

Interview by Carlos Montalvo, Executive Director of EIOPA, conducted by Adrian Ladbury, the Report "Asset Management for Insurance, Europe"

Adrian Ladbury: How will the introduction of Solvency II shape European insurers' tactical asset allocation on a national and European level?

Carlos Montalvo: Solvency II is nothing more and nothing less than a risk-based supervisory framework. This means enhanced transparency, better understanding of risks and, therefore, better decision-making at the level of the companies. Insurance is a type of business that is focused on both – assets and liabilities – sides and the idea of Solvency II is that insurers should have better information in order to make well-informed decisions. In this regard Solvency II will have a positive effect on the assets allocation. Furthermore, the new framework will enhance diversification because it not only brings transparency, but also foresees that capital charges are set up on the basis of risks you are exposed to and of the way that you are managing them. It also creates incentives that sound risk management will be rewarded in terms of capital.

AL: Do you see any directions in the way that it is structured, that will push towards different assets?

CM: I don't think so. Solvency II aims to be a neutral system: if you look at the different assets, they all have different risk profiles and we cannot pretend that they would end up by having the same capital charge. All of these different assets are calibrated on the basis of the same confidence level. In practice, they will be requiring the same level of capital even with different percentages within the different types of assets because the underlying risk is different. In other words, more risky assets will require a higher capital charge and vice versa. Another advantage of the framework is that the diversification will allow for a good blend. On a global portfolio you will be able to include riskier assets because it will be compensated through diversification with other types of assets. This will ensure that you are able to have a sound manageable and understandable portfolio.

AL: How is the riskiness of the assets calculated?

CM: A number of years ago, when we being still CEIOPS started the idea of Solvency II, it was decided that, in terms of capital requirements, Solvency II would be designed on the basis of a value at risk with the confidence level of 99.5%. With this in mind we set up a formula that had a number of modules (like market risk etc.) and sub-modules. Then CEIOPS was asked to get experts together and to derive the capital charge that should be needed in order to reach 99.5% confidence level for real estate, equities, corporate bonds et c

We introduced the idea of rewarding sound risk management and good diversification by setting up correlations between modules and sub-modules. Even a lawyer like I knows that, when you introduce correlations, you are reducing the effective capital charge that you had ex ante the correlation. Effectively the better diversified you are, the bigger the reward is going to be with regards to a reduction on the final applicable capital charge.

AL: From an operational perspective, if an insurer diversifies too much does that introduce operational risk?

CM: It is something that the company's CRO, CFO, CEO and board need to understand. Solvency II is bringing in a new idea - the Own Risk and Solvency Assessment (ORSA). This is the own risk capital assessment which, performed by the company, tries to understand how much capital do companies need to hold on the basis of the risk that they are bearing and of their medium- and long term planning, in order to make sure that they will meet their objectives. The diversification strategy will be part of the asset allocation strategy of the company, bearing in mind the idea of risk appetite, business model, etc.

One of the lessons to learn from the financial crisis is that you shouldn't buy assets that you do not understand. If your diversification strategy leads you to buy such products just for the sake of being more diversified, you aren't doing things right. Being well diversified is a mean, rather than a final goal. That is why the new framework creates business opportunities rather than operational risks.

AL: It sounds as though it comes into the PILLAR 2/PILLAR 3 area?

CM: Yes, as you cannot work on a standalone basis. You need to have interlinks with all the pillars – this is the idea of Solvency II. No pillar prevails, all are equally important.

AL: Did you find yourself under pressure from politicians who asked Solvency II to result in a de-allocation of assets into pensions funds or similar? Were there macro considerations to be included within the calculations?

CM: We have advised on the basis of sound technical calculations taken by the supervisory community (and in particular by the actuarial teams that were involved). I would not say that the way that Solvency II looks now is a politically driven outcome. We need to understand that every piece of legislation and regulation is based not only on the mathematical works and assumptions but also on the impact of the suggested measures, because we need to fully understand what we are proposing and its implications.

There is always political pressure, but EIOPA has always proved that it is an independent body and we put forward what we consider to be good, sound, technical advice. Is Solvency II perfect? No. Can it be improved? Probably yes. But it is an extremely good starting point, so let's have it started!

We don't want anything, such as capital charges, to become another obstacle for the already difficult final stages of the Solvency II project. Once we see how it is working, we will have the courage to say which things can be improved.

AL: Will Solvency II require insurers to adopt new asset pooling techniques or will it create an environment whereby individual asset classes win out?

