MILLIMAN BRIEFING NOTE

EIOPA Solvency II 2020 Review:

Liquidity and Systemic Risk Management Plans

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As part of the Solvency II 2020 review, EIOPA published an opinion, in December 2020, including the view that "a macroprudential perspective should be incorporated into the current prudential Solvency II framework….". As part of this, EIOPA has proposed to enhance the current regime by adding some additional, formal requirements around liquidity risk and systemic risk.

Amongst the macroprudential requirements, EIOPA has suggested that the framework be enhanced by introducing requirements in relation to:

- Liquidity Risk Management Plan (LRMP). EIOPA's view is that all companies under Solvency II regulation should be required to draft a LRMP to identify and address liquidity stresses that they are exposed to, with the possibility of waiving the requirement for companies less vulnerable to liquidity stresses under the proportionality principle.
- Systemic Risk Management Plan (SRMP). EIOPA suggests that supervisory authorities should require insurers to draft and maintain SRMPs where they have a higher likelihood of creating or increasing systemic risk.

EIOPA is expected to issue guidance to help supervisors to identify the insurers that will be required to draft SRMPs. The proposed criteria for selection of insurers to be subjected to SRMP requirements include:

- The size of the undertaking/insurer
- The nature of exposures, scale, and complexity of the insurer's activities
- The global activity of the insurer and its interconnectedness with the financial system

EIOPA has also suggested a systemic risk capital surcharge for entities activities or behaviours, that are deemed to be sources of systemic risk. In its consultation paper, EIOPA has indicated that the capital surcharge should be at the discretion of regulators and may be calculated using the same methodology as for the existing capital add-on (Article 37 of the Solvency II Directive). Procyclical effects should also be considered if regulators decide on the use of such a surcharge.

In advance of any formal guidance from EIOPA to produce LRMPs and SRMPs, it is useful to look at what the International Association of Insurance Supervisors (IAIS) required from global systemically important insurers (G-SII institutions). G-SII institutions were required to produce both an LRMP and an SRMP up until 2020. The G-SII designation was suspended last year and this leaves somewhat of a gap in current guidance in relation to liquidity and systemic risk assessment. It is clear that EIOPA intends to broaden the base of insurers required to draft macroprudential risk management plans.

Liquidity risk

Liquidity risk is defined by the IAIS as "the uncertainty, emanating from business operations, investments or financing activities, over whether the insurer will have the ability to meet payment obligations in a full and timely manners in current or stressed environments".

Liquidity risk is fundamentally different from solvency risk. If liquidity risk is not managed appropriately, even solvent insurers can experience financial distress or failure in times of market turmoil or other stress events. Companies with liquidity issues can also fail in normal economic conditions. For example, insurers holding illiquid assets together with liquid liabilities[1] may be subject to liquidity risks if there are unforeseen increases in surrenders or a downturn of financial markets.

There are already existing liquidity risk management requirements under the existing Solvency II framework. Article 260 of the Solvency II Delegated Regulations refers to liquidity risk management requirements.

EIOPA's Opinion on the 2020 review of Solvency II stated that supervisors should be granted powers to incentivise insurers to reinforce their liquidity position in order to increase available liquidity.[2]

Further guidelines on the operational details of the liquidity risk framework are expected to follow, although EIOPA have not yet provided a date for issuing these guidelines

Other regulators have also been very active around liquidity risk. The Central Bank of Ireland ("CBI") has identified liquidity risk as an area of focus. On the 8th of June 2020, the European Systemic Risk Board ("ESRB") wrote to the

[1] An example of a liquid liability is where the policyholder can lapse their policy immediately without notice or penalty.
[2] https://www.eiopa.europa.eu/sites/default/files/solvency_ii/eiopa-bos-20-749-opinion-2020-review-solvency-ii.pdf

Chairman of EIOPA regarding liquidity risk in the insurance sector in light of the COVID-19 pandemic. [3]

In addition, the IAIS has recently consulted on liquidity metrics and that, while not directly relevant to liquidity risk management plans, is a potentially useful source of information on future regulatory requirements in the area of liquidity risk management. The first phase of consultation[4], which closed on 7 February 2021, focussed on the development of liquidity metrics to help identify trends in insurer and insurance sector liquidity. In the next phase of the development of liquidity metrics, the IAIS will develop further metrics including a company projection approach which will use insurers' own cashflow projections in order to assess liquidity risk. The IAIS expects to continue to develop other liquidity metrics and plans to finalise a set of liquidity monitoring metrics in 2022.

