# Interview by Gabriel Bernardino, Chairman of EIOPA, conducted by with Patrick Eisele, Portfolio Institutionnell (Germany)

**_Mr. Bernardino, what is the reason of the further delay of Solvency II?**

**Gabriel Bernardino:** The main issue is to deal with long term guarantee products. And the idea of this delay is to have an assessment offered, how the different tools that have been designed in order to deal with this long term guarantee products work. Measures like matching adjustment, countercyclical premiums need to be tested and they have never been tested in the past. But the exact timing for this testing is still under discussion. The Commission, the Parliament and the Council of the EU have to decide when this test will come and what the basis of this test is. After the test we will make conclusions and will provide our recommendations to the EU political institutions.

It´s fundamental to have clarity and certainty – not only for supervisors but also for the industry. The worst situation is to have a kind of open situation without clarity and without a clear commitment to one date. That would be the worst situation.

**_Wasn´t it the strategy so far to start as soon as possible and then try to improve Solvency II while it is running?**

This you have to ask the political institutions. Our view on Solvency II is that the system we use today is not sufficient because we need better and more information. Different types of risks are not reflected in the capital calculations right now. Therefore we definitely need Solvency II. We need Solvency II also because Solvency II is much more than capital. Solvency II is a new completely different way of looking to risk management. Solvency II is a huge step in terms of transparency, too. All these elements are very much relevant for the insurance business for protection of the policy holders.

A second thing is the political timing. Especially for these long term products in the life insurance sector there are some challenges in terms of applying an economic evaluation because of the volatility right now. EIOPA's message: we need Solvency II to be implemented. But we also need to bring clarity and certainty to the process.

**_Insurance companies would agree that clarity to the process is needed. But what they need much more are other stress factors for the asset classes!**

Have a look at the development of Solvency II, which is a risk based system: The basis is to look at the business risks of insurance companies and one of the most important risks is related to their investments. Then there needs to be a decision on the level of prudence that you want to have into the system. And that's of course a political decision. The political institutions in Europe are quite clear in the Directive of 2009 saying "we want companies to have capital requirements in order to reduce the number of failures to probability of 99,5 %". Again it was not the supervisors decision, it was a political decision for this level of prudence. Then the supervisors made an analysis of risks based on the available data . Taking for example the volatility of equity markets in calculation we got 39 %.

But what you have to understand by this capital calculation: it is not only about the risk charges on each category of investments. You have to consider the correlations, too. Taking into account the correlations, the equity risk can come down to around 15 %!

**_I think the impacts of diversification is very important but little known.**

Yes. If you look at the formula, insurers are not bound to have a capital which is a sum of all the risk charges. The formula takes into account the correlation. So if you have a well-diversified portfolio then your numbers are coming down! I think this is a good incentive. And we should further incentivize companies to have a good diversified portfolio.

**_But isn´t there the threat that everyone is discovering the same Solvency-II-efficient asset allocation and so systemic risk is emerging?**

No. In countries which have already implemented a risk based regulation there is no herd behaviour in terms of asset allocation. There will be some optimal asset allocations. But risk appetites will continue to be different. There will be companies which have for example good management skills on real estate and so will have here a higher allocation. The investment policies are not only driven by regulatory requirements. On the contrary, we are going in comparison to Solvency I in a completely different direction. The portfolios will evolve much more because of the reality of the economy or because of the rates of guarantee contracts.

**_But getting 5 or 6% for Spanish and Italian sovereigns and having no stress factors is a big stimulus.**

The way the risk of sovereigns was seen when we started to develop this regime has changed. The experience was that there are no defaults in OECD-countries. But you are right if you argue that the probability of future defaults should be taken into account. The perception of sovereign risk has changed. Therefore we should look what is the best way to integrate this in the overall system. Risk charges could be one solution. Another solution could be to take into account the concentration, that for an exposure percentage of X risk, Y charge is required. There are various ways of dealing with this – not only to immediately make recourse to a risk charge which will be based on rating agencies. What we want too, is to reduce the reliance on ratings.

But changes should not be implemented in the regime right now immediately because that will even provoke more problems and more questions and more systemic risks than to solve anything right now. I think it is a question of balance and arbitrage in there and of course you need to take it in the overall picture.

**_A main point of the sceptic is that Solvency II doesn´t fit in the low interest world of today. The stress factors are too high in comparison to the yields.**

The stress factors are a reflection of the situation of the economic cycle and the stress factors are not constant. Constant is only the 99,5% confidence level. The risk factors are not set in stone. There will be a review of the risk factors. The risk charges will be recalibrated as time goes by. Most of the risk factors take into account the evolution in the markets.

Let´s be frank: Solvency II is not perfect. There are no perfect regulatory systems. Regulatory systems are based on reference points. You have to understand that the system is built upon a European average. So it cannot reflect exactly the risks of typical German insurer. But the "beauty" of Solvency II is that we have besides the standard formula the possibility to use partial models or internal models. These models bring capital calculations closer to the risk and I am sure these models will grow in the future.

**_Typical for a German insurer is that they have a significant allocation to German real estate and that they have not enough resources for an internal system.**

The system has the tools to adapt the specific risk profile of a company. They can build a partial internal model that applies to this investment. I believe it is true that 25% is a huge risk charge for the German real estate market. But for other countries it is a bit lower than it should be. But the system has the possibilities to overcome that. Therefore it is a more complex system.

