Interview with Carlos Montalvo, Executive Director of EIOPA, conducted by Garry Booth, Reactions magazine (the UK)

Can you explain what the interim Solvency II measures, sometimes known as Solvency 1.5, encompass?

Perhaps I should start with a disclaimer: I think the name Solvency 1.5 is unfortunate. We are not building from Solvency I, we are preparing for Risk Based Supervision. EIOPA will issue Guidelines addressed to national supervisors on how to proceed in the interim phase leading up to Solvency II. These Guidelines will cover the system of governance, including risk management system and a forward looking assessment of the undertaking's own risks (based on the ORSA principles), pre-application of internal models, and reporting to supervisors. For more information you may wish to consult the EIOPA Opinion on interim measures regarding Solvency II:

https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/opinions/EIOPA_Opinion-Interim-Measures-Solvency-II.pdf

Does the proposal have acceptance among EU country supervisors? Will everyone move forward together?

The above-mentioned Opinion of EIOPA was first welcomed, and then approved by the EIOPA Board of Supervisors, which consists of the national supervisory authorities of the EU Member States. EIOPA expects that all our Board of Supervisors members are committed to set the grounds to develop a consistent and convergent supervisory approach with respect to the preparation of Solvency II. EIOPA's Guidelines will ensure that important aspects of the new regime will be phased-in, taking into account due proportionality. However, by nature these Interim Guidelines are soft regulation (i.e. used on a so-called "Comply or Explain basis"), so there will be no sanctions if some National Supervisory Authorities (NSAs) do not fully comply with the Guidelines at this stage.

Why have you decided to issue guidelines (Spring 2013)? What's in the guidelines?

In the absence of a final agreement on Solvency II in the scheduled timeline, EIOPA has expressed an opinion in order to ensure and enhance sound risk based supervision and prepare the industry for the final Solvency II Directive. Instead of reaching consistent and convergent supervision in the EU, different national solutions may emerge to the detriment of a good functioning internal market. In order to avoid this scenario EIOPA decided to develop guidelines and to take a lead in the preparatory process aimed at a consistent and convergent approach with respect to the preparation of Solvency II. EIOPA Guidelines will allow supervisors and undertakings to be better prepared for the application of the new regulatory framework.

To cut a long story short, the guidelines are an excellent way for all parties to use the extra time of the delay as a way to be better prepared for implementation.

The CRO of global reinsurer recently told me, 'We are experiencing ever increasing requirements for internal model approval, with each country carrying out its own assessment, with limited relation to proportionality... This process consumes a lot of resources without creating value - it has even started to destroy value. And the situation might get even worse until the full formal implementation of all Solvency II's three pillars in 2015/16 (or even 17). It is my sincere hope that EIOPA will have the power to convince local supervisors to stick to the original intention: a principle based approach following the principle of proportionality.'
What's your response?

The requirements for the use of internal models are set out in the Solvency II Directive, and will indeed be further developed in the upcoming implementing measures, and EIOPA standards and guidelines. Such requirements will have to be fulfilled by all undertakings (irrespective of their size) if they want to use an internal model for SCR calculations under Solvency II.

EIOPA has been supporting the role of Internal Models in a risk based framework, even after the experience of the Banking sector, where models which were too principle based had a significant role in the crisis. This support should be acknowledged, and the need to learn from what happened as well.

EIOPA recognises that the uses of the internal model will vary from undertaking to undertaking and will point out to NSAs that they have to assess compliance with

requirements based on proportionality, according to the nature, scale and complexity of the risks and business of the undertaking.

Having said that, it is fair to say that EIOPA recognises that differences between supervisory cultures, Member States' legal regimes and a number of resources available, have led, in the short term, to some inconsistencies in the supervisory approaches with respect to internal model reviews in pre-application. Precisely because of that, when you look at our Work Program and objectives for 2013 onwards, you will see that EIOPA is building a Center of Expertise for Internal Models that will work on enhancing consistency and supporting those supervisors that may need help achieving it.

There’s been a lot of uncertainty around the implementation date of Solvency II. Realistically, when will the project be completed?

Let’s start with what matters most: Solvency II will be implemented, and there should be no doubts about it.

On the application date, we are confident that the framework will be applicable in 2016 though I cannot give you 100% reassurance because the decision is not made at the EIOPA level. The decision has to be made by agreement between the European Council, European Parliament and the European Commission.

I can confirm that EIOPA will do the necessary work to make the implementation of Solvency II happen on January 2016.

But let’s be clear, once we settle the pending issue of Long Term Guarantees, parties must avoid the temptation of reopening more issues. Solvency II is a good framework, it will not be perfect on day 1, but this should not be an obstacle to start.

