest any immediate changes. They did, however, recommend a small change to the regulatory technical standards as a result of the decision to postpone the inclusion of UCITS in the PRIIPs regime. Providers of so-called multi-option products ("MOPs"), such as unit-linked insurance products where the underlying investments were UCITS, had the option to rely on the UCITS KIID for their disclosures under PRIIPs. However, this dispensation was due to expire at the end of 2019 when the exemption for UCITS providing PRIIPs KIDs also expired. In light of the extension of the UCITS exemption, the supervisors proposed a quick fix to also extend the dispensation for multi-option products to the end of 2021. The supervisors called on the European Commission to adopt the changes as soon as possible with the hope that they could be signed-off by the co-legislators before the European Parliament elections.

And an agreement on the Pan-European Pension Product is reached

In February, it was announced that the European Parliament and Member States had reached an agreement on a proposal for the creation of a new Pan-European Pension Product ("PEPP"). The new product label would apply to a private pension vehicle that can be ported across the EU. The product will include a default option, the basic PEPP, which can consist of either a guarantee or a life-cycling option. However, at the insistence of the European Parliament, the basic PEPP will be subject to a 1% fee cap. EIOPA will be tasked with developing regulatory technical standards, including around the new PEPP Key Investor Document and on risk mitigation techniques.

Key dates to watch:

April 2019: Agreement on Sustainability Disclosure Proposal and Pan-European Pension Product by co-legislators

30 April 2019: EIOPA to submit advice to European Commission on integration sustainability risks in Solvency II and IDD

Summer 2019: EIOPA to begin consultations on Solvency II Review

Autumn 2019: European Commission to begin PRIIPs Review

30 September 2019: EIOPA to submit advice to European Commission on integrating sustainability in Solvency II

November 2019: IAIS Annual Meeting to approve new ComFrame including macroprudential toolkit

30 June 2020: EIOPA to submit advice to European Commission on Solvency II Review.

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