When we will start to implement this, we will see possible ways. Solvency II is going to be a system that is capturing the risks much better than it is done today. And this will not happen that companies need more capital than they should have. This is not a desire of the regulators and supervisors. We want to have an optimal allocation of capital. Therefore, we want to have Solvency II. Within Solvency I we have companies that really don´t need that amount of capital. But others need more capital because they are engaged in investments which are more risky.

**_To overcome the disadvantages of an system that is based on European averages it needs permission for internal models. But so far there is not any permission.**

We are not yet in the process of having the approval. What has EIOPA done is to create a pre-application process in which companies can already be involved with supervisors to start the dialogue. Hopefully at the end of this pre-application process supervisors will be able to tell companies, “yes, you are now in a sufficient situation to present now formally the process and then we are able to validate it formally”. Or we can say, “no, please develop this or that further”. The validation and the approval can only come when the directive will be enforced.

Of course this validation process of internal models is complex. One thing is the so called “Use Test”. Companies need to show that the model is really used on a daily basis. We cannot accept things like black boxes.

One advantage of Solvency II is that we allow partial internal models. We don´t have only big insurer in our mind. Partial models can be a good way for small medium size insurers that have a good understanding of the risks. I think there is a huge misconception, that smaller insurers don´t have the possibility to use these tools. I don´t agree with that.

**_But how many risk managers do they have to have an internal or partial internal model?**

There is no formula for this. But Solvency II will be applied in a proportionate way. You will not need 20 risk managers or so if you´re a small or medium sized company. That is also a misinterpretation of Solvency II.

**_What do they miss is the interpretation of the proportion principle.**

What I can assure is that EIOPA is building the best we can in terms of guidelines to apply the system in a proportionate way. But the supervisors should not be defining how the companies will implement in their organizations these risk management systems and how they will work it out. It should be done by the companies themselves. They should structure it according to their own conviction of doing a good job in terms of risk management, in terms of internal control. And then the supervisors will analyze. What I can assure you is that we will build guidelines on how the supervisors should approach this.

**_What have pension funds to expect out of Solvency II?**

Right now nothing. But we believe that occupational pension funds also need to have a much more risk based regulation. At the moment we kind of “reality check” the needs to be brought to the occupational pension funds area. For the future it is important to understand the steps that are needed. We came to three main conclusions.First, is that the requirements and principles that we have in Solvency II on the governance side should also be applied to occupational pension funds. The principles, especially the requirements about risk management, are very much relevant for occupational pension funds, too. But of course in a proportional way.

The second conclusion is about transparency. Solvency II improves information not only for supervisors but also for externals. We recommended the Commission for example that in case of contribution schemes a key information document should be given to (future) members of the plan, which would outline costs, charges, commissions and so on.

Third conclusion: also in the occupational pension funds you should have an economic valuation of assets and liabilities. Because we have to prevent the situation when a problem is faced, but it is too late to solve it. But of course you have to realize the differences to insurance companies. The role of the sponsor company or of guarantees has to be taken into account.

**_Don´t you have a conflict of interests by caring for pension funds and for their members?**

On the contrary. The best way to deal with these two perspectives is to take them together. The best consumer protection is to look for a sound and robust pension fund or insurance company. On top of that there are other elements which are fundamental too like a fair treatment, good information, good service.

**_But a consumer wants to have a high pension and this is not healthy for a pension fund.**

Of course you want to have the highest pension possible. But this cannot be achieved with increasing risk from the plan or the insurer. Because that can be a risk to the pension when you are old. The element of stability on the system overall and the element of consumer protection need to be considered together.

And look at the crisis in the banking sector: Who is paying at the end of the day when you have instability?

**_The tax payer.**

All of us. So you cannot say that financial stability and consumer protection need to be seen in isolation. To come back to the target of having more reality in valuations of pensions and having a better understanding of the challenges and of the risks that can come: then we are just kicking the can down the road. We have seen what has happened in public finance when you don´t want to see the reality. When the markets are going to look at this reality and take this into account, then it will probably be too late.

**_How does EIOPA take the low interest environment for life insurers into account before it is too late?**

It is in our responsibility to think in advance of what could come. The best way to deal with risks is to try to measure them and to be preventive. We want at least to see what are the different ways of dealing with this. We have performed a stress test on major insurance players in Europe with a focus on low yield scenarios. This test is public. We are now entering into the second stage of this analysis where we are talking to the different supervisors in Europe and look what kind of activities have been performed. Then we will concentrate on those cases where the analysis has to go deeper. There are various possibilities to deal with this. Important is that companies recognize this situation and change their products and their investments. But again the same lesson: it is better to start now to deal with that.

**_The ultimate German solution is Protector.**

I am sure we will not arrive at that. There are many steps that can be taken in between. And when it is more transparent it is also a push for you to deal with the risk in a proper time.

**_Wouldn´t the insurance company do this without Solvency II?**

Some of them yes. But keep in mind the competition in the markets. The one who will be the first to change the type of products, is running the risk of losing market shares. But the common regulation  helps to give to all companies the level playing field.

**_Did you expect your job being this difficult?**

I have been all my life a regulator and a supervisor. So I know that this is not an easy task of course. The challenges right now are immense due to the economic reality. But at the same time it is important that we can contribute to a more stable business in the European economic area.