Dr Elke Koenig, president of the German supervisor Bafin recently said of Solvency II, “You have created a massively complex system which is probably only fully understandable for those that have created it.” What’s your response?

The basis of the system is quite simple: it strives for risk based supervision that incorporates transparency, calls for a clear understanding of risk and good

governance. So the idea is simple but the way it has to be translated into a regulatory framework is complex. So Dr Koenig is right in that sense.

Why is it so complex? I would say that it is everybody's responsibility (the regulators, the European Commission). But in many cases the complexity is also being driven by the industry.

What can we do to make things less complex? We need to enhance the principle of proportionality while bearing in mind that the same objectives can be met in different ways in particular for the companies that are not doing complicated business, for SMEs et c. EIOPA is also aiming at reducing part of this complexity, with initiatives such as an IT toolkit for undertakings that could include a way to calculate the SCR, etc. We don't just acknowledge the problem, we try to come with solutions.

Another CRO told me that regulators appear to no longer follow the original Solvency II framework route of principle based regulation. For example, the Level Three proposal to add a compliance function and an actuarial function, with the added requirement that no person can be simultaneously responsible for more than one function. Should Solvency II, as a principle based regime, force companies to make such departmental changes?

I was surprised at this question. The actions the CRO refers to, are explicitly captured in the level 1 Directive (articles 46 and 48). There is a full article on the actuarial function (Article 48) that contains number of requirements. The level 1 text is principle based and there is a second level which gets into more nitty gritty details to do with best practice around the compliance and actuarial functions. But the principle of proportionality should always be kept in mind.

Furthermore, the intention of Solvency II is not to force companies to do their business in one way or another. It should ensure that risks are addressed and that the means to do so, subject to proportionality, are implemented. On that basis we are not going to force companies to recruit a person to be a compliance officer or anything like that. What we expect is that they comply with the principles stated in levels 1 and 2 – comply in a sound way but not in the same way for all the companies.

Some individuals interpret the principles as prescriptive - but it is not our intention to tell companies how to structure their business. We use the word actuarial *function* but function does not mean *person*. So in a tiny company you could have an actuarial function that does not have to be performed by a 'pure' actuary but instead by someone who has strong mathematical knowledge.

Are country supervisors straying from the original Solvency II script?

Our duty is to make sure that all 27 NSAs understand the principle of risk based supervision in a convergent way and apply it consistently. Some of our members have told us that they need to enhance risk management, internal controls, or disclosure. So they had some internal projects on hold because these projects were to be channelled via Solvency II, which is the same for everybody. Now Solvency II is not coming in January 2014 as they expected and they want to move in those areas.

So exactly the necessity to avoid the development of national solutions was stated in EIOPA Opinion on Interim Measures Regarding Solvency II, where we are talking about number of areas for which there will be interim guidelines targeted to enhance preparedness towards Solvency 2. These Guidelines indicate that supervisors are supporting the original idea of convergence and harmonization, they believe in the concept of risk-based supervision, and EIOPA is taking the lead to ensure that implementation will take place in a consistent way.

EIOPA wants to "pave the way for further mutual understanding and future convergence between the EU and the U.S. on insurance regulation and supervision". But many people in the US argue strongly against convergence. Why is convergence important in your opinion?

The convergence is important for our overriding aim, which is to develop strong global regulatory and supervisory standards. The purpose of the EU-US Insurance Dialogue is to enhance mutual understanding and co-operation as well as to promote business opportunity, consumer protection and effective supervision. We remain respectfully aware of the commonalities and differences of both regimes, continue to strive to address important issues in technical detail, and may, over time, move toward improved compatibility that will benefit insurance consumers, industry participants, and the economy.

There is a growing view that Solvency II will lead to restructuring in the re/insurance industry with M&A and consolidation to follow. Do you agree this could be an unintended consequence?

I have been hearing this for the last 15 years and also often asked this question at conferences by representatives of smaller companies. And I used to give such an example: I like to buy books and I buy my books in a tiny bookshop in Madrid. The owner reads a lot and he knows what the customer likes and always gives me great recommendations. I could buy my books at Barnes & Noble or at Amazon. But as long as I get such a level of service [from my little bookshop] I will never do that.

If smaller insurance companies understand the needs, bring added value to their customers and also understand the specifics of the business they underwrite, they will succeed. They will even benefit from Solvency II because it gives them the right incentives to have better risk management.

As for companies that are subjected to restructuring or mergers, they will face such issues because their problems are related to globalisation - and not to Solvency II.