SPEECH

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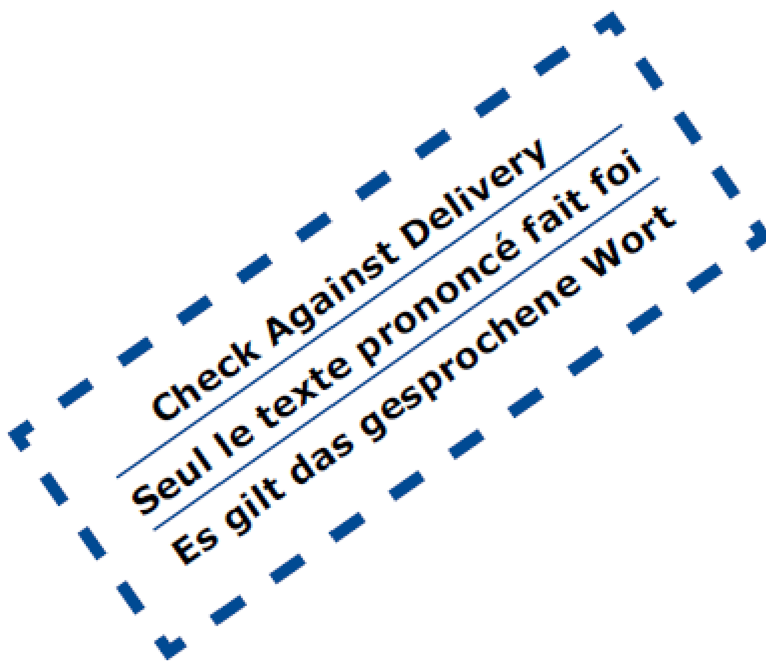
CROs – How to balance twin roles



The CRO Forum 10th Anniversary Event
Bologna, 26 September 2014

Ladies and Gentlemen,

First of all let me congratulate you, the CRO Forum, on your 10th anniversary which you are celebrating at this event and let me express my thanks to you for the honour of being one of your guests.

During these past 10 years the CRO Forum has made quite an impressive contribution to the development of risk based regulation and to raising the standards of risk management in the insurance industry.

In my different roles and capacities at both national and EU levels I have had the pleasure to interact with you, to learn from you and to build up a constructive dialogue, based on mutual respect and common willingness to move regulation closer to sound business practices.

I thank you for that.

CROs have helped to shape the new risk-based regime in insurance and in return regulators have placed risk management as one of its main building blocks.

This opportunity should be used to embed a strong risk culture in the day to day operations of undertakings, ensuring that business units themselves “think and act” from a risk management perspective.

It is also important to emphasize that risk management goes well beyond compliance. It is about making sure that risk considerations, and their capital consequences, are explicitly taken into account in the strategic decisions of the company. The matching of the own funds to the risk profile of the undertaking should help to promote a strong risk culture and can be an essential tool in the sound running of the business.

At the same time, sound governance and risk management evolve over time. In this context, it is now particularly important to include adequate strategies and processes to deal with conduct and consumer risk in the governance systems. From product design to claims management, insurers need to put customers at the centre of their business decisions.

CROs are instrumental in delivering these results. But this progress takes time, commitment, effort and especially a clear tone from the top.

In an optimal world CROs are at the centre of a company's organisation because the failure to take risk behaviour into account when setting business strategies and plans puts the institution itself and their shareholders in danger.

Of course a strong CRO is a very good signal of strong governance from a supervisory perspective and it definitely helps in attaining the regulatory objectives of increased financial stability and consumer protection.

But, first and foremost, having a strong CRO should be seen as a sound business practice and not a regulatory requirement.

In modern organisations CROs need to find a balance between being the devil's advocate, offering challenge and alternative views, and at the same time being involved in business developments and strategy.

It's a dual role, where you need to need to be "independent but involved".

What do we expect from you?

We expect that you set an appropriate risk framework, capable of dealing with risk concentrations and emerging risks, but also that you contribute to driving the business and to setting the strategy on a sound and sustainable path.

To perform this job the CRO should have a place in the organisational structure that allows him/her to play an effective role on strategy setting and decision making.

CROs need to raise their status within their organisations and be part of the board or report directly to the CEO.

We see a clear movement in this direction but there are still some organisations where the current reporting lines have to be challenged and should be rethought.

Our current risk assessment

We continue to live through a fragile economic recovery.

We observed some positive developments in equity markets and further improvements in sovereign spreads but there is a perception that there may be some asset price misalignments driven by excessive liquidity.

Insurers' solvency and profitability levels remain moderately satisfactory but reinvestment risk has further increased due to the persisting low yield environment.

So, there is a sense of divergence between market perceptions and fundamental data, which suggests a cautious approach.

For example, take sovereign debt; the developments in the market spreads do not correspond to the increasing public indebtedness (government debt in GDP has been increasing).

As primary surpluses are not expected to improve substantially in the medium term, these markets indicators reflect mainly the accommodative monetary policy.

But, despite the remaining macroeconomic imbalances, markets seem to be optimistic.

Corporate credit spreads are tightening, allowing cheaper access to funds, even for low graded entities, and we are back to low volatility levels in line with the period before the crisis.

The insurance sector seems to maintain a stable path with CDSs reflecting the rapid improvements in market perceptions.

