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Converging Ideas: Building a European-Wide Supervisory Culture in Insurance and Pensions

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Summary

- The establishment of the three European Supervisory Authorities will be recognised as one of the most fundamental reforms in the European financial sector coming from the financial crisis. The potential benefits for the EU internal market coming from the creation of these Authorities are huge, both for the industry and for consumers.
- EIOPA's mission is to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the European Union economy, its citizens and businesses. Since formation in January 2011, it has established a structure, recruited staff and built internal rules, processes and procedures.
- With Solvency II implementation dominating the work plan, the last year has seen several important consultations facilitating the preparatory work for firms. It has also provided advice the European Commission for its dialogues on international risk management.
- Meanwhile the Authority has progressed its consumer protection remit, publishing an initial overview of Key Consumer Trends, and taking forward work on payment protection insurance, and the use of price comparison websites.
- Among the key challenges ahead, the need for robust and realistic risk assessments ranks highly, which has implications on not just firm solvency but also general risk management and consumer protection.
- Another challenge will be occupational pensions, where a better risk assessment model is needed to find the right balance between security and affordability objectives. Such a model must reflect the true risks that the different stakeholders are running and help to preserve schemes.

CII Introduction: after what seemed like a flurry of regulatory activity in a relatively short space of time, the European Insurance & Occupational Pensions Authority (EIOPA) was formed in January 2011. It seemed like the body was formed while many in the industry were still wondering how a pan-European insurance supervisor of supervisors could operate in practice without compromising the work of the national authorities. In this article, Gabriel Bernadino, Chair of EIOPA provides a perspective on the Authority's first year of operation. This article should be read in conjunction with our other Thinkpiece by Karel van Hulle, Insurance Head of Unit at the European Commission.[1]

We are living exceptionally challenging times. The current crisis touches fundamental aspects of our economies and many changes are happening or are bound to happen in the years to come. In a few years the setting up of the European Supervisory Authorities will be recognised as one of the most fundamental reforms in the European financial sector coming from the financial crisis. The potential benefits for the EU internal market coming from the creation of these Authorities are huge, both for the industry and for consumers.

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EIOPA's Mission

EIOPA's mission is to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the European Union economy, its citizens and businesses. This mission is pursued by promoting a sound regulatory framework and consistent supervisory practices in order to protect the rights of policyholders, pension scheme members and beneficiaries and contribute to the public confidence in the European Union's insurance and occupational pensions sectors.

We aim to be a modern, competent and professional organisation that acts independently in an effective and efficient way towards the creation of a common European supervisory culture. We are governed by a set of values that guide our action and the daily relationship with our members and stakeholders: independence, responsibility, integrity, transparency, efficiency and team spirit.

These have been challenging times since the beginning of 2011. We had to establish our structure, recruit staff and build our internal rules, processes and procedures. In spite of this we managed to deliver a very ambitious plan, covering all areas assigned to EIOPA by the European Regulation.[2]

Regulatory Initiatives

On the regulatory front we launched a number of important public consultations in order to facilitate the preparatory work of insurance undertakings for Solvency II in areas such as the Own Risk and Solvency Assessment (ORSA) and Supervisory Reporting and Public Disclosure, including the Solvency II XBRL Taxonomy.

We continued to work on the Solvency II specifications for example by issuing a joint report on calibration of non-life risk factors in the standard formula.

Furthermore, we delivered advice to the European Commission on the review of the IORP Directive, setting the scene to improve risk-based supervision in the pension funds sector.

Oversight

On the oversight side we took as a priority our participation in the colleges of supervisors, contributing to a more consistent practice, setting an annual action plan and monitoring its actual implementation. Clear timelines were defined within the colleges for the setting up of an appropriate work plan to deal with the group internal model validation process.

Furthermore, we have initiated visits by EIOPA staff to the national supervisor authorities in order to have a better understanding of local markets realities and their respective supervision.

Consumer Protection and Financial Innovation

In this area, we put out for public consultation a Good Practices Report analysing the disclosure and sales of

[1] See Karel van Hulle, From Brussels with Love: A Perspective on Developing Insurance Regulation at the EU Level, CII *Thinkpiece* no.74 (May 2012). Available from www.cii.co.uk/thinkpiece

[2] See for example, EIOPA Work Programme 2012, 23 Jan 2012

Variable Annuities and a set of Guidelines and a Best Practices Report on Complaints-Handling by Insurance Undertakings. Furthermore, we presented a Report on financial literacy and education initiatives by competent authorities.

