

Interview with Gabriel Bernardino, Chairman of EIOPA, conducted by Anke Dembowski, Institutional Money (Germany)

1. Insurance companies vs. Occupational Retirement Provision (IORPs)

EIOPA has submitted its advice for the Occupational Retirement Provision (IORP)-directive on 15th of February 2012. What is EIOPA's standpoint in this advice?

The intention is not to have a copy-paste exercise between Solvency II and the pensions directive. The intention is to find out the elements that - in terms of risk - are similar between those two. If risks are similar, you should treat them in a consistent way. And if risks are different, you should treat them in a different way. That's what we advocate in this advice.

Which are the main differences between pensions and the insurance system?

One of the differences is the type of involvement the sponsor company, i.e. the employer has in the pension fund. If there is a need for more capital within an insurance company, the shareholders are often subject to a limited liability regime. This is different in the pension fund area. Here, you don't have a transfer of the risk to the pension fund. The fund is only a vehicle to finance the responsibilities of the employer. Consequently, if there is a need for capital, the employer may be required by social and labour law to put the money in.

You want to introduce a holistic balance sheet. How does that look like?

At the regulation level, we need to take these differences into account. That's why we are trying to develop the concept of a holistic balance sheet, where we integrate not only the market value of the assets, but also the economic value of the liabilities. In addition, we are integrating other elements that take account of the specificities of the pension area. And there are different elements in each country. For example, the Dutch system, where you have the possibility to cut back the pension benefits retroactively. Or take the systems where you can reduce the indexations of the pensions for the future, et cetera. These specifications have an effect on the value of the liabilities, and you need to take it into account for the holistic balance sheet.

And which similarities do you see between pensions and insurance companies?

For example, all the elements about governance, risk management and transparency. We firmly believe that the sound principles of Solvency II can also be applied in a context of pension funds - provided of course, that you take into account the necessary proportionality. We are aware that there are many pension schemes that are quite small and that we cannot fully apply in a mechanistic way all the good principles of governance, risk management and control to them.

What is the timeframe for the Solvency II and the pension directive?

Solvency II has already been discussed for many years and we are now in the last phases of implementing measures. We intend to have the Solvency II framework implemented in 2014. On the IORP side, the process is still at an early stage. As you have mentioned in the beginning, the European Commission has asked us a long list of questions in a call for advice and we have answered them, on 15th of February. We believe that several tests need to be made, especially on the calculation of the technical provisions and of the solvency requirements. So we want to run the first quantitative impact study (QIS) on the pension side soon.

Will those QIS-studies be similar to the ones that you have done on the insurance side?

Again, there are some elements that are common, but some different elements will be coming from the holistic balance sheet approach. And also the process in itself is going to be different. In the insurance QIS we tried to capture most of the insurance market in Europe. But it is not the case for pensions, because the pensions market is so diverse across the 27 EU member countries. Therefore, we are going to conduct the first QIS-study only in those seven countries where defined benefit plans are more relevant: Germany, UK, Ireland, the Netherlands, Portugal, Sweden, and Belgium. We are working on the common technical specifications to be applied in the test and will discuss the timeline with the European Commission. The Commission intends to have a first schedule for proposal on the revised IORP Directive by the end of this year.

And what qualitative measures are necessary for pension funds?

Also pension funds need to have a liquidity assessment and a management of their liquidity needs. This is part of the qualitative pillar II-requirements. But making an analysis of ones liquidity needs is part of common good management rules anyway. Of course, a pension fund needs to know the pensions it has to pay in the years to come and what its revenues from the assets will be. Only then the fund can try to match those two and try to avoid surprises.

2. Investment issues for insurance companies

Insurance companies have been refinancing banks in the past, and we cannot see banks isolated from insurance companies. Basel III regulation is now forcing banks to hold higher equity ratios. Will insurance companies under Solvency II be able to refinance banks as they used to in the past?

Well, it is not the purpose of insurance companies to finance banks. The purpose of insurance companies is to have good products for their customers and to provide long term security for their customers. Solvency II will not force insurance companies to only buy one type of assets. But it is clear: The more stability you have in the banking sector, the better it will be from the risk perspective to invest into banks. It is normal that when banks are in a stress situation, or when there are doubts about their capital capacity, investors - not only insurance companies - refrain from investing long term into banks. With the elements that have been introduced about recapitalizing the banking sector, I believe that in the future, insurers will come back to finance banks.

So EIOPA's intention is not to disconnect the insurance and the banking sector in order to reduce cyclical ties?

No, with Solvency II or any kind of regulatory regime we are not trying to intervene in that sense. But what we want to do is to introduce a risk based system. We say that the more risk an insurance company has, the better capitalized it must be. We do not say 'don't invest into risky assets' or 'only invest into sovereign bonds' - that is not up to the supervisors. We only say that the capital has to commensurate with the risk. An insurance company can have a bigger risk appetite, but then on the other side, it needs to provide more capital. That is a fundamental element in the whole financial system.

