

INTERNATIONAL DEVELOPMENTS IN REGULATION

INTERROGATING THE SOLVENCY II REFORMS



CARLOS MONTALVO

Former Executive Director of EIOPA and current Global Insurance regulatory leader at PwC, Carlos Montalvo, discussed the crucial improvements in the upcoming Solvency II reforms, emphasizing simplification, adaptation to technological changes, and maintaining a risk-based framework. He highlighted the importance of the long-term guarantee package and volatility adjustment, noting their imperfections but necessity.

Which improvements have been most crucial in the upcoming Solvency II reforms?

‘Conceptually, simplification, as the model is way too complex. Now this is easier said than done, and I’m not sure that we are achieving what we want in terms of simplifying the framework. The second element that I think is relevant and important is that in addition to simplification, there is an element of adaptation. The directive was adopted in 2009 and many things have changed since then in the way we do insurance on a day-to-day basis – technology, data, AI, etc. If we are not adapting the framework >

‘**And let’s be honest, EIOPA came with evidence that there are deeper markets at 30 years than at 10 or 20**

to today’s reality and challenges, the regime will be outdated and we are going to end up in trouble. The third point that I think is still relevant with some caveats, is that we remain under a risk-based framework. In other words, there is an underlying basis that justifies changes but retains consistency and soundness. So I think those three elements are key.

There are other issues that could be seen as more controversial in terms of facilitating a certain type of agenda. I think regulation should acknowledge reality and today we are also talking about productivity, competitiveness and so on. It is only fair to reflect those and not to work in silos. When we started this process 25 years ago, we always had in mind that the main objective was to enhance the protection of policyholders, and as a secondary objective the financial stability of the system... but – quoting Bob Dylan – the times they are a-changin’. Today’s challenge is to add these new objectives but not at the cost of eroding the old ones.’

Important aspects of the Solvency II reforms include the Ultimate Forward Rate (UFR) and Volatility Adjustment (VA). Will the new proposals solve the issues and make the framework more market-consistent? Or should the UFR and VA be abandoned altogether?

‘My take on a long-term guarantee package is that perfection is the enemy of good. They are by no means perfect, technically. And this is an actuarial magazine, there are a lot of question marks over how they have been designed. However, without those measures, we had created a massive problem with regard to live business. So they are not 100% bulletproof from a technical standpoint, but they have been a key part of the model, one

without which Solvency II had failed. The new methodology for UFR is still more generous than what reality tells us. We talk about deep, liquid and transparent markets. And let’s be honest, EIOPA came with evidence that there are deeper markets at 30 years than at 10 or 20. So there is not only, let’s say, a technical dimension, there is also another dimension that acknowledges the business reality.’

With the VA, it’s very much the same approach. Is the review heading in the right direction?

‘Well, it may not be perfect, but it can be good. At the same time, I am strongly convinced that the MA is a much better instrument than the VA in terms of a proper ALM, in terms of discipline, in terms of risk management, and so on. And it comes with a list of conditions that need to be met. If properly enhanced, it should also allow life insurers, for example, to come back and offer attractive guarantees at the right price. The combination of limited changes to MA with the impact of those to VA will make MA even less attractive. So I think it’s also been a lost opportunity to further enhance and push towards the use of MA for new products throughout the European market with the reform, products that should play a key role, for example, to enhance long-term savings of citizens for their pensions.’

Solvency II allows for internal capital models which can differ significantly amongst insurers. As a result, most large European insurers use very different complex models for their capital. Is this diversity and complexity desired? Or should the industry move towards simpler and more harmonized internal capital models, like the banking industry? >

‘*And if models are bespoke by definition, there should be differences among the different players*

‘I would start by saying in my view, internal models make sense. We have a core principle on Solvency II, which is proportionality – but proportionality must be a two-way street. Make it easier for the smaller companies, but expect that a large company or global player, should not be using a standard formula, but should elaborate an internal model. So, models make sense. And if models are bespoke by definition, there should be differences among the different players.