Reflecting our commitment to this area we have also published an initial overview of Key Consumer Trends in the EU, where we identify three key consumer areas that will be subject to further review and analysis:

- Consumer protection issues around payment protection insurance;
- Increased focus on unit-linked life insurance products and
- Increased use of comparison websites by consumers.

Finally we have organised our first EIOPA Consumer strategy day where we had the opportunity to discuss several relevant consumer issues with the different stakeholders.

Financial Stability

EIOPA was also active in the Financial Stability domain by assessing the resilience of the EU insurance sector to major shocks through the EU-wide stress test exercise and by testing different scenarios on the low yield stress test which shows that the insurance industry would be negatively affected if a scenario were to materialise where yields remain low for a prolonged period of time.

Furthermore, EIOPA is contributing to the macro-prudential discussions and risks analysis in the context of the European Systemic Risk Board, supported by the establishment of the EIOPA Risk dashboard.

International Activities

On the international front we provided final advice to the European Commission on the assessment of the Solvency II equivalence of the Swiss, Bermudan and Japanese supervisory systems and we started to contribute to the development of robust international standards by actively participating in the work of the International Association of Insurance Supervisors.

The crisis clearly showed us how fundamental is to the sustainability of the financial system that financial institutions use robust and realistic risk assessment and pricing.

Paramount to our activity was the involvement with the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group. The exchange of views and the opinions from the Stakeholder Groups were essential in the development of EIOPA's work.

Key Challenges Ahead

Looking ahead, I would like to give you my perception about some key challenges we face:

Need for robust and realistic risk assessment

The crisis clearly showed us how fundamental is the sustainability of the financial system and that financial institutions use robust and realistic risk assessment and pricing.

On the insurance side, Solvency II was designed to take into account market information for solvency purposes. Of course, being grounded on an economic-based valuation of all asset and liabilities and on a total balance sheet approach to financial resources and risks, Solvency II will bring some level of volatility to the own-funds.

Especially for long-term illiquid liabilities (like annuities and pensions) this volatility could be mitigated, for example by adjusting the relevant "risk free" rate used to discount these liabilities.

If we want to reinforce consumer protection, it is fundamental to preserve the basis of Solvency II as a sound framework for risk-based supervision, giving the appropriate incentives to better risk management and enhance transparency.

Naturally, appropriate consideration needs to be given to the necessary transition periods to deal with the business already written.

Pensions: balancing security and affordability

On the pension's side, while we need to find the adequate balance between different objectives like security and affordability, I believe that continuing to use liability valuations and risk assessments that deny market reality is not an answer. This will not contribute to a better management of the risks, it fails to reflect the true risks that the different stakeholders are running and helps to preserve schemes that are clearly unsustainable, postponing the taking up of measures in due time about the nature of the pension promise.

Within this picture, the inevitable consequences in the short to medium term will be a sudden lowering in the value of pensions for the members and beneficiaries, higher concentration of costs for employers and ultimately intergenerational conflicts.

The holistic balance sheet concept recommended by EIOPA has the potential to be a relevant instrument in the direction of further transparency on the analysis of the solvency situation of pension funds. But we need to test it.

One size of regulation does not fit all

Another lesson is that in regulation one size does not fit all. We need to have a constant effort to look at proportionality and we should not cede to the temptation to treat equally what is different. In fact different sectors have different business models and consequently different risks. For example, this is the case of systemic risk.

A new consumer protection paradigm

The regulatory approach to consumer protection has also undergone major changes since the financial crisis. Events have highlighted the need for fresh thinking on existing techniques, complemented by more proactive policies aimed at preventing problems in the first place.

Conficts of interest

First and foremost, we need to take a new look at conflicts of interest. Unfair practices leading to consumer detriment in the insurance and pensions market are often due to situations of conflicts of interest. Insurance is an industry where agency incentives can be the main driver of the kind of product to be sold. Sometimes these results in the sale of products which are not suitable for the consumers concerned.

A key element of consumer protection is to ensure that selling practices, whether through intermediaries or direct writers, should meet certain high standards.

Ensuring advice to consumer's best suits their profile and their needs, taking into account the complexity of the contract and the risks involved is a key element of consumer protection. This necessarily entails that selling practices, whether through intermediaries or direct writers, should meet certain high standards.

Standardisation and comparability of information

Secondly, we need to reinforce the standardisation and comparability of the information to be provided to consumers, helping them to take informed decisions. However, information should not be used to shift responsibility from the providers to consumers.

