

Solvency II Experience and Trends in Europe



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Brasilia, 9 June 2011

- Insurance: why it is a unique sector
- Global regulatory standards: an historical perspective
- Solvency II
- Excessive Capital requirements' impacts
- Better Regulation: recent experience in Europe

■ Insurance – a unique sector

- Insurance and banking are both part of the larger financial services industry
 - Therefore, regulators approach both sectors in a similar manner to:
 - ... ensure a level playing field
 - ... avoid regulatory arbitrage
 - But there are important differences between these two sectors, in particular:
 - Different balance sheet structures;
 - Different exposure to liquidity risk;
 - Different degree of interconnectedness within the two sectors;
 - Different 'risk ownership';
 - Different exposure to volatility;
 - Different exposure to economic cycles.
- ➔ Insurance and banking need to be treated differently
- ➔ They need to be treated in line with their respective business model

Insurance: why it is a unique sector

	Insurance	Banks
Funding and balance-sheet structure / ALM	<ul style="list-style-type: none"> • <u>Long-term funding</u> through insurance policies with up-front premiums • <u>Average duration</u> 8-10 years on funding offset by shorter term invested assets provides stable balance sheets • <u>Pre-set payout</u> trigger events and conservative portfolios • <u>Asset allocation</u> driven by the cash-flow profile of the liabilities that fund them; conservative investments to fund expected payout patterns of claims 	<ul style="list-style-type: none"> • <u>Short term funding</u>, exposed to withdrawals of funds, no linkage between assets and liabilities • <u>Value of assets</u> exposed to economic cycles (eg. Aggregate loan losses) • <u>Duration mismatch</u>: <ul style="list-style-type: none"> - Assets have a generally longer duration than liabilities; - risk that assets cannot be liquidated to meet obligations on time
Liquidity risk	<ul style="list-style-type: none"> • <u>Risk diversification</u> within portfolios, stabilising payouts 	<ul style="list-style-type: none"> • <u>Maturity transformation</u> business model might cause funding shortfalls in withdrawals or wholesale market distressed scenarios • <u>Short term funding</u> dependence leads to interconnectedness within the sector

Insurance: why it is a unique sector

	Insurance	Banks
Risk ownership	<u>Most business risk is retained</u> , max 20% is reinsured, ceded risks stay on balance-sheet	<u>Originate to distribute model</u> : intense use of securitisation prior to the crisis resulted in inadequate underwriting standards and deteriorating asset quality
Interconnectivity	<ul style="list-style-type: none"> • Inter-company funding is extremely low • No domino effect in reinsurer default: high quality reinsurance carriers, use of cancelation triggers (eg. downgrade clauses) • Exposure to extreme non-financial events is either spread across the global insurance market, transferred to capital markets (ILS) or borne by government schemes 	<p>Interconnected business structure:</p> <ul style="list-style-type: none"> • Interbank funding and repo markets • loan syndicates, securities underwriting • Investments in securitised assets • Substantial trading and transaction activities within the sector • Chain reactions in deposits withdrawals

Insurance: why it is a unique sector

	Insurance	Banks
Business volatility	<ul style="list-style-type: none">• Short-term volatility has little impact as insurance revenues and payouts are stable	<ul style="list-style-type: none">• High earnings volatility: short-term nature of business, customer defaults may require write-offs, pro-cyclical leverage effects
Macro-economic role	<ul style="list-style-type: none">• Protection and savings products not interlinked with the functioning of the economy	<ul style="list-style-type: none">• Leverage, innovation and growth• Direct transmission channels for monetary policy• Critical players in the payment systems

