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**Session [12A] - SOLVENCY II:
QIS4 early feed back from
the industry; Group support
and diversification effects
management, level 2 terms
of reference.**

The Panel

Moderator: **Karel van Hulle**, Head of Unit, Insurance and Pensions, DG Internal Market and Services, European Commission

Panelists: **Henri de Castries**, Chief Executive Officer & Chairman of the Management Board, Axa Group;

Peter Skinner, MEP, Committee on Economic and Monetary Affairs, European Parliament;

Gérard de La Martinière, Vice-President, European Insurance and Reinsurance Association (CEA) and Chairman, French Insurance Association (FFSA)

Asmo Kalpala, Chairman & President, Tapiola Group and President, Association Internationale des Sociétés d'Assurances Mutuelles (AMICE);

Tommy Persson, President, European Insurance and Reinsurance Association (CEA) and President, Länsförsäkringar AB

The Debate

The current system of regulation for the insurance industry was 30 years old and it lacked risk sensitivity, did not allow accurate and timely supervision and did not facilitate optimum allocation of capital, said **Karel van Hulle**, Head of Unit, Insurance and Pensions, DG Internal Market and Services, European Commission, introducing the session. In addition, there was a lack of convergence of supervisory groups, which led to sub-optimal supervision.

"There are four principal objectives of Solvency II," Mr van Hulle said.

- Deepen the Single Market
- Enhance policyholder protection
- Improve (international) competitiveness of EU insurers
- Further Better Regulation

Some outstanding issues remained to be resolved, such as surplus funds, equity risk, MCR, whether Solvency II should apply to pension funds, group support regimes, mutuals and exclusions, he added.

Solvency II is essential for the future of the industry, said **Henri de Castries**, Chief Executive Officer & Chairman of the Management Board, Axa Group. "We are pleased by what is on the table, even if on some points further discussions will be needed."

The market turmoil showed that the safety and stability of financial institutions was key. Capital and risk management were vital to ensure the safety of the system. "Solvency II is improving the picture. Moving to a more economic approach to risk measurement will create more transparency, more efficiency and greater safety." Solvency I did not deal properly with some categories of risk or with capital diversification.

"It is very important that market players are forced to have very effective risk management systems but also that they are allowed to allocate capital in the most effective way. If not, products will be more expensive for clients or coverage will be more limited and returns on capital will be lower," the Axa CEO said. "Moving in the direction of diversification, one of the core elements of the industry, being better recognised and having risks better measured is very significant progress."

Axa also welcomed group support, which would create better regulation and more transparency, but Mr de Castries recognised that certain questions remained. "It is vital for regulators in a crisis to be able to see the full extent of that crisis as early as possible."

But, as with all regulation, the devil was in the details, he added. The MCR (minimum capital requirement) should be expressed as a percentage of the SCR (solvency capital requirement), "so we are pleased with what is on the table". On diversification, it was important for the framework to recognise the diversification benefits coming from non EU entities. "Diversification means not having all your eggs in one basket and diversifying outside the EU improves your risk profile. Not recognising this would diminish the safety of the system."

Another key question was how equity risk was calibrated. Equities were more volatile than other asset classes, but applying the one-year horizon to them failed to recognise that sometimes liabilities were long-term. "We have to ensure regulation is not too pro-cyclical, otherwise there will be no equities in insurance portfolios, which will lead to sub-optimal performance, more expensive products and lower capital returns."

Supervisors also needed to be aware that readings of QIS4 were inconsistent across different countries, for example in the way tax was handled.

The next stage in the progress of the directive was to hold a series of compromise meetings, said **Peter Skinner**, MEP, Committee on Economic and Monetary Affairs, European Parliament. "We are looking at the technical details but we need to ensure that Europe operates at the optimal level."

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On diversification, businesses should be able to reap the benefits of diversification if they had adopted the risk-based approach the EU was asking them to. "We expect companies and regulators to demonstrate the enforceability of this directive so that the economic benefits can flow to the companies and be passed on to consumers," he added. "Consumers have so far been left out of this, in so many ways. We need to ensure that there is not just a solution that is sustainable in terms of companies benefiting but consumers concerns should be taken into account."

G rard de La Martini re, Vice-President, European Insurance and Reinsurance Association (CEA) and Chairman French Insurance Association (FFSA), said he had been working on solvency issue for 30 years and it was vital for Solvency II to be adopted and implemented as soon as possible. He added: "The industry deserves it as well, because of the high level of investment and support it has provided to the Commission, the Parliament and CEIOPS."

