



## **KEYNOTE SPEECH**

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# **Looking back to look ahead: First experience with Solvency II Implementation and the way forward**



**Slovenian Insurance Conference: “SOLVENCY II – LES2ONS LEARNT”**

Insurance Supervision Agency of Slovenia AZN

Ljubljana, 6 September 2016

Ladies and Gentlemen,

It is a great pleasure to be able to speak to you here, in Ljubljana, in the heart of Slovenia, this gorgeous country between Alps and Adria, of which I have fond childhood memories and, which this year, celebrates its 25th year of independence.

Your conference comes at the perfect moment and is dedicated to EIOPA's top priority – the implementation of Solvency II, a highly sophisticated risk-based and market-consistent insurance regulatory and supervisory regime which took more than 15 years to develop. It entered into application on 1<sup>st</sup> January this year which truly marked a historical event in the insurance world.

I would like to congratulate the Insurance Supervision Agency of Slovenia for setting up this important conference to exchange on the first experiences we gained with Solvency II, and to thank in particular its Director Sergej Simoniti, with whom we work closely as a member of EIOPA's Board of Supervisors, for the kind invitation to be a keynote speaker today.

Do you still remember last year's conference theme? It was: "Solvency II - What can go wrong?". This year, we already draw the first lessons of its implementation. We will also discuss the drastic changes the current macro-economic environment and the revolution that digitalisation and BIG DATA bring to the insurance market and how consumer protection will need to evolve to keep pace with these developments to ensure fair treatment. In this context, we must not forget the Solvency II Directive's ultimate goal of protecting consumers.

Upfront, I would like to emphasise the huge efforts made by the industry to be ready for Solvency II but also from the side of the supervisors to prepare. These efforts will need to continue to fully benefit from the new regime and to

ensure consistent implementation and supervisory convergence. Despite this journey will be a long one, having everyone on board is key.

“Looking back to look ahead”, the motto of this speech, triggers the following questions which I would like to consider in the next half an hour:

1. Where do we stand now? Did something go wrong?
2. What are the challenges ahead? What are the current tools at hand?
3. What are the key areas to focus upon for shaping the future?

Let's start immediately with the first set of questions.

## **1. Where do we stand now? Did something go wrong?**

What do you think? Did worst case scenarios come true?

Over the past two years, EIOPA focused on the delivery of the Solvency II Implementing Technical Standards and Guidelines, which are indispensable instruments for achieving supervisory convergence. Some Guidelines concern the basic alignment of supervisory processes while others provide clarity to firms on what supervisors' expectations are.

With all the Solvency II preparatory and compliance measures undertaken, both by industry and supervisors, we sometimes tend to forget the essential: “Why did we develop Solvency II and what will it bring?” Let me therefore have a short look into the past and remind us about the principles and benefits of Solvency II.

The situation in the European Union was that we had an outdated and fragmented regulatory and supervisory regime in insurance - Solvency I. It

was not risk sensitive, contained very few qualitative requirements regarding risk management and governance and did not provide supervisors with adequate information on the companies' risks: consequently, national competent authorities were introducing different add-ons in their regimes in order to cope with market developments.

Compared to Solvency I, the Solvency II regime is kind of a quantum leap because it uses the latest international developments in risk-based supervision, actuarial science and risk management, which allows it to efficiently deliver on its main objective - to increase the policyholder protection for European citizens.

On 1<sup>st</sup> January 2016, after a long period of political and technical negotiations Solvency II has finally become reality. This date marks the beginning of the new era in the European insurance supervision. Let us all quickly remember the fundamentally sound principles this new regime is based on:

- A total balance sheet approach and an economic market-consistent valuation of assets and liabilities in order to have a realistic basis for assessing risks;
- Two – Minimum and Solvency - capital requirements (MCR and SCR), assuring a risk based calculation but also a more robust and simpler floor designed for ultimate supervisory action.
- Updated group supervision approach with the definition of a group solvency requirement and clear powers assigned to the group supervisor;
- Robust system of governance, including the definition of a number of key functions.
- The Own Risk and Solvency Assessment (ORSA), according to my opinion the very heart of Solvency II, is now considered as the best practice at an international level.

- EU harmonised templates for supervisory reporting and enhanced public disclosure.

Do all these principles make Solvency II “the perfect regulatory regime”? I don’t think so. Because there is no perfect regulatory regime as such.