- Treatment of systemic risk in insurance: take account of the specificities of the sector!
 - Insurance is different from banking:
 - The insurance sector is by nature **less systemically risky**, especially for **core insurance activities**: less interconnected, size is a positive factor, substitutability is high;
 - Some activities (speculative derivatives trading and short-term funding mismanagement) can be systemically relevant in certain conditions;
 - Specific approach to systemic risk:
 - Instead of focusing on **firms**, insurance supervisors should focus on the nature and scale of engagement in potentially systemically risky **activities**;
 - “**Right response**” is a combination of:
 - ‘Macro-prudential supervision’: focus on interactions between participants and potential consequences of failure for the broader economy;
 - ‘Micro-prudential level’: A risk-based approach, combined with group supervision, is the right way to supervise insurance firms, also for their potentially systemically risky activities.
 - “**Wrong response**”: draw a list of G-SIFIs in insurance to mirror the work in banking and apply the same measures on these firms (e.g. capital add-ons)

- Global regulatory standards
– a historical perspective

Different starting points for international regulatory standards:

- **Banking: long tradition of coordination of regulation at international level**
 - 1974 Basel Committee established
 - 1988 Basel I introduced minimum capital requirements with focus on credit risk. Accord implemented by more than 100 countries
 - 2004 Basel II upgrade, e.g. wider risk coverage, more risk-based approach, 3-pillar approach
 - Dec 2010 Basel III to correct weaknesses made apparent by crisis (e.g. inappropriate coverage of liquidity risk)
 - End 2011 All major G-20 financial centres committed to adopt Basel III capital framework

- **Insurance: patchwork of national frameworks**
 - 1994 International Associations of Insurance Supervisors (IAIS) established
 - To date No common international insurance regulatory standard

■ Solvency II

■ State of the art regime:

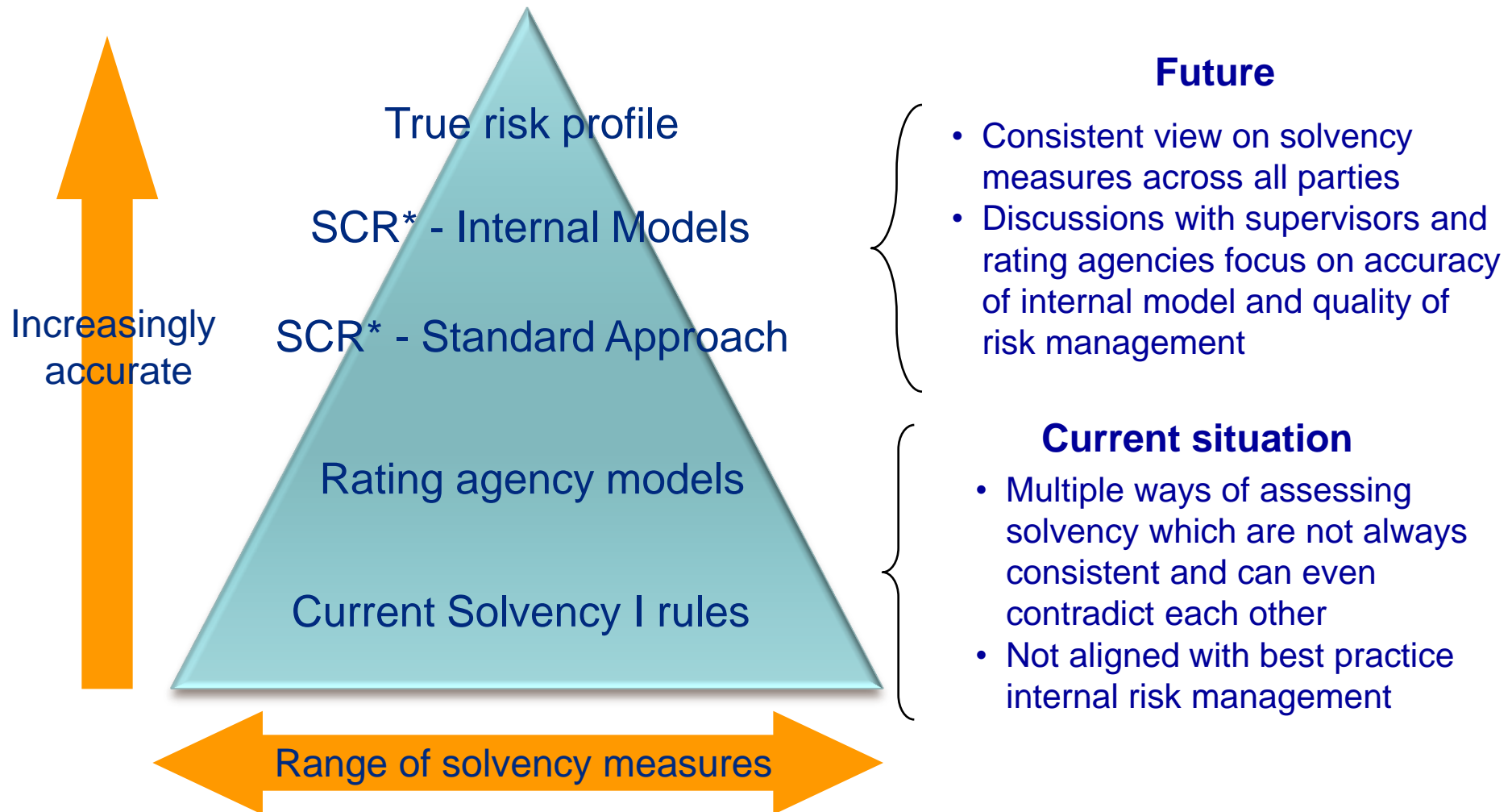
- Economic valuation of assets and liabilities
- Holistic, cross-balance sheet risk based approach recognizing diversification and risk mitigation
- Possible, intelligent use of internal models for regulatory purposes
- Incentive to enhanced ERM
- Ladder of supervisory intervention (MCR-SCR)
- Group supervision
- Increased policyholder protection
- Increased harmonization and transparency leading to opening up to discipline of market scrutiny
- Risk-proportional application

