Insurance ERM

Eiopa's Bernardino: We will see if a countercyclical requirement makes sense for insurers

17 March 2016

Published in: Risk management, Capital Models, Regulation, Solvency II, Investment risk - strategy, People

Companies: Eiopa

In the second part of an interview with Hugo Coelho, the Eiopa chairman responds to the ESRB report and sets expectations about the looming reviews of Solvency II

It's been two months since Solvency II came into force, but the planned reviews of the regulation already loom large on the horizon. The European Systemic Risk Board (ESRB) in December made the case for the introduction of a bank-like countercyclical requirement, which would force insurers to build up capital in good times.

Commenting on the idea for the first time, the chairman of the European Insurance and Occupational Pensions Authority (Eiopa), Gabriel Bernardino, is non-committal. A macroprudential view on Solvency II is "welcome", but the report was not "unanimous". In time, regulators shall see if the bank-like requirement fits in the regime, he concluded.

Bernardino is more unequivocal about other elements of the directive that are for review, in particular the treatment of sovereign bonds. He argues that measures must be taken to discourage concentration, and the rules should be aligned with banking regulations. "It is not tenable anymore to say we have a risk-based system without looking at sovereigns. It is a political decision at the end of the day, but I don't shy away from giving my opinion on this."

As for the looming revision of the methodology to determine the ultimate forward rate (UFR), Bernardino goes to great lengths to assuage fears of an abrupt change that would bring the rate down, but dismissed suggestions that this will be compensated by concessions in other elements of the regulatory framework, in particular the matching adjustment.

This is the second and final part of the interview. The first part, which focus on national inconsistencies and stress tests can be read here.

Eiopa has launched a review of the UFR and admitted its value could be changed in 2017. What is the justification for doing that in the first year of Solvency II?

Solvency II defines principles for the UFR – it states that it should reflect the long-term expectations for interest rates – but it leaves it up to Eiopa to decide on its value. We have started with 4.2% for the euro, which was in line with the UFR used in the quantitative impact studies. Now we are setting the methodology on how and under what circumstances this value should change. I want to be clear that we are not changing the regime; we are setting out a methodology. What we don't want is to have people second guessing every month whether the expectation on long-term rates has changed, and whether the UFR is changing as a result. This approach should be predictable.

"We do not envisage any change in the value of the UFR during this year"

When you say predictable, does that mean that you are going to set out a formula, and the changes will be automatic?

I don't want to anticipate that. The different options are still to be discussed by the Board of Supervisors, and will be afterwards released for public consultation. We do not envisage any change in the value of the UFR during this year.

Is it reasonable to say it will come down in 2017?

It is premature to say when the value can change, because this can happen in different ways depending on the methodology. We will transmit to the market well in advance what is expected and when it is expected.

In an interview with *IERM*, Marco Vet, a former chairman of the CRO Forum, argued that a downward revision of the UFR should not be made in isolation, rather considered together with the review of the matching adjustment (MA). Is this an option on the table?

I don't agree with that. The review of long-term guarantees (LTG) package, which includes the MA, is in 2021. At that point, we can discuss the MA. The UFR methodology is not about reviewing the regime, it is about implementing it.

Yet, some of the parameters that are relevant for the UFR were mentioned in the recitals and, as you pointed out, 4.2% was the basis of the studies that informed the calibrations of the other LTG measures.

There are references in the recitals in relation to the parameters at that moment in time, but the directive makes it clear that these elements can change. The directive states the UFR is not a market rate, but needs to reflect the long-term expectations of interest rates and inflation. Therefore, I cannot agree with that kind of assertion.

"If political intentions change, we will have to adjust, but bringing forward the LTG review is not on my desk"

If you take away the UFR, large parts of the industry in some countries could become insolvent...

We need to have a methodology to bring the UFR in line with the long-term expectations on interest rates and inflation.

Some people seem to believe that the review of the LTG will be done before 2021... Are you willing to bring it forward?

I am working under the assumption that we will follow the calendar set out in the directive. This is a review of the standard formula by 2018, and a review of the LTG measures by 2021. Eiopa has to produce an annual report on the implementation of LTG covering a long list of elements, which should inform that review process. If political intentions change, we will have to adjust, but bringing forward the review is not on my desk.

The ESRB published in December a report picking holes in the Solvency II framework. It criticises the volatility adjustment, and proposes the introduction of a countercyclical requirement, which would force insurers to increase their capital in good times. Is this a good idea, or an inapt 'pastiche' of bank rules?

The report is a technical analysis and it makes no proposals or recommendations. It takes a macroprudential perspective on the issues, which I welcome.

"I am not saying that countercyclical capital buffers cannot be applied in Solvency II, I am just warning against the temptation of cherry picking and analysing elements in isolation"

Do you favour the introduction of a countercyclical requirement?

