EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

**KEYNOTE SPEECH**

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# Implementation of Solvency II: The dos and the don'ts

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

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Ladies and Gentlemen,

It is a great pleasure to be able to talk to you here, in Ljubljana, at a conference dedicated to EIOPA's top priority – the implementation of Solvency II.

I would like to congratulate the Slovenian Insurance Supervision Agency for the setting up of the conference in a perfect timing and to thank its director Segej Simoniti, with whom we work closely in EIOPA's Management Board and Board of Supervisors, for the kind invitation to be a keynote speaker.

In my intervention today I would like to point out some important sound principles of Solvency II and highlight a number of key elements that the different actors need to take into account in order to make Solvency II implementation a success.

The title of this conference talks about "what can go wrong". It is a very important task to make sure that collectively we grasp the risks but also the opportunities of Solvency II implementation. In doing so we will ensure that the overall objectives of increased consumer protection and enhanced financial stability are met.

**Sound principles of Solvency II**

For decades the European Union (EU) was facing an outdated and fragmented regulatory and supervisory regime in insurance. Solvency I is not risk sensitive, contains very few qualitative requirements regarding risk management and governance and does not provide supervisors with adequate information on the undertakings' risks: consequently, national authorities have been introducing different add-ons in their regimes in order to cope with market developments. This has leaded us to a patchwork of insurance regulations in the EU.

It took almost 15 years of development and negotiations at the political and expert level in order to bring to light a new era – the one of the risk-based European insurance supervision.

Solvency II brings a new risk culture and enhanced consumer protection while using the latest international developments in risk-based supervision, actuarial science and risk management. It encourages companies to explicitly identify their own risk appetite and risk profile, and asks Executive Boards to take business decisions recognizing their economic capital consequences. Thanks to Solvency II we will be in a position to initiate a journey towards convergent supervisory practices in the EU.

Solvency II is based on fundamentally sound principles:

- A total balance sheet approach and an economic market consistent valuation of assets and liabilities in order to have a realistic basis for assessing risks;
- Two capital requirements (MCR and SCR), assuring a risk-based calculation but also a more robust and simpler floor designed for ultimate supervisory action;
- Updated group supervision approach with the definition of a group solvency requirement and clear powers assigned to the group supervisor;
- Robust system of governance, including the definition of a number of key functions;
- Own risk and solvency assessment (ORSA) that is now considered as the best practice at an international level;
- EU harmonised templates for supervisory reporting and enhanced public disclosure.

Can we call Solvency II "a perfect regulatory regime"? No, because perfect regulatory regimes are non-existent. But Solvency II is a pretty good starting point. Especially under circumstances when the European insurance sector is continuously facing such major risks as the weak macroeconomic environment, protracted low interest rates and increased credit risks. In today's macroeconomic reality the use of the risk-based approach and sound principles of Solvency II is a must and a true game changer.

As I said Solvency II is not a perfect regime. There are no perfect regulatory regimes. Going forward, EIOPA will be very attentive to any material unintended consequences of Solvency II implementation, especially if they have a negative impact on consumers. Let me mention some areas:

- Investment behaviour of insurers

  The implementation of a risk-based capital regime comes, of course, with profound changes in the way investments are treated from a regulatory perspective. First, the prudent person principle eliminates regulatory restrictions and limits on investments but creates the onus to insurance undertakings to establish their own limits and investments restrictions. This is going to be closely monitored, especially in a period of low interest rates where “search for yield” is a rational decision but can create additional risks for the insurer, in particular if they invest in new asset categories or increase concentrations in certain specific assets. Second, the risk charges applied to the different assets are one of the elements that can influence investment policies. The asset risk calibration in Solvency II is not designed to give any particular incentives to specific assets. It tries to translate the underlying risk behaviour of the different asset classes and calibrate it to the overall confidence level established in the Solvency II Directive.

There are some concerns on the possible consequences on long-term investments by insurers. In this sense EIOPA has been looking to the treatment of infrastructure projects. During the first half of this year EIOPA published a discussion paper; consulted representatives of public authorities, insurance and infrastructure industries, asset managers and academics and finally launched a public consultation in early July. In the consultation paper we have come up with proposals to have new definitions and criteria to identify qualifying infrastructure debt and equity investments, which may warrant a more granular treatment in the standard formula capital calculation. We made some proposals regarding the calibration for these qualifying infrastructure investments and the relevant additional risk management requirements. Currently we are considering the feedback received during the public consultation and our final advice will be submitted to the EU Commission by the end of September. One thing is clear to me: asset risk calibration in Solvency II should not be used to privilege or incentive any specific asset class: if the regime creates incentives that are not properly aligned with risks we will see the emergence of price distortions and vulnerabilities.

