A look at Solvency II and other improvements in supervision

It is a pleasure to address once more a room full of stakeholders and others with an interest in Solvency II. It's good to see the house so packed. In the runup to today, we had a few intense weeks, and there are bound to follow more.

I will naturally dwell on the state of affairs regarding Solvency II. The need to establish a harmonised and risk-based supervisory framework is as pressing as ever. Not that *with* Solvency II we might have prevented the present crisis, but insurance supervision would certainly have been tighter here and there. I will return to this in a minute. But I'll start with the crisis.

When in late 2009, at a similar symposium in Ermelo, I performed the kick-off for Solvency II as a large-scale, joint project, my message was that 'Twenty Twelve' was to be the big Solvency II year.

And yes, 2012 is indeed going to be a crucially important year. But for another reason. In recent weeks, the big question was whether the edge of the precipice would serve as the ultimate warning, or whether that edge had already started to give way.

One thing is clear: the financial and economic situation in the eurozone is extremely worrisome. Debt securities of many sovereigns has become tainted, interbank markets have all but dried up and economic growth is coming to a standstill. The key to the solution of the problems is in the hands of the governments. Consequently, all eyes were fixed on Brussels last week. The outcome of last week's European summit looks somewhat encouraging:

1. In the first place, the political leaders agreed on the further reinforcement of budgetary discipline in the eurozone. Budgetary discipline is a sine qua non for EMU.

2. In the second place, the safety net was enlarged. European governments are making an extra EUR 200 billion available, through the IMF, for countries that run into trouble. Expectations are that non-European IMF member states will match this amount in the form of bilateral loans to the Fund. Together with the prospective reinforcement of the EFSF and the ESM and the standing financing capability of the IMF, there now is a considerably larger safety net in place. Whether it will prove sufficient is difficult to say. At least, there now is agreement on the need for a larger safety net – something DNB had been advocating for some time.

3. In the third place, the summit has made it clear that eurozone governments are prepared to take far-reaching decisions on the organisation of the European Union. That an accord for the entire EU could not be reached, is regrettable. Yet European leaders have shown themselves willing to go to a long way if they have to to protect the eurozone.

Meanwhile, the ECB is actively using its range of crisis containment measures. For one thing, the ECB is supporting the bank lending channel through unconventional monetary policy measures. In this way, it supports the liquidity position of the banking system, removing for some time to come any doubts about banks' liquidity positions. Also, the ECB is intervening in the disrupted sovereign bond markets. To guarantee the ECB's objective of maintaining price stability, its non-restrictive monetary policy must be transmitted to financing conditions for the household and corporate sectors.

This will clearly take more than just one 'summit of summits'. Both the necessary modification of European institutions and the necessary debt reduction will require time as well as effort.

While this accord on budgetary restraint was reached, elsewhere in Europe negotiations about Solvency II continued. The course of events surrounding the harmonisation of budgetary discipline enables us to draw lessons for the Solvency II harmonisation process. I can see at least the following lessons:

1. First, come to solid prior agreements on sanctioning and on the exact powers of central governments instead of waiting until the next crisis.

2. Second, the enforcement of European regulations turns out to require powerful institutions. And putting that message across in practice requires the exertion of considerable pressure.

3. And third: always, despite the crisis, keep the final goal in mind – in this case, Solvency II. Doing so makes things easier once the crisis is over.

I am taking these lessons on board in the further development of Solvency II. For me, Solvency II is an indispensable element in improving financial sector supervision. Suppose we had already had Solvency II. *What would have gone differently, gone better?*

1. For one thing, there would have been ORSA. ORSA compels insurers to look further ahead and ensures that supervisors and insurers speak the same language when it comes to risks and capital. It would have brought vulnerabilities to light at an earlier stage and would have pointed towards solutions.

2. In the second place, EIOPA would have had comparable figures available, taking away the need for different reporting tracts from DNB and EIOPA. It would be worth a thing or two to me, to be able to compare data on insurers at the European level and to take concerted action with other supervisors.

3. Thirdly, a stress situation could have been declared top-down if the need arose. Member states would not have to determine their individual positions, including the concomitant 'first mover' dilemma. Within Solvency II, recovery periods, dampeners and a countercyclical price level ('CCP')

could be called upon when needed, resulting in concerted crisis control.

4. Finally, Dutch insurers would, thanks to their past hands-on experience with marking to market and scenario modelling, be excellently equipped to compete with their foreign peers.

So no question about it: for me, Solvency II could not come too soon.

However, Solvency II will take some time to arrive yet. That's the way things are. Yesterday at EIOPA, for instance, I heard tell that the Omnibus 2 directive may not be finalised until April 2012. I will return to the timing issue in a minute. Until 2014, improvement of DNB's insurance supervision will thus have to come partly from somewhere else. I will dwell briefly on that topic. That DNB is not sitting on its hands you may meanwhile have noticed.

This past year, DNB worked energetically to realise our priorities for supervision in the 2010–2014 period. They are:

1. Focus on firms' strategies and business models

2. Focus on firms' conduct and culture, and

3. Better interlocking between macroprudential supervison and microprudential, institution-level supervision (cross-institutional approach).

Within Europe, DNB this year set the tone with the subject of *strategy and business models*. Not only banks have noticed this, but insurers as well. In this context, we recently made a thematic study of the profitability of the life insurance industry, and we also held a stress test with regard to cost levels. The profitability study may have reached you through our DNBulletin series or the papers.

Another type of change launched this year is DNB's more Intrusive and Decisive supervisory approach. This approached is expressed in supervisory meetings but also, for insurers, in matters such as expertise testing for directors and assessments of prospective insurance market entrants.

