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Solvency 2 News, May 2021

Dear members and friends,

We will start with an interesting paper, the *Opinion on the supervision of the use of climate change risk scenarios in ORSA*, from the European Insurance and Occupational Pensions Authority (EIOPA).

1. Legal basis

1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Opinion on the basis of Article 29(1)(a) of Regulation (EU) No 1094/20101.

This article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union by providing opinions to competent authorities.

1.2. EIOPA delivers this Opinion on the basis of Directive 2009/138/EC (Solvency II Directive), in particular in relation to Articles 41, 44, and 45 thereof, Commission Delegated Regulation (EU) 2015/35 (Delegated Regulation), in particular in relation to Articles 262 and 306 thereof, and EIOPA's Guidelines on own risk and solvency assessment.

1.3. This Opinion is addressed to the competent authorities (CAs), as defined in point (i) of Article 4(2) of Regulation (EU) No 1094/2010.

1.4. The Board of Supervisors has adopted this Opinion in accordance with Article 2(7) of its Rules of Procedure.

2. Context and objective

2.1. Climate change constitutes a serious risk for society, including insurance and reinsurance undertakings (collectively “undertakings”).

The detrimental impact of global warming on natural and human systems is already visible today and without further international climate action, the global average temperature andassociated physical risks will continue to increase, raising underwriting risk of undertakings, impacting asset values and challenging their business strategies.

The Paris Agreement on climate change requires its signatories to reduce greenhouse gas emissions with the objective to hold the global temperature increase to well below 2°C and to pursue efforts to limit it to 1.5°C compared to pre-industrial levels.

Keeping the global temperature increase below 2°C would require annual reductions in carbon emissions greater than occurred in any single year in the last 100 years, including during the deepest recessions, and 70-80% of proven fossil fuel reserves to be stranded.

Hence, the transition towards a zero-carbon economy, especially when unanticipated, may seriously depress investments in carbon-intensive sectors.

The transition may also induce higher legal claims on companies that fail to take into account the impact on climate change, which may affect undertakings directly or indirectly through their underwriting of legal liability risks.

2.2. The Solvency II Directive requires undertakings to consider in their system of governance, risk-management system and own risk and solvency assessment (ORSA) all risks they face in the short and long term and to which they are or could be exposed, also when these risks are not (fully) included in the calculation of the Solvency Capital Requirement (SCR).

The European Commission has published a draft delegated regulation amending the Delegated Regulation, specifying that undertakings should integrate sustainability risks in their risk management and ORSA.

2.3. EIOPA's Guidelines on own risk and solvency assessment state that the undertaking should ensure that its assessment of the overall solvency needs is forward-looking, including a medium term or long-term perspective as appropriate, recognising that it represents the undertaking's own assessment of its risk profile and the capital and other means needed to address these risks, given the nature, scale and complexity of the risks inherent in its business.

2.4. The Task Force on Climate-related Financial Disclosures (TCFD), established by the G20's Financial Stability Board, issued recommendations to encourage companies to disclose climate-related information.

The European Commission's Guidelines on non-financial reporting on climate-related information (Commission Guidelines) integrate the TCFD's recommendations, providing guidance for disclosures in the five reporting areas distinguished in the Non-Financial Reporting Directive (NFRD).

This includes a description of the resilience of the company's business model and strategy, taking into consideration different climate-related scenarios over different time horizons, including at least a 2°C or lower scenario and a greater than 2°C scenario. The requirements of the NFRD apply to large listed companies, banks and insurance companies with more than 500 employees.

2.5. On 30 September 2019, EIOPA published its Opinion on Sustainability within Solvency II in response to a request from the European Commission, providing advice on the integration of sustainability, in particular climate-related developments, into the Solvency II framework.

EIOPA recommended that undertakings consider climate risks beyond the one-year time horizon, which cannot be fully captured in the Solvency II capital requirements, through the system of governance, risk-management system and their ORSA.

This Opinion considered that further work would be needed to define a consistent set of quantitative parameters that could be used in climate change-related scenarios that undertakings can then adopt as appropriate in their ORSA, risk management and governance practices, also recognising that other parameters will depend on the specificities of each undertaking.

2.6. EIOPA conducted an information request among the CAs in the EEA on the use of climate change scenarios by undertakings in the ORSA. The results show that a small minority of ORSAs included in the sample assessed climate change risk using scenario analysis.

Moreover, where undertakings performed a quantitative analysis of climate change risk, most assessments took a shortterm perspective.

To read more:
https://www.eiopa.europa.eu/sites/default/files/publications/opinions/opinion-on-climate-change-risk-scenarios-in-orsa.pdf

New improvements to Solvency II

BaFin Federal Financial Supervisory Authority

The European Insurance and Occupational Pensions Authority, EIOPA, has made a number of proposals to the European Commission about how to further improve Solvency II, the European supervisory regime for insurers. This article presents the key points.

Solvency II, the Europe-wide risk-based supervisory regime, has stood the test and should therefore remain in place – this was the provisional appraisal of the European Insurance and Occupational Pensions Authority (EIOPA) at the end of last year.