I believe that Solvency II brings the right approach to investment by insurers. It privileges the matching of assets and liabilities promoting long term investments. It recognises asset diversification as a key prudential element. EIOPA will closely monitor the consequences of the Solvency II implementation on the asset side and will work on the review of the calibration in due time considering the new data available.

- Product availability

Solvency II, as a risk based regime, encourages innovation by insurers in the product design. Applying a risk-based regime does not mean that insurers should avoid risk. Risk management is the core business of the insurance industry. But, with Solvency II insurers will take more conscious decisions on the risks that they are running and that are embedded in the products they sell. It is clear that Solvency II will bring more awareness and transparency on the true risk profile of certain business models, and that is a key positive element of the new regime. Furthermore, the pricing of insurance products would be more aligned with the underlying risks. Unsustainable business models need to be avoided because they will inevitably bring detriment to consumers and to financial stability. But Solvency II does not intend to unduly penalise specific products. That is why we had adjustments made with the long term guarantees package. I believe that with the matching adjustment and the volatility adjustment insurance companies can continue to provide long term products to their clients. But they need to do so in a sustainable way and pricing correctly the different guarantees and options included on the contracts. EIOPA will closely monitor the consequences in product availability, especially in the context of the low interest rate environment.

- ORSA and risk culture

The qualitative requirements of the new framework such as the Own Risk and Solvency Assessment (ORSA) represent in my view another area where special implementation efforts are crucial.

I see the risk that insurance companies will be putting emphasis on capital requirements while considering the ORSA a second priority. This would be a dramatic error: to consider only capital charges while mitigating the risks is wrong. Capital will never cover up for the lack of proper governance!

One of the core principles of Solvency II is to look at risks and capital in an integrated way. Within Solvency II the ORSA is an important management tool that brings together in a comprehensive way risk and capital management.

When assessing the "overall solvency needs" as part of the ORSA, insurance companies should consider their risk profile, approved risk tolerance limits and business strategy. Furthermore, the ORSA needs to reflect the mitigation techniques that the undertakings intend to use to manage the risks they face. So, the basis for the ORSA is not the regulatory needs or requirements. On the contrary, the ORSA is based on the companies' DNA – their strategy.

Very importantly, the ORSA will allow insurers to determine the adequacy of their regulatory capital position and can help boards to control their responsibility not to take on more risks than the capital base allows. Furthermore, the determination of the "overall solvency needs" under the ORSA is expected to provide input to a number of important strategic decisions such as the definition of the risk retention level, the ways to optimize the capital management and the establishment of the appropriate premium levels. An effective ORSA can also provide useful insights into the capital efficiency of the business and management actions needed in the future. The ORSA will enable companies to evaluate the long-term capital efficiency of particular products and assist in the design of new policies. All of this should drive a greater consistency of decision making and link it to risk appetite.

It is important that the executives of insurance companies remember: ORSA is a cultural change and this change should start from the top. I am fully aware that it is not an instantaneous task. It takes time, commitment, effort and especially a clear tone from the top. So the key role in the implementation of the ORSA belongs to the top management. It is up to the boards to set, communicate and enforce a strong 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 frameworks and processes.

The implementation of the ORSA is a great opportunity to further embed the strong risk culture in the day to day operations of an undertaking, providing at the same time for an appropriate balance with the natural sales driven culture. In fact, an important element of embedding risk culture is to ensure that risk considerations, and their capital consequences, are explicitly taken into account in the strategic decisions of the company. Doing this rightly will represent an investment; otherwise it will be nothing but a cost.

EIOPA will closely monitor the way the Solvency II system of governance is implemented in the different member states, including the use of due proportionality.