Two elements which I think are important: comparability and soundness. On the first one, comparability, it should cover both other model users, but also standard formula. This idea was embedded in the proposal to require model users to disclose standard formula calculations, to facilitate a comparison. In the end, what has come is a little bit of a compromise, saying, well, it's not a full standard formula calculation that you are requested to disclose, but an approximation. I wouldn't shy away from explaining the differences. Because those have to do with the effective risk underlying your own company, and your own profile. So if you are able to educate the market around that, that would be business as usual. The other element is soundness, and I think that EIOPA has to play a bigger role in terms of ensuring that the same risk ends up leading to similar or the same type of capital charges, and different risks lead to different ones. I'm not talking about EIOPA as a single supervisor, or being in charge of supervision of internal models, but in ensuring a high level of consistency in terms of outcomes, including identifying outliers.’

Let's zoom out a bit and look at international developments in investments by insurers and private credits. Which global developments do you see as most important or promising from an investment perspective for insurance companies?

‘The starting point is to understand where we come from as an insurance sector that was heavily invested in sovereigns and corporates. But if we remain too prudent on the asset side, it is going to be very difficult to offer appropriate and attractive products to policyholders. In other words, too much prudence can become non-prudent. So there has to be a different type of assets' blend – and that's one of the beauties of Solvency II. The so-called prudent person principle means you should be allowed to decide where you want to invest in, under the double assumption that, on the one hand you understand the risks and, on the other, that more risk should lead to more capital. Fine, you decide that it makes sense for you, for your product offering, for your policy holders, for your shareholders, and you go for it.

Now, what is important is to understand whether this is the right product for your company and whether it is rightly priced – from the point of view of liquidity risk as well as credit risk. But also whether it is delivering a return for you. What doesn't make sense is to pretend that insurers, as institutional investors, can end up investing in assets where the cost of opportunity is suboptimal. In other words, where the return they're getting for the risk they are taking doesn't make sense.’ >

‘The bad news is that we come from a hard market, and in the future, we will also be confronted with that

Let’s look at international developments in (re)insurance. Which global developments do you see as most important or promising for the reinsurance market? What are the impacts of climate change for the future of the reinsurance markets?

‘When it comes to reinsurance, the good news is that we have a soft market now in the sense of capacity and offering. It seems that reinsurers are there, and they are taking most of the risk that is there in the market. And that is good news. The bad news is that we come from a hard market, and in the future, we will also be confronted with that. So we need to make sure, particularly for those traditional risks that are more exposed, is that we are already anticipating a return to hard markets.

The second thing we are seeing is a non-traditional type of reinsurance, which is a way in which capital is coming to the market again. Don’t forget one thing: We need to evolve. We need to be proactive, but we also need to avoid being complacent if we have a soft market. If we do nothing, we are going to end up confronted with a problem.’

Bermuda, which represents approximately 35% of the world's reinsurance capacity, has been declared an equivalent jurisdiction in the Solvency II regulatory framework. However, it turns out that there remains considerable supervisory resistance despite this equivalence. EIOPA has launched a public consultation regarding the use of reinsurance provided by third-country reinsurers. Is the European supervision too strict or too lenient on third-country reinsurers?

‘Well, taking the Bermuda example, they were granted equivalence back in 2015/2016, but interestingly enough, they have embarked on a number of reforms of the model to retain that equivalence. And I would say that they have succeeded, particularly because they reviewed the model under the acknowledgement that, indeed, some differences had led to arbitrage, and that was not ideal so they had to change that. Also because among other things, they have decided to make host regulators part of the solution, so that, e.g., prior to granting approval of a reinsurance transaction, they consult the host supervisor. And if the regulator poses an obstacle, they will basically decline the transaction. In other words, they considered that for their market to remain competitive -and Equivalence was a key factor for this-, they had to raise the bar, rather than lowering it. In my view, they got it right!

But let’s be honest, we all tend to be local because we think that if things go wrong, localism is going to protect us better than globalisation and internationalisation. Is that something which is 100% true or bulletproof? I think it’s not about black and white. Globalisation must be part of the solution, because it brings capital and diversification, and both are most needed. But I have been a regulator for nearly 20 years, one that felt more comfortable when the assets were at reach compared to assets being far away, so I can also understand how my former colleagues feel about it. That is reality, you may call it human bias, and it has nothing to do with regulation. The good news is that biases can also be addressed.’ <