So, business as usual then? No. In its Opinion on the 2020 review of Solvency II, EIOPA recommends that the European Commission take specific steps to strengthen the supervisory regime in several places.

It was already clear when the framework entered into force at the beginning of 2016 that the effectiveness of its individual elements would be scrutinised after several years.

In a call for advice in February 2019, the European Commission asked EIOPA to issue an opinion, which the industry generally refers to as the Opinion on the 2020 Review. The coronavirus pandemic delayed its release by six months but it is now here in all its complexity.

BaFin has approved the Opinion as a whole. From BaFin's point of view, it was important that the long-term guarantees that are typical in the German insurance industry continue to be possible in the even more market-oriented regime envisaged in the review.

BaFin also argued for reporting to be more risk-based and for the proportionality principle to be implemented more systematically.

The key topics covered in the review also include the national insurance guarantee schemes (IGS) and issues surrounding recovery and resolution, as well as the inclusion of macroeconomic elements in the supervisory framework.

As is typical of a compromise, BaFin managed to achieve some of these goals but had to give ground on others.

Long-term guarantees

Of great significance are the measures for long-term guarantees (LTG) that life insurers, for example, provide to their customers.

One of the objectives of the review was for these guarantees to be incorporated into the provision for long-term contracts in order to more adequately take risks into account, also in view of the low interest rate environment.

In the German market, the most important LTG measures include the extrapolation of the risk-free interest rate term structure, the volatility adjustment and the transitional measures set out in sections 351 and 352 of the German Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG).

Extrapolating the risk-free interest rate term structure makes it possible to recognise provisions for insurance contracts whose terms extend further into the future than reliable capital market information on risk-free interest rates.

Since sufficient long-term bonds are not available, a last liquid point of 20 years has applied to date – from this point, extrapolation starts, i.e. observable and reliable interest rate data is used to draw conclusions about uncertain interest rates for which there is no reliable data.

The proposed extrapolation method requires insurers to factor in new market information, also beyond the starting point of the extrapolation.

This would increase market consistency and ensure that the interest rate term structure remains stable enough to avoid excessive volatility in the technical provisions and solvency position.

An additional "emergency brake" mechanism is aimed at ensuring that the amount of the provisions remains manageable for undertakings in the industry, even in difficult market situations.

The basis for this mechanism is the situation at the end of 2019. At the time, the net effect was more-or-less balanced in terms of positive and negative effects on capital.

In the case of low interest rates, the mechanism kicks in and limits the adverse effects of the extrapolation, ensuring that there is a balance between positive and negative effects. However, the mechanism is temporary in nature.

At low interest rates, the proposal will therefore place a burden on the capital of German undertakings until final implementation of the new extrapolation method.

The new extrapolation method is a compromise: some representatives of national competent authorities (including BaFin) saw no need for modification, while others advocated a significantly later last liquid point.

The additional capital requirements make it likely that the proposal will give rise to debates in the political negotiations at EU level.

If EIOPA's proposal is approved, the volatility adjustment (VA) will be better aligned with the objectives of the adjustment.

The new VA is aimed at better taking into account the illiquidity characteristics of liabilities and at ensuring a quicker and more efficient response to turbulences on the financial markets.

Those aspects make it simpler to offer long-term guarantees, and BaFin consequently sees their incorporation in the EIOPA Opinion as a success.

EIOPA proposes that insurers better inform professional readers in their solvency and financial condition reports (SFCR) of the transitional measures that they use (see expert article on the BaFin website dated 29 March 2021).

Back in early 2016, the transitional measures were conceived to ease the transition from Solvency I to Solvency II.

And in its current Opinion, EIOPA takes the view that national competent authorities should no longer issue blanket approval of new applications.

For example, if an insurer suddenly finds itself having to rely on the transitional measures five years after Solvency II has entered into force, the national supervisory authority should look into the matter.

In addition to the LTG measures, EIOPA makes further recommendations for Pillar 1, where Solvency II stipulates own funds requirements.

For example, EIOPA proposes to successively reduce future capital requirements within the risk margin to reflect the fact that the probability of recurrence declines once a risk has occurred.

This would significantly reduce the risk margin and thus provide capital relief.

Capital requirements

In BaFin's view, recalibrating interest rate risk is the most important recommendation made by EIOPA with regard to the standard formula that insurers use to calculate their solvency capital requirement (SCR).

This would remedy a technical shortcoming in Solvency II, since the standard formula has so far not taken into account the existence of negative interest rates.

By contrast, the shift approach now proposed maps negative interest rates well, resulting in the actual interest rate risk finally being reflected more appropriately in the SCR. However, this proposal would also impose a burden on undertakings.

The technical proposals that EIOPA has made with the intention of increasing the risk sensitivity of the standard formula comprise recalibrating the market risk correlation between interest rate risk and spread risk, partially recognising retrospective non-proportional reinsurance in non-life reserve risk, and strengthening the effective transfer of risk to reflect risk mitigation techniques.