The directive would be highly beneficial, giving better risk management and competitiveness for companies and better risk protection for clients. Nonetheless, it would be a huge investment for the industry. "It will cost a lot of money to implement – it is not that often that an industry is willing to revolutionise the way it does business. For that reason, we urge the decision-makers to come to a decision soon."

Group supervision, even it was a difficult issue, was the cornerstone of Solvency II, Mr de La Martini re said. The insurance industry was ahead of banking in terms of the integration of European markets, making it appropriate to have the discussion on group supervision first in insurance. "We do not have the liquidity risk that banks do, which should make the appropriate solutions easier to design than in the banking sector. I expect Solvency II to provide the reference point for the combination between group and solo supervisors that will allow the effective integration of the European financial industry."

Prudential regulations for insurance should not be considered in isolation because of its role in social and economic life. "Beyond policy holder protection, it has a role in managing long-term savings and investment. We cannot ignore that, especially during this time of crisis. Insurance has to provide financial stability and we have to make sure the new regulatory framework will allow that."

Asmo Kalpala, Chairman & President, Tapiola Group and President, Association Internationale des Soci t s d'Assurances Mutuelles (Amice), said that Amice welcomed Solvency II's risk-based economic approach, which worked for policy holders as well as insurance companies.

The organisation also supported the maintenance of a threshold for the application of the Solvency II regime. However, the current threshold of  5m was 20 years old and it should be increased to  10m, he said.

Markets having problems with surplus funds should be given adequate time to adapt step by step to the new requirements.

The key issue for Amice was the treatment of mutual groups. "The group approach brings competitive advantages for group companies compared to solo companies in terms of capital costs and supervision administration costs." Amice believed that the definition of a group should not be dependent on the legal form of group companies but should apply as soon as companies were treated as groups in accounting figures. "As soon as the legal requirements are fulfilled, the group approach should be possible," Mr Kalpala said.

The EMS (European Mutual Society) statute was also an important issue for mutuals, and should ensure that capital maintenance was possible for mutuals. In Finland, Sweden and Germany, equalisation reserves were a very good tool for enabling the growth of financial mutual growth. If used on the investment side, it could be a very good tool to strengthen countercyclical effects. "It is important for mutuals because we do not have access to capital markets, so we need different methods to finance our growth," Mr Kalpala said.

Tommy Persson, President, European Insurance and Reinsurance Association (CEA) and President, L nsf rs kringar AB said that the CEA was very committed to QIS4 and the feedback so far was that participation would be much higher than for QIS3, "which would guarantee the high quality of QIS4." There were still areas needed work, such as proportionality, and calibration, along with some elements of valuation assumptions.

Nonetheless, Solvency II was a major step forward incorporating a range of features that the industry had long advocated, such as a risk-based economic approach that ensured true exposure of risk could be reflected; a market-consistent approach to valuing assets and technical provisions; and recognition of diversification benefits.

Unlike other solvency regimes, Solvency II did not confuse prudential and capital requirements by incorporating implicit margins in technical provision liabilities, Mr Persson said. "There are clear and distinct Solvency II does not confuse prudence and capital requirements by incorporating implicit margins in the technical provisions liabilities. Instead, there are clear and distinct roles for technical provisions and capital requirements, with the latter being an explicit and objective assessment of the capital being needed to protect policyholders against unexpected adverse experience."

Mr Persson added his voice to support for the MCR and SCR calculations to be aligned so they responded consistently to changing economic conditions. It was right to discuss a range of calculation methods as long as they were risk-sensitive, allowed diversification and were not an impediment to the group support regime.

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“Now is the time to reach agreement, even if that means compromises on key issues.” Mr Persson said. “We have the opportunity to lead the world in setting new standards. We must remain true to our principles and avoid diluting the strong economic foundation on which Solvency II is based.”

Mr van Hulle said that the Commission was appreciative of the industry’s input to the QIS exercise. “The response was very good, which is crucial if we want to make decisions based on fact not theories.”

He then addressed a number of questions to Mr de Castries.

- Why should we look at equity risks differently from other risks?
- What is the capital charge that Axa applies to its internal model for investment in equity?
- If we have to accept compromises on the group solvency regime, what kind of restrictions could there be without causing too much damage to the regime?

