Interview with Gabriel Bernardino, Chairman of EIOPA, conducted by Christoph Baltzer, VersicherungsWirtschaft (Germany)

Insurers seem to be the victims of a scenario of financial repression, especially with low interest rates. What would be the consequences of the policy of cheap money for insurers?

We see this in some countries in the EU where a low interest rate environment starts being a big challenge for some types of products, especially when you have got long term guarantees. We at Eiopa have identified it already in 2011. We have run the first stress test exercise particularly on low interest environment, because we see it as something which is approaching. The experience of Japan showed us what can be the consequences of such a scenario. It's the responsibility of the supervisory authorities to be proactive on this. This is an area where we need to be attentive. We have identified certain vulnerability: there are companies that could face problems if this low interest rate scenario will be maintained. There are number of supervisors in the EU that have already taken steps, but earlier in March EIOPA issued its Opinion, in which we recommend a coordinated supervisory response to the long-lasting low interest rates.

Gladly, on the insurance or pension market we still have sufficient time to deal with it, provided that we identify risks sufficiently in advance and take necessary actions. That's a difference comparing to the crisis in the banking sector, where you need to act immediately.

At the same time some new products that were introduced before the crisis should be adopted to the new economic environment: insurance companies should reflect on the type of products and the type of guarantees that they are issuing to the market.

Does Solvency II help to prepare for this scenario?

One misunderstanding that needs clearly to be spelled out is that it's not Solvency II that provokes challenges to business. It's the economic environment. Solvency II makes one difference: You need to recognize it earlier. If you have a market consistent valuation of assets and liabilities it will be much more clear that you have a challenge in your portfolio. If you continue to have a valuation that does not reflect the market, then you can pretend that there is no problem. But the problem exists. Solvency II makes this transparent and that is

good for consumers, for companies and also for supervisors. We need to have a preventive supervision. Supervision should not be there to act when the fire is already in your home. Supervision should be there to prevent that the fire occurs.

Versicherungswirtschaft wrote in 2003 that Solvency II would be in force in 2006. Do you believe that Solvency II will be in force when your term finishes?

My term finishes in 2016. That's a date that is still possible to have Solvency II in place. Before that we need a number of political decisions, but I believe that Solvency II will be in place. It's fundamental from a supervisory perspective because we now have a regime that does not respond to the risks. We have to remember why we started Solvency II. The purpose was to increase policyholder protection and incentivize better risk management. And from all the work that we have done in Solvency II there is already some positive evolution in the way insurers manage risks.

We have seen a banking crisis in 2008. What we forget about is the insurance crisis in the years 2001 until 2003. This was caused by equity investments, reserve deficiencies and unprofitable business in many lines. Do you think a scenario of this kind will still be possible under Solveny II?

No regulatory regime can avoid crisis. There is no perfect regime. Solvency II brings much more awareness of risks at an early stage. From the side of the companies it's a fundamental change of culture when companies while investing in markets, need to understand the risks that they are running. The supervisors in their turn will also have necessary tools and information in order to look at the companies from the risk-based prospective. Is this a zero failure system? No. There are no zero failure systems. But there has been progress. You mentioned the crisis of 2001 until 2003. The industry has learned from that and we incorporated it in Solvency II. The push for increased risk management and for better understanding by companies when they invest in certain types of assets – these are the lessons learned from that past.

This is fundamental right now: one of the consequences of the low interest rates is that insurance companies are searching for yield. It's bound to happen that they go to other types of investment. But then it's fundamental that they have a good understanding of those classes. And that's what Solvency II brings.

Insurers criticize what they refer to as artificial volatility in the balance sheets under Solvency II. Some even talk about irrationality of capital markets. Do you understand this criticism?