If EIOPA’s proposal is approved, national competent authorities such as BaFin will require insurers to prepare a finance scheme as soon as they are merely at risk of non-compliance with the Minimum Capital Requirement (MCR).

In this situation, the supervisory authorities will be required to actively examine whether to restrict or prohibit the free disposal of assets.

It must then be stipulated in Level 2 which minimum actions supervisory authorities must take in the event of imminent MCR non-compliance and what the minimum content of the finance scheme must be.

Thresholds and proportionality

To reduce the burden on low risk profile insurers – i.e. mostly small undertakings – EIOPA has pursued two regulatory approaches that BaFin welcomes and supports: thresholds and proportionality.

EIOPA is in favour of increasing the Solvency II exclusion threshold in Article 4 of the Solvency II Directive and proposes a future relevant threshold of EUR 50 million in technical provisions.

It is envisaged that – under certain conditions – Member States will be able to raise the threshold for annual gross written premium income up to a maximum of EUR 25 million.

In Germany, this would likely benefit a notable number of smaller undertakings which would then revert to Solvency I.

Low risk profile insurers are to be allowed to consider as minimum requirements a series of statutory requirements that can be used to apply the proportionality principle.

This would set them apart from medium to high risk profile insurers. Nevertheless, insurers with a higher risk profile are to benefit from the simplified procedures as well, but only with BaFin's consent.

Simplifications in Pillar 1...

Simplifications are to be introduced in all three pillars of Solvency II. In Pillar 1, insurers determine their best estimate, which is an integral part of their technical provisions.

EIOPA intends to reduce the requirements for their stochastic valuation, where permitted by the risk profile. Another proposal is the introduction of a simplified methodology to calculate immaterial risk modules within the standard formula that contribute little to overall risk.

EIOPA also intends to make it easier for low risk profile insurers to perform the stochastic valuation of options and guarantees. Since guarantees also include interest guarantees under life insurance contracts, BaFin considers this recommendation to be inadequate for German life insurers, which are not low risk profile undertakings.

EIOPA also details how insurers should factor the contract boundaries within their portfolios and assumptions about future management actions and expenses into the calculation of their technical provisions.

...and in Pillars 2 and 3

As regards the governance requirements under Pillar 2, many of the new measures are already covered in the Minimum Requirements under Supervisory Law on the System of Governance of Insurance Undertakings (Mindestanforderungen an die Geschäftsorganisation – MaGo).

As a result, the majority of these measures serve merely as clarifications for supervisory practice in Germany.

For instance, EIOPA refers to the opportunity for low risk profile undertakings to combine key functions, to combine key functions with operational functions, or to combine being a key function holder with management board membership.

In Germany, this is already permitted based on the established interpretation. What is also new in Germany is the proposal that insurers with a low risk profile will no longer be required to review their written internal policies on an annual basis but rather every two or three years. Undertakings are to conduct an own risk and solvency assessment (ORSA) only every two years, not annually.

BaFin also supports further Pillar 3 simplifications to be made in the area of reporting. EIOPA recommends introducing risk-based thresholds for quantitative reporting.

In future, undertakings would only submit non-core templates if they exceed the risk-based threshold determined for the reporting template.

The new thresholds would be more tailored to the specific undertaking since they consider the characteristics of the relevant business model more precisely.

The result would be more risk-based and above all less time-consuming submission practices for undertakings.

The solvency and financial condition report (SFCR) and regular supervisory report (RSR) are to be slimmed down and the SFCR is also to be made more suitable for its target audience.

In future, the SFCR is to comprise a two-page summary for policyholders and a more detailed part for professional readers.

Expanded requirements are also planned in specific areas, such as sensitivity analyses for key indicators at undertakings relevant for financial stability purposes.

EIOPA also intends to simplify the supervisory reporting templates; some are to be deleted.

On the other hand, gaps in the reporting package are to be closed, e.g. with EIOPA collecting data on cyber risk with the help of the national competent authorities.

The quantitative reporting requirements for internal models are to be expanded, in some cases significantly. Some deadlines for qualitative and quantitative reporting are to be extended.

Group supervision

Solvency II embodies a supervisory model under which the national competent authority responsible for the ultimate parent undertaking also supervises the group in question.

However, if a subsidiary has its registered office in another EU Member State, the subsidiary is supervised by the local authorities as a solo undertaking. This has occasionally led to inconsistent approaches, which is why EIOPA has taken a closer look at some regulatory areas.

In the past, there have repeatedly been significant differences between Member States with respect to the scope of group supervision. In its Opinion, EIOPA has revised the definition of the term “group” and has developed an overall approach for group supervisors' options not to include individual undertakings in their supervision.

In EIOPA’s view, holding companies must also be included in the SCR and MCR at group level.

If the capital requirements at group level are calculated by combining the accounting consolidation-based method and the deduction and aggregation method, double counting is to be avoided and no material risks are to be overlooked.