Product Suitability

Thirdly, we need to pay further attention to product suitability. I believe we should explore the merits of labeling products based on common risk features. Furthermore, we should develop a framework for early detection of unfair products, clauses or practices. I believe that this can usefully include the request of an independent opinion on the product design and characteristics by the internal governance functions of the insurer.

We should strengthen conduct of business supervision. Supervisory authorities should have the authority, capabilities, tools and resources to effectively and efficiently regulate and supervise the conduct of business of undertakings and intermediaries.

Training standards

I believe that the convergence of supervisory practices is as important as the single rule book.

Another task related to consumer protection and financial activities that EIOPA must carry out under its founding regulation is developing industry training standards.[3] This is a very new area of responsibility for any EU-level institution and one which carries many challenges within a diverse and varied market. EIOPA will be examining various aspects of this task over the coming months and then we will be contacting relevant stakeholders for early-stage consultation.

[3] See Regulation 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), *Official Journal of the European Union*, 24 Nov 2010, Article 9(1)(c).

The convergence of supervisory practices in the EU

I believe that the convergence of supervisory practices is as important as the single rule book. EIOPA is committed to assuring day-to-day supervisory oversight of financial institutions is done within a consistent framework. This allows an increased level of protection of policyholders and beneficiaries across the EU.

Convergence does not mean harmonisation. The process of convergence should encompass the issuance of guidelines and recommendations on the common framework for the supervisory review process and the development of best practices in the different supervisory areas. Importantly this should leave sufficient flexibility to judgment by national supervisors.

Nevertheless, especially regarding the major EU cross-border groups, it is much relevant to assure a high level of consistency in the supervisory approaches. It is a question of preserving a level playing field within the internal market and also a question of overall consumer protection.

EIOPA will continue to pursue its objectives in a pragmatic way with a clear vision and strategy for the future. We will create a truly European supervisory culture that promotes stability, enhances transparency and fosters consumer protection. A culture based on intelligent and effective regulation that adds credibility and promotes good practices. We will do it in constant dialogue with all stakeholders.For many individuals, and for low- to middle-earners in particular, group risk cover is often the only long-term insurance coverage they have. In terms of total protection insurance held in the UK, group life schemes have for many years provided around 40% of all insured death benefits. In the case of long-term disability income, group schemes now account for almost 75% of insured benefits.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

This article is loosely based on a presentation by Mr Bernardino to the Insurance Institute of London at Lloyd's of London on 15 March 2012. A podcast of his speech is available here, or by searching www.cii.co.uk/knowledge.

Gabriel Bernardino is the Chairman of the European Insurance and Occupational Pensions Authority (EIOPA) since that organisation's founding in January 2011. Prior to his current role, Mr.Bernardino has been Chair of the EIOPA's predecessor, CEIOPS, since October 2009. He previously worked for *Instituto de Seguros de Portugal* (the Portugese Insurance and Pension Funds Supervisory Authority) since 1989, where he held positions of increasing responsibility culminating in Director-General for Development and Institutional Relations. During the Portuguese Presidency of the EU in 2007 he chaired the Council Working group discussing the EU Commission Directive proposal on Solvency II.

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Recent articles in the Thinkpiece series:

No.74: **From Brussels with Love: A Perspective on Developing Insurance Regulation at the EU Level,** by Karel van Hulle (May 2012).

With EU insurance regulation landscape more relevant to individual firms than ever before, Karel van Hulle, the European Commission's lead official on insurance & occupational pensions, and author of many of the proposals under discussion in these areas, offers his own strictly personal view of insurance regulation in the post-financial crisis world.

No.73: **Is it Possible to Have Sustainable Flood Insurance without Sustainable Flood Risk Management,** by David Crichton (April).

Climate change models are predicting more extreme and uncertain weather. A particular concern stems from extreme rainfall events, with Scotland, Wales, and much of Europe managing to reduce the incidence of flooding using sustainable flood management methods. However, England's refusal to consider more sustainable solutions is resulting in a growing incidence of flooding. Will the demise of the Statement of Principles pave the way for the introduction of sustainable flood management in England?

No.72: **The Need to Know: Transparency and Confidentiality in Insurance,** by Duncan Minty (April).

Telematics has been welcomed by onservers for finally providing insurance pricing that is usage-linked and non-discriminatory. However, like GPS devices in mobile phones, it requires customer acceptance of reduced privacy in exchange for better services. Recent stories about insurers selling customer data has left the public justifiably unsure whether the industry could be trusted. What can insurers do to win back this trust?

No.71: **The Challenge of Age: Global Longevity Trends and Economic and Social Implications,** by George Magnus (23 March).

