

Interview with Gabriel Bernardino, Chairman of EIOPA, conducted by Jan Wagner, Versicherungsmagazin (Germany)

The EU's new regulatory regime for insurers, known as Solvency II, will take effect from 2014. Although hailed by EU regulators as an innovation, the regime has come under sharp criticism from smaller insurers, including several in Germany. They complain that the scheme favors bigger insurers who have the resources to easily adjust to the new regime. Wrong says Gabriel Bernardino, who as chairman of the EU insurance and pension regulator EIOPA will be Solvency II's chief enforcer. Versicherungsmagazin spoke to him at length.

Why is Solvency II needed? Has not Solvency I ensured for a well-functioning insurance industry? I know of no cases in Germany where the insured lost their money when an insurer went under.

The idea was never that Solvency II would fix the market because Solvency I failed, or because insurers needed more capital. The idea was rather a move toward a risk-based system.

The problem is that there is misallocation of capital among companies. Some have more capital than they need, and some have less. This has negative consequences for protection and pricing. To illustrate this, let us take two insurance firms with the same liabilities but two different investment strategies. One is based on shares and the other is based on bonds. From a market perspective, you would conclude that the firm with a share-driven strategy would need to hold more capital than the one with a bond-driven one. But the current regime doesn't require this! The risks on the asset side are not taken into account, and that's what Solvency II aims to resolve.

Are European insurers prepared for the transition to Solvency II?

When Solvency II begins in 2014, there will be no 'Big Bang.' That's because some of its elements are already in the system. In Germany for example, incentives for better risk management and governance are embedded in MaRisk, which is already in force. The objective is not to force insurers to have more capital. It is rather to have capital better aligned with the risks.

You will have companies that have more capital than they need under a risk-based system and others that do have less than they need. For those who have less, it's fair to ask them to raise more capital.

But even in the latter situation, Solvency II is accommodating. You don't need to apply it immediately from 2014, so you have time to raise the capital you need. Another example is the life business where a transition period applies to calculations of the liabilities according to Solvency II.

Isn't it true though that big listed insurers have an advantage over mutuals, as they will be able to raise the capital they need under Solvency II more easily?

If you look at mutuals around Europe, they collectively have much more capital than public companies. I therefore don't think Solvency II will be a big burden for them. Moreover: If they can demonstrate to the regulator that they effectively manage the risks on their investments, they may deviate from the standard model with its set of risk charges and use an internal one which is more flexible.

So smaller insurers have nothing to fear from Solvency II?

I'm not saying that the introduction of Solvency II will have no effect on the market.

Something like this always does. One possible consequence of Solvency II is that there will be some concentration in certain markets. But we're seeing this already!

Some insurers complain that Solvency II will compel them to invest in safe, but low-yielding instruments like bonds, as they carry no risk charge.

Clearly that's not what we have seen and that's not what we will see. The US asset manager BlackRock did a survey some months ago in which it asked European insurers what asset classes they would target even under Solvency II. They replied that they would invest more in alternative investments like hedge funds, venture capital and project finance. And why? In a low interest rate environment insurers have to find ways of boosting returns. No one is saying that with Solvency II you have to invest more in this or that asset class. We're merely saying that if you have more risk, you should have more capital.

Given the European debt crisis, does it still make sense to require no risk charge for sovereign bonds. Greek bonds can hardly be considered safe instruments...

Although there is a zero risk charge for sovereign bonds, Solvency II deals with the specificity of the various asset classes in that market valuations are used. This is different than in the banking sector. If sovereign debt in the portfolios of insurers were to be assessed under Solvency II, it would need to be rated according to the risk that the markets perceive nowadays. And that perception has definitely changed with the debt crisis, no question.

So if say German Bunds decrease in value, this is immediately reflected on the portfolios of the insurers, and this is the figure you take into account in order to calculate the difference between your assets and liabilities. If therefore an insurer has a 100 percent solvency requirement, but the markets penalize some bonds on the portfolio, then the assets diminish value and your solvency diminishes. So you see, Solvency II does take the risk associated with sovereign bonds into account. For assets which are more volatile like shares and real estate, a further risk charge applies.

Will the reporting requirements under Solvency II be a burden for smaller insurers?

The requirements are harmonized around Europe, so this makes things easier for cross-border companies. But this is also good for medium-sized ones with business in two or three countries. Having one system of reporting provides a huge cost benefit for all insurers doing cross-border business. The idea is to bring more commonality to supervision.

Secondly, we've got the principle of proportionality applied to the ultimate extent. There will be of course more complexity for those insurers who are invested in say structured products or use derivatives. But if you don't invest in these kinds of instruments your reporting will be less complex. There will be annual reporting, which is more comprehensive, as well as quarterly reporting on the most important elements. But for smaller companies whose risk profile doesn't really change, the regulators have the option of waiving the quarterly reporting requirement.

Will Solvency II be applied to pension funds?

As I have always said, this is not a copy-paste exercise. There are elements of Solvency II that make lots of sense for pension funds, such as governance,

transparency and risk management. These are known as the second and third pillars of Solvency II. In terms of the capital requirements, or the first pillar of the regime, we concluded that there is great diversity among pension plans in Europe. There are plans that are basically insurance type contracts, and in those you should have a regime like Solvency II. But there are also employer-sponsored plans where the risk is not transferred to the insured. This is a different type of system than the insurance-type, and it makes little sense to apply exactly the same capital requirements.