As regards the application of partial internal models at group level, EIOPA also recommends demonstrating and documenting the appropriateness of integration techniques more clearly than has previously been required.

To date, the classification of own-fund items at group level has not been uniform across the EU. EIOPA's clarifications work towards ensuring that the requirements are applied consistently.

For instance, groups are to justify the availability of expected profits in future premiums (EPFIPs) at group level.

The generally undisputed inclusion of transitional measures at group level is to be documented in a reconciliation that also calculates the solvency ratio without the benefits at group level.

EIOPA also proposes a specific, uniform method that insurers can use to calculate the minority interests they are required to deduct from consolidated group own funds.

In EIOPA's view, it should be clarified that groups must include in the calculation of group solvency their holdings in companies from other financial sectors with their sectoral own funds or capital requirements.

In relation to governance issues, EIOPA is in favour of removing all room for interpretation and clarifying that the ultimate parent undertaking is responsible for compliance with legal and administrative regulations at group level.

From BaFin's point of view, the proposals are adequate and appropriate to address existing gaps in the regulations and legal uncertainties and to ensure more effective supervision of insurance groups in the EU.

Macro-prudential instruments

To date, Solvency II has only provided for the risk-based solvency supervision of individual insurance undertakings.

EIOPA is now proposing that the macro-prudential perspective be incorporated into the framework in addition to the micro-prudential perspective.

Moreover, national competent authorities are to have the power to set capital add-ons for systemic risk and to prohibit distributions such as dividends.

EIOPA is also proposing that the national competent authorities use the ORSA for macro-prudential purposes and be able to expand their risk and liquidity management requirements to include macro-prudential aspects.

So far, EIOPA has only provided a rough outline of the instruments; in BaFin's view, these require further development.

The next steps

The Opinion was submitted on 17 December 2020. The European Commission must now address the recommendations and then make its own proposal to the European Council and the European Parliament; this is expected to take place in the third quarter of 2021.

In addition to the requisite modifications to Solvency II, the focus should be on the balance of the package as a whole. This will be followed by trilogue negotiations and it is uncertain how long these will take.

The coming issues of BaFinJournal will address national insurance guarantee schemes (IGS) and the recovery and resolution framework for insurers.

How to improve funding of bank resolution in the banking union: the role of deposit insurance

Fernando Restoy, Chairman, Financial Stability Institute, Bank for International Settlements, at the 2021 Biennial International Association of Deposit Insurers Research Conference "Navigating the New Normal for Financial Stability, Deposit Insurance and Bank Resolution", Basel.

Introduction

It is a pleasure to participate in this event organised by IADI.

This research conference provides a great opportunity to scholars in the field to share, among other contributions, analytical work on the interaction of crisis management frameworks with deposit insurance.

This is a key issue within the ongoing reflection in the European Union on how to improve the current arrangements for bank failure management and, in particular, on how to best adjust the existing funding mechanisms.

It is unlikely that authorities will be able to achieve consensus quickly on what to change and how to do it. But the ongoing discussions already show that an agreement may be emerging on the diagnosis of a few relevant flaws of the current framework

First, at present the banking union lacks an efficient and sufficiently harmonised framework to deal with bank insolvency.

Second, the combination of a common resolution framework with a constellation of heterogeneous insolvency regimes generates inconsistencies that can severely damage authorities' ability to deal with the failure of systemic banks without relying on taxpayers' support.

And third, some banks are too large for their failure and market exit to be managed through conventional insolvency regimes, but still do not qualify, or cannot meet requirements for, resolution under the Bank Recovery and Resolution Directive (BRRD). These banks are what I have referred to elsewhere as the "middle-class".

Some of us have long been suggesting that the above deficiencies could be largely corrected by putting in place harmonised mechanisms to facilitate transfer transactions – such as the sale of a suitable combination of deposits and assets from the failing entity to an acquirer – for small and medium-sized banks under both resolution and insolvency.

Under the EU resolution framework, such transactions are labelled "sale of business" (SoB). In that regard, a helpful reference – although not a full solution – can be found in the US regime administered by the Federal Deposit Insurance Corporation (FDIC).

Those mechanisms would entail adjustments in the institutional framework at the EU and national levels. However, the most important modifications affect the available funding arrangements for relevant crisis management strategies. Money is, as always, key.

In crisis situations, sufficient funds are required to protect the public interest when resolving banks (ie the continuation of critical functions). In addition, they may be needed to preserve banks' net asset value and therefore to protect the interest of the deposit guarantee scheme (DGS) and other creditors under insolvency.

The amount of funding needed crucially depends on the chosen bank failure management strategy. The market exit of a failed bank – even when its critical functions are preserved through an SoB transaction – typically requires fewer resources than its restoration through recapitalisation.

In what follows, I will review the existing funding mechanism and propose a few concrete modifications that could help address the main drawbacks of the current setup.

The existing funding mechanisms

In principle, there are three different sources of funding for the orderly management of bank failures under resolution or insolvency: public funding, a bank's internal loss-absorbing capacity and industry-funded sources such as a deposit guarantee scheme or resolution fund.