In order to reap the benefits of Solvency II all stakeholders need to play their role in the new regime and live to the sound principles that underpinned its development. Let me touch on some particularly important elements from both the insurers and the supervisors' sides:

- Insurance undertakings:

  Insurers need to look at Solvency II as a tool to foster a true risk culture in the organisation. Solvency II cannot be viewed as a "compliance exercise". Boards of insurance companies need to make sure that the implementation of Solvency is used as an opportunity to reinforce good governance in the organisation. It is the responsibility of the boards to make sure that this happens. The implementation of the system of governance requirement is an essential feature of Solvency II.

  Insurers should make sure that the Solvency II key functions are implemented in a sound and proportionate way and that they deliver on their responsibilities.

  Insurers need to make sure their risk management function has the capacity to assess the risks posed by the different assets on which they invest, including new asset categories like infrastructure.

  Insurers need to implement proper processes to deal with product design, development and marketing and identify and manage consumer risks. This is a key feature to ensure that conduct risks are mitigated since inception. Any conflicts of interest in the distribution of insurance products need to be identified and managed; otherwise they will create vulnerabilities in the business model, possibly cause consumer detriment and ultimately damage the reputation of the company and the sector.

  Insurers need to make sure that the increased disclosure and transparency requirements are used to give a better insight in their business to investors and consumers. An effort needs to be made to explain in a simple way the new Solvency ratios and especially the fact that they will be more volatile than in Solvency I.

- Supervisors

  Solvency II is also a game changer for supervision. Supervisors need to move towards "risk-based supervision", going beyond a "tick the box" approach.

  Supervisors need to have the capacity to analyse risk data and take early enough intervention to protect policyholders. This requires an increased degree of supervisory judgment. Supervisors need to analyse business models and judge on their sustainability; they need to interpret risk-based early warning indicators and perform stress tests.

  Supervisors need to be able to challenge the effectiveness of board governance, the way the prudent person principle is reflected in the investment policies, the asset liability matching, the possible conflicts of interest in selling products. Supervision needs to be more forward looking and intrusive in order to be more preventive.

  National authorities need also to be part of the process of convergence in supervisory practices required by the EIOPA regulation. All of this requires an upgrade in the quality of supervision.

  It is fundamental that Member States create the conditions for the national insurance supervisory authorities to play their important role in the Solvency II implementation. They need to have the capacity to hire and maintain experts that can deliver on these new responsibilities. As it is expressed in the Solvency II Directive, (Article 27), "Members States shall ensure that the Supervisory Authorities are provided with the necessary means, and have the relevant expertise, capacity and mandate to achieve the main objective of supervision, namely the protection of policyholders and beneficiaries".

It is also fundamental that supervisors have appropriate independence and accountability.

We encourage national legislators to reinforce the framework of independence and accountability of national supervisors. It is crucial to ensure that supervisory decisions are taken independently of any industry or political influence. This was always a key issue but it gains even more relevance with Solvency II due to the necessary degree of supervisory judgment in the application of a risk-based regime. In markets where some key companies are state owned, as in Slovenia, it is particularly important that supervisors can ensure a level playing field and that all companies are supervised in a consistent way.

Credible and independent supervision is a key important asset for the confidence of consumers and investors. It is in the insurance market interest that the supervisory authorities have sufficient human and financial resources to ensure proper risk-based supervision. Failure to achieve that will imply less capacity to dialogue and a more "mechanistic" and "tick the box" supervision that is not compatible with Solvency II and it is detrimental both to consumers and the industry.

As we are in an internal market in the EU, the issue of national supervision is not only a local issue; it is an EU issue. EIOPA and NSAs are part of the European System of Financial Supervision. That's why EIOPA is tasked with responsibilities on ensuring consistency and convergence of supervisory practices. The EU supervisory system will be as strong as its weakest link.

EIOPA will be very attentive to national practices and will monitor the capacity and independence of national authorities using all the tools assigned to it by its regulation, including through peer reviews.

**Conclusion**

Let me conclude.

I think we all can be proud of the quantum leap in the insurance regulation we are all witnessing. Absolutely each participant in this conference has already contributed one way or another to the fact that Solvency II will see life on 1 January 2016. Let’s boldly face problems and get inspired by the thought that we all are doing a good thing for the European consumers and the European economy. With Solvency II we will have intelligent and effective regulation which does not stifle innovation. It is a solid step towards financial stability, better transparency and enhanced consumer protection. It is up to all of us to implement it in a responsible way.

Thank you for your attention.