Will Solvency II have an effect on the products that insurance companies will offer?

I believe that with Solvency II consumers will continue to have choice between different products, with different types of guarantees and liquidity characteristics. If an insurance company creates liabilities which attract more risk - for example if it wants to offer products with a guaranteed interest rate for 20, 30 or 40 years, it can do that, because consumers value those products. But the risk involved needs to be priced correctly. We must not bring risk into the system without pricing it well. I think that this is the lesson we clearly learned from the financial crisis.

What exactly was the lesson the insurance sector learned from the financial crisis?

In the banking sector we have seen that there was poor underwriting on the subprime business, where risks were brought into the system without being priced correctly. We have also seen that if you bring risk into the system, it will never disappear, no matter how much packaging and re-selling you do with it. The risk remains there and you need to manage it. If it is not well priced, someone will pay in the end, either the companies, the consumers or the taxpayer.

Does the regulation intend to reduce the risk to a minimum?

No! When the financial system is risk averse, the economy will not work. Look what the insurers are doing for us as individuals: We transfer our risks to them. Insurers by definition cannot be risk averse, because dealing with risk and managing is their core business. As regulators, our duty for the society is to have a good balance between security and growth. If you want to have a system with 100 Percent security, it will be unaffordable. So I am not advocating that we have capital requirements that are bulletproof. In Solvency II, we are building a system based on a with a 99.5 percent confidence level. But in an extreme situation, an insurance company can become insolvent. What we want to assure is that insurers will have excellent risk management systems that will help them to manage prudently their risks.

Looking at the low interest environment: Do you think that life insurance companies will need to change their business models, for example to avoid the long guarantees that stretch over the lifetime of a man?

Yes, we will probably see some changes in the products. But it is not because we are applying Solvency II, that long lasting guarantees are problematic- the products exist already. What Solvency II brings, is more market consistent pricing of risk, so that we can see clearer where the difficulties could lie when going forward. Some of the risks of long lasting guarantees need to be better assessed, and probably some of these products will cost a bit more in the future.

What happens if an insurance company falls below the solvency capital requirement?

Then the supervisor and the insurance company will need to maintain a close dialogue, and together they analyze the reasons behind it. The company will have to present a plan how it intends to recover its capital or reduce its risk. So this approach is anti-cyclical. The company does not immediately need to reinforce capital, as this would have a procyclical effect on the market. However, if things continue to go wrong and the capital falls below the minimum capital requirement, the supervisor has the duty to close the business and in drastic situations even to close the company, because then the policy holders' rights are at stake.

The system is designed in a way that it is not a safe heaven, it's not a zero failure system, but it has different levels of protection.

How does transparency help investors?

From the investor's perspective, Solvency II is a system that gives far better information to decide on an investment. That is the biggest added value a regulatory regime can have. The worst thing would be to give an incentive to hide the risk. In the current system, the solvency figures in the insurance sector are completely stable, as they are not based on the market value of the assets. But we all know that markets are volatile, so investors feel that something is wrong. Under Solvency II, the solvency capital requirements will be more volatile. You can have a situation where in one quarter you have 160 percent of your capital requirements, and in the next quarter only 120 percent.

Is more transparency always better?

Under the Solvency II regime, insurance companies will be disclosing more information, and the information given will be much more linked to the reality of the risks and the markets. At first sight, it will seem that figures are more volatile, but this is due to the higher transparency we will have, not because the insurance company has intrinsically a more volatile business. We as supervisors know this, and we hope that analysts and investors will understand this as well and will not penalize insurance companies by higher cost of capital.

Under the current Solvency II - regime, government bonds from OECD countries do not have any capital requirements at all. This seems a bit odd, considering the problems that some European countries are currently facing. What is the reason why capital requirements for government bonds are not pegged to their rating, like it is the case for corporate bonds? And are there plans that this policy will be changed in the future or is that a very political issue?

Before the euro area debt crisis government bonds were widely considered as risk free instruments that is why there was no need to peg capital requirements for government bonds to their rating. Naturally in this area as in others the perception of risk is constantly evolving and so I believe that in the future we need to explore ways to deal more properly with the risks of sovereign exposures and find a suitable way to integrate them in the overall risk-based framework.

Should the insurance supervision be directive or pre-emptive?

We want to have a supervisory system where we capture things in advance. We do not want to be like firemen that arrive when there is already a fire. We want to see things in advance and to avoid the fires. This is preventive supervision.

What gives you sleepless nights at the moment?

I think that the overall market situation certainly worries all of us because it definitely has an impact on the whole financial system. Insurers basically need two things: Stability of the markets and a well functioning economy. This also includes a certain level of interest rates, so that insurance companies can fulfill their role of providing long term guarantees. Having the low interest rates we are

seeing now, is of course a difficult situation for insurance companies. But ... I am still sleeping well.