Solvency II will give figures that will be more volatile than in the current situation. It was clear from the beginning. Everybody was alerted to that. What has changed is the magnitude of this volatility. We didn't have as high volatilities in the past as we had in the recent years. We have to deal with this volatility in the system. That's what we are doing right now with the long term guarantee assessment (LTGA), which precisely focuses on that. The LTGA is trying to understand what kind of adjustments we need to make to the regime to deal with artificial volatility. But not all volatility is artificial. Much of it is representative of what is in the market. I don't want to discuss whether markets are rational or not. If you have long term liabilities and long term assets and you have a very good match between them, your numbers are less prone to have this volatility. If you have a huge level of mismatching then on the one side you are taking advantage of opportunities in the markets, but you have a risk. But for some long term liabilities we need to have some adjustments to cope with the fact that the products and the liabilities are long term and the short term volatilities in the assets have a meaning, but they don't have an economic meaning for the type of liability that insurers have. This is the adjustment that we are trying to effect right now. The regime was since the beginning based on the idea that we want to see the reality. And the reality is that markets are more volatile nowadays. We need to recognize the reality.

What would be a positive political solution for that?

An agreement on Omnibus II which is preserving the fundamental elements of Solvency II, preserving the market consistent valuation that we have got in Solvency II and preserving the principles of a robust and prudential regime while considering also the economic nature of the liabilities. I think that we have got some good proposals on the table.

Government bonds are categorized as no risk investments. Do you think that this is a good way to tackle problems of state debt?

More than any other system Solvency II takes into account the reality of financial markets, including on sovereigns. In a Solvency II balance sheet, sovereigns will be assessed at market value. It's much more advanced than other regimes. Any kind of influence that markets are putting on any kind of sovereigns in Europe right now, is taken into the Solvency II numbers

immediately, without any kind of adjustments. Then there is the element of capital requirements on top of that. But it's important to understand the magnitude. If you look at technical provisions and capital requirements, technical provisions represent 80 to 85 percent of a balance sheet. Capital requirement is just a small item compared to that. By having market consistent evaluation in the technical provisions and in the balance sheets, you have already a huge reflection of all the risks the assets have, including sovereigns. Now the perception of sovereign risk is completely different from what it was ten years ago, when we started to develop the system. Going forward we need to consider this.

What is also important to understand is when something should be done, it should be done for all sectors. We cannot have a different appreciation of sovereign risk for insurers and for banks. It needs to be done for the financial system as a whole.And it's also important to take due attention to the time when we are doing this. It's not a good policy to change this when you are still in a crisis.

How do you evaluate the Swiss Solvency Test? It's in use since 2006 and is in force already for two years.

The principles are very much aligned to Solvency II. I think it's very good that they started to implement the system because Switzerland is an important insurance market and EIOPA has very good relationship and closely cooperates with the Swiss authority FINMA. We can observe challenges but also a good outcome from the implementation of a risk-based regime in Switzerland: we have seen some changes in behavior in the markets and in the products that Swiss insurers sell. But let's be frank: it's much easier for one country to implement a regime than to have a decision on a table with 27 different approaches.

What are the most important tasks for German insurers to tackle on their way to Solvency II?

There are some companies that are more prepared and others that are less prepared. That's why we are developing guidelines for the preparation phase for Solvency II. We have defined areas where we want supervisors to ensure that undertakings are prepared: governance, risk management, pre-application of internal models, elements related to the Own Risk and Solvency Assessment (ORSA), the information to be provided to supervisors. The objective of these

guidelines is to help markets and supervisors to have a clear idea of how to prepare to the new regime. For example there is a need to make progress in the systems and processes that are necessary to deliver high quality data to be provided by companies and further analysed by supervisors. This is fundamental for the risk-based environment. So by our guidelines we are not introducing Solvency II early on, but we expect national supervisors to start implementing these elements in a consistent and convergent way and to request from companies to prepare themselves in these areas in order to be in a good shape when Solvency II is enforced. It is a win-win situation for both companies and supervisors.

Is there a situation where systemic risk becomes a problem for insurers and reinsurers?