■ Right response to the financial crisis

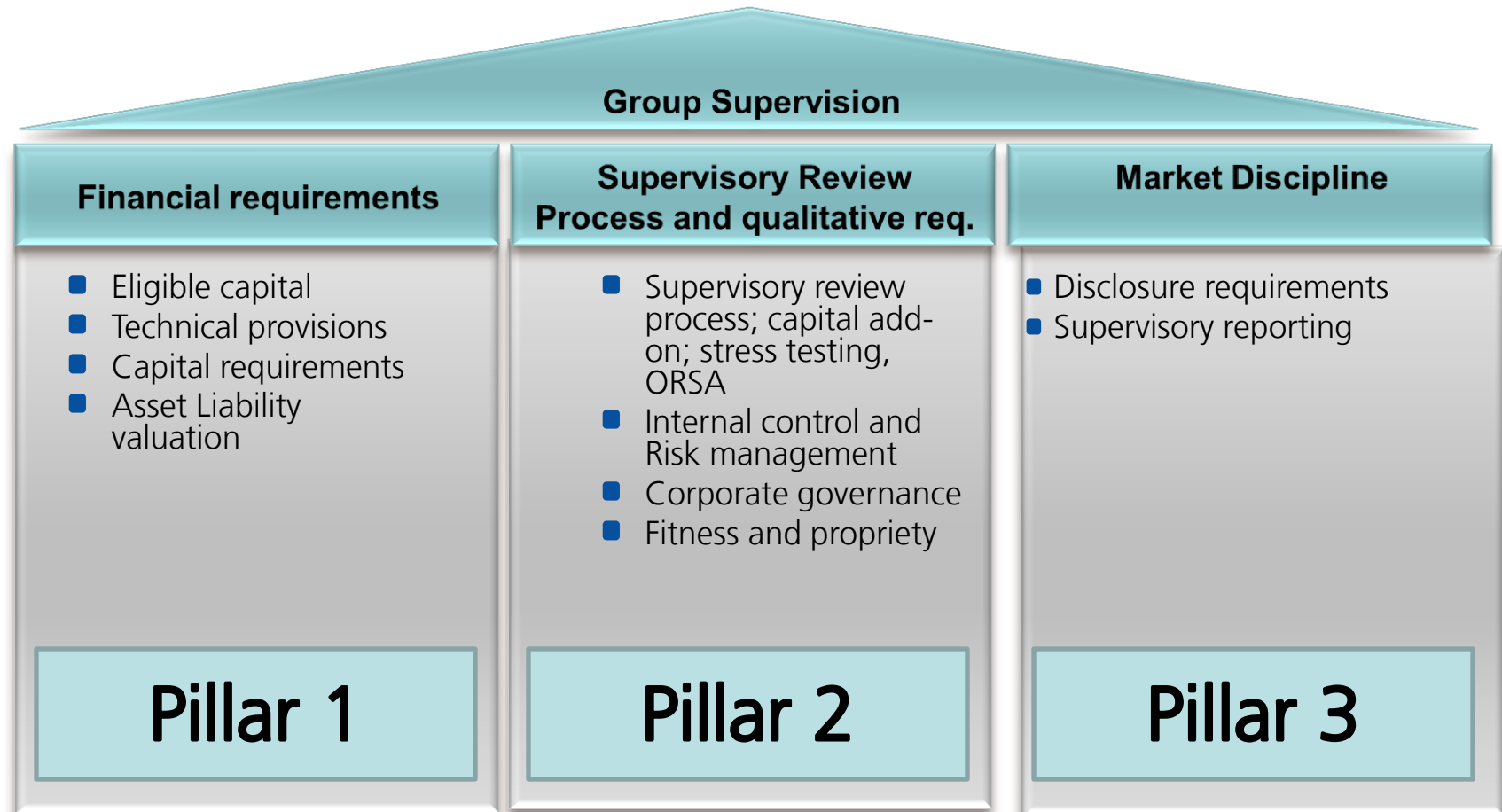
European decision making: Lamfalussy process

