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Implementation of Solvency II - The way forward for insurers and supervisors

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Dear ladies and gentlemen,

After more than ten years of preparation, Solvency II was introduced on January 1st, 2016. Looking back on two years of experience with Solvency II I am glad to have the opportunity today to talk about our experience as well as the priorities for further development of the system and its application.

Let me first make a remark about the culture under Solvency II. High quality and effective supervision under Solvency II is risk-based, proportionate and forward-looking. It focuses more on the economic substance than the form of entrepreneurial decisions and their consequences for our supervisory objectives.

One actual German example is our approach regarding external run-offs, which can occur either in the form of a share deal or a portfolio transfer. From a formal perspective, there are two different supervisory processes for the sale of a company on the one hand and the transfer of a portfolio on the other hand. Economically, the result for the insureds, whose interests we have to protect, is very similar. Therefore, we ask for the same level of protection for the insureds in both kinds of transactions. This is only one example, but a very important one, for the principle of "substance over form".

Another cultural change is the new level of transparency under Solvency II. Undertakings have to publish a lot of information on the solvency position in the so-called Solvency and Financial Condition Report (SFCR). We think that the quality of the reports last year was good. The result was positive. However, as it was the first time undertakings had to create these reports it is clear that there is still room for improvement. We have addressed the deficiencies we have identified to the industry. They will be followed-up this year and we expect progress in this area.

Transparency is not only a topic for undertakings, but also for supervisors. Therefore, EIOPA and we as BaFin have made a number of publications to provide guidance on the solvency position of the industry and the quality of reporting like the ORSA and the SFCR under the new regime.

However, the requirements of Solvency II on transparency of supervision go beyond this. Among others, Solvency II requires the disclosure of the main areas of ongoing or planned supervisory activity. Therefore, we will regularly publish the key topics we want to focus on in our supervisory review process. We have just put the topics for 2018 on our website. Examples are risk-based reviews of cyber security, the sustainability of investments and the so-called Regular Supervisory Reporting (RSR).

Proportionality is another key aspect of the new supervisory culture and one of the core principles of Solvency II. It strengthens the own responsibility of insurers and gives supervisors more leeway within the legally defined framework. Proportionality aims at both insurance undertakings and supervisors, so that the requirements of Solvency II may be implemented properly.

In pillar I, proportionality applies often to the calculation of technical provisions; a large number of insurers make use of simplifications.

One important area for proportionality in pillar II in Germany is the separation of functions, where approximately one quarter of the companies use proportionality. A specific example is the combination of risk-taking and risk-controlling functions in the board of management. A number of entities have installed risk-mitigating measures here instead of a strict separation of these functions.

In pillar III, the European legislator has foreseen the possibility for waivers from certain reporting requirements. We have informed all undertakings which may make use of theses waivers and have explained the application process. However, the companies must also use the exemption options. By far not all companies have done that.

During the drafting of the approximately 700 EIOPA guidelines BaFin has duly taken care that the principle of proportionality is considered. This is one of the reasons why we have been able to confirm our compliance with all but a few guidelines in the ‚comply or explain�'-process.

The new supervisory regime Solvency II presents tremendous challenges to companies, in particular to small and medium ones. In my opinion, the principle of proportionality has helped that these companies, with their resources, can meet all requirements and continue their business activities. There is certainly a need for further work in this area. The companies and BaFin stand in exchange for this continuously.

Despite all criticism in the details of Solvency II: I do not know anyone, who seriously questions the pillars of the new solvency regime – not in Germany and not in Europe either. Therefore, there will be improvements resulting from the current reviews of Solvency II and certainly, they are necessary. However, I do not see any fundamental changes of the core principles.
BaFin is working very actively on these improvements at a European level under the roof of EIOPA. Let me now sketch you our position in the reviews, as this is the future of Solvency II.

EIOPA has recently delivered its report on the so-called SCR-review. The focus was on the calculation of the solvency capital requirement with the standard formula. We wanted to address inconsistencies, which have appeared by now – shortly after the introduction of Solvency II.

The standard formula has often been criticised to be too complex. BaFin shares this critique. Therefore, we have advocated a reduction of complexity during the review. We strongly welcome the simplifications proposed by EIOPA, in particular regarding the counterparty default and the catastrophe risk modules.

However, the standard formula is not only complex, to some extent it is also outdated. The economic environment has changed since it was developed and the standard formula needs to be adapted accordingly. The prime example in this regard is the calculation of the interest rate risk. In contrast to internal models,

the standard formula is currently not able to deal with negative interest rates, which is obviously inappropriate.