The most direct form of funding is government bailout. That has been, in practice, the most relevant funding source for managing the failure of significant banks to date.

The new resolution framework, however, is built with the objective of avoiding recourse to government funds to maintain the critical functions of failing banks. Yet, as recent experience shows, taxpayer funds are still available to fund banks' exit from the market under national insolvency regimes.

At the other extreme, a core source of funding is banks' own internal resources. Creditor bail-in – ie the writedown or conversion into equity of debt instruments for loss absorption and recapitalisation – could fund the continuation of critical functions by failing banks. This is the cornerstone of the new resolution framework.

In order to make this strategy feasible, banks that may be resolved are typically asked to issue a sufficiently large amount of debt instruments that could be bailed-in in resolution. In the EU, that takes the form of a minimum requirement for own funds and eligible liabilities (MREL).

The current SRB approach to setting MREL aims at ensuring that all banks whose failure may have public interest implications should have a credible resolution strategy that entails no need for external support, from either the government or industry-funded sources, such as a resolution fund or a DGS.

To meet that objective, banks subject to a preferred resolution strategy based on open bank bail-in must satisfy MREL requirements that are consistent with their estimated needs for loss absorption and recapitalisation in resolution, so that the entity can continue to operate immediately after resolution, pending restructuring.

For banks with a credible SoB transaction as a preferred strategy, MREL needs could, in principle, be lower as the bank will cease operating after resolution.

However, given the uncertainty about the availability of a suitable buyer at the point of resolution, the SRB also develops a variant strategy for such banks that is less dependent on third parties and market conditions. In most cases, that is open bank bail-in. The SRB then calibrates MREL at the level needed to implement that variant strategy.

As a consequence, significant banks in the banking union are generally asked, in practice, to satisfy stringent MREL requirements regardless of their preferred strategy. In other words, MREL is effectively calibrated so as to primarily accommodate a restoration strategy.

However, the SRB may need to adjust this approach somewhat as the new Single Resolution Mechanism Regulation (SRMR) explicitly links possible adjustments to MREL requirements to the needs of the preferred resolution strategy.

A third source of funding is the national DGS. Those funds can contribute to supporting transfer transactions in both resolution and insolvency. However, there is a tight limit on that contribution (a financial cap): funds provided by the DGS cannot exceed the net costs for the DGS of paying out deposits if the bank in question is wound up under the national insolvency procedures.

"Net costs" in this context refers to net of the recoveries the DGS would have made in a liquidation following a payout of insured deposits. In the EU, DGS claims rank senior to other deposits and securities issued by banks (they are "super-preferred"), so expected losses for the DGS in liquidation and, therefore, the available support for a SoB transaction are typically small when not negligible.

Therefore, while a financial cap is a necessary protection for DGS funds that prevents excessive expenditure in a single bank failure, the way in which the cap currently applies makes DGS support for SoB transactions largely irrelevant in practice.

Finally, another source of possible funding for bank failure management in the banking union is the Single Resolution Fund. The SRF is only available for banks meeting the positive public interest assessment required for resolution. Available SRF support is capped at 5% of total liabilities and, more importantly, requires the prior writedown of at least 8% of total liabilities.

Minimum bail-in requirements ensure that the SRF funds are available only when the liabilities that can realistically absorb losses – ie without undermining the effectiveness of the resolution or the resolution objectives – have done so.

The 8% minimum bail-in condition for SRF access is imposed across the board regardless of the failing bank's preferred resolution strategy. It does not therefore accommodate the situation of banks with a large amount of deposits relative to other liabilities that can absorb losses without unintended effects.

Imposing the same minimum bail-in conditions for SRF access by any bank further reinforces the SRB's approach of imposing stringent MREL requirements on all significant banks irrespective of their preferred resolution strategy.

The current framework is therefore internally consistent: restrictions on the use of DGS and SRF funds to facilitate an SoB transaction justifies requiring all banks to satisfy large MREL requirements. Banks that can meet those conditions may credibly be subject to open bank bail-in (as the preferred or a backup strategy) and may also satisfy the conditions required to obtain SRF support if that is needed. The problem, of course, is that a relatively large subset of banks under the SRB remit run business models that could not easily cope with the conditions imposed (MREL requirements) for their resolution strategies.

On the basis of the new provisions of the SRMR, the SRB will need to adjust downwards MREL requirements for all banks whose preferred resolution strategy is SoB. However, under current arrangements that adjustment cannot realistically be far reaching.

Without further reforms that would increase the feasibility of SoB for a failing bank, the lack of sufficient loss-absorbing liabilities could severely jeopardise the orderly resolution of that bank. Absent a suitable buyer, the bank might only be able to continue operating and have access to the SRF if sensitive liabilities – such as deposits – were bailed-in.

Therefore, solving the middle-class issue requires a comprehensive approach that could lead to a new internally consistent setup that would be less disruptive than the current one.