But Solvency II is a very good starting point and I am sure that while being active and open to learn and adapt to the new requirements, both insurance industry and supervisors can make full use of this regime.

And not to forget: It is a huge step forward towards Union-wide consistent and a similar level of policyholder protection and for the single European insurance market.

This brings us immediately to the second pair of questions.

## **2. What are the challenges ahead? What are the current tools at hand?**

The regulatory phase of Solvency II is completed and this journey came to an end, providing us with a sound basis for the future to build upon.

So let’s start a new, even more challenging and exciting journey towards supervisory convergence. Given the current differences of supervisory cultures and practices between Member States, we do not expect full supervisory convergence to happen overnight. This journey towards consistent and convergent application of the new risk-based regulatory framework is a long one. In this regard, it is fundamental that Member States create the conditions for the national insurance supervisory authorities to play their important role in the Solvency II implementation, including appropriate independence and accountability.

EIOPA will play a key role in the process of achieving the core aim of supervisory convergence. But it is also about guaranteeing a level playing field and preventing regulatory arbitrage in the internal market.

In this context, EIOPA's role is unique: on one hand to be of added value for the national supervisors and on the other hand – to challenge them.

In the following I wish to mention some examples of the tools we have at hand and important actions carried out so far.

EIOPA is building a **comprehensive information system** based on the data collected under the new harmonized Solvency II reporting templates.

With this system, the insurance supervision in the EU will have several new and vital assets:

- It will further develop the capacity to provide reliable risk analysis and early warning indicators, both at individual, group and system-wide level.
- It will improve the supervisory understanding of cross-border groups.
- It will provide National Supervisory Authorities (NSAs) with peer group comparisons, increasing supervisory capabilities at the national level.

The first quarters of **supervisory reporting data** have already been received and we started to analyse them and consider these data as of sufficient quality for the beginning. This will certainly reinforce both, micro- and macro-supervision in the European Union.

Another important work stream related to convergence is the **Supervisory Handbook** EIOPA is developing on a step-by-step basis. The Handbook sets out risk-based supervisory good practices covering different areas of Solvency II, for example, such as:

- Risk assessments and business model analysis

- Supervision of board responsibility within the Solvency II governance system
- Supervision of technical provisions
- Prudent person principle in investment policies
- Monitoring of internal models

EIOPA strongly encourages national competent authorities (NCAs) to implement these good practices in their supervisory processes.

As you will well be aware of, since January 2016 and after an intense preparatory phase in 2015, we are publishing on a monthly basis the **risk free interest rate** term structures to be applied by all insurance and reinsurance companies in the calculation of their technical provisions. Despite some criticism, the use of harmonised discount rates ensures a more consistent calculation of technical provisions by companies throughout the European Union.

In addition, EIOPA devotes a special attention to the **on-going monitoring of internal models**, an area where material differences can have a huge impact in the level playing field and policyholder protection. Last year we issued supervisory Opinions covering risks related to sovereign exposures and absence of formal decisions on equivalence, via which we invited NCAs to follow respective practices. This year this work will continue by prioritizing the areas where different approaches lead to a material impact: For example we have been taking a closer look at the volatility adjustment in internal models. Going forward we will focus on the development and testing of sound on-going appropriateness indicators and benchmarking for internal models. This work is fundamental to ensure that internal models will fulfil the required standards and avoid that they become a capital optimization tool. "A race to the bottom" will kill the underlying idea of an internal model.

Already some years ago, we created an **Oversight Team** in order to provide the national supervisors with an independent and challenging feedback on supervisory practices. EIOPA's oversight work is already starting to prove its vital importance in ensuring strong but fair supervision and a forward-looking approach to risks. For example the 2015 balance sheet review done in cooperation between EIOPA and the local supervisor in Romania proved to be essential to increase the credibility and enhance consumer protection and confidence in the Romanian insurance sector. A similar exercise is currently being organised in Bulgaria, where EIOPA's Oversight team is also providing significant technical support. In the last two years our oversight experts conducted more than 35 bilateral visits to the NCAs and we will continue such bilateral engagement, facilitating cross-border discussions and supporting improvements in local supervision.

