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European Insurance stress test: keep calm

Today, the European Insurance and Occupational Pensions Authority (EIOPA) released the results of the 2021 Insurance Stress Test. Both capital and liquidity positions of insurers remained strong under shock, and assets over liabilities coverage met policyholders needs. Exposure to market shocks remains one of the key vulnerabilities

Aerial shot of the European Insurance and Occupational Pensions Authority headquarters in Frankfurt, Germany

Set up

EIOPA released the results of very much awaited 2021 Stress Test of the insurance sector. The objective of such an exercise was to assess the resilience of insurance undertakings to adverse scenarios and see if they can withstand the shock. The proposed scenario was a double hit – how would insurance companies cope with "lower for longer" interest rates all while having to withstand the prolonged Covid-19 pandemic. The impact on both capital and liquidity positions came into focus. In total, the stress test covered 75% of the insurance market of the European Economic Area with 44 participants. As mentioned before the main objective was to assess the resilience of the sector, which is necessary to be able to consider any further recommendations as well as to be able to estimate if there is any spill over into other markets and sectors.

Main findings

While EIOPA stress tests remain a non pass/fail exercise, it had an aim to observe participants under shock. EIOPA concluded that insurers have sufficient Solvency II buffers which allowed them to absorb the shock of an adverse scenario. Under the fixed balance sheet approach the Solvency II ratio decreased by on average 92 percentage points (from 218% to 126%) and by only 79ppt under a constrained balance sheet where certain reactive measure actions were already applied. Most of the ratio decrease was triggered by the drop in own funds (and the deteriorating quality of those funds), however a slight increase in the solvency capital requirement also played a role. Only 9 participants breached the 100% Solvency II ratio requirement under fixed balance sheet, while 7 of them managed to regain compliance with the capital requirement under a constrained balance sheet.

Long-term guarantees and transitional measures were flagged as still being important shock absorbers. To give an idea of the importance of these measures, without them the decrease in Solvency II ratio under shock would amount not to 92, but to 126 percentage points (fixed balance sheet). It's important to keep in mind that while LTGs is a permanent structure under Solvency II, transitional measures will be phased out by 2032, but their impact in general is much less significant than that of LTGs.

Under a double hit scenario, assets over liabilities coverage also shows a material decrease, dropping from 110% to 106% (under both fixed and constrained balance sheet). The ratio not falling below 100% gives EIOPA confidence that "the sector, even under a severe scenario, proves to be able to meet its promises to the policyholders". The drop in assets was partially offset by a decline in liabilities. EIOPA stated that one of the key vulnerabilities of the insurance segment is exposure to market shocks. In the stress scenario government fixed income assets were reduced by 2.8%, corporates by 4% and equities by 43%. The change in derivatives position was positive, partially offsetting the shock and highlighting an active use of derivatives by insurance companies in order to navigate adverse market environment. On the liabilities side life provisions saw a marginal decrease, whereas non-life provisions increased.

As insurers were allowed to apply reactive management actions for calculation post-stress positions under constrained balance sheet, it gave EIOPA an opportunity for a macroprudential exercise observing which measures were used and what effect they had. Only measures which were already part of the insurers' governance frameworks were allowed. Amongst such measures were decisions not to distribute dividends, de-risking of assets and liabilities, issuance of subordinated debt and equity, reduction of costs, reinsurance, use of VA, etc. EIOPA stated that not all of the actions resulted in desirable results, and also not all actions were in the best long-term interests of the companies.

In terms of liquidity position, no significant shortfalls were identified in adverse scenarios. A shortage in the net liquidity position of €10bn under a fixed balance sheet quickly turned positive through management actions under a constrained balance sheet. Given the strong

liquid asset position there is always a substantial buffer to cover any shortage that was identified under fixed balance sheet.

The results were released on an aggregate basis. A handful of insurance companies in the EIOPA sample agreed to share information on their individual results. No Dutch names however were amongst them.

Potential consequences

As EIOPA's insurance stress test is not a pass/fail exercise, it holds no direct consequences for insurance sector. However, the potential scope of repercussions can be rather wide. Based on the analysis of the results, EIOPA will assess whether it needs to issue any further guidance and recommendations. National supervisory authorities can as well provide recommendations to be implemented by the insurance undertakings in their jurisdiction. Identifying the vulnerabilities of the sector and possible spill over into other markets is a crucial step towards a more effective work on recovery and resolution procedures in 2022.

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