That might be achieved by adopting three main reforms:

(i) first, make DGS funding less restrictive by replacing the current super-preference of covered deposits by a general depositor preference rule;

(ii) second, redefine the methodology for calculating MREL requirements for banks with a resolution plan based on SoB transactions to accommodate a higher likelihood of success of that strategy; and

(iii) replace the currently universal 8% minimum bail-in conditions for SRF access by a case by case calibration linked to MREL requirements. Let me review each of those three proposals.

To read more: https://www.bis.org/speeches/sp210511.htm

2021 COST AND PAST PERFORMANCE REPORT

In line with the European Commission's Request to the European Supervisory Authorities (ESAs) to periodically report on the cost and past performance of retail investment products, this report provides an analysis of costs - for the year 2019 – and past performance – for the period 2015-2019.

The products within scope for this iteration of the report by European Insurance and Occupational Pensions Authority (EIOPA) are: Insurance-based Investments Products (IBIPs) and Personal Pension Products (PPPs).

The report covers the European Union (EU) markets until 2019 and excludes UK, being most of the analysis based on ad-hoc data collection developed after the UK Brexit final decision.

While the focus is 2019, some general considerations on the impact of COVID-19 on the retail investment market are also presented. Given the extent of the crisis, some preliminary considerations are drawn as the length and depth of the crisis raises a number of issues with regard to the costs and performance of retail investment products.

Beyond possible illiquidity risks, market shocks have indeed impacted returns and in the longer terms costs.

The findings presented are based on a sample covering:

› More than 680 IBIPs being marketed by over 160 insurance undertakings covering the 60% of the European IBIP market; and

› More than 210 PđPPs marketed by 69 insurance undertakings representing circa 1.4 million of contracts.

IBIPs

Following general financial market trends, 2019 was characterized by an extremely positive year for the IBIPs market.

Unit-linked products overall performed better than profit participation products and hybrids.

A consumer investing € 10,000 in January 2015 in a putative unit-linked product would have achieved, after costs, a net value of € 11,450 (2.7% per year) in December 2019.

For the same time frame, an investment of € 10,000 in an average profit participation product would have paid a net value of € 10,706 (1.4% per year). For hybrid products the net value at the end of 2019 would have been € 11,122 (2.1% per year), in nominal terms.

The difference in net return is explained by the structural differences in the level of costs and return volatility of the mentioned products.

While the level of costs is generally stable and in line with findings of the previous editions of this report, exposure to risky assets and volatility for unit-linked and hybrid products is much higher than profit participation products.

Buying unit-linked products consumers can reach higher net profits in case of favourable market scenarios while being exposed to negative returns in lesspositive market developments.

Looking at last year's data it could be observed that a putative consumer investing over the years 2014-2018 would have had a higher return with a profit participation product because of the protection offered during the 2018 market contraction.

While profit participation products offer 'stability', their performance after costs is low throughout the reference period.

In particular when considering the impact of inflation, the value offered to consumers has been, on average, very little in real terms, though this is also true for other comparable financial instruments with conservative investment profiles, due to the European low interest yield environment.

Trends at Member States level differ. However, given the overall broader market stability, 2019 data confirms more homogeneous trends with respect to last year both in term of past performance and costs.

In terms of costs, profit participation products continue being cheaper (1.5%) than unitlinked (2.5%) and hybrid (2.1%), in terms of reduction in yield (RIY) at recommended holding period (RHP).

Amongst the different drivers of net performance and costs level analysed – by market, risk classes, recommended holding period and premium frequency, it can be observed that:

› the clearer driver of performance for unit-linked products was the risk level, while the main factor for profit participation products was the recommended holding period.

› Hence, riskier unit-linked products and longer term profit participation products paid higher net return in the years 2015-2019.

From a 'value for money' perspective, some trade-offs need to be considered in terms of returns and costs for hybrid products.

In fact, while generally they have a higher degree of complexity because combining different option with different features, in case of positive market trends, on average terms, they show significantly lower profitability than unit-linked products.

On a five years basis the median net return of hybrid was 2.1% vs. 2.7% of unit-linked, while being more expensive than profit participation products, 2.1% vs. 1.5%.

Finally in terms of costs composition, administrative costs continue being the most predominant driver of costs, often representing more than half of the total costs paid by consumers, followed by investment management costs and distribution costs. Biometric costs are minor costs elements.

To read more:
https://www.eiopa.europa.eu/sites/default/files/publications/reports/eiopa-cost-past-performance-report-2021.pdf

Peer Review of the United Kingdom

FSB FINANCIAL STABILITY BOARD

Main findings

The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) (the Authorities) have implemented financial sector compensation reforms in the UK that are consistent with the P&S.

The initial focus was on the banking sector but over time the Authorities have increasingly implemented the P&S in the insurance and asset management sectors.

For all three sectors the Authorities have adopted a risk-based and proportional regulatory and supervisory approach.

In addition, there is strong cooperation and information-sharing between the PRA and FCA and clear communication with the industry about their remuneration expectations.

