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Eiopa's Bernardino: "Supervisors shouldn't kick the can down the road on low rates"

10 March 2016

Published in: Risk, Risk management, Capital Models, Solvency II, Investment risk - strategy, UK, Rest of Europe, People

Companies: Eiopa, Insurance Europe

The chairman of Europe's insurance authority lifts the veil on this year's stress test and discusses with Hugo Coelho the limitations to consistent implementation of Solvency II

Gabriel Bernardino. Image: Eiopa

One law to rule them all – so is the promise of Solvency II. Yet national authorities from Amsterdam to London eagerly emphasise the differences in approaches and implementations, and even tell analysts off for comparing insurers with reference to their solvency ratios.

Is consistency a chimera? To the chairman of the European Insurance and Occupational Pensions Authority (Eiopa), Gabriel Bernardino, consistency is a "journey", which is at its "start".

Talking to *InsuranceERM* in Frankfurt, the Portuguese mathematician who has the task of bringing national supervisors into line, recognises there are limits to what the European authority can achieve, but makes the case for the legitimacy of the figures and sets out the areas of the directive on where convergence is a priority.

A case in point is the modelling of the dynamic volatility adjustment (VA), which has split the Board of Supervisors twice: "My personal opinion is that the modelling of the VA should be possible," he says, before noting that Eiopa has informally set guidance for the countries that are allowing it.

Bernardino also shares details about the looming EU-wide insurance stress test. The stresses, still under development, will focus on the low interest rate environment, and the coverage of the exercise will be expanded to 75% of the market share, to go beyond the large groups.

This is the first of a two-part interview. The second half will focus on the review of the regulation, and will be published on Thursday 17 March.

With a few weeks into the reporting period, the first under Solvency II, fears about large swings in stock prices of insurers did not materialise. Is this proof that investors have already come to terms with the new regime?

There have been no surprises, but it is still early days. Solvency II represents a change in metrics, and it is important that analysts and financial markets understand them and accept that solvency ratios will react to market movements and will be more volatile than before. Implementation of Solvency II is the start of the new journey.

Allianz anticipated the probable impact of the market volatility in the first quarter during the year-end results presentation. Is this pro-active approach what you expect of companies?

I expect and have been encouraging insurers to be more transparent about their solvency position, and explain their sensitivities. Everybody needs to make an effort to be more transparent.

What is Eiopa doing about it?

We are organising meetings with analysts, where we explain what figures are going to be disclosed, in particular the contents of the Solvency and Financial Condition Reports [to be published from 2017] and elaborate on potential sources of volatility in the regime.

> "At the end of the day, implementation is in the hands of national authorities."

The Dutch National Bank and the UK's Prudential Regulation Authority have advised analysts not to make a crude comparison of the solvency ratios of firms from across the EU, suggesting that Solvency II implementation in their respective countries is less forgiving than elsewhere. Is this justified?

I cannot comment on statements I do not know, but if you think about the world we are coming from, there is no doubt that Solvency II makes the solvency ratios much more comparable. Insurers are now calculating assets and liabilities on a consistent basis throughout Europe, and that alone makes a huge difference. Besides, insurers must disclose the impact of the adjustments used in the calculations: the matching adjustment (MA), the volatility adjustment (VA) and the transitionals, for instance. There are still some inconsistencies, owing to different interpretations, but Eiopa is working to address those.

Addressing inconsistencies

Does Eiopa have sufficient tools to ensure a consistent implementation of the regulation?

We have a number of tools, and we are going to use them, but there is obviously a limit to what we can achieve because, at the end of the day, implementation is in the hands of national authorities. We have started with guidelines, which helped to pre-empt many inconsistencies. We also work through the colleges of supervisors and our supervisory opinions [Editor's note: opinions are one of the tools used to promote consistency of practices and approaches].

We have issued opinions on internal models and in particular on the treatment of sovereign bonds in internal models, on third-country equivalence, on the group solvency calculation and we are now monitoring how these have been followed, before considering further action.

> "Going forward we will be issuing further guidelines, but to a lesser extent.

Trade body Insurance Europe urged Eiopa to refrain from issuing guidelines, and to conduct peer reviews instead. Are these not more effective?