There are a number of tools in Solvency II that are intended to deal with the issue of pro-cyclicality, such as the equity dampener and the VA. The VA is not strictly symmetrical, yet one must look at the system in its entirety to judge it. Unlike banks, insurers are discounting their assets and liabilities on market rates. With this I am not saying that countercyclical capital buffers cannot be applied in Solvency II, I am just warning against the temptation of cherry picking and analysing elements in isolation. I would also note that even in a low rate scenario, Solvency II, which is a micro-prudential framework, is a good framework to address critical macroprudential issues, namely the risky search for yield behaviour.

We should focus on having Solvency II implemented and assessing how it works over time. At the review process, we can consider the idea of a countercyclical requirement, and test it and see if it works and if it makes sense as a part of the regime.

You don't sound very supportive of the idea...

I welcome the report, to which Eiopa, as member of the ESRB, has contributed. It adds a macroprudential view on the regime, and gives contributions on the issues cyclicality and liquidity, just to name a few. This does not mean that the report, as a technical analysis, is consensual, and this was mentioned in it.

The ESRB also criticised the reduction in capital charges for infrastructure and securitisations. The Commission, which decided on these, was more lenient than Eiopa advised. Are you comfortable with the trade-off between investment incentives and prudential rules for these asset classes?

This is another issue where people have very different opinions: some say the risk charges are punitive, others say they fail to recognise the risks. I have said many times: I don't think prudential regimes are the proper place to do incentives to invest in certain types of instruments. The role of prudential regimes is to try to deal with the risk in the best possible way and to provide the right incentives for risk management.

"It is not tenable anymore to say we have a risk-based system without looking at sovereign bonds"

Eiopa has been quite proactive in this area [review of the charges on some investments]. We spearheaded the idea of having low quality and high quality securitisations, and backed this with evidence. Recently, we have worked together with the European Banking Authority and provided input to the standardised and transparent securitisation framework. On infrastructure we identified instruments that could attract a lower capital charge.

Overall the charges in Solvency II are within the ranges that we consider appropriate. If policymakers want to go beyond that... it is not up to us, supervisors, to make a leap of faith.

In a recent speech, you elected the treatment of government bonds as one of the priorities for the standard formula review due in 2018. What change do you envisage?

We have a clear view on this matter. As the legislation stands, sovereign bonds attract a 0% risk charge. For internal models, last year, we recommended that sovereign bonds be risk-weighted, when relevant. As supervisors, this is what we can do to bring the regime closer to a true risk-based regime.

I would like to see this element addressed during the review of the standard formula. There are three points that are key to me. Firstly, we must discourage concentration, which is the biggest risk that sovereigns pose.

Secondly, any solution must be subject to a comprehensive impact assessment, because of legacy portfolios, and transitional periods may be allowed, too. Thirdly, there are needs for consistency between banking and the insurance rules; otherwise you will create opportunities for arbitrage within conglomerates.

This issue was politically toxic in the past and remains so, as proven by the resistance of the Italian regulator to follow Eiopa's opinion and the ongoing discussion on how to complete the banking union. What makes you think that it will be possible to agree on it next year?

It is not tenable anymore to say we have a risk-based system without looking at sovereigns. It is a political decision at the end of the day, but I don't shy away from giving my opinion on this.

The UK is eager to see how the formula to calculate the risk margin changed. Is this warranted?

The element of the fixed cost of capital might increase procyclicality. I believe this will be looked at during the review of the regime.

"We are seeing countries adopting different solutions, with different elements, so it will be much more difficult in a few years to bring the regimes in line"

Do you support the introduction of legislation or regulation on recovery and resolution for insurers? This does not seem to be a priority for the European Commission at present...

We have been quite clear on advocating a recovery and resolution framework for insurers in Europe. This is an element that we need to ensure we have got both micro and macro perspectives on prudential regulation covered.

We have set up a working group at Eiopa to look at this – to consider the reasons why we need it and what the basic principles of such a framework should be. This is not a 'copy-paste' from the banking side, it is insurance-specific.

The Financial Stability Board (FSB) has provided guidance on this already, yet you have lamented the fact that Eiopa was excluded from those discussions. Do you think the annex to the key attributes is not appropriate?

Most insurance regulation themes at an international level are being discussed at the International Association of Insurance Supervisors, but there are a few, like recovery and resolution, which have been discussed only at the FSB. The problem is that we don't have a seat at the table and thus have not been part of that discussion. So when these standards are adopted in Europe, things will be more difficult.

I don't think the key attributes are particularly controversial. The issue starts when you go deeper and talk about the tools you need to have in insurance, especially the resolvability tools, and talk about the critical functions and the appropriate level of loss-absorbing capacity. Our concern at a European level is that we are seeing countries adopting different solutions, with different elements, so it will be much more difficult in a few years to bring the regimes in line. At Eiopa we want to set a common basis, which can inform the design of national legislation and eventually pave the way for a European framework.

One of the most controversial ideas in the FSB's framework is the use of a bail-in tool. Do you agree that this would be useful to resolve a failing insurer?

That is something we have not looked at yet. Our work will be done in two stages: first we are going to develop some common principles, and only then can we discuss what the right tools are. Bail-in is an option among others.