Axa currently applied a capital charge on liquidity risk of 39% currently, “but if it moves to 32%, which is on the table, we would take that,” Mr de Castries said. “We are a large player and we are very strongly capitalised. We will live with practically any regime – but we have our very, very deep beliefs on what is right and what is wrong. You have to step back and look at the system you are going to create.”

A few industry figures had flagged up the fact that accounting standards changes to the fair value model would increase pro-cyclicality and volatility. “In the Solvency II framework, the time horizon is one year but we all know that the duration of liabilities for insurance risks is far in excess of one year.” This meant the optimal allocation of assets would be distorted if there was only a one-year horizon. “All players will reduce their equity portfolios and invest more in bonds.”

Investments in bonds carried a capital requirement 1/16th of that for investing in equities. “Is this really what you want to happen? It will lead to a situation where insurers, which have had a countercyclical structure, will not have the same amount of equities in their portfolios.” Those equities would then be bought by hedge funds, sovereign wealth funds and retail investors, “who are all totally pro-cyclical in their behaviour”. “Is this going to increase the financial stability of the system? I am not convinced.”

On group support, Mr de Castries understood that there was some concern from some local regulators about the management of crisis situations.

There should be further exploration of the issues involved and “it would be understandable in the first phase not to have 100% of excess capital available for group support”.

Mr van Hulle asked Mr Skinner:

- Where are compromises needed and what solutions do you have?
- How can the industry make your life easier?
- Having said that you look at Solvency II from a global perspective, how do others from outside the EU see us and what are the chances of them moving in the same direction?

The scrutiny of the European Parliament was important in shaping how the rules were interpreted by authorities seeking regulatory equivalence, Mr Skinner said, adding that he had been involved in discussions with the US on Solvency II. But it was not just the US Europe had to be concerned with. “There are lots of markets like India and China that we need to impress. We need to make sure that Europe is able to compete effectively in other markets but we cannot arrogantly say we are creating a gold standard without inviting others to join us. Reaching out is vital,” Mr Skinner said.

“We also need to increase the capacity of global standards to allow for a globally competitive environment where European companies can compete.”

In terms of the industry making life easier, Parliament had never had an easy time from industry, he added, but industry had a pivotal role to play. There were areas where compromise was needed, such as getting group support to work and proportionality, where he was willing to see some movement. “I am looking for a wider perspective from those countries that feel insecure on group support – we want them to be part of a proper European solvency regime that includes group support,” the MEP said.

Mr van Hulle’s questions for Mr de La Martinière were:

- Why do French insurers look at equity risk differently from insurers elsewhere?
- What would happen if we were to depart from the one-year time horizon, which is the basis for Basel II?
- Why do we hear from France that there can be no level playing field unless pension funds are included in Solvency II?

In the French insurance market, a significant part of professional liabilities were covered by special mutual organisations with very long coverage, such as buildings insurance or professional indemnity. “Their risk exposure is clearly linked to the characteristics of their business and the length of their liabilities,” said Mr de La Martinière. One of the main risks for such businesses was inflation, and the only protection from inflation was to be invested in equities.

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The French did not have pension funds, for historical reasons, so people had developed their coverage through life insurance products, meaning that the life insurance market was determined by the need to provide retirement revenues. As a result, companies held many long-term assets so policy holders had the right level of annuities or capital.

“The one-year horizon was never in dispute – it was the de facto standard and everyone was comfortable with it,” he added. But there had been a change from an analysis of a company’s risk profile over a year to “how to liquidate an insurance company after one year. I do not know any insurance companies that are managed on that basis.” One of the key objectives of the new regulation was to align supervision with company management “and here, we have a clear deviation from management objectives”. An appropriate alternative methodology was needed.

Providing pensions services in France was a strategic objective for French insurers and there were proposals on the table that would be subject to Solvency II. “If we have to compete on a European basis with other funds that have prudential requirements far different to what they would have to do under Solvency II, there would be a level playing field issue. Our concerns are about competition on a pan-European basis – we do not care about how local pension funds are regulated in other markets.”

Mr van Hulle asked Mr Kalpala:

- Mutual groups – what exactly is the problem?
- Should all supplementary calls to mutual members be automatically treated as Tier 2 capital?
- Mr Skinner did not want a proportionality threshold because it was too complicated while you want to raise it. What regime should companies believe?