We have done peer reviews in the past and we will continue doing them. The first we have done was on the pre-application for internal models, which is an area prone to inconsistency. We have also conducted peer reviews on the work of the colleges of supervisors and on cross-border businesses. We are now planning to conduct a review on the application of the proportionality principle over 2016 and 2017. In addition, our oversight team visits national authorities and has a challenging look at local practices.

All of this is about consistency and convergence, as much as guidelines. There was a period – the stage of preparation for Solvency II – when we had to make extensive use of guidelines, because the guidelines are the basis for the consistency of the regime. Going forward we will be issuing further guidelines, but to a lesser extent.

Dynamic VA and DTA

The use of the dynamic VA is one area where inconsistency is apparent. I understand this matter was twice discussed at the Board of Supervisors of Eiopa, but there was no agreement on a common response. When and how do you expect to solve this issue?

The VA is an element of the regime, but there are indeed different interpretations on how to implement it. We discussed the issue at the level of Eiopa's Board of Supervisors with the aim to align practices. We developed criteria on VA modelling, which were followed by some supervisors. We are now monitoring and collecting information on how, and under what circumstances and conditions, insurers are using the dynamic VA. Hopefully by the end of the year we will have completed an analysis to take an informed decision on how to push for further consistency on this matter.

What are these criteria? Is this linked to the valuation of assets?

There were a number of elements regarding the portfolio analysis that insurers must do. The criteria are good practices, and will be set out in our supervisory handbook. At some point in time, though, we hope to include them in a supervisory opinion.

So you back the use of the dynamic VA?

My personal opinion is that the modelling of the VA should be possible.

> "[With the stress tests] we are not trying to have a second guess of capital requirements."

The treatment of deferred tax is another area of divergence, which has a significant impact on firms' capital position...

It is not an easy subject, because it mixes the market consistent basis of the Solvency II balance sheet with the realisation of deferred taxes, which depends on national tax systems. This is one of the issues on our list for the next two years. It is difficult and complex one, but in my view it should be possible to achieve a higher level of consistency.

Stress testing

Later this year, Eiopa will conduct an industry stress test. The previous exercise demonstrated that some parts of the industry are particularly vulnerable to low interest rates, but since then the situation in the market has arguably worsened. How different will these stress tests be?

The last two insurance stress tests were broad in scope. This year we are going to focus on two specific risks to the industry: the low interest rate environment and the double hit scenario, where there is an abrupt reversal of risk premiums. The actual stresses are being worked out together with the European Systemic Risk Board, and will be published in May. They are going to be plausible, but strong. We will also expand the coverage, especially where these vulnerabilities exist. We want to go beyond the level of large groups. The last time we aimed at 50% of the market, but this time the aim is to go up to 75%.

Image: Eiopa

What kind of action could the results prompt on the part of Eiopa and national authorities?

We are not trying to have a second guess of capital requirements, this must be clear. The Solvency II requirements are sufficient for companies to withstand the risks they face on an ongoing basis. The stress tests, on the other hand, are a valuable risk management and supervisory tool, which allows us to focus on the vulnerabilities of insurers.

On the back of the results in 2014, we issued recommendations to national supervisors, and we have been in touch with them, especially in the countries that are most affected. Since then we have seen in a number of countries increases in the aggregate level of technical provisions, and clear messages about shifting the business mixes. National supervisors are closely monitoring and analysing the sustainability of the business models, too. We want supervisors to focus in time on the issues and not to kick the can down the road.

The response to the threat of low rates has been diverse across the EU. In the Netherlands, the supervisor is asking insurers assess their capital position without the benefit of the ultimate forward rate, while in Germany and Austria there is an additional reserve on account of interest rate risk. Is this not a problem, and does it not cast doubt over the appropriateness of Solvency II?

I see those as the end-result of national analysis on the sustainability of business models. The way they are doing things is reflective of the situation in their markets, but is in line with our recommendations. As for the interest rate reserve in Germany, it does not clash with Solvency II. The solvency capital requirement coverage ratio is calculated in the same way. The additional reserve is just another way of ensuring that companies have sufficient resources to cover their liabilities.