- Flexible regime able to adapt to market developments and innovations

From Solvency I to Solvency II: Towards a coherent economic approach



*Solvency Capital Requirements (SCR)



Capital requirements plus internal management and disclosure requirements

➤ Makes managers aware of the risks they run

- One major lesson from the crisis is that supervision needs to be increased at group level
- Solvency II group supervision:
 - Assessment of consolidated risk profile in line with groups' economic reality
 - All material risks included arising from a group's regulated and non-regulated entities
- IAIS Common Framework for international active groups
 - Valuable tool for accelerating regulatory convergence and establishing a strong basis for better international coordination.

- Provides insurers from non-EEA countries with an opportunity to receive the same treatment as EEA insurers
 - Increased market access
 - Reduced frictional cost of conducting business
- Reduces duplication of supervisory efforts
- Enhances market efficiency
- Facilitates the international supply of insurance and reinsurance

Consolidation and Solvency II

Financial requirements

- Consolidation is currently apparent in the European market
- Will Solvency II enhance or slow down the market trend?
- The new regime is designed to capture and measure the specific risk profile of the company in terms of capital requirements
- Being based on an economic approach, the new regulation is going to reward well diversified companies
- To the extent that the size will positively affect the risk profile (e.g. by limiting volatility), and assuming that diversification increases with the increase of the size, one could conclude that the current trend towards consolidation in Europe would not be stopped by Solvency II

Consolidation and Solvency II

Principle of Proportionality

However, Solvency II takes account of the fact that small companies could also be well diversified:

- Reinsurance and other risk mitigation mechanisms are a way for buying diversification
 - As the volatility is assessed over the net portfolio, smaller companies can reduce their volatility by purchasing reinsurance and can therefore also benefit from lower factors
- The quality of the portfolio in terms of risk is not necessarily connected only to the size. Small companies could have advantages related to a better knowledge of their policyholders (in particular for niche market), to a better selection, to a more efficient management of insurance process
 - Companies can use company-specific data to derive their own factors ("Undertaking Specific Parameters")
- Calculation of capital requirements in Solvency II are not always influenced by the size. In some cases (when using a scenario approach) the formulae capture the risk profile independently of the size

How can Solvency II be neutral?

