

GETTING UNDER THE SKIN OF SOLVENCY II

INTERVIEW BY
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Karel Van Hulle, Professor Emeritus at KU Leuven, and honourable professor at Goethe University Frankfurt, was closely involved with the development of Solvency II. After his retirement from the European Commission in 2013, he became a member of the Public Oversight Board and serves now as a Director at the Bermuda Monetary Authority. He sat down with **The European Actuary** to talk about the current state of the profession, the Solvency II review and what we need for the future. >



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Let's start with a big broad question. In your opinion, what is the main role of the actuary?

'Actuaries are professionals who have deep expert knowledge about the measurement of risk in a forward-looking perspective. That is the reason why the role of the actuary is particularly important today, in a time of sustainability. Actuaries need to think about duration – about how long things will last in terms of assets and liabilities.

So, for me, the main role of the actuary is to help understand and measure future developments. But it's also important to accept that life includes a lot of uncertainty. And as the future is uncertain, actuaries must avoid giving the impression that they can control the future through their calculations. Their mathematical skills should therefore be combined with qualitative assessments in order to place the data in a proper context.'

You mentioned data. Actuaries deal more and more with data science, especially for pricing new products. Do you think the actuarial function on the reporting side could also benefit from data science? Or should we make reporting simpler, more uniform and transparent?

'That's a good question. Data science can help actuaries to address future challenges and help them to develop new, innovative technologies and solutions. For instance, actuaries should be involved more in the design and pricing of new insurance products. There is too little innovation in the insurance industry and too little concentration on risks that really matter. Data science and the validation of data might help to increase the

insurability of risks. This is particularly important in ensuring the insurance sector remains relevant. Actuaries should assist in better assessing likely future developments and in finding opportunities for insurers to reduce the expectation gap.

In terms of reporting, data science can certainly contribute to making the reporting more fit for purpose and help actuaries in translating the complexity of data into language which is understandable for decision-makers. I would be hesitant to call for more uniform reporting particularly from the actuarial function. We need to know what the actuary really thinks both in quantitative and qualitative terms.'

Very few companies use internal models. Has Solvency II placed too many constraints on their use in your opinion?

'I don't think it's the constraints of Solvency II that result in fewer companies using internal models. Internal models are an essential feature of Solvency II. Under a risk-based solvency regime, it is for the insurers to know and to manage their risks. A standard formula is only a helpful tool and is by definition wrong, as it can never capture the risks of every single insurance undertaking or group.

Of course, one can argue that all models are wrong and that it is not correct to state that internal models are by definition right. Nevertheless, I believe that an internal model, if it is construed using all the safeguards that were introduced by Solvency II, is likely to better reflect the true risk position of an insurer.

If I take you back to the early stages in the development of Solvency II, you will recall that >



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there was a lot of criticism when the European Commission proposed the use of a full internal model by insurers. This happened just after the financial crisis when banks were criticised for having abused internal models for lowering their capital requirements. But we still went for this approach, because we believed that only an internal model can capture the true risk position of an individual insurer.

I do not believe that Solvency II places too many constraints on the use of internal models. The problem is that the model can only be used for solvency purposes if it has been approved by the supervisor. Approving an internal model is a complex process and I can imagine that supervisors are not always keen to get involved in that process. Supervisors should however be able to assess whether an internal model has been construed properly. If that has been the case, there is no reason why supervisors should believe that the model provides less guarantees than the standard formula.

I am therefore worried about attempts by EIOPA to streamline internal models so as to make them more comparable. That goes against the letter and spirit of Solvency II. If all internal models are the same, we are creating a new systemic risk. The advantage of allowing for the use of internal models is that we avoid creating such a systemic risk. The use of an internal model should incentivise insurers to improve their risk management. There is obviously always some subjectivity in risk assessment. This should be recognised. Judgement is important and should not be overruled by regulation.

Similarly, I also find it wholly inappropriate, as proposed by the European Commission upon

EIOPA's advice, to require internal model users to communicate to their supervisor the solvency position calculated on the basis of the standard formula. That goes against the idea of a risk-based solvency regime. It sends the wrong signal and should be seen as an example of over-regulation. The best way to ensure that the difference between internal models and the standard formula does not grow too widely, is to regularly review the standard formula and to update its calibrations.'

And what do you think of the Solvency II review? What is the most important point according to you? Are there still areas you think should be reviewed?