The directive focused more on vertically integrated groups such as those with a holding structure, which did occur in the mutual sector but there were also groups with horizontal structures that wanted to benefit from group support, said Mr Kalpala. “The text should be written in such a way that does not take a position on the form of the company but on how support can be provided. At the moment, we cannot be sure it is possible for horizontally-integrated groups.”

Supplementary calls on members were one way for mutuals with a homogenous client base to finance operations but it was not possible for all mutuals because of price competition. “We have to take care of our solvency in other ways,” he added.

It was important to put mutuals on a level playing field to maintain the pluralism of the financial system. Mutuals provided a counterbalance to other business models, allowing the building of a balanced and stable market in Europe. “Having companies with different structures is the best

way to ensure the stable development of the market. If we do not have real competition, it encourages the worst parts of the system to flourish.”

On the question of thresholds, Mr Kalpala said they were a way to ensure the interests of smaller companies were taken into account in a process that was heavily focused on the interests of the biggest market players. “Many smaller companies have been running successfully for decades with no problems and we have to respect that. Companies that have been running well should be able to continue to do so under the new regime.”

Mr Persson was asked:

- With 821 amendments to the directive tabled in the European Parliament and some tough debates going on in the European Council, are there any bright spots for the industry?
- You said the move to mark-to-market was a positive one, but hadn’t the financial crisis shown that it was the wrong thing to do and shouldn’t we go back to the old acquisition costs principle?

There was no unwillingness to find compromises, Mr Persson said. The main obstacle to a harmonised regime was the different business models that pertained in different countries. On top of that, many countries had their own solvency regimes. “There is a threat to the harmonised market if we do not keep to the timetable because national governments might move to revise their national regimes instead of adopting a common regime,” he added.

On fair value, Mr Persson pointed out that banks had about \$500bn set aside for potential losses from the sub-prime crisis, but no more than 10% of this was related to actual losses. The problem was not fair value, but the complexity of products, he said.

Pervenche Bérès said that if Parliament and the Council of Ministers wanted the directive to be passed by the end of the year, there would have to be compromises in both chambers. “Let’s be realistic. We need to discuss and listen to each other. There is a place for negotiation, but it is tough. We need to move forward step by step.”

Solvency II was a directive that had been initiated by the industry, which said that it needed a strong cross-border regime. They were right, Ms Bérès said, but they needed to implement the directive quickly, fairly, consistently and on an equal basis across all member states.

Pensions policy should not be decided at an EU level because it was at the heart of social cohesion models in member states. “When people claim the EU is interfering too much, this is the type of thing they have in mind,” she said. In France, there was a clear social consensus that it did not want pension funds. “Let’s get committed to this directive and get it right, not just for reasons of market equality but also to increase stability and to reduce systemic risk for the whole sector.”

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Michel Dupuydauby, the president of the French Association of Mutuals, said that the aims of Solvency II showed a certain lack of respect for European citizens' ability to protect themselves through mutual societies for hundreds of years.

Mr Persson said that equities could provide profit for companies, making them more competitive and allowing them to reduce premiums. "When we allocate reserves between bonds and equities, equities give better returns. They are good for shareholders and good for consumers," he said. "However, even though we should not have a regime that will unduly reduce the amount of equities in portfolios, appropriate level of protection should be considered." An additional consideration was that the insurance industry made up about 12% of the equity market, "so cutting the industry's equity exposure would have many consequences".

Mr Kalpala agreed, saying: "I am in favour of encouraging risk-taking because without taking risks you do not get growth." Nonetheless, fair value was a real problem because of its countercyclical effects. One solution was to have closer links between supervisors and central banks so risks were recognised as soon as possible.

The Polish supervisor asked whether local supervisors would get any powers over Tier limits, given that if solvency requirements were breached, it was nothing to do with the group.

Mr de Castries said that under Solvency II, there would be much better risk management and supervisors would be much better informed under the supervisory college regime. "The proposal will allow supervisors to know much earlier what the situation is on group support. You have to trust your peers – the whole directive will create a framework that gives you much a better view and allows you to decide how to implement group support," he said.

Summing up, Mr van Hulle said that it was clear the process was not finalised yet and that the final compromises would have to be negotiated very intensively. But, he said, "the mood is positive and there is a consensus that this should get on the statute books as soon as possible". There was a need for support from all stakeholders on support mechanisms. "There is still a lot of work to do. Rome was not built in a day, but I hope that Solvency II is adopted before we start thinking about Solvency III."

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