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Solvency II – The way ahead

Insurance Europe's Solvency II Conference: Two years on and two reviews

Brussels, 26 June 2018

Dear Commissioner,

Dear President of Insurance Europe,

Ladies and gentlemen,

The introduction of Solvency II in 2016 was a big step forward for policyholder protection and market stability but also a huge challenge for the European insurance industry and for supervisors.

We can now say that the implementation was successful. Even if it was done in a difficult period with an unprecedented low interest environment. Good preparation, due to several quantitative impact studies and a preparatory phase, was the secret.

The implementation of the risk-based regulatory regime was a significant improvement compared with the previous framework and brings a number of benefits for the insurance industry and for consumers.

With Solvency II, the insurance industry has capital better aligned to the risks it runs, uses a risk-based approach to assess and mitigate risks and can therefore better price them. This was an important element in the adaptation of business models in face of the low interest rate environment.

Insurers have strengthened significantly their governance models and their risk management capacity, by putting in place a number of key functions and ensuring that Boards consider risk and capital factors in the strategic decision making.

With Solvency II, insurers throughout Europe use harmonised templates for supervisory reporting, instead of a patchwork of national templates, and publicly disclose much more relevant information creating the basis for market discipline. This is a big step towards more transparency.

As part of good regulation, there are merits in reviewing the practical implementation of the regime and that is the purpose of the two reviews envisaged.

In my view, while it makes perfect sense to review and evaluate the recent reforms to mitigate any unintended consequences and increase proportionality, I firmly believe that we should not abandon the main values

of market stability and policyholder protection that were at the centre of these reforms.

We should not forget that the post-crisis regulatory agenda was put in place to restore citizens’ confidence in the financial sector.

In the context of the first review, due at the end of this year, EIOPA analysed 29 different topics and focused on:

- Increasing proportionality
- Removing technical inconsistencies
- Removing unjustified constraints to financing the economy

On increasing proportionality:

We advised to further simplify calculations for a number of sub-modules of the Solvency Capital Requirement (SCR) such as natural, man-made and health catastrophes, in particular fire risk and mass accident.

We simplified the use of external credit ratings in the calculation of the SCR (an issue especially relevant for small insurers).

We reduced the burden of the treatment of look-through to underlying investments.

We developed simplifications in the assessment of lapse and counterparty default risks.

We recommended the use of undertaking specific parameters for reinsurance stop-loss treaties.

I am quite happy with this outcome because it really reduces complexity and increases proportionality.

On removing technical inconsistencies:

One of the major technical inconsistencies found relates to interest rate risk. The methodology used for the calculation of interest rate risks was developed with data up to 2008 and did not capture negative interest rates. As a consequence, the risk profile of certain insurers now deviates significantly from the assumptions set in the standard formula.

So, we recommend to take this fact into account using a methodology already adopted by internal model users. Furthermore, given the material impact on capital requirements, we suggested to implement the methodology gradually over three years.

EIOPA carried out an analysis of the loss-absorbing capacity of deferred taxes practices. In face of the evidence of wide diversity, especially concerning the projection of future profits, EIOPA proposed a set of key principles that will ensure greater convergence and level playing field, while maintaining a certain degree of flexibility.

On removing unjustified constraints to financing the economy:

EIOPA analysed the treatment and the evidence available on unrated debt and unlisted equity and proposed criteria for a more granular treatment, namely with the use of financial ratios.

In some areas the analysis of recent developments did not provide for sufficient reasons to change. This is, for example, the case of mortality and longevity risks and the cost of capital in the calculation of the risk margin.

The evolution of financial markets does not justify a change in the cost of capital: the decrease in interest rates has not lead to a decrease in the cost of raising equity.

We are now starting to look deeply to the 2020/2021 review.

We received a detailed request for information from the European Commission on:

- Characteristics of insurance liabilities
- Investments of the insurers
- Long-term guarantee measures
- Market valuation of insurance liabilities

We are waiting for a request related to the action plan on sustainable finance.

But we are also attentive to market evolution, namely regarding the change in business models, especially in life insurance, with the move towards

contracts with lower and more flexible guarantees and, in some countries, the significant increase of pure unit-linked products.

While this is a natural management reaction to ensure long-term sustainability of the insurers commitments and optimise capital, it also increases the transfer of risks to policyholders, putting more pressure on conduct risks.

We started recently to thoroughly analyse the evidence available on the characteristics and risks of different long-term life insurance products, especially concerning the illiquidity characteristics of the liabilities and the ability of insurers to mitigate short-term volatility by holding assets through-out the duration of the commitments, even in times of market stress.

We are going to look at the regularity treatment of the spread and equity risks. This will also be very relevant in the context of the Pan-European Personal Pension Product.

Supervisory convergence – Looking ahead

Solvency II was a profound change for the insurance industry but now it is time to ensure an effective implementation of this regulatory regime by the different players in the insurance market and an appropriate supervision and enforcement by the supervisory authorities. This will ensure a high degree of consistency and quality of prudential supervision in the European Union.

In Europe, supervisory practices differ substantially due to different traditions and different starting points.

We in EIOPA are now looking very closely at how the implementation is done in practice across the European Union and how the supervision is executed by national supervisory authorities.

Supervisory convergence is a long-term strategic goal and is a joint effort by EIOPA and all national competent authorities, building common supervisory benchmarks and an independent evaluation of national supervisory practices by EIOPA.

We are working both, on supervisory culture and on supervisory practices.

In November last year, EIOPA published an important document on the key characteristics of a common European supervisory culture. A culture that should deliver high-quality and effective supervision throughout the European Union. A culture that should be:

- Risk-based and proportionate
- Forward-looking, preventive and proactive
- Challenging, sceptical and engaged
- Comprehensive, and conclusive

These key characteristics would help in delivering a decisive contribute to impede supervisory arbitrage, ensure a level playing field and safeguard a similar level of protection for all policyholders and beneficiaries.

More recently, in April 2018, EIOPA published its Supervisory Convergence Plan for 2018-2019 in which we identify three main areas:

- **Development of new common supervisory tools and benchmarks**, including further work on the supervisory risk assessment and the application of proportionality; the establishment of common benchmarks for the supervision of internal models and, most importantly, the supervisory assessment of conduct risk.
- **Supervision of cross-border services**, with a special attention to the detection of potential unsustainable cross-border business models and the sufficiency of technical provisions in the cross-border business context.
- **Supervision of emerging risks**, focusing on the supervisory practices in the resilience of IT systems, vulnerability to cyber risks, the usage of Big Data and Brexit risks.

Our strategy is clear and focused and the first results are encouraging. Nevertheless, there is a long way in front of us. Culture does not change from one day to another. We need to work on it constantly to see more of positive results in the medium-term.

In conclusion:

Solvency II is a major step forward. We should be proud of having developed the most advanced insurance risk-based regulatory framework in the world.

Solvency II evolution and fine-tune needs to preserve the core objectives of policyholder protection and market stability.

Harmonised regulation is only the start of the journey. Supervisory convergence is fundamental to ensure "equal protection" and level playing field within the internal market.

EIOPA will continue to play its role in an independent and transparent way, engaging with all the different stakeholders.

Thank you for your attention.