Such communication, including through the publication of letters to Remuneration Committee Chairs, has helped firms understand and embed the requirements over time.

Other initiatives such as the Senior Managers and Certification Regime (SM&CR), the FCA 5 Conduct Questions Programme and research published on conduct and culture complement the remuneration regime.

In combination with the SM&CR, the remuneration regime has helped firms become more disciplined in mapping responsibilities and resulted in greater consistency and transparency on acceptable remuneration practices.

With implementation well-advanced, the Authorities are increasingly focused on evaluating the effectiveness of the regime and require firms to periodically review the design and implementation of their remuneration policies.

The UK is the first FSB jurisdiction to conduct an effectiveness review with a focus on performance adjustment, including the use by firms of tools such as clawback, malus and in-year adjustment.
In parallel, the PRA reviewed the SM&CR regime for banks and insurers, publishing the results in December 2020.

Some of the Authorities' approaches to implement the P&S are at the forefront of FSB members' work on compensation and can serve as examples of good practice for other jurisdictions to consider.

These include setting expectations through public communication to Remuneration Committee Chairs; a supervisory approach that focuses on close interaction between prudential and conduct rules and reinforces accountability with links to compensation outcomes; and a focus on evaluating the regime's effectiveness.

At the same time, steps can be taken to further strengthen the financial sector compensation framework in a few areas.

These include: reviewing the interaction between the UK's remuneration regimes and the SM&CR; improving the efficiency of data collection; considering other supervisory approaches for assessing the effectiveness of the regime; and providing additional guidance to the insurance sector.

Review the interaction between the SM&CR and compensation

The remuneration and SM&CR regimes were set up with different, albeit complementary, objectives, and there has been progress to date in their concurrent application.

The linkages between the two regimes provide the Authorities with comfort that accountability has practical consequences that contribute to prudent risk taking behaviour.

However, the link could be made more clear. In some instances, the application of performance adjustment tools to material risk takers (MRTs) who are also Senior Management Functions (SMFs) may be applied inconsistently between firms.

MRTs and SMFs have separate but overlapping identification criteria and, as reported by some industry participants, this could generate confusion and contribute to a general reluctance towards proactive risk taking ("a culture of fear").

The Authorities should consider further strengthening the alignment between the two regimes.

Improving the efficiency of data collection

Remuneration data collection differs based on the size and type of firms, in line with the Authorities' proportionate approach to regulation and supervision.

With regard to regulatory reporting, the largest (level one) banks and investment firms must provide remuneration data on their MRTs across all business areas while level one, two and three banking and investment firms provide data on all employees with total remuneration of €1 million or more per year.

Additionally, the Authorities provide firms with self-assessment templates and tables, called Remuneration Policy Statements (RPS).

Supervisors expect level one banks and investment firms to submit the data on their remuneration policies and practices by completing these templates annually.

This can require a large amount of information; indeed some firms indicate they have to prepare summaries for Authorities overlaying the RPS, or that rarely is the information submitted to the Authorities also useful for internal purposes.

In addition, the RPS are analysed manually by the Authorities.

However, with increased attention by the Authorities on understanding the effects and effectiveness of the regime, data needs will change, including for the need to examine trends across a larger number of players.

The Authorities should consider streamlining and automating the data collection and analysis for level one banks and investment firms.

They could also consider collecting remuneration data from a broader range of firms whilst having regard to the cost and complexity for all stakeholders, including minimising the burden on firms where possible.

This would enable the Authorities to conduct a sample-based review of the remuneration arrangements across a broader range of firms to support a wider view of industry practices.

For example, they might consider asking level two and three firms to submit the RPS periodically (such as every three to four years).

The ongoing work by the Authorities to implement a new data collection platform and streamline various aspects of the reporting process offers an opportunity to review the cost, complexity and benefits of information collected for firms of varying sizes.

To read more: https://www.fsb.org/wp-content/uploads/P140421.pdf

From master masons to information architects: how standards can transform reporting (and bring benefits well beyond it)

Gareth Ramsay, Executive Director for Data and Analytics & Chief Data Officer of the Bank of England, webinar hosted by The EDM Council

Hello all – it's a great pleasure to be speaking to you. I'd like to thank John Bottega and the EDM Council for virtually hosting us today.

I want to begin by talking about cathedrals.

The great cathedrals of Europe were built in the Middle Ages by teams of skilled stone masons.

To get the dimensions of the building right, it is said that each team would use measures based around the body of the master mason: his foot, his stride, his arm, and so on. And so a local standard was born.

Those standards were designed with one specific use in mind – the construction of that cathedral. And very useful they were, too. But they were closed systems – the foot and the yard used to build one cathedral were different from those used to build another.

And this was not just an English peculiarity: across the channel, a foot length in Strasbourg was 295 mm, a foot in Paris was 325 mm, but a foot in Bordeaux was a relative whopper at 344 mm.

Of course people came to understand the great benefits of enforcing universal, common standards.

In part for maintaining the cathedrals themselves, so that new, replacement stones could be sourced that would fit snugly between their neighbours.