Drafting an LRMP

Before the G-SII designation for institutions was suspended, G-SII's were required to report at least annually on their liquidity management and planning, and the IAIS issued guidelines on effective liquidity management and planning. [5] We can draw on these guidelines to help us understand what might be required in an LRMP.

A liquidity risk management policy is already required from Insurers under the existing Solvency II framework and will likely form a good starting point to developing an LRMP. The following paragraphs summarise the minimum requirements for LRMPs as per the IAIS.

The LRMP should have a statement of objectives which could include the institution's liquidity risk policy, an explanation of its governance arrangements around liquidity management and a clear outline of its risk tolerances.

The liquidity risk policy should outline the following:

1. The institution's liquidity risk tolerance, including quantitative requirements such as excess liquidity targets and liquidity coverage ratios, in addition to qualitative objectives.
2. An assessment of liquidity needs and the sources, assumptions and expert judgement used to arrive at this assessment.
3. Assignment of responsibility for decisions and contingency funding plans.
4. That the LRMP should be communicated to all relevant functions within the insurer.
5. An assessment of the arrangements the insurer has in place to monitor, manage, mitigate, and reduce liquidity risks.

LIQUIDITY GAP ANALYSIS

A liquidity gap analysis is a useful tool to determine an insurer's liquidity needs. It is a forward-looking assessment of liquidity sources and needs and is carried out on both current conditions and future stress scenarios.

The IAIS outlined the guidelines below on producing a liquidity gap analysis. EIOPA have not mentioned whether a liquidity gap analysis will be required, but they have suggested that the IAIS guidance on liquidity risk management planning provides a useful basis, and hence, this may provide clues as to what EIOPA may look for in the future.

1. Project over time the insurer's liquidity sources and needs, under current and stressed conditions.
2. The projection time horizon should be appropriate to the business, but both short- and long-term time horizons should be assessed.
3. Liquidity sources and needs should be measured using consistent assumptions.
4. Exclude any encumbered or ringfenced cash or assets.
5. New or rollover secured market borrowing should be assumed to be zero in the stress scenarios.
6. Assume haircuts on collateral posted in adverse market conditions.
7. Assess existing borrowing agreements for contingencies.
8. Calculate a liquidity coverage ratio as the ratio of the insurer's liquidity sources over liquidity needs.
9. Regular monitoring should take place and "early warning indicators" such as a target liquidity coverage ratio or other indicators should be used.

[3] https://www.esrb.europa.eu/pub/pdf/other/esrb.letter200608_to_EIOPA_on_Liquidity_risks_in_the_insurance_sector~e57389a8f1.en.pdf?f94513cd100e65181f65326349fe409d

4 https://www.iaisweb.org/page/consultations/closed-consultations/2021/development-of-liquidity-metrics-phae-1-exposure-approach

[5] https://www.iaisweb.org/file/47800/liquidity-guidance-final

10. Consideration of capital planning such as future dividend pay outs should be allowed for in the liquidity gap analysis.

GOVERNANCE

The Board should approve the LRMP and has responsibility for the effectiveness of the plan. Day to day monitoring can be delegated to the risk committee or another appropriate committee with responsibility to report to the Board on a regular basis.

The LRMP should be reviewed at least annually, but more frequently if there are significant changes to business strategy such as a change in investment strategy or new product launches.

