EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

KEYNOTE SPEECH

Gabriel Bernardino
Chairman of EIOPA

Milestones of preparation for Solvency II

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

European Insurance Conference
London, 2 June 2015

Ladies and Gentlemen, Good afternoon,

I am particularly glad that modern video conference technologies allow me to participate in this conference despite the fact that this time I was unfortunately not able to travel to London. Thank you very much to JP Morgan for giving me the opportunity to speak to all of you today.

In six months' time, we will usher in a new era in the European insurance supervision – the era of risk-based supervision. Solvency II brings a new risk culture and enhanced consumer protection. Solvency II encourages companies to identify their own risk appetite and risk profile, and asks Boards to take business decisions recognizing their economic capital consequences. At the same time we will initiate a journey towards convergent supervisory practices in the EU.

Is Solvency II "the perfect regulatory regime"? No, for the simple reason that there is no perfect regulatory regime as such. But Solvency II is a huge step for consumer protection and stability of the EU insurance business.

Still before the new framework enters into force, intensive efforts are required from both supervisors and insurance companies. The implementation of Solvency II will be indeed a real test for undertakings and supervisors in the EU. Today I would like to touch upon some of the challenges and explain how I see the role of EIOPA in the move from regulation to supervision.

Solvency II – challenges

ORSA

I always say that the Own Risk and Solvency Assessment (ORSA) is the heart of the Solvency II regime. Implementing ORSA takes time, commitment, effort and especially a clear tone from the top of the companies. That is why boards have a fundamental role to play. They need to set, communicate and enforce a risk culture that consistently influences, directs and aligns with the strategy and objectives of the business and thereby supports the embedding of its risk management framework and processes.

The implementation of the ORSA should be used as an opportunity to further embed the strong risk culture in the day-to-day operations of the undertakings, providing at the same time for an appropriate balance with the natural sales driven culture. We need to see in all insurance companies that risk considerations and their capital consequences are explicitly taken into account in their strategic decisions.

Internal Models

Solvency II is one of the first insurance regulatory regimes in the world to allow for the use of internal models to calculate the undertaking's capital requirements. Conceptually, internal models will be more risk-sensitive, will better capture individual risk profiles and will provide a better alignment between the truly underlying economic risks and the capital requirements placed on insurance companies by Solvency II.

However, internal models are subject to validation and approval by supervisory authorities. Insurance companies and groups need to demonstrate that their internal model meets a number of requirements: the use test, statistical quality standards, calibration standards, validation standards and documentation standards. And here it is important to remember: in order to convince the supervisors, you have to explain how you convinced yourself as a modelling professional and also how you convinced your board. Only such an approach would allow having an appropriate model that meats the tests and standards.

As insurance supervisors we observe that the use of internal models in the banking side has been subject to increased scrutiny and scepticism. Lessons need to be learned: internal models should not become a capital management and especially a capital optimization tool. A race to the bottom will kill the underlying idea of an internal model.

Going forward, it is another responsibility of the boards of insurance companies - to make sure that internal models will continue to adhere to the highest possible technical standards and that the corresponding capital will continue to fulfil the prudential requirements set out in the Solvency II regime.

Solvency II harmonized reporting requirements

Another major step of Solvency II is the harmonization of reporting requirements. This will allow huge economies of scale for the industry, especially for cross-border groups, and will create a basis for consistent risk-based supervisory analysis within the EU.

EIOPA has dedicated since a long time special attention to this work stream, extensively engaging with industry and other stakeholders through various consultations. The comments and suggestions received helped us to shape a more efficient and proportionate reporting package.

Recognizing the need of early engagement and preparation, EIOPA included the provision of information to supervisors in the Solvency II Preparatory Guidelines, which has significantly increased awareness and readiness for Solvency II reporting.

Lastly, in the first quarter of 2015, EIOPA has publicly consulted on the final reporting package. We totally understand that finalizing a reporting package so late in the process of implementing Solvency II is not the optimal solution. However, the reality is that only after the publication of the Delegated Acts on Solvency II EIOPA could finalize the templates and consult on them. Facing the changes coming from the Long Term Guarantees Package, we have done our best to limit the modifications in the final templates compared to the preparatory phase ones.

We acknowledge that later this year companies will need to allocate efforts between preparatory reporting of the 3rd quarter 2015 and the reporting under Solvency II in 2016. With this regard I would like to urge insurers to focus their efforts both on the annual reporting, as a real test for the Solvency II application, and on the preparatory reporting of the 3rd quarter 2015, as a very important step for testing their processes and systems.

The time has come to make a final push in preparing for the actual submission of information. Both the industry and supervisors will benefit from this last effort. The new reporting requirements will increase the quality of the data available in the companies, which is a fundamental element to upgrade risk management. At the same time, supervisors throughout the EU will have access to better and more granular data on assets, liabilities and own funds of insurers, allowing for a quantum leap in terms of risk-based supervision.