And as though the internal renovation of DNB had not gone far enough, we intend to maintain our improvement agenda for 2012. We are going to make *explicit choices for more effective supervision*. Put briefly, we are going to make prudential supervision even more decisive and straightforward, as by directing our capacity more explicitly towards the severest risks. I won't be much more explicit today, though. The example of the Dutch Tax Authority shows how one may make successful and explicit choices in one's approach while – or even by – making clear where one stands. And to vary on the Tax people's maxim, even *we* can't make supervision more *fun*, but we *can* make it easier to *understand*. That gauntlet I will gladly take up.

And this takes me back to Solvency II. Fundamental changes require vision, a support base and time. Solvency II brings such a fundamental change. It will bring insurance supervision up to present-day standards. DNB therefore consistently upholds the vision underlying Solvency II and its commitment to Solvency II's risk-based supervision.

Right now, however, Solvency II is somewhat short on the critical factors of support base and time. Both on account of the crisis and because the legislation process has become so complicated. Let us take a closer look at this latter aspect by tracing the timepath for Solvency II. The first concrete deadline at the European level is the conclusion of Omnibus 2. This directive provides for the powers of EIOPA, the phasing in of Solvency II and the legal procedures governing Level 2 and Level 3 regulation.

This takes me to the Level 2 implementing measures. These detailed rules prescribed by the European Commission have been largely finalised. On some points, political debates are still going on in the European Parliament. Level 2 may not be formally concluded until after Omnibus 2 has been. Subsequently EIOPA will face the major challenge of readying its regulatory framework. EIOPA is eager to make an early start with the consultations for the Level 3 measures, so as to have the principal guidelines and standards ready by end-2012. That will put the second half of 2012 under considerable pressure, even allowing a brief grace period into 2013. Once all regulatory texts are finished in 2012, the year 2013 will be used as the implementation year, in which, among other things, the formal internal model application process should take place. Also at this moment, supervisors are anticipating the implementation plans insurers will be submitting in mid-2013, to explain how they intend to meet the Solvency II requirements by 1 January 2014.

A first necessity, however, is for the European Parliament to adopt the Ombibus 2 Directive, thus enabling us to move on. It would appear the MEPs could do with some help there.

I now come to the preparations for Solvency II at a time of crisis. My message is that throughout the crisis, we must continue to anticipate the arrival of Solvency II. I also spread this message actively as a member of EIOPA.

A principle from the more dynamic lines of sport is: 'Where you look, there you will land'. It means that after a jump or a launch, your body will direct itself to the spot where you focus your eyes. The same applies, I think, to the preparations for Solvency II.

You, insurers, and we, supervisors, have a common interest in keeping our eyes focussed internally and externally on Solvency II. This happens at a time when the pension sector and life insurers feel the pinch of low interest rates and the continued weakness of the stock martkets. The deterioration of institutions' solvency positions caused by the low interest rates may also occur under Solvency II.

Therefore I am optimistic when I conclude that under Solvency I, the Netherlands has already taken an approach that enables us to look ahead. It does not provide immunity from worries, but still. Market valuation is no novelty for us, and the impact of low interest rates forces us to anticipate and to respond.

I cannot finish this without dwelling briefly on the impact of Solvency II.

In early 2011, I was still relieved to find that Dutch insurers would not go under *en masse* on account of the quantitative requirements under Solvency II. Even so, it was also clear that major debates were still waiting to be held.

Issues that were discussed on the basis of QIS5 were:

- Will the new rules be introduced all at once or in phases, and when?
- How will Solvency II deal with the volatility of long-term liabilities?
- Will the risk-free curve remain a valid instrument?

There were also discussions on the tiering of own funds and, in particular, the treatment of 'expected profits incorporated in future premiums', abbreviated into the tongue-twisting 'EPIFP'. The requirement to disclose expected profits is welcomed by DNB as a useful measure.

Amendments to the framework will be discussed further in the panel discussions, after lunch. Mind you, I am the first to admit that the framework will not be perfect right from the start. For one thing, I need not tell you that a zero risk on European bonds is a point for improvement. If this issue is not addressed soon, it certainly will be at some later moment.

Let me sidestep for a moment to an article by two DNB staff members, Janko Gorter and Melle Bijlsma, that will appear in early 2012 and discusses the impact of Solvency II on the investment behaviour of insurers.

One of the arguments put forward in the article is that given current calibrations, corporate bonds – including bank bonds – will continue to remain attractive investment objects under Solvency II. In a broader perspective, I do not envision Solvency II as causing serious imbalances in insurers' investment strategies, let alone macroeconomic disruptions. These observations add shading to the stark picture of Solvency II raised in the media from time to time. Insuers will naturally adjust their investment policies to Solvency II, and this will lead to reallocations. However, we find no evidence, and in this we are supported by, for instance, *Deutsche Bank*, that Solvency will generate perverse incentives – not even with respect to long-term investments, as was at one time thought.

Still, I am aware of the debate going on in Europe about RBMS. Dutch parties and EIOPA are keeping watchful eyes open.

Some finishing remarks. We are living through a time of crisis. An enervating period where the financial picture shifts from week to week. Europe has indeed embarked on a course towards further harmonisation, yet the effort still seems to lack spirit.

This is also the right time for strengthening the foundations of the financial sector. To achieve this, better risk management is a major cornerstone. But risk-based buffers of sufficient size are as least as important to make financial institutions robust against the heaviest storms.

Solvency II will provide me, and to you as well I should think, with the building blocks for better risk management and better, risk-based solvency requirements; building blocks designed to weather many future storms.

So let us keep our eyes fixed on Solvency II, even at a time of crisis.

I wish you an inspiring symposium.