Systemic risk

Systemic risk, as defined by the International Monetary Fund (IMF), Bank for International Settlements (BIS), and Financial Stability Board (FSB), refers to the risk of disruption of financial services that is caused by an impairment of all or parts of the financial system which has the potential to have serious negative consequences on the real economy. [6] [7]

There are many areas where exposures in the insurance sector may have systemic impact:

- Interconnectedness between the insurance sector and the real economy.
- Individual insurers may have counterparty exposures to other companies in the broader financial system.
- Interconnectedness may also occur within the insurance sector between insurance and reinsurance undertakings.
- Insurers who are part of financial conglomerates, who engage in cross border activities, or who are active in financial markets also increase the level of interconnectedness within the system.
- Lack of substitutability of insurance products in the wider non-insurance financial sector. For instance, there may be concentrations within a national insurance market, some insurers may operate in niche markets or there may be barriers to entry to new providers.

Sources of systemic risk can relate to both individual institutions and groups of institutions.

Drafting an SRMP

The IAIS issued a guidance note in December 2013[8] to their group-wide supervisory members on how to develop SRMPs. We can draw on this guidance to help us understand what might be required from an SRMP.

The purpose of an SRMP is to describe how an entity will manage, mitigate, and reduce possible systemic risk to which it is exposed.

The following paragraphs summarise the guidelines for producing SRMPs. These guidelines may provide some useful guidance for drafting an SRMP if a company is asked to produce one.

1. Include reference to liquidity planning. This might link to the company's LRMP as this plan should detail how the company will manage its liquidity risks.
2. Include reference to the company's recovery plan and how the company would mitigate systemic risk in a recovery situation. The recovery planning exercise should also describe the recovery triggers that require a reassessment of recovery plans
3. Description of intra-group transactions including guarantees granted and intra-group reinsurance.
4. A description of linkages to any other plans that might be used to mitigate and reduce systemic risk.
5. If a company plans to continue growing in systemically risky activities, then a plan on how this will be managed to mitigate systemic risk going forward should be included. An example of a systemically risky activity might be using reinsurance contracts or holding counterparty exposures to other financial institutions. If the company decides to discontinue such systemically risky activities, then a planned timetable is required.
6. If the company is planning to raise capital, a timeline and plan of how it is going to do so is necessary.
7. A timeline and a detailed strategy for any planned separation of non-traditional or non-insurance activities.
8. An explanation of how the steps above are adequate to address systemically risky activities.

GOVERNANCE

The IAIS did not issue specific guidance on the governance of an SRMP, but it is likely that responsibility of an SRMP would belong to the Board and would need to be monitored

[6] https://www.imf.org/external/np/g20/pdf/100109.pdf
[7] The real economy concerns the production of goods and services within an economy, rather than the financial economy which consists of financial products and services
[8] https://www.iaisweb.org/file/34255/iais-srmp-guidance-final-20-december-2013

annually or more frequently if there was a departure from current business strategy.

Conclusion

Following the Solvency II 2020 review, a specific macroprudential framework will be developed, and more insurers will be asked to produce SRMPs and LRMPs. Guidance on what will be required from insurers' SRMPs and LRMPs has not yet been issued.

At present, most (re)insurance companies will already have a liquidity policy under the existing Solvency II directive, but will need to enhance their liquidity policy with a liquidity risk management plan. Some companies will also be asked to produce systemic risk management plans which might be an area that companies have not previously spent a lot of time on.

The details in this note should help insurers form a starting point on drafting SRMPs and LRMPs. Further guidance should also be forthcoming from EIOPA in due course.

How can Milliman help?

Milliman can assist you with various aspects of your systemic and liquidity risk management, including advice on:

- Assessing systemic and liquidity risk exposure
- Incorporating systemic and liquidity risk plans into your risk management system
- Systemic and liquidity risk reporting and KRI's
- Incorporating systemic and liquidity risk assessments into your ORSA
- Best practice in relation to systemic and liquidity related risk financial disclosures
- Systemic and liquidity risk modelling

We can also assist with all aspects of your risk projects including:

- Financial risk management
- CRO and outsourced risk support
- ORSA
- Recovery and resolution
- Enterprise risk management
- Reinsurance
- Operational risk management
- Cyber risk

If you are interested in discussing this, or any aspect of your risk management and governance please contact the authors below or your usual Milliman consultant.

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