**Colleges of supervisors** across the EU have been fundamental to increase the exchange of information and to move towards a more common analysis, measurement and understanding of risks. A leading role in ensuring consistent work of colleges has become one of our high priorities. In addition, through its membership in the colleges EIOPA sets the yearly targets, organises group supervisors' trainings, collects and shares practical examples and solutions in colleges.

**EIOPA's "peer reviews"** will continue to be used to compare and assess the quality of implementation of Solvency II and corresponding supervisory practices, followed by concrete recommendations to address the issues identified. Recently, a peer review regarding Freedom to Provide Services (FOS) was finalised.

Let's now talk about the future.



### **3. What are the key areas to focus upon for shaping the future?**

Now, with Solvency II being in place we need a certain period of stability of the regulatory framework. But financial regulation and supervision cannot exist independently from economic reality. A sound process of post-evaluation of the new regime is an integral part of good regulation.

We are confronted with and are observing a very challenging macroeconomic environment, in which we may struggle but have to deal with. From the supervisory perspective, EIOPA is currently trying to assess the vulnerabilities that will require our response and attention, by conducting **another insurance stress test**. We are currently entering into the phase of centralised validation by EIOPA of all the submitted results.

This year's stress test exercise concentrates on two major risks: the prolonged low yield environment and the so-called "double-hit" scenario, when the assets' value decreases while the value of liabilities is sustained. The double hit scenario has been developed and operationalised in cooperation with the European Systemic Risk Board (ESRB). I must admit this year's stress scenarios are so severe that they look almost unreal. This was done on purpose because the macroeconomic conditions deteriorate very quickly: Looking at EIOPA's 2014 stress test demonstrated that the current reality is already much worse than the most severe scenarios that were developed two years ago. We believe that by having very severe shocks, we can better see the issues requiring particular supervisory attention and response to the potential built-up of systemic risks at the European level.

The last part of my speech is devoted to outline and re-emphasise the **key areas for Solvency II implementation** going forward:

***a. Reinforcing risk culture: The benefits of the ORSA***

The Own Risk and Solvency Assessment brings a paradigm shift in the companies' risk management and culture by creating a clear link between risk exposures and capital needs and providing the right incentives to sound risk management. A clear tone from the top is key!

We encourage insurers to increasingly use robust risk management capabilities to deal with the different challenges posed by the economic slowdown, the low interest rate environment, the financial market volatility and the stress on sovereign debt.

***b. Rethinking business models: The use of transitional measures***

In order to cope with the challenging macroeconomic reality, companies need to re-think their business models and look for innovative approaches. To this regard, Solvency II transitional measures provide companies with the additional time to re-consider their business models. The time given by transitionals should be used as a reason to change and not as an extension of the current situation.

***c. Dialogue between supervisors and industry is essential***

EIOPA can only properly shape and fine-tune our policy if you all here in the audience keep sharing with us your concerns and your suggestions. I would thus like to call on you to make full use of our communication channels such as the EIOPA Insurance and Reinsurance Stakeholder Group, the Questions & Answers tool for supervisory convergence, public consultations and workshops. Only in close cooperation, EIOPA and the national supervisors will be able to make the convergent implementation of Solvency II a success story for the

sake of financial stability and in order to protect interests of every European consumer and insurance policy holder.

***d. Foster the understanding of the regime's disclosure element to inform the market***

One of the cornerstones of the Solvency II regime is transparency. The new regime requires companies to publicly disclose essential information on their solvency and financial condition. For most parts of the European insurance and reinsurance market this is a novelty in terms of communication with the outside world. And this requirement should be used as an opportunity. An opportunity to address stakeholders' perception on alleged opaqueness and inadequacy of publicly disclosed information. We encourage insurance and reinsurance undertakings to embrace this opportunity and to actively engage in consistent, comparable and high quality communication with their stakeholders on their solvency and financial condition.

Here I would also like to highlight the importance of a good understanding of the Solvency II disclosure by those who shape the public and market opinion about companies – financial analysts, researchers and journalists. A collective effort is needed to ensure that the Solvency II metrics and their sensitivities are properly understood, in particular because they will be more volatile than in the past. Therefore, this year, EIOPA has already engaged, as promised, in a series of workshops to promote and explain the Solvency II disclosure elements.

***e. Enhancing policy holder protection within and beyond prudential supervision***

When putting in practice the fundamental sound governance basis of Solvency II, special attention is devoted to the companies' processes related to the manufacturing and distribution of products (e.g. POG).