The standard model must be able to consider a further decline of interest rates even in an environment of low or negative rates. We have recently seen negative rates for a large number of issuers and a prolonged period. Unfortunately, this means we can no longer classify them as outliers.

Therefore, I support the proposal of EIOPA to adapt the methodology of the standard formula. The interest rate risk has to be reflected adequately in the capital requirements. "Adequate" naturally means that the risk shall not be overestimated either. I think that we have come to a balanced result in this regard at EIOPA.

We will now see how the co-legislators at EU-level deal with the report. In any event, I strongly advocate that the calibration of all modifications of Solvency II resulting from the current reviews will be assessed in a combined impact assessment during the LTG-review.

The future of the so-called LTG-measures, i.e. the measures, which shall take account of the specificities of long-term guarantees, is another aspect of the future of Solvency II – and very important for German insurers with their long guarantees. From our point of view the LTG measures have three objectives:

- First, undertakings must still be able to transfer their legacy book with very long-term interest rate guarantees to the new supervisory regime. The transition should put them in a position to strengthen their capital base during the transitional period in order to meet the capital requirements for new business as soon as possible.
- Second, the measures should mitigate incentives for a pro-cyclical investment behaviour resulting from a market consistent valuation.
- Finally, they should be designed in a way that undertakings will still be able to provide contracts with long-term guarantees to their customers. In order to achieve this goal, risks resulting from long-term insurance business must be reflected appropriately. This should in particular be the

case, where insurers cover long-term guarantees with long-term assets, which are held to maturity.

The first two objectives, a smooth transition to Solvency II and the prevention of pro-cyclical behaviour, have already been crucial for us during the negotiation of Solvency II and the LTG-measures. The third goal is new. It reflects the necessity to deal with the consequences of Solvency II on the new business of life insurers and product design. In doing so we will also consider current initiatives to promote long-term retirement provisions like the discussion on the introduction of a so-called Pan-European Pension Product (PEPP).

There is a natural area of conflict between a supervisory regime based on market values and long-term insurance business. And this is not without consequences: The trend to shift risks to the customer for new products is already clearly visible. However, we must find ways to preserve the valuable contribution of insurance companies to old-age provision. Regulation is faced with the challenge of maintaining the principle of market consistency, while at the same time taking due account of the nature of the long-term insurance business. The LTG-measures shall mitigate this conflict – in particular the volatility adjustment and the design of the discounting of technical provisions.

Before I get to this, a few remarks on the transitional measures. In the LTG-working group, BaFin is strongly committed to the preservation of the transitional measures, which are used by a large number of German life insurers. Which we support, because that is how companies can gradually meet the new requirements under Solvency II. With the transitional measures, undertakings have the possibility to set up the process of portfolio transformation in a proper way.

So far, the transitional measures are working well, i.e. they guarantee a smooth transition of the legacy book to Solvency II. However, in case the current reviews should result in higher capital requirements for the legacy book, the effectiveness of the transitional measures would have to be checked and strengthened, if necessary, e.g. by an extension of the transitional period.

Some people criticise that the volatility adjustment is not working as expected. Therefore, I think it is important to put it to the test in the LTG-review. The volatility adjustment allows undertakings to use a discount rate for technical provisions above the risk free rate. They may increase the discount rate by a portion of the credit spread of the EIOPA reference portfolio. In this way the effect of the volatility of credit spreads resulting from a market value based valuation should be reduced.

However, as the credit spreads in the reference portfolio have become smaller in the last months – up to zero very recently, the intended relief by the volatility adjustment has also declined. I am aware that undertakings are dissatisfied with this result. However, I reject calls for a simple flat-rate increase of the volatility adjustment. In the LTG-review, we must build on a factual analysis. In doing so we will also consider the 'illiquidity' of the liabilities and the equity and spread risk of assets covering illiquid liabilities. There is still a lot of work to do here. We are ready for it.

We will also have a look at the extrapolation of the term structure of interest rates beyond 20-year maturities in the LTG-review, i.e. the determination of the discount rates for technical provisions. Here we should be very careful with changes. Therefore, BaFin has already asked German insurance undertakings in 2017 to calculate the effect of changes in the extrapolated part of the term structure. In this connection, we have focused on the solvency position of insurers as a first step.

We have to analyse this further – in particular with respect to the effect on product design and financial stability. The impact on the insurance industry may be significant. However, I am confident that we will come to reasonable results throughout the review.