But the benefits of universal measurement standards could be applied a long way beyond the niche discipline of cathedral building.

Now some of you may think that today's financial system is not perfectly comparable to the glorious gothic cathedrals of the Middle Ages.

But like those cathedrals, many of the data systems underpinning today's financial firms and markets were built with narrow reference to their own needs, by their own master masons – their CIOs and systems architects.

They too were closed systems. Each needed to be able to record, track and manipulate its data.

Its data points needed to fit snugly alongside each other. But the design of each system often paid little attention – understandably – to any broader public good.

In this speech, I want to talk about whether there are wider public benefits that might flow from standardising these data labels, and set out a way forward to reap those benefits collectively.

So let me turn from mediaeval architecture to data.

At a central bank like the Bank of England, data is our life blood. We depend on our ability to access it, analyse it, and draw conclusions from it to set policies.

Effective management and use of data is how we meet our goals.

Of course, we are far from alone here – many organisations rely heavily on their use of data. But we are, perhaps, different to many in that the vast majority of the data we want is generated by others rather than ourselves.

The data we care about is the sum of millions of financial and economic interactions, taking place every second. And much of that data is captured and stored by financial institutions, as they go about serving their customers.

We need to get our hands on that data. We need data on the financial system in aggregate and also on specific markets within it, to help us understand where risks are emerging and to help us calibrate policies to maintain stability. And we need data about individual regulated firms, for our work as supervisor and as resolution authority.

So we have built data collection processes to give us that data. We publish reporting instructions. Firms then go through various steps: they interpret our instructions, identify the right data within their systems, put in place processes to integrate, cleanse and check the data, and then sign it off and deliver it to us.

But the amount of data we collect through these processes has been growing. It's hard to capture all of our data collections in a single measure.

But the accompanying chart shows the number of data points we collect through our regular rule-based banking collections.

Since 2014, this has grown around seven-fold. This growth has partly been a response to the financial crisis of 2008, when regulators and authorities around the world discovered huge gaps in what they knew, and what they could see, of risks emerging in the financial sector.

At the same time, technological change has been increasing the volume of data being produced, and the demands we can put upon the data. Like many of the financial firms we regulate, we want to make more extensive use of this bountiful data, using bigger datasets and newer, more complex analytical techniques.

These developments – the availability of, and need for, more data, and the desire to do more with it – have put growing strains on the processes and systems we use to collect it in the first place. That poses a growing challenge for us and for firms who are sending us the data, each firm doing so independently and in a different way.

And if it's hard for firms to supply us the right data, well, that matters for us. It may take industry longer to meet our requests. And if different firms interpret our requests in different ways, that makes it harder for us to draw conclusions from the data we receive.

To read more:
https://www.bankofengland.co.uk/speech/2021/april/gareth-ramsay-webinar-hosted-by-the-edm-council

Covid-related fiscal measures and debt sustainability

Prof Claudia Buch, Vice-President of the Deutsche Bundesbank, at the ESM seminar on debt sustainability Panel II "Policy implications in the new normal".

The pandemic has been a stress test for the global financial system

The coronavirus pandemic has been the biggest stress test for the global financial system in recent decades. It was unexpected, it has been truly global, and it has differed in scale and scope from the global financial crisis in 2008.

In the global financial crisis, excessive leverage in the banking sector led to contagion and a financial crisis that impaired the functioning of the financial system. The coronavirus pandemic, in contrast, threatens the liquidity and solvency of the corporate sector.

So far, the financial system has weathered the storm and continued to function – because policy coordination has worked well during this crisis. Fiscal and monetary policy responses have been bold and timely.

The financial system has proven to be robust: Thanks to the G20 regulatory reforms following the global financial crisis, the banking system is better capitalized, and there is greater regulatory flexibility to reduce pro-cyclicality. Policy responses have been coordinated internationally.

However, key challenges for debt sustainability and financial stability may still lie ahead. Dealing with increasing insolvencies, maintaining crisis-related policy support only as long as necessary, and ensuring financial sector resilience will be among the policy priorities going forward.

There is still a high degree of uncertainty concerning the future evolution of the pandemic and the damage that has been done to the real economy.

One cannot rule out an adverse scenario with feedback loops to the real economy if banks deleverage to meet capital requirements imposed by regulators or markets.

Hence, monitoring the interaction between debt sustainability in the public sector, the corporate sector, and the banking sector will be crucial.

Recognising the importance of fiscal support for financial stability, the European Systemic Risk Board (ESRB) has established a regular monitoring framework.

Since mid-2020, the 30 ESRB Member States have reported the size and uptake of fiscal policy support measures on a quarterly basis (ESRB 2020, 2021). The measures include loan moratoria, public loans and guarantees, direct grants, and tax deferrals, among others.

The reporting has three parts covering the characteristics and volume of measures, their uptake, and qualitative information. Data on characteristics of measures like their announced size, end-dates, or eligibility criteria are made publicly available.

To read more: https://www.bis.org/review/r210423b.pdf

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