'It's almost impossible to identify things that are not included in the review, because the review is so huge. But let me first of all say that I am happy that all parties concerned share the view that Solvency II is working well and that there is no reason to depart from the risk based approach that was agreed in 2009. Solvency II should therefore not become Solvency III.

It was always envisaged that the solvency regime should be reviewed from time to time so as to ensure that it remains fit for purpose. Personally, I believe that too much has been included in this review. Looking at the negotiations in the Council and in the European Parliament, I fear that the regulatory regime will become even more complicated than it is at present. The more complicated a regulatory regime is, the less likely it is that it will be properly applied and supervised.

To me, the following points are important in this review: ensuring that proportionality >

means something in practice; finding a better solution for the valuation of long-term liabilities by taking account of the long-term nature of insurance; removing some exaggerated prudence; introducing a requirement for insurers to take account of the development towards a more sustainable society; and enhancing the regulatory regime by adding liquidity risk and systemic risk.

I am not at all convinced that we need to introduce a new chapter on macro-prudential supervision, nor do I believe that we need a complex regime for recovery and resolution. It is not good to add more rules to an already complex regulatory regime. It would be more appropriate to come back at a later stage with a more holistic view of the solvency regime of insurers by placing that regime in a broader context that includes insurance guarantee schemes, recovery and resolution and systemic failures. That would mean, for instance, that the confidence level in Solvency II might have to be lowered, as policyholders would receive additional protection from the backstop offered by an insurance guarantee scheme and that special

measures could be taken by supervisors where certain activities carried out by insurers might lead to a systemic failure.

What is presently missing is an update of the whole standard formula and a review of those calibrations that are largely based on UK data. Missing is also a clear requirement for supervisors to act in a European spirit.'

There is an ongoing discussion about whether the actuarial profession is sufficiently protected, for example compared to accountants? Do you think it worth changing the 'protection' approach to a 'recognised by authorities' approach?

'This is not a new debate. I believe the answer to that question is that the profession's protection depends to a large extent, from its own behaviour. If actuaries are well trained, if they have the skills, which are needed in order to make the solvency regime work, there is no need for legal recognition. >





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When we discussed the development of Solvency II, I was a strong advocate of giving more prominence to the role of actuaries. That has led to the creation of the actuarial function. I believe that this was a good idea and I am sure that the actuarial profession has greatly contributed to the success of Solvency II. In those early days, the actuarial profession also lobbied for a legal recognition of the profession. I opposed this then and I am still opposed to it now. I do so because of my experience with the regulation of the audit profession, for which I was responsible in an earlier part of my career.

The profession should focus on substance rather than legal form. To the extent that people with an actuarial qualification are properly educated and that they follow professional standards, it is obvious that they will be the preferred experts to occupy the actuarial function. That is presently happening in most Member States. Legal recognition will open up the debate about qualification and equivalence. That is usually an unpleasant debate in a European context. I believe that the profession should concentrate on making sure that it attracts the right people with the right skills and on ensuring that more people are interested in acquiring an actuarial qualification. We need more actuaries and should therefore be careful not to create a new monopoly.'

We often say that the actuary is the fuse in case something goes wrong. So what's your advice for the profession in the future? How do you see the next 10 years in terms of an evolution?

'I think it's very important that the actuarial function which we presently have under Solvency II fully plays the role which was assigned to it.

It is very important that actuaries actually speak up! The actuarial function is meant to be a control function in its own right, i.e. with the same importance as all other key governance functions. It is therefore important that the actuary delivers the actuarial report directly to the Board and that this is not left to the chief risk officer. There is a tendency for actuaries to hide behind the back of the chief risk officer. I regret that. If the actuary believes that technical provisions are not calculated appropriately or that the internal model is not properly reflecting the true risk position, the actuary must act, identify the deficiencies and give recommendations on how such deficiencies can be remedied.

I have had the pleasure of working closely with the actuarial profession during my career with the European Commission and I have been involved for many years in the education of students who wanted to qualify as actuaries. I therefore have great respect for the actuarial profession.

Looking at the future, I have three messages for the actuarial profession. First of all, do not limit your role to calculating and modelling. But get involved in real decision making. That's to say, put your technical work in a broader context. A second message is: improve your communication skills. Make sure that people actually understand what you are talking about. Very importantly, and lastly, do not give in to pressure, and say what you think, because you are too intelligent, to deprive society from the benefits of your thinking.' <