George Magnus ("the man who predicted the financial crisis") argues that the current economic turmoil is colluding with rising longevity to severely depress returns for the elderly. Governments, societies and industries must take robust action now in order to ensure that rising longevity is celebrated rather than feared over the decades to come.

No.70: **Rethinking Risk: The Future of Insurance and Renewable Energy,** by Steve Kingshott (9 March).

With rising fuel prices now a routine feature of our time, and the spectre of a "peak oil scenario" in the not-too-distant future, investing in renewable energy has become not just a matter of curbing CO_2 emissions any more. Steve Kingshott, CEO of Renewable Energy at RSA Insurance describes the work the insurance industry is doing to help deal with the challenges in renewable energy investment and development.

No.69: **Taking Charge: Employer Ownership of UK Skills,** by Trevor Matthews (16 February).

A skills system that fulfils the needs of employers and individuals is vital to the future competitiveness of the UK economy. Trevor Matthews, Commissioner of the UK Commission for Employment & Skills (and CEO of Aviva UK) articulates the sector's needs to government and its work seeking solutions of its own.

No.68: **Who Saves for Retirement? Analysing Incentives for Saving Using the Wealth & Assets Survey,** by James Lloyd and Timothy Fassam (26 Jan)

James Lloyd of the Strategic Society Centre and Tim Fassam of the Prudential summarise the results of an extensive survey exploring public attitudes driving pension saving, and draw conclusions in the context of the Government's new workplace pension auto-enrollment system starting this October.

No.67: **Insurance Regulation in 2012: Finding Solutions to the "British Dilemma",** by Mark Hoban MP (11 January).

Financial Secretary Mark Hoban MP summarises the UK Treasury's latest work in insurance regulation, including the UK regulatory reforms, Solvency II, and response to the European Court's gender ruling. He the UK's dominance in the global insurance markets both retail and wholesale which cannot be underestimated, and any regulatory reforms must be reflective of the unique issues in this sector.

No.66: **Retaining Today's Knowledge for Tomorrow: Capturing the Knowledge of Retirees**, by Adele Wilter (12 December 2011).

Knowledge loss can be an unintended consequence of retirements and can prove costly for firms. Adele Wilter of Capita Consulting provides a short guide on how best to capture this knowledge and prevent a brain drain.

CPD Reflective Questions

Learning Outcomes

- To gain an understanding of the issues underpinning the development of insurance supervision at the EU level, taking into account approaches followed in individual member-states.
- To be able to summarise how the new European Insurance & Occupational Pensions Authority (EIOPA) reconciles the various national solutions to given regulatory issues, and balance the concepts of regulatory convergence and harmonisation; and equivalence and duplication.
- To be able to list the main areas of interest and work for EIOPA over the next few years, and the reasons behind this focus.

Reading this Thinkpiece with respect to the above learning outcomes can count towards *Structured CPD* under the CII CPD Scheme. These questions are designed to help you reflect on the issues raised in the article in relation to these learning outcomes. The answers are not meant for CPD records purposes.

1. In what ways is the setting up of the European supervisory authorities a key component in global level financial regulation? For additional insight, you might want to refer to CII Thinkpiece no.40 The Future of International Financial Regulation (June 2010) and some of the issues discussed there. Thinking of examples of specific insurance regulatory issues, in what way do harmonised policies at the EU-level add credibility to the direction of global regulation?

2. The author states that EIOPA's mission is "to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the EU economy, its citizens and its businesses". What are your views on the link between public trust and confidence will result in improved market stability? Can public trust and confidence go wider than simply consumer protection in retail markets?

3. What issues drove the formation of EIOPA? What do you think are the pros and cons of regulatory convergence and the development of a single European rulebook for insurance and occupational pensions? Many countries are in the process of reforming their insurance regulation. Can you identify some key similarities or differences between the formation of the EU supervisory authorities with those reforms in your own jurisdiction?

4. There is much debate across Europe about how and whether national regulation should be supplanted by a common EU rulebook. The article speaks to this by discussing the vital differences between equivalence and duplication and the importance of better regulation, and the importance of understanding substance over form of regulation. Moving away from the political debate, what do you think are the economic issues at play here, especially affecting firms operating in this environment?

5. The article summarises the key challenges ahead, among them are the need for robust risk assessment, consumer protection, conflicts of interest and training standards. What recent developments across life and non-life sectors do you think will be of most interest to EIOPA going forward? How does EIOPA's proposed model of developing supervisory standards compare with what the national supervisors will be doing?