Interview with Carlos Montalvo, Executive Director of EIOPA, conducted by Victoria Tozer-Pennington, the Risk Universe (the United Kingdom)

The recently announced further delay to Omnibus II have been greeted with dismay by firms eager to see the final rules to Solvency II. How do you account for the delays and what is your advice to firms?

Carlos Montalvo Rebuelta: A credible timeline for the implementation of Solvency II is a must have.

Regardless of these uncertainties, there is a strong need for risk-based supervision. This need has been only reinforced by the lessons taken from the current crisis. In order words, the idea and the principles of Solvency II are more actual and valid than ever.

Our advice to the firms is not to wait until the political discussions are over, but to use the time in order to better prepare for Solvency II internally: to make sure that the Boards of firms keep considering Solvency II a priority; and to take advantage of the information that they are already collecting, as part of such exercise, in terms of better understanding the risks they face, and how to address them.

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.

How have the individual Member States of the European Union progressed with their adoption of Solvency II and are you confident all will be able to implement the final rules on time?

Montalvo: The Member States can and must successfully implement Solvency II and they have already started to make necessary preparations for it. Some steps in the right direction have already been taken, there is a good work already in progress, but there are still challenges with regards to the whole implementation process both for companies and supervisors. Ignoring them would be irresponsible.

In your opinion how will Solvency II serve to reduce cost, complexity and risk for insurance firms?

Montalvo: First of all, it is not possible to eliminate or even reduce risks. The insurance business is a risk-related business that by its nature is based on taking, managing risks and making profit out of those risks. The objective of Solvency II is not to reduce risks, but to allow companies to properly understand, price and manage the risks they face.

Solvency II will enhance better understanding of the risks, and such understanding will help companies to better manage the risks and therefore, to make better decisions. This will create an immediate benefit to the undertakings.

As regards complexity, complexity is particularly challenging for small and medium-sized enterprises. Solvency II is more complex than it was originally foreseen. Beyond the principle of proportionality and its application, we have currently on our table such initiatives as looking for the calculation of the Solvency capital requirements (SCR) and developing an IT tool to facilitate it, or a toolkit to convert data required into XBRL. We acknowledge the problem and together with industry we want to find ways to tackle the excess of complexity of the framework, because complexity should never be an obstacle to the clear benefits of Solvency II.

Why are insurers having such difficulty communicating the impact of Solvency II to the business?

Montalvo: Solvency II provides firms with a lot of relevant information for them to run their business, and to do so in a more sound manner. But this also implies changes and it is always challenging to explain the benefits of change, to send the message that we may have to change our approach to certain risks, products… that are embedded in the normal functioning of the company, simply because they can threaten the firm itself.

Compliance with the rulebook is certainly not the driver towards Solvency II, as it only brings the downside of it, costs and complexity, but not the upside, namely quality information, understanding of risks and the subsequent opportunities. Therefore, a change of approach, in terms of both action and communication, should take place to deal with the described situation.

There are significant data management issues connected with Solvency II; do you recognise the challenges firms face and what advice do you have in this area?

Montalvo: We are aware of the challenges originated by reporting requirements and we are working in order to minimize this burden for companies. The data challenges come from two sources: the valuation of the activity using a harmonised market consistent approach and the detailed requirements for public disclosure and supervisory reporting.

The market consistent valuation is a high-level principle, which was set early on in the process (Article 75 of the Solvency II Directive).

EIOPA recognised from the start the data challenge that undertaking will face and has expended maximum effort to allow undertakings to start preparing themselves, by consulting on the detailed expectations regarding public disclosure and supervisory reporting. The implied advice remains the same: continue (or urgently start for the late comers) to prepare your internal systems to be ready on time. EIOPA has also recently launched an IT development project (Tool for Undertaking) to make sure that all undertakings will have access to at least one costless possibility to create the Solvency II reporting submissions expected by supervisors.

The ORSA [Own Risk and Solvency Assessment] remains a challenge for many insurers, which has not been helped by a lack of detailed guidance from the regulators. Given how much firms are struggling with this, do you expect to offer more guidance once the final rules are published? If so, when and on which areas?

Montalvo: The ORSA process must be owned by the company. We indicate the aim of ORSA but cannot provide very detailed guidance because we don’t want to intervene in the management processes of companies and to tell them how exactly they should conduct the ORSA.

At the same time we understand the concerns of industry and precisely because of this, we already conducted public consultation on our preliminary views on the ORSA. And this is not the end of our work on ORSA, but a link to the work we are doing in terms of supervisory review process and other areas. We plan to continue involving the industry on how to enhance understanding and how to make the ORSA an operative toolkit for the companies, a toolkit that would allow them to understand their solvency position, their risk challenges and the continuity of their business, beyond a one year time horizon. In terms of supervision, the ORSA should be brought to a qualitative level and that is what EIOPA is also working on.

A final point I think appropriate to raise on ORSA is its use as a way to impose add-ons by supervisors. If we would do so, it would be a one and done exercise, we would never realistically be able to pretend that undertakings would perform, for their own internal purposes, a serious ORSA exercise, but a compliance box ticking one.

A recent survey showed that although firms (in the UK specifically) are well on their well to implementing their internal models, sources say that the bigger issue of passing the use test could be a problem. Do you have any advice on preparing for the use test?

Montalvo: Internal models go beyond a simple toolkit to calculate capital requirements because they are a fundamental management toolkit. On the basis of this, since day one, the use test became a cornerstone of the whole process.

As part of the use test, undertakings need to demonstrate that the internal model is widely used in terms of decision making and plays an important role in their system of governance, and that the model at all times reflects the risk profile of the undertaking.

EIOPA is developing guidelines that will clarify the requirements related to the use test. These guidelines have already been pre-consulted with selected stakeholders.

One of the most crucial points is that national supervisory authorities (NSAs) should asses individually the compliance with the use test for each undertaking individually according to the requirements. Although there are minimum requirements for the use test, there is no detailed and complete list of uses that the undertakings have to abide with. EIOPA recognises that the uses of the internal model will vary from undertaking to undertaking. NSAs will assess compliance with requirements based on proportionality. Some uses may not be materially important to the undertaking given the nature of their business.

Does EIOPA have any information on the preferred blend of scenarios and loss data from a modelling perspective?

Montalvo: Internal models by definition are tailored to the specific needs of individual companies. On that basis EIOPA cannot have any concrete preferred approach when it comes to blend of scenarios and loss data and in general to internal models as they are specific to companies. It is up to the undertaking to justify its own approach and methodology to the supervisory authority as part of the approval process of the use of an internal model for the calculation of the solvency capital requirement. This justification includes demonstrating both that the approach is adequate taking into account the specific risk profile of the undertaking, and that the internal models requirements related to test and standards are fulfilled.

From an operational risk loss data point of view, firms are coping with a dearth of data and scaling issues using external loss data. Has EIOPA done any work on this area or can you offer some advice to firms on the issue of the preferred use of internal and external loss data, sources of loss data, and scaling problems?

Montalvo: EIOPA or more precisely, its predecessor CEIOPS has performed several studies in order to calibrate the Operational Risk Capital Charge. The studies were based on different sample sizes (number and size of undertakings) in different Member States. The final calibration was based on the analysis of larger sample of data. It is important to note that the results are not far different from those produced by other analyses.