As you know, the LTG-review runs until the year 2010 and thus longer than the SCR-review, which has just been finished with EIOPA's advice. We also need that time to carefully analyse the impact of the LTG-measures. Because this is not

just about the effect of the individual measures on the solvency position of insurers in pillar I. The effect on the protection of the insured, on product design and financial stability also plays a role – only to mention the most important aspects.

And there is a lot at stake: Which guarantees are insurers still able to afford in the future under Solvency II? At this point, regulation is not just an actuarial exercise for mathematicians, but primarily a socio-political question, namely, how insurance companies can contribute to old-age provisions in Europe. And because it is a political decision, the European legislator takes the decision – after being advised by EIOPA.

As a national supervisory authority, BaFin is contributing with its expertise to the Solvency II-reviews. In doing so we also keep an eye on the overall impact of individual measures - and their interactions with each other. Changing individual parameters in isolation carries the risk of unwanted side effects in the overall view.

A popular topic in the political discourse is the use of supervisory capital requirements for the promotion of economic development – for example, to promote investments in infrastructure and sustainable investments. Such efforts may require regulatory changes, too.

Caution is advised: Solvency II is a principle and risk-based supervisory regime. Adequate risk measurement has top priority and may not be replaced by other considerations. Those who subordinate adequate risk measurement to other goals lead the market consistent system ad absurdum. As supervisors we have the responsibility to point this out. BaFin faces up to this responsibility.

Sustainable investments are becoming more and more important for society, undertakings and thus supervision. The opportunities and risks of all investments need to be considered carefully taking into account the aspect of sustainability.

However, I am sceptical to promote certain asset classes like green investments using regulatory capital requirements. Proper risk management must be the

decision criterion here as well – some so-called green or infrastructure investments seem to incorporate considerable political risk.

In the face of the challenge, which guarantees insurers will be able to offer in the future under Solvency II, I consider it more purposeful to turn to the question, how adequate capital requirements for long-term guarantee business look like – and we are doing that right now.

Strategically the future prospects of Solvency II are also influenced by global initiatives, the last topic of my presentation today. At the IAIS, the International Association of Insurance Supervisors, we have agreed to the main features of an international capital standard (ICS) for internationally active insurance groups (IAIGs).

Following the completion of field-testing in 2019 there shall be a five-year monitoring phase for the ICS. In this period, the ICS will be used for confidential reporting to group-wide supervisors and discussion in supervisory colleges, but not as a prescribed capital requirement. Still, the medium-term goal subsequent to the monitoring phase remains the implementation of the ICS as a global (minimum-) capital standard.

The core element of the ICS is a market value based valuation and a calculation of the capital requirement with a standard formula. At the option of the group-wide supervisor, additional reporting is possible. In particular, this may include capital requirement calculations based on an internal model. Here we have a very clear opinion: In our view, internal models are an indispensable component of any supervisory regime. However, some important states are sceptical. They fear arbitrary self-regulation of insurers. This danger can only be overcome by an intense and hard-hitting supervision of internal models. We are convinced that we are on a very good way here.

We have had many and consistently good experiences. Our expectation has been confirmed: Internal models do reflect the individual risks of insurance undertakings better than the standard formula. For example, we could deal with the phenomenon of negative interest rates much better and faster compared to the standard formula.

The benefits for supervision are obvious. If undertakings use internal models, they can monitor their risk-profile much better and risk- as well as capital-management can act more accurately. They can also develop superior risk mitigating management actions. At the same time, internal models are an important steering instrument for companies.

Of course, that does not mean that internal models can replace common sense, nor can they reflect all risks. The reality always looks different from a model. I am therefore far from saying that internal models are the panacea.

But nevertheless, in my opinion they are the champions league of risk management in an insurance undertaking. Therefore, we will continue to support internal models.

Let me briefly summarise:

1. We have successfully implemented a new principles- and market-value-based solvency regime.
2. There will not be a Solvency III, but a further development of the current system.
3. Improvements are necessary and on the way regarding the calculation of the SCR and the LTG-measures.
4. We will pay particular attention to mastering the challenge of a market value based system and the need for long-term guarantees.
5. Apart from technical aspects, the new system also comes with a new culture for supervision.
6. We will further enhance the proportionality of our supervisory actions and increase our transparency.

As you see there is still much to do with respect to Solvency II – for both undertakings and supervisors – and we do it with a sense of proportion in the best interest of the insureds.