Solvency II adjustments and transitional periods

The Solvency II regime includes a number of adjustments and transitional periods on top of the market consistent basis of measurement. The level of use of the adjustments and the transitional periods will probably be different in different countries because of the different types of contracts and products.

It is fundamental that insurance companies provide clear and transparent information to the market on the actual use of all the adjustments and transitional measures included in the regime. This will provide an unbiased and objective representation of the financial condition of the undertaking.

It is also fundamental that market analysts and investors understand that Solvency II adjustments and transitional measures are a legitimate part of the regime. Transitional measures do not distort the solvency reality: they are designed to ensure a smooth transition to the new regime, avoiding disruptions in the market and allowing a certain period for companies to fully recognize the impact on old books of contracts that have been underwritten in a different regulatory framework.

In a prolonged period of low interest rates, a robust risk assessment is absolutely essential. Hence, the timely implementation of the Solvency II risk based framework recognising these challenges is more needed than ever.

In this environment it is fundamental that supervisors monitor the situation very closely and challenge the industry on the sustainability of their business models. Furthermore, action is needed from the industry to deal with the vulnerabilities of the "in-force" business and to restructure their mix of products.

Especially within the context of the low interest rate environment, it is important that while using the transitional measures, firms will continue to take the necessary steps to restructure their business models.

Regulatory treatment of infrastructure investments

Following a request from the European Commission, EIOPA is looking at the possibility to establish a more granular treatment of infrastructure investments. The idea is to define a specific infrastructure asset class with clearly defined criteria and appropriate regulatory treatment. This should include adequate calibrations according to the underlying risk profile of that category and suitable risk management requirements.

We have been working intensively on this issue and benefited from extensive dialogue with different stakeholders (from the demand and supply side and from academia) in a couple of Roundtables. We already published a discussion paper and a public consultation with draft proposals will be published in the beginning of July.

We are targeting Infrastructure projects that generate stable cash flows, are robust under a number of stresses, possess a strong contractual framework, low financial risk and mitigated construction risk. To find a proper calibration of the risk charges to apply to this subset of infrastructure projects is definitely a challenging task. But we are confident that we can deliver a sound proposal that will reflect evidence of the true risk posed by this specific asset class.

Let me be very clear: We are not privileging infrastructure investments. It is not the objective of a prudential regime to incentivize any asset class in particular. Investment decisions are to be taken by company managers not by regulators. Nevertheless, we believe that in a prolonged period of low interest rates where search for yield is a reality, insurers will go beyond the traditional asset classes and we should have a more robust framework to deal with it. Infrastructure projects may be part of more diversified investment portfolios and that could be something positive. But we should have infrastructure investments treated in a sound and controlled way.

EIOPA – from regulation to supervision

So what is being done by EIOPA for the consistent implementation of Solvency II?

I see the mission of EIOPA in developing a European supervisory culture that can ensure the consistent implementation of Solvency II throughout the EU. Knowing the current different supervisory cultures in the member states you would agree with me that this is a huge task.

EIOPA is instrumental in delivering the desired outcomes and since 2013 we started to refocus our strategic approach in the insurance area from regulation to supervision.

First of all, let me mention our work on Technical Standards and Guidelines. In the Technical Standards we define forms, templates and procedures for specific areas under Solvency II, while by our Guidelines we ensure common, uniform and consistent application of the regime and establish consistent, efficient and effective supervisory practices.

In October 2013, EIOPA issued the Guidelines for the preparation of Solvency II, paving the way for a consistent preparation of the new regime by insurers and supervisors during 2014 and 2015.

In October 2014, EIOPA delivered to the European Commission 6 Technical Standards on the supervisory approval processes for Solvency II that have been recently published in the Official Journal. We are now finalizing the review, after a public consultation, of another 10 Standards, including the crucial harmonization of regular reporting requirements by insurance undertakings in the EU.

At the same time EIOPA developed Guidelines in a number of areas, 19 were published in February 2015 and 8 are under review after consultation. Some of these Guidelines concern the basic alignment of supervisory processes while others provide clarity to firms on what are supervisors' expectations and limit the risk of divergent interpretations by national supervisors.

I understand the concerns from some parts of the industry in relation to the sheer volume of regulation and would like to assure you that we will be extremely attentive to limit further regulatory texts in the coming months to the indispensable ones. But I remain convinced that overall the benefits in terms of supervisors alignment, level playing field and better policyholder protection will outweigh the costs.

But EIOPA's role goes well beyond issuing standards and guidelines. Our vision is to add value to the overall supervisory process in the EU, using our unique position to upgrade the quality and consistency of national supervision and strengthen the oversight of cross-border groups.

Our oversight activities are structured in 3 main areas: the participation in Colleges of Supervisors, the Centre of Expertise in internal models and the Supervisory Oversight team.

Colleges of supervisors

We intend to strongly use and continue reinforcing EIOPA's participation in the colleges of supervisors. In the EU, in most of the Member States, colleges have made good progress in the last years and have been fundamental to increase the exchange of information between supervisors worldwide, moving towards a more common analysis and measurement of risks.