- Provided Solvency II is finalised appropriately, it is not expected to unduly affect market trends

Essential elements to achieve this are:

- Full recognition of risk mitigation mechanisms
- Use of entity specific data for calculating the standard SCR
- Use of internal models (also partial)
- Adequate application of the principle of proportionality
- Appropriate supervision of outsourced activities
- Recognition of diversification effects at group level

Impact of Solvency II on the cost of raising and holding capital

- Companies expect to raise capital more easily under a risk based economic Solvency II framework
- Companies expect that the recognition of more eligible elements will decrease the cost of raising capital in the future
 - However, companies expect that a overly burdensome regulatory framework will increase the cost of raising capital
 - The appropriate finalisation of the regime is therefore essential.
- The initial and ongoing admin costs of Solvency II are expected to outweigh the benefits of Solvency II.
 - again this is depended on the appropriate finalisation of the regime

- It is difficult to quantify the benefits of the Solvency II framework. However, the expected qualitative benefits of Solvency II include:
 - Increases in transparency and disclosure for investors and consumers
 - Increased competition in European Insurance Markets
 - Sharper and fairer pricing of insurance products
 - Better incentives to insurance product development
 - A better functioning internal market for insurance services
 - Providing also regulatory incentives to companies to better manage their businesses (towards more efficient economic capital structures, and reducing inappropriate risks)
 - Improving investors' confidence by better understanding of the company's risk (reduces risk premiums for the industry)
 - Greater confidence in the insurance sector by preventing of potential future industry crisis
 - All stakeholders, including consumers, will ultimately benefit from a Solvency II regime that is based on a risk based economic framework

■ Finalising the regime

- Setting appropriate calibration and reviewing it over time
- Keeping consistency of regulatory framework, avoiding unjustified spill over from regulation of other financial sectors
- Ensuring a smooth transition to the new regime

■ Implementing the regime

- Being ready to implement:
 - Insurers have a lot to do in order to set risk-based tools, processes and culture throughout their organization
 - National supervisors should have resources and expertise to implement the new regime and behave consistently across Europe (important role of EIOPA)
- Ensuring that actual implementation of supervisors is consistent with the regulatory framework and does not lead to pro-cyclical reactions
- Converging as appropriate supervisory standards worldwide

■ Potential impact of excessive capital requirements

- Costs and risks arising from excessive capital requirements:
 - For Insurers
 - Limited returns to shareholders might attract fewer capital investors. Capital migration to more favourable regulatory regimes.
 - Reduce underwriting capacity, increase prices of products with high capital consumption.
 - Life insurance products' offer will shrink due to overly conservative (low-yield) investment strategies, making it a less attractive product

■ Costs and risks arising from excessive capital requirements:

■ For the Economy

- The role of the insurers as long term investors will be challenged by its reduced investment in equities and banking securities
- There will be unusual growth in low-risk asset classes, such as high rated government bonds
- Substantial wealth transfer from the European insurance industry to the pension funds, capital markets and to other geographical players
- Lower investment returns could imply lower consumer spending and a higher savings rate for retirement

■ Costs and risks arising from excessive capital requirements:

■ For Consumers:

- Reduced supply of life policies with minimum guaranteed returns would give rise to a social cost, at increased price and risk to policyholders.
- Less choice between insurance market players due to mergers, activity reduction or extinction
- Reliability on other pension providers, subject to different solvency requirements, while consumers may not be aware of the differences.

■ Better Regulation

- European Commission approach to „Better Regulation“:
 - Intensive consultation with all stakeholders at all stages of the process;
 - Pre-consultation/informal consultation
 - Formal consultation
 - Feed-back statements published by the Commission
 - Impact assessments conducted at various levels:
 - The original proposal
 - The implementing measures
 - Cost benefit analysis

For more information
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