We understand what is systemic risk in banking. Looking at the insurance sector it's also challenging. But the type of business is different. The maturities of business are different. If you talk about traditional insurance business, we don't see much evidence of all these factors that can bring systemic risk. But insurers can involve themselves in some types of business which is much more prone to systemic events, for example exposures to credit default swaps. Systemic risk in the insurance market is more a questions of the activities rather than insurers by themselves being systemic. If you have a type of business that is much more leveraged, where you have maturity transformations like you have on the banking side, if you walk and run like a bank, then you need to be treated like a bank.

Are the colleges of supervisors able to cope with their task, especially if you look at the vastness of some insurance enterprises.

It's important that supervision is performed in a way that it can deal with reality. It's important that we look at the risks from a group perspective. In Europe we have recognized this much earlier than many jurisdictions around the globe. In the late 1990s we had an insurance group directive which said that it's not sufficient to supervise single companies, but to do supplementary supervision at a group level. With Solvency II we are recognizing the reality: The groups manage their business in a much more centralised way and this needs to be reflected in supervision in order to avoid duplications and double burdens but at the same time in order to have a better perception of the real risks that are run at the group level. That's why colleges of supervisors are such an important tool. The progress that they have made is huge. The role of EIOPA in these colleges is

to make sure that there is a consistent and convergent supervision. This is a process. We have still some room for improvement.

Do you think a more centralized approach would be better for the big financial institutions?

There are steps that need to be taken in this area. I think the best way to do that is to build up on the role and responsibilities given to us by the Regulation establishing EIOPA. We can build a step by step approach towards a more centralized supervision. I don't believe in ruptures. That needs to be an evolution and not a revolution. We gain from having more centralization in some areas. For example internal models are fundamental for the new regime. It's important that there is good understanding of how the models work on individual and groups' level Here we could have an approach centralized by EIOPA because it's not possible that all the authorities in all the countries where you have companies within a group, will have the same experience immediately to deal with it. But it needs to be a step by step approach.

In UK it is now prohibited for brokers to take commissions. Do you think that this will improve consumer protection?

Intermediaries are the visible face of the industry towards consumers. The quality of the information and advice that is provided is crucial. There are a number of things to improve. But is it all about disclosure? Is disclosure the key issue? The reality proves that this is not the case. Disclosure is important but it's not the panacea. I think this is not fair to say "We gave all the information to the consumer, but he doesn't understand it, so it's his problem" That is not a policy I would recommend from a perspective of consumer protection.

First of all there are different types of intermediaries and businesses we are talking about. In life insurance it's important that the consumers have good knowledge of the commission the intermediaries are taking. This is a contract for many years, so in life insurance the mandatory disclosure should be the rule. If you look at the non-life side you should have the right to get the information. But the conditions for non-life contracts can be changed on an annual basis, they are not fundamental for your decision. The conflict of interest is much less relevant for non-life products.

What is important in consumer protection then?

You need to understand what consumers are worried about. Evidences tell us that in many cases the commission the intermediary gets, is not fundamental for consumers. They want to have a good advice. But if they needed to pay for that advice directly, then they would not buy the product. But as a society do you want people to be less insured? So banning the commissions this measure needs to be well analyzed.

Should pension funds be obliged to fulfill the requirements of Solvency II?

It's not our intention that pension funds should follow Solvency II. When we advised the European Commission, we said that there are some areas, where we see an advantage of applying the same basic structure Pension funds are dealing with the similar kind of risk, so it's important for the protection of members and beneficiaries to have good risk management, good governance, better transparency et c. But we said also that a straight forward approach like in Solvency II is not the best solution for pension funds. There are different types of security mechanisms around Europe. It's important in any kind of solvency regime that the calculation of liabilities and the value of the assets are taken more realistically. We made a QIS exercise and we will have preliminary results from this test at the end of March or in the beginning of April. Some of the QIS options were consistent with Solvency II, others were less consistent. But we never said that we should follow Solvency II.