IVASS
ISTITUTO PER LA VIGILANZA
SULLE ASSICURAZIONI

2nd CONFERENCE

"SOLVENCY II AND SMALL AND MEDIUM-SIZED INSURERS"

WELCOME ADDRESS

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President of IVASS

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Ladies and gentlemen,

I am delighted to welcome you all to this Conference.

I want to thank Gabriel Bernardino, President of the European Insurance and Occupational Pensions Authority (EIOPA), and all the other panelists, for kindly accepting our invitation.

This is the second conference we hold in IVASS on Solvency II. This time we decided to focus on a specific topic, the effects of the new prudential framework on small and medium-sized insurers – SMIs from now on.

After Gabriel's keynote speech we will have two panels: the first one will have a more international flavor, while the second one, opened by Bianca Maria Farina, President of the Italian Insurance Association (ANIA) , will be focused on the Italian market.

The panelists are well known representatives of both the supervisory community and the industry. The moderators will be Karel Van Hulle, one of the founders of the Solvency II framework, former Head of the Insurance Unit at the European Commission, and Ferdinando Giugliano, journalist and economic commentator.

Alberto Corinti, member of the Board of IVASS and of the Management Board of EIOPA, will offer some concluding remarks.

Why a conference on small and medium-sized insurers?

I gave some hints last June, when presenting IVASS Annual Report. At that time only few months had passed since Solvency II entered into force, but we could already notice how difficult this new world had become for small companies.

Solvency II pursues the objective - I said in June - of creating a risk-sensitive prudential regime for all and of incentivizing good corporate governance. To this end it has introduced three pillars of new rules: 1) some very complex methods for calculating the capital requirement; 2) a minimum, but still high, level of organizational requirements; 3) and a detailed information system, over and beyond balance-sheet reporting obligations.

Smaller firms are finding the investment consequently needed in human, technological and organizational capital something of a burden.

Even the IMF has many concerns. Its Report *The Insurance sector: trends and systemic risk implications* issued in April 2016[1] saw a clear tendency by small companies to run more risks, also in an attempt to cover the growing costs of compliance with rules that have become much more stringent than before.

If just one small firm fails, then there may be a loss of confidence in the entire system and a macro stability problem. So it is certainly wise for supervisors having also macro prudential responsibilities to be worried; it is not only a matter of market efficiency.

Let me concentrate on capital requirements. The main goal of Solvency II is that of linking each company's capital requirement to the actual risks that it faces. Such risks are self-measured by the company through methods controlled or even validated by the national supervisory authority. Ordering these tools by increasing complexity, we have the so-called "standard formula", then the "undertaking-specific parameters" (USPs), and finally the "internal models".

Inevitably, when you go from basic - Solvency I - to sophisticated - Solvency II - you have to accept an increase in the level of complexity. So, no surprise, not only are internal models very complex, but also USPs and even the standard formula. The latter is the method chosen by most SMIs to calculate their capital requirements. Though it is the simplest of the three methods, it is much more complex than the one in use under Solvency I.

Many SMIs lament that Solvency II was conceived and developed having the big market players in mind. Is this true? I don't know, but in any case trying to answer such a question would be sterile. A more subtle and useful question is whether the increased complexity of regulation just reflects that of the business, or whether it adds a further, and unnecessary, layer of sophistication to the picture, especially for SMIs.

[1] FMI, *Global Financial Stability Report*, April 2016.

Are small insurers too small?

We may argue that the modern world is "no country for midgets" to paraphrase the title of a famous movie. The two big challenges that the world insurance industry is facing nowadays - digitalization and persistently low interest rates - seem to be even bigger for SMIs, so that many foresee a consolidation of the insurance services supply, with more and more M&As taking place that will significantly increase the average size of companies.

Let's consider technological innovation first.

On the one hand, digitalization is a unique opportunity for SMIs. Internet of things and big data are revolutionary trends that have the power to induce a deep transformation also in the insurance sector. Technological innovation connects people, integrates and manages data, automates processes, stimulates new products engineering. SMIs will have the chance to play an important role if they are able to cover the many niche markets that will arise.

On the other hand, this still largely unexplored world is full of threats, in particular for SMIs.

Cyber risk is a clear example of opportunity/threat coming from technological innovation. It is a relatively new and promising market for insurers: as soon as firms and families realize how dangerous cyber risks are, a lot of new insurance policies could be designed and sold. However, insurers themselves may gain more visibility as a target for cyber-attacks while they migrate towards highly integrated and big data storage systems. The higher the sophistication of the security system in place, the lower the exposure. Are SMIs able to use sophisticated enough security systems? That's an open question.

Another risky factor for SMIs is the persistently low interest rates environment. It is partly linked with the monetary policies in the current phase of the cycle, but also, in a longer term perspective, with the evolution of longer term fundamentals and demographic trends; it is intertwined with technological change, since it may accelerate it, and so the ensuing M&A process[2]. We still don't know how long this environment will last: as for monetary policy, headline inflation has increased lately, largely owing to energy prices, but underlying inflation pressures remain subdued.

[2] ESRB, *Macroprudential policy issues arising from low interest rates and structural changes in the EU financial system*, November 2016.

Most insurance companies are being induced to change their business models, lowering guarantees offered to policyholders or shifting towards products with a stronger "financial" component, or to take more risk on the asset side. SMIs are less equipped to weather this storm. Is a SMI capable of managing more complex, innovative products? Is it capable of managing more risky assets like stocks? Here is another engine of potential consolidation.

It is likely that, eventually, market interest rates will have to somehow normalize from the current very low levels. When that happens, the market value of bonds in insurers' portfolios will be reduced. At the same time returns on bonds will get back to more "normal" levels, allowing insurers, in particular life insurers, to offer again to their customers traditional insurance products, with a guarantee attached. That would require new contracts.

Timing will be crucial: if the rise in market interest rates is gradual, as well as the shift in policyholders' demand from existing contracts to new ones, then the regime change can be managed by companies and can result in a net benefit for them. Sudden hikes on both fronts may instead be dangerous, and SMIs may be the most affected. That's a further reason for consolidation.

But these are market forces. We as regulators must ask ourselves whether regulation itself is such as to induce consolidation, without any explicit prudential reasons to do that. An excessive number of M&As may result in a reduction of market competition, in lack of diversity in insurance coverage, and may eventually feed the never dormant "too big to fail" issue.

Is proportionality a solution?

Proportionality in the application of Solvency II could be a way out of these doldrums. It will be interesting to hear from you on this point.

I think that proportionality is a good principle, and its application to the second and third pillar of Solvency II - that is governance and reporting - is certainly worth being discussed. For instance, in IVASS we have been working a lot on the national implementation of the governance requirements set by Solvency II, and we have spent quite some time in thinking on how best to ensure their proportionate application, taking into account the needs of SMIs.

Following previous fruitful experiences, we see merits in an early involvement of the industry in this process. We shall be launching a public consultation soon.

Applying the proportionality principle to the first pillar - the capital requirement - is instead a more thorny affair. The forthcoming SCR review led by EIOPA and by the European Commission might be an occasion to examine this issue. Insurance companies could take advantage of the public consultation that EIOPA is running.

For sure, in the meantime we could make a better use of the existing prudential framework. For instance, the Own Risk and Solvency Assessment (ORSA), on top of being used internally, can serve the purpose of improving the intensity and quality of the dialogue with supervisors.

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To conclude, I very much hope that this Conference could be of inspiration to the reflections and works that both regulators and insurers will conduct on this delicate issue. I wish everybody an interesting and fruitful discussion.

Thank you for your attention.