POLITICAL CONDITIONS FOR THE ADOPTION OF SOLVENCY II

The adoption of the proposed Solvency directive is coming up against several difficulties: the treatment of surplus funds, pension funds and equities, as well as the organization of supervision for cross-border insurance groups. However, pragmatic solutions delivering responses to the legitimate expectations of the insurance industry's various players, Member States and their supervisors are within reach.

The economic approach for risks underpinning Solvency II requires certain clarifications.

The exclusion of pension funds from the scope of the directive is causing problems. Faced with the same need to cover their retirement, Europeans, whether they take out life insurance or sign up for pension funds, would have two different levels of security, which they will not be able to perceive. At the same time, this differentiated prudential treatment would lead to a distortion of competition between these two industries. Hence, similar risks should be subjected to the same prudential treatment.

This principle could be implemented within the framework of the next revision of the IORP directive governing pension funds. As of today, it seems important to ensure that a revision of the IORP directive will be carried out based on economic principles that are consistent with those underpinning Solvency II.

With a general solvency requirement evaluated over a one-year period under Solvency II, equity investments – whose volatility is high over the short term, but rapidly reduces over the long term - are subject to capital requirements which appear excessive when compared with those retained for bonds. Such levels are penalizing and would force insurance companies to modify the traditional allocation of their portfolio, to the detriment of equity investments. At the same time, equity investments offer better protection against inflation than fixed-rate financial assets, for long risks, such as for pension products, and higher yields than other asset classes. That is why the Solvency II standard model should relax capital requirements for covering the volatility of assets, and equity in particular.

The directive provides for the direct recognition as own funds of the profit reserves - surplus funds - available in certain Member States (Germanic and Scandinavian countries). These surplus funds represent the immediate capital gains on assets that belong to policyholders as counterparts for their insurance policies. However, while it is important to recognize the capacity of surplus funds to absorb losses, it is also appropriate to establish a framework for their use in order to avoid any distortion of competition between companies, depending on their home country. For instance, the surplus funds could not be used to provide group support requirements, their use should be systematically disclosed, they could only be allocated to the potential losses that they can effectively cover.

Only integrated supervision of cross-border groups can make it possible to benefit from the economic assessment of risks.

The reform introduces one major innovation with the application of a specific system for the supervision of pan-European groups. In order to factor in the inter-relation of risks within groups, and more specifically enable the reallocation to the subsidiaries of the diversification benefits realized by cross-border groups, Solvency II provides for the solvency of these groups and their various local entities to be assessed based on the consolidated prudential capital evaluated by one dedicated authority: the group supervisor. This group supervision goes hand in hand with a mechanism put in place to organize the insurance group's support for its subsidiaries (group support regime).

However, certain Member States seem to want to continue with the solo supervision approach and reduce the scope of the group support system. This would limit the economic benefits delivered by the reform, which would no longer be able to recognize the benefits of diversification. The CEA case studies[1] make it possible to estimate the additional costs for such policies: reduction in group solidarity for subsidiaries by two thirds; 15% increase in capital requirements for the entire group; twice as low levels of capital freed up by Solvency II.

However, in reality, the hostility of certain Member States in relation to the new prudential supervision architecture reflects several factors:

- The risk assessment models developed by the groups seem to be generating a certain level of mistrust among certain Member States.
- Some Member States are afraid of a distortion of competition between domestic companies and the subsidiaries of cross-border groups, which, benefiting from being able to factor in the impacts of diversification, will need to meet lower prudential requirements.
- Certain countries are afraid that in the event of difficulties, local supervisors might block the asset transfer that would be expected to materialize the group support. The group supervisor also seems to be perceived above all as a national supervisor.
- In addition, the directive does not provide for any mechanisms for supervising the activity of the group supervisor, or any possibilities for appeals by national supervisors if they disagree with a decision by the group supervisor.

1 CEA group support - case 2 - Group regime starting point

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Furthermore, insurance mutuals in Europe are calling for their relations between entities that are not based primarily on parent-subsidiary relationships to be explicitly recognized in the directive, while asking for them to be able to benefit from the mechanisms for group support and diversification benefits. The key issue for them is to ensure that they will be able to meet their current challenges, while maintaining their specific features - moving outside of their usual markets, particularly outside of their home countries -, use the consolidations made necessary in order to move outside of their usual markets and continue improving their operational efficiency under conditions for balanced competition with ìcommercialî groups. While the proposed directive explicitly sets out that mutualist groups may look to implement a group support system and capitalize on their diversification benefits, full buy-in should be obtained among all professionals.

A political fine-tuning of the Commission's proposal on group supervision must pave the way for the rapid emergence of a consensus in Europe.

In order to make it possible to achieve a consensus between the various Member States, the new supervision framework put forward must factor in the needs of insurance companies in their diversity, as well as the needs of the various supervisors for insurance groups. It must also take into consideration the current specific features of certain countries, which may be only gradually reduced.

To this end, in terms of supervision, EUROFI is first of all proposing a political agreement providing for:

- The establishment for each group of a college assembling the European supervisors involved in the supervision of the group. Each college will have a clear mandate aimed at ensuring identical protection for all of the group's European customers,
- A specific role entrusted to the supervisor from the group's home Member State, ensuring that decisions relating to capital requirements and the organization of supervision can be taken quickly and effectively. The group supervisor will also ensure that information is rapidly made available to all the other supervisors,
- The committee of European supervisors (CEIOPS), which is entrusted with handling possible differences of views between the supervisors for a given college and ensuring conditions for fair competition between all financial institutions in Europe.

Such provisions should enable the various Member States to agree to an approach for evaluating the MCR[2] that is simple to implement, sensitive to companies' effective risks, and consistent with the method used for evaluating the SCR[3] (for example, the so-called compact approach proposed by professionals, calculating the MCR based on the consolidated SCR and quarterly changes in technical provisions).

The French Presidency seems to have drawn on these various elements for its recent compromise proposal. However, to make it possible to lift, at least gradually, the various quantitative restrictions over group support requested by certain Member States, they will need to be combined with rules providing for:

- The reallocation of powers to home country supervisors if the insurance group is unable to propose a satisfactory recovery plan for a subsidiary in difficulty;
- The definition by the college of supervisors, as soon as the first signs appear that the group is in difficulty (SCR breach), of a fair sharing of the capital available between its various entities. The directive must be able to ensure the effective transferability of this capital from one country to another.

Furthermore, in light of the crisis, a regulatory framework with a less procyclical nature needs to be put in place. In this respect, making the timeframes set for insurance companies to return to target prudential capital levels (SCR) more flexible represents one area to be looked into.

2 Minimum Capital Requirement
3 Solvency Capital Requirement

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