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Liquidity risks in the insurance sector

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Dear Mr Bernardino,

I am writing to you in my capacity as Chair of the European Systemic Risk Board (ESRB). Further to the General Board of the ESRB's discussion of the impact of the coronavirus (COVID-19) pandemic during three extraordinary meetings in April and May, I would like to inform you of its views on the monitoring of liquidity risks in the insurance sector so as to enhance Europe's preparedness to potential future shocks.

The COVID-19 pandemic and the necessary containment measures represent a severe and unprecedented shock to European economies. Against this backdrop, at its meeting on 2 April 2020, the General Board decided to focus on five priority areas in which coordination among European authorities is likely to be particularly important for safeguarding financial stability. One of these priority areas relates to issues surrounding market (il)liquidity, with a particular focus on the implications for asset managers and insurers.

The sharp fall in asset prices observed at the onset of the COVID-19 pandemic was accompanied by a significant deterioration in financial market liquidity. While market conditions have stabilised recently, largely on the back of decisive action taken by central banks, governments and supervisory authorities in the EU and globally, market liquidity conditions may deteriorate further in the future, with potential adverse implications for financial stability in Europe.

EIOPA has already taken prompt action to mitigate the impact of the shock caused by the COVID-19 pandemic. These include recommending that insurers take measures to preserve their capital position by temporarily suspending discretionary dividend distributions and share buybacks, as well as allowing insurers some flexibility on the timing of supervisory reporting and public disclosures.

(Re)insurers are less exposed to liquidity risk than banks, but risks can nevertheless arise on both the asset and liability sides of their balance sheets. In contrast to banks, which engage in liquidity transformation as part of their business model, (re)insurers typically receive premia before they need to pay any claims or cash outflows – which in turn are spread over months or years. This usually shields them from liquidity risk. However, given the highly unusual nature of the current shock, some insurers could nonetheless be prone to liquidity risk because parts of the sector may now be facing a number of concurrent cash flow shocks. These potentially include an increase in claims (e.g. event cancellations), shortfalls in expected premia inflows (especially in countries with public health lockdown measures), margin calls, a decrease in investment income (e.g. moratoria on mortgages, lower dividend income) and lower liquidity of insurers' investment assets. There are some historical precedents of insurers experiencing liquidity pressures. For example, as mentioned in the ESRB report "Enhancing the macroprudential dimension of Solvency II" (February 2020), mass lapse events have taken place at EU and non-EU insurers in the past. In most cases, their negative effects were mitigated by regulatory intervention.

In addition, some insurance products allow investors to redeem their funds at short notice, while the underlying assets are structurally, or can suddenly become, relatively illiquid. As previously flagged by the ESRB and other financial stability authorities, this liquidity mismatch between liabilities and assets exposes insurers to potential liquidity risk in times of stress. Unit-linked insurance products, in particular, have specificities that may expose insurers to structural liquidity risks, similar to those inherent in investment funds. Indeed, insurers also invest funds in investment funds on behalf of investors. Liquidity mismatches in unit-linked products could make it difficult for insurers to liquidate assets if faced with an increase in redemptions, which could ensue if withdrawal penalties for investors are sufficiently low.

Any crystallisation of liquidity risks in insurance could affect financial stability through two broad channels. First, insurers may face risks to their own viability if they are unable to meet the liquidity needs stemming, for example, from their liabilities from margin calls on their derivative positions. This may result in contagion effects to other parts of the financial system which are exposed to these insurers. Second, if insurers seek to meet liquidity needs by rapidly selling less liquid assets, this could result in fire-sale dynamics and pose challenges to the orderly functioning of some markets.

To date, there has been a lack of consistent data for assessing the magnitude of potential liquidity risks in the insurance sector and the related financial stability risks. Supervisors may therefore not be in a position to judge with confidence (i) the scale of potential liquidity pressures in the future and (ii) the potential financial stability implications of a crystallisation of such liquidity risks.

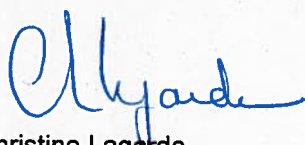
The ESRB judges that, in the near term, priority should be given to improved monitoring of liquidity risks in the insurance sector so as to enhance Europe's preparedness to respond to potential future shocks that could lead to a deterioration in financial stability conditions. The ESRB notes that EIOPA and its members have already been considering the development of a liquidity monitoring framework for

insurers as a response to COVID-19. The ESRB strongly encourages EIOPA and its members to finalise and operationalise that framework promptly. This will facilitate a more informed and timely assessment of any potential financial stability risks stemming from liquidity risks in the insurance sector (including those arising from the mismatch between the redemption profile and the asset liquidity of unit-linked products). Given the significant heterogeneity both across and within the insurance sectors in individual jurisdictions, a proportionate approach would be appropriate so as not to create an unnecessary additional reporting burden.

Beyond the immediate need to address risks and vulnerabilities arising from the current crisis, and as the ESRB has flagged in the past, the Solvency II review presents an opportunity to better enable supervisors to address liquidity risk in insurers with a vulnerable liquidity profile. The recent episode highlights the need to better equip insurers to deal with future periods of stress. To this end, the ESRB had previously noted that the Pillar 2 provisions in Solvency II need to be enhanced in the medium term to enable supervisors to require individual re(insurers) with a vulnerable liquidity profile to hold a liquidity buffer.¹

Ensuring that the financial system in Europe helps to absorb, rather than amplify, the severe shock of the COVID-19 pandemic requires significant coordination, both across supervisory authorities of different segments of the financial sector and across borders. This is particularly the case for capital market activities which are characterised by large cross-border flows and rely on a number of actors in order to function smoothly. I believe EIOPA's contribution to this collective effort has already been – and will continue to be – invaluable.

Yours sincerely,



Christine Lagarde

Chair of the European Systemic Risk Board

¹ See proposals in ESRB report "**Enhancing the macroprudential dimension of Solvency II**" (February 2020).