Keynote Speech

Gabriel Bernardino
Chairman of the European Insurance and Occupational Pensions Authority (EIOPA)

Preserving regulatory certainty: The review of insurers' capital requirements

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Public Hearing "2018 Review of the Solvency II Delegated Regulation"

Brussels, 27 March 2018

Ladies and Gentlemen,

I would first like to thank Vice-President Valdis Dombrovskis for the invitation and his welcoming words. For me it is of course a great pleasure to address today's audience about the revision of solvency capital requirements.

The introduction of Solvency II was a challenge and the biggest change in the history of the European insurance industry. We will all agree that the implementation of the risk-based regulatory regime in 2016 was a significant improvement compared to the previous framework and brings a number of benefits for the insurance industry and importantly for the consumers.

Thanks to Solvency II, the insurance industry is now much stronger, has **capital better aligned to the risks**, uses a **risk-based approach** to assess and mitigate risks and can therefore better price them.

The insurance industry has also **strengthened the governance models**, with the requirements to establish key functions and greater involvement of Boards which are now playing a completely different role. This increases the understanding of the business and risk environment in which the insurance companies are operating.

With harmonised templates for supervisory reporting and enhanced public disclosure, the insurance industry has also **become a more transparent industry**.

Two years after the implementation of the framework, and following the principles of better regulation, we are now on a journey to assess and review its main components. In this review we looked at the **balance between simplicity and risk sensitiveness**, between **using market consistency** and **mitigating pro-cyclicality and volatility**. We need to make sure that **the regime remains fit for purpose**, **works for insurance companies of all sizes and types** and that we continue **to preserve regulatory certainty**.

The first phase of preserving and continuously improving the existing regulation was the completion of **the Solvency Capital Requirement (SCR) standard formula review**. In our Advice, split into two parts, we have analysed 29 topics and focused on three main areas:

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

With regard to **proportionality**, our focus was on small and medium sized insurers and reduced granularity where risk profiles justified this. We advised to further simplify calculations for a number of sub-modules such as natural, man-made and health catastrophes, in particular fire risk and mass accident. To reduce over-reliance of insurance undertakings on external credit ratings in the calculation of the SCR, EIOPA recommended applying simplified calculations by nominating only one credit rating agency and calculating capital requirements for the remaining non-complex assets only subject to credit quality step 3.

One of the main simplifications is the reduced burden on the treatment of look-through to underlying investments. Access to data was always an issue and we recommended allowing the grouping of underlying exposures and simplifications for the calculation of capital requirements. This change should be a significant relief in terms of administrative burden. Other simplifications included relief in the assessment of lapse and counterparty default risks. Furthermore, we included a proposal for the use of undertaking specific parameters for reinsurance stop-loss treaties to allow for better reflection of the risk profile.

To contribute to the objectives of the Capital Markets Union and to remove potential **unjustified constraints to financing the economy**, EIOPA carried out an analysis of the treatment of unrated debt and unlisted equities to support improving insurers' ability to invest in private placement offerings and in private equity.

As for infrastructure, we identified circumstances and recommended objective criteria, such as financial ratios, that allow giving those asset classes the same treatment as rated debt and listed equity without having a negative impact on the protection of policyholders.

The availability of more recent data required **revised calibrations** in a number of areas such as natural catastrophe risks, assistance and medical expenses, as well as legal expenses risks. EIOPA also advised to create a new asset class for non-listed guarantees issued by regional governments and local authorities to align insurance with the banking framework and by that to ensure improved risk-sensitivity of the calculations.

Let me now address three remaining topics that I have not yet touch upon and are a substantial part of our Advice:

- **Interest rate risks**

- **Loss-absorbing capacity of deferred taxes**
- **Risk margin**

In the area of the calculation of **interest rate risks**, the capital requirements were calibrated with data up to 2008. This current approach does not cater for negative interest rates and is not effective in the new world with low yield environment. For this reason, we recommended to implement new calibrations that take recent evidence such as negative rates into account. The proposed approach is effective at both, high and low level of interest rates, was recommended by the vast majority of stakeholders and has already been adopted by internal model users. Given the material impact on the capital requirements for certain types of insurers, EIOPA suggested to implement the methodology gradually over three years to mitigate the impact.