In the context of this cautious approach I would like to highlight the low interest rate environment, and the corresponding "search for yield" behaviour.

The low interest rate environment continues to be at the top of the risks for the insurance sector.

The perspectives of maintenance and even reinforcement of the accommodative monetary policy send a clear signal.

Companies seem to have started to adapt to this new reality, both by changing the mix of products and diversifying their investment choices.

Portfolio diversification could be good news provided insurers reinforce their capacity to understand and manage the "new" risks.

In fact further investment diversification, in a controlled environment, could minimise the sometimes excessive concentrations in sovereign and banks.

Search for yield

The "so called" "search for yield" behaviour has been a growing concern largely triggered by the persistent low interest rate environment as firms seek to enhance their investment returns.

Strictly speaking all kinds of investment decisions seek to optimize or maximize returns against risk. But we need to differentiate between usual behaviours to optimize yields by re-allocation of portfolios from undesired behaviours which result in an uncontrolled or unsustainable increase in risk exposure.

Our monitoring activity suggests that, up to now, there is some evidence of a "search for yield" but there is no evidence of significant changes in the overall portfolio of insurers. The investment choices seem to continue to fall within the risk-bearing capacities.

Changes in investments can be summarised as:

- Increased investments in infrastructure and interest in direct lending;
- Changes in the mix of the bond portfolio (sovereign/corporate mix or reinvestment in lower grade bonds)
- Increased exposure to emerging market securities
- Marginal increase in equity exposures

One interesting aspect is that the movements do not seem to reflect a herd behaviour. There are different strategies; some going for longer and illiquid investments, others preferring a move to shorten durations.

If this really materialises it is good news from a financial stability perspective.

Nevertheless, we need to better understand the behaviour of small and medium size insurers. Their capacity to understand and manage the risks associated with

new asset classes (securitisation, infrastructure, etc.) need to be upgraded if they want to invest in these instruments.

I believe that insurance undertakings and pension funds can play an important role in fostering sustainable economic growth in the EU.

As one of the major institutional investors insurers are well equipped to take different types of risks on the investment side, using assets of longer duration and less liquidity to match their liabilities.

The political pressure on insurers to invest more in credit risks (through securitisation or direct lending) and infrastructure is understandable.

But from a prudential perspective we need to emphasise continually that undue incentives to buy any asset class should not be part of a risk-based, prudent regime.

EIOPA has been working on the calibration of the different asset classes. It is always a question of a balance between simplicity and granularity.

For example, in securitisation we came up with the proposal to split between different types of securitisations based on their historical performance.

This approach to higher and lower quality securitizations is to be included in the EU Commission's delegated acts and will also be part of the liquidity coverage ratio in the banking sector.

We came up with a simple approach but stand ready to develop a more granular approach, looking at the quality of the underlying assets, in order to further differentiate the risk charges.

I know that some are of the view that the risk charges of some assets classes remain a clear disincentive for insurers to buy them. On another view, I see interesting analyses from investment houses which state, quite correctly, that stand-alone risk charges are not the appropriate measure because diversification benefits need to be taken into account. So the marginal capital requirement is of course a more appropriate measure.

In fact, using a methodology very similar to the one EIOPA used in its assessment, Blackrock concluded that, based on the marginal return on regulatory capital, investments in infrastructure debt and private equity are, at least on a relative basis, quite attractive.

EIOPA guidelines

The objective of EIOPA's guidelines is to guide NCAs on the practical implementation of the new regime in order to ensure a consistent application and a level playfield.

I understand the desire for clarity and the note of caution on the large number of guidelines; we made a big effort to be as clear as possible e.g. by giving examples, and to limit the number of guidelines.

However, given our discussions with NCAs, believe me when I say that the absence of guidelines would only increase the risk of divergent interpretations which would not make your lives easy, on the contrary.

We remain open to dialogue and welcome your constructive comments. We will continue to work in a transparent way with you and other stakeholders.

This is my direct message to the CRO Forum and I welcome your direct communication with EIOPA.

Challenges in implementation and Supervisory convergence

This is a key issue going forward. To align regulation is just the first step. Supervisory convergence and consistency of supervisory practices is the most important element if we want a true level playing field.

EIOPA has (already) started on this process. We will use all the tools available to us.

- Colleges (common risk assessment)
- Peer reviews
- Centre of expertise in IM (sound indicators and benchmarking)
  (1 package for application of internal models supervisory approval)

- Opinions to NCAs (clear recommendations)
- Supervisory handbook
- Supervisory Oversight team

Analysis and feedback

Even though we are facing a very difficult period, let me finalise with a positive note.

The new insurance, risk based, regulatory regime is here and it is starting to be implemented.

I remain optimistic and convinced that, provided both supervisors and companies remain faithful to the sound, basic principles of the framework, the results for enhanced consumer protection and financial stability will be very positive.

I count on the CROs to deliver sound and sustainable business practices and strategies.

EIOPA will do its utmost to ensure that the regime is applied consistently within the EU, ensuring a similar level of protection to all EU citizens and a level playing field for the industry participants.

I may have repeated my messages in my speech but there is one thing which I haven't mentioned at all. I haven't once mentioned the words "Solvency II" and that is an achievement.

Thank you for your attention.