The implementation of Solvency II represents a big change for colleges. EIOPA has prioritised the consistent and coherent functioning of colleges and we will closely follow the implementation of the new risk-based requirements, starting with the discussions around internal model approval.

EIOPA staff will keep on working closely, in both informal and formal way, with group supervisors and individual supervisory authorities to improve the status and quality of the Colleges work.

EIOPA's Centre of Expertise in Internal Models

EIOPA's Centre of Expertise in Internal Models was created two years ago with the objective to contribute to the enhancement of convergence and consistency through the development of new tools and practices in the area of internal models.

The Centre proved to be very instrumental. Last year it helped to develop the Common Application Package aiming to promote consistent supervisory practices for the application processes related to internal models. The package supported insurers in understanding the granularity of documentation and evidence that is required for the formal application process.

Recently EIOPA issued the Opinion on Internal Models covering some key areas where we found inconsistencies in approaches. In the Opinion we provided our position that for example risks related to Sovereign Exposures should be appropriately taken into account in internal models. We provided guidance to NSAs on how to assess applications prepared in the absence of some related formal decisions, including decisions on granting equivalence to the third countries; and finally on the need to use comparative studies on internal models at the national and EU levels.

Currently the Centre focuses on the development and testing of sound on-going appropriateness indicators and benchmarking.

Later on, we will engage with the NSAs in a follow-up exercise to our Opinion. Our goal will be to understand what actions have been taken in light of this Opinion and afterwards to consider the further measures required.

Supervisory Oversight Team

In order to build trustful relations with the NSAs, which would allow EIOPA to provide independent and challenging feedback on supervisory practices, we created a Supervisory Oversight Team.

Last year, this team already conducted 10 bilateral visits to the national supervisory authorities. As part of its oversight role and in close cooperation with the national supervisory authority, EIOPA is overseeing the balance sheet review of the Romanian insurance sector.

At the same time I would like to underline: EIOPA does not replace national supervisory authorities. The responsibility of the day-to-day supervision of individual undertakings and groups rests with the NSAs.

In 2015, EIOPA adopted a multi-annual Oversight Strategy with the following goals:

- To achieve a convergent approach to supervision across the EU in order to bring a level playing field, and remove scope for supervisory arbitrage.
- To ensure a consistent implementation of European regulatory and supervisory frameworks.
- To increase the quality of supervision in the EU, including contributing to an appropriate supervision of undertakings within the EU, and finally
- To increase the overall efficiency of the supervisory system by promoting effective exchange of information and developing high quality supervisory tools.

Our strategic oversight approach is to gain experience, gather information and build trust and credibility. We want to improve quality, efficiency and consistency of the supervision of insurance firms.

EIOPA's feedback to NSAs can be about different issues: for example about the way they interpret and implement EU regulations; their information exchange with other authorities; risk and financial stability analysis; actions or non-actions to particular events.

EIOPA's feedback will be insightful, because it comes from experienced staff and is based on their observations and data about individual NSAs in the context of a view across multiple NSAs. At the same time our feedback can sometimes be challenging. Convergence often implies change and movement from the status quo.

As part of our oversight work we also perform "Peer Reviews". Their purpose is to compare and assess the practices of supervisors and contribute to the creation of convergent supervisory standards.

EIOPA has developed methods allowing for the objective assessment and comparison between the authorities reviewed. On the basis of the Peer reviews, EIOPA identifies the outcomes achieved; best practices and makes concrete recommendations for improvement.

Underpinning all the supervisory convergence agenda, EIOPA is also developing a Supervisory Handbook. The objective is to build an array of good supervisory practices on the different areas of Solvency II.

We have already covered areas like risk assessment; how to supervise board responsibility within the Solvency II governance system; business model analysis; supervision of non-life technical provisions; proportionality in the key functions of the system of governance; as well as prudent person principle in investment policy.

EIOPA encourages NSA's to adequately implement these good practices in their supervisory processes.

In my view, this programme fully reflects on the purpose for which EIOPA was created: to promote supervisory convergence; to contribute to upgrading of the quality and consistency of national supervision and to strengthen oversight of cross-border groups. Fundamentally we need to recognize that supervisory convergence is a journey.

Conclusion

The UK market has certainly one of the best levels of preparation to Solvency II. The experience coming from the implementation of the ICAS regime and the commitment and effort put in place during the transitional phase, both from the PRA and the UK insurance undertakings and groups, is paying off.

The challenges we all are facing with regard to the Solvency II implementation are manifold - legal, financial, technological, organisational and even cultural. But we can overcome those challenges if we all have the same vision and work for the same goal: to create a truly level playing field in the internal market for the ultimate benefit of EU undertakings and consumers.

A solid risk culture from the side of companies and a strong, credible insurance supervision from the regulatory side will move us forward towards this goal. Let's work together on this.

Thank you for your attention.