When designing products, insurers have to identify the target market of the product, analyse its characteristics and ensure that the product meets the identified objectives and interests of that target market.

The distribution channels selected also have to be appropriate for the target market and clear, accurate and up-to-date information has to be disclosed to distributors.

In effect, companies need to establish processes so that they and their senior management and boards can take more responsibility for ensuring their products are only sold to those they are designed for. **A consumer-centric approach** is not only good for consumers but it increases consumer confidence and, hence, is good for companies, too.

In this respect, we are at the cross-road of prudential and conduct supervision; consumer protection is at the heart of both. EIOPA is therefore convinced that work needs to go hand-in-hand and on-going cooperation is key, e.g. by integrating consumer protection perspectives in the risk assessment and having joint on-site visits in the future.

#### ***f. The Review of Solvency II***

As part of its regulatory mandate, EIOPA will ensure a rigorous, evidence-based and transparent review of Solvency II, assessing cumulative effects and unintended consequences and privileging principles like simplicity and proportionality. Areas like the investment behaviour of insurers and the product availability to consumers will receive special attention.

From this year till 2020 EIOPA will perform a yearly assessment of the implementation of the **long-term guarantee measures**. The data for our first assessment we will collect simultaneously with the results of the insurance stress test 2016, which was launched on 24 May. This approach was chosen to limit the burden on the insurance industry.

By 2018 we also need to **review the SCR Standard Formula** including the calibration of different asset classes under Solvency II, and this should include sovereign bonds. The recent financial crisis has demonstrated to all of us that sovereign bonds are not always risk-free. So, a risk-based regulatory framework should take this fact into account. EIOPA's Opinion from April 2015 already recommends that risks related to sovereign exposures "should be appropriately taken into account in internal models".

However, a possible consideration of sovereign risk in the Pillar 1 standard formula is a more complex one. Regulatory arbitrage should be avoided; it is thus of particular importance that we work on a consistent approach towards sovereign risks for the entire financial sector, covering banking and insurance.

Furthermore, the future review of Solvency II should also benefit from the progress achieved at an **international level**. EIOPA will continue to give the European Union a **strong voice in international fora** and will further strengthen its successful participation in the development of the insurance International Capital Standards. We consider Solvency II as the practical implementation of the ICS.

#### ***g. Macro-prudential supervision as an integral element of the Solvency II regime***

As said, the current macro-economic and financial environment remains extremely challenging for insurance but also pension funds. Although it is generally assumed that yields will remain low for a foreseeable period of time, the ongoing debate on whether the present levels represent the "new normal" or the gradual move back to the long-term averages should be expected, is still non-conclusive. Nevertheless, a moderately prevailing view among economists and analysts point out that the so-called "low for long" scenario is more likely than a gradual increase of interest rates to the previous levels.

It is clear that the market needs to use robust risk management practices to deal with the ongoing challenges. However, in the insurance sector, not all institutions are equally affected by the low interest rate environment due to diverging market conditions, different product or business lines, maturity of liabilities and varying levels of guaranteed interest rates. For already several years, EIOPA has been devoting a lot of attention to these risks, monitoring the implications of such an environment and recommending concrete actions from supervisors and the industry.

Solvency II is by construction a micro-supervisory regime but it also contains some elements that were designed to limit pro-cyclicality and deal with system-wide risks. Looking forward, within the Solvency II review process we have to carefully analyse the way the current anticyclical tools work in practice and assess if further macro-prudential tools are needed in order to achieve an adequate balance between risk-sensitiveness and pro-cyclicality. Moreover, it is fundamental that the potential macro-prudential tools are integrated in a consistent way within the Solvency II framework in order to ensure a common risk basis to address individual, system-wide and systemic elements.

Recently, EIOPA published a paper outlining our potential macro-prudential approach to the low interest rate environment in the Solvency II context.

Discussion on systemic risks in insurance is evolving and EIOPA contributes to it not only at the ESRB level but also at the level of the International Association of Insurance Supervisors (IAIS).

## **Outlook**

As an overarching resume, by looking back to look ahead, I would like to conclude with a famous quote of the well-known former German football player, manager and national coach Sepp Herberger who said more than half a century ago:

- "After the game is before the game."

Let's continue to work together to further develop Solvency II in a challenging environment for the benefit of financial stability and consumer protection alike and across the European Union.