CM: Solvency II should be neutral. The same risk-the same capital charge or different risk- different capital charge on the basis of the same type of value of risk with the same value of confidence level. If we have rightly designed the capital charges for each of the assets, then it should be completely neutral. This

would depend on the type of business you are doing. If you take re-insurers for example, they are exposed to not much frequency in terms of events but the severity or intensity of these events is quite high and they may have to be paid back very quickly. This affects their portfolio as they tend to have more liquid assets etc. Another example: if you were in the pensions business, where you didn't expect to have outflows within the next 20 years, you can have more illiquid assets in your portfolio. This is something that Solvency II is also encouraging through an enhancement of the Asset and Liability Management Policy.

AL: What would you say to critics who argue that Solvency II is yet another restriction on the European insurer's investment capacity?

CM: To say that it is a restriction, would contradict the entire Solvency II idea. Solvency II is a development from Solvency I whereby you are allowed to invest in any type of asset you want. Today there are restrictions and some assets are forbidden, Solvency II on the contrary is going to give people the opportunity to invest in whatever they want. However, there is going to be a price in terms of the capital that you will have to hold, if those assets are deemed to be too risky.

AL: Credit derivatives were thought to look very good ten years ago - how frequently will you update those weighting charges?

CM: Companies were pooling a number of different assets in the same basket and were benefiting from an enhanced diversification, so conceptually credit derivatives did look great. However, we were not able to identify that the ratings were not designed for this type of element and that there was a melting effect that everyone, including the regulators, underestimated. Solvency II aims to see behind the surface and to assess what are the collateral and underlying assets that are behind these various products. But Solvency II is not against derivatives that instead of leveraging bring hedging, on the contrary.

AL: How do you go about updating the weighting?

CM: It cannot be a fixed thing. The world is obviously more complicated because the effects of capital charges are in the so called 'level 2'. This level 2 is not to be adopted by EIOPA as we provide advice which then goes to the European Commission and the European Parliament who can oppose if they find it necessary. The way it works is based on evidence when you are a supervisor looking at a particular asset. As a supervisor, you then identify problems and raise your concerns to the level of community of supervisors. From this you would trigger action by issuing a note, raise awareness and ask whether it makes sense to trigger a change in this particular area. If it makes sense, then you put it out at the committee of experts that we will have. These experts will be coming from all the 27 Member States and EIOPA. We make sure that we have a good technical basis and evidence to suggest a better alternative to what we currently have. This is a democratic process, that involves different parties, and you cannot unilaterally change the framework as it would create the legal risk and increase the level of uncertainty.

AL: How does Solvency II account for the Accounting Standards?

CM: Solvency II is almost there. We want to keep the momentum going but also ensure that there is consistency and convergence. Because we have a single market, and there are players who are operating throughout the entire single market, it doesn't make sense to come back to divergences that we have today: 27 countries and 27 frameworks. This takes time and needs resources in order to make sure that it works.

In the medium term we need to see whether it is working, and how can it work better. If necessary we will suggest changes and ultimately decide whether we are delivering what we want with Solvency II with a better understanding of risk, more disclosure and all in all a framework that aligns with the reality of the business on the one hand whilst protecting consumers on the other.

As for IFRS, I have been working on Solvency II for twelve years and when we started we did want to align completely with IFRS. At a given moment we had to move forward because in the accounting areas progress was not being made sufficiently: in some areas there were gaps, even divergences, but we couldn't afford to wait until the whole accounting debate was finalised.

IFRS will affect us because it is extremely important and so we are monitoring it to make sure that there is as much consistency as possible with what we are setting up in Solvency II. There has to be a clear understanding that reporting requirements for supervisory purposes should be, the more the better, aligned. We also welcome the ideas of enhanced transparency that the IRFS is bringing, as this is also on the agenda of Solvency II. It will be a lot of extra work but it doesn't mean that we are going to reinvent the wheel.

AL: What is the latest thinking on captive insurance? Are they going to be treated differently and get the simplifications that the risk managers want for their captives?

CM: Captives fit into Solvency II. This is a valuable business and companies in Europe transfer a lot of risks via captives, that is why captives have a perfect fit into Solvency II, which as framework aims at enhancing and incentivising risk management. If the regime would not address appropriately the specificities of the Captive business, companies could just move to a different jurisdiction and as European regulators we need to be aware of this. We need to ensure that the Solvency II framework allows for captives' treatment in an appropriate way. There is the famous concept of proportionality which should allow for a simplified treatment of captives, and also specific simplifications in the Standard Formula only for captives but, as I already said at a Captives Conference in Luxembourg a few months ago, captives are still insurers and thus need to follow the same corporate governance and risk management standards as all the other insurance undertakings under Solvency II. This makes a lot of sense and so we have to make it work for the captives that are registered in the European or equivalent jurisdictions. We certainly believe that captives are an excellent way of managing and transferring risks but the same principles of Solvency II need to be applied to them as to all other insurers.