EIOPA also carried out an analysis of the **loss-absorbing capacity of deferred taxes** (LAC DT) across the European Economic Area including supervisory and industry practices. The results of the analysis showed that similar practices are applied with respect to 75% of the around 100 billion euros of LAC DT. But for the remaining 25%, insurers' and supervisors' practices were divergent. In order to strike a reasonable balance between flexibility and to foster greater supervisory convergence, we developed a set of key principles, consistent with the Solvency II framework, that allow proportionality and flexibility in the calculation while increasing the comparability of outcomes. For example they refer to projections of future fiscal results that should be consistent with the business plan or to the projection of future return on assets that should be prudent and backed by evidence.

In some areas the analyses of recent developments didn't provide for sufficient reason to change the calibrations. That is the case for mortality and longevity risks, but also for the **cost-of-capital, one of the key elements of the risk margin**. An in-depth assessment of several methodologies showed the results can vary significantly according to the methodology which calls for a stable methodology to avoid introducing regulatory volatility.

The evolution of financial markets does not justify a change in the cost of capital: the decrease of interest rates has not led to a decrease in the cost of raising equity. Therefore, we are of the opinion that the cost-of-capital needs to be kept on the same level while the review of other aspects of the risk margin should be assessed in the upcoming overall review of the Solvency II regime scheduled for 2021.

Ladies and Gentlemen,

Our work is the outcome of intensive research and continuous engagement with stakeholders during the entire exercise. We are grateful to all stakeholders for the constructive approach on how to improve the current regulatory framework.

The goal of the review was to detect areas for **improvements and simplifications** as well as **to remove inconsistencies** where possible. Through all our work we have been guided by **evidence and facts**.

Reflecting developments in the insurance sector and in the wider financial services environment, EIOPA recommended a mixture of revised calibrations, simplifications and, where needed, proposals to achieve greater supervisory convergence. Overall and leaving aside the advice on interest rate risk, EIOPA's proposals do not lead to significant changes in terms of capital requirements but will bring significant improvements for the industry, in particular reducing burden for smaller market players.

EIOPA continues to believe that proportionality in solvency requirements should be achieved by the use of simplified methodologies and that **all undertakings** should be subject to the **same quantitative solvency requirements**.

We also believe that unjustified constrains to long-term financing should be removed as long as the protection of consumers is not questioned. The core values of stability and consumer protection that presided to Solvency II should not be abandoned.

With the changes proposed in our two sets of Advice, accompanied by a full impact assessment, we are convinced that complexity will be reduced while at the same time a proportionate, technically robust, risk-sensitive and consistent supervisory regime for the insurance sector is retained. In changing economic circumstances these adjustments to the capital requirements are necessary and will help the insurance industry to stay a competitive and strong industry responsive to the environments and treating consumers fairly. This is in particular the case for the interest rate risk, where the insurance industry cannot leave in a Solvency II world that does not cater for negative rates observed for several years.

With these two sets of Advice to the European Commission, EIOPA, as an independent supervisory Authority, fulfils its duty by recommending evidence-based changes which are in line with economic reality. I am fully aware changes are not necessarily always welcomed. But approaching them together constructively they will bring the changes for the protection of the European consumers, which each individual consumer deserves.

Furthermore, a solid and stable insurance sector is a precondition for economic growth and sustainable long-term investment. The proposed adjustments will reinforce Solvency II as a modern, risk-based and proportionate regime; a European regime that is the worldwide reference on insurance regulation.

Thank you very much for your attention and I am looking forward to interesting discussions in the different panels of today's agenda.