

Solvency II – Introductory Note

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With the new Solvency II directive currently going through the adoption process, the insurance world is about to experience a major shift in its regulatory landscape. Notable features of this reform include:

- adopting an economic approach for assessing insurance companies' solvency;
- setting an explicit solvency level (probability of an insurance company defaulting set at 1 in 200 over one year) intended to balance sufficient protection of insured parties, reasonable product prices and strengthened competitiveness for European insurers in a global economy;
- taking financial innovations into account;
- promoting best risk management practices within the profession;
- consolidating the role of insurers as institutional investors for the long-term financing of the European economy.

This reform, according to the Lamfalussy process, has undergone technical preparations in which the supervisors of member states have been heavily involved. There is a risk that technical considerations might push the political aims into second place. That is why, from level 1 of the Lamfalussy procedure, the institutional work linked to Solvency 2 must qualify certain key points. These include, in particular:

- the appropriateness of the calibration of the standard model for assessing risks in relation to the level of confidence set by the directive;
- the provisions for dealing with equities, which must protect the role of insurers involved in long-term financing of the economy under good prudential conditions;
- the procedures for supervision of insurance groups, which must recognise the benefits arising from either geographical or economic sector risk diversification;
- taking into account the specificities of mutual insurance companies' own-funds and the specific contractual links on the basis of which mutual insurance groups are often constituted;
- guaranteeing fair competition between the insurance company and pension funds in respect of products which meet the same consumer requirements.

In addition, measures for implementation (level 2) must not be allowed to downgrade or limit level I provisions that aim at maximum harmonisation. It would therefore also seem to be essential for the text of the directive to emphasise certain principles for application that would include:

- explicit outlawing of all national options (there are, at present, 101 options within the Capital Requirement Directive! - CRD) and all national add-ons;
- regulatory recognition of the guarantee provided by cross-border groups for their subsidiaries, as compensation for local reduced capital requirements. This reduction is a concrete reflection of the benefits that arise from diversification of risks, especially in geographical terms;
- implementation of consolidated supervision for pan-European groups, based on identification of solvency requirements (SCR – Solvency Capital Requirement) at group level;

Finally, it is important to ensure or to check that implementation procedures have been devised in line with the political guidelines of the directive by means of:

- the obligation placed on national regulators to justify in advance any request for an "add-on" which would also have to be authorised by the college of supervisors of the

group¹. The application of the CRD has made clear that the requirement for publication of such add-ons is not, in itself, always sufficient to limit additional demands.

- the implementation of a specific Quantitative Impact Study, once the calibration work has been completed, intended to check that the standard models will match, for each operator in the profession, the target level of solvency (1/200), without any deficiency and without any excessive demands for prudential equity capital.

One point deserves particular attention: the mathematical models, which are at the heart of the new prudential regulation for financial operators. Pillar 1 of Solvency II, for example, rests to a very considerable extent on quality and maintenance of the actuarial models, whether based on either standard formula or internal models used by companies in assessing their risk profiles. The point is that the recent crisis in the “subprime” market has given rise to criticism of the use of these techniques for assessing the risks of financial instruments. In addition, the models are sometimes seen as being a way to manipulate the balance sheets of financial institutions. The lack of liquidity in certain markets does indeed make the “mark to market” approach ineffective for assessing assets in the balance-sheets of financial institutions. Though in order to compensate for this situation, international accounting standards (IFRS) are forecasting the implementation of models.

It is not the use of risk-assessment models as such that is at the root of the present difficulties but rather the absence, improper use or incorrect calibration of these models: in particular for the banking sector as a result of the inadequacies of Basle I. And indeed, amongst the sources of the crisis, one might mention in particular:

- Some operators in the financial professions who have, in certain countries, developed their activities in the absence of any appropriate consumer-protection measures;
- The flat-rate approach to setting prudential requirements (Basle 1) which set at zero the risk linked to credit facilities opened to conduits for securitisation;
- These same prudential regulations, which did not include provisions for adjusting prudential requirements to specific risks possibly flawing in this legislation (Pillar II of Basle II allows the supervisor to introduce specific prudential requirements where necessary);
- But also the models applied by rating agencies in assessing securitisation operations without submitting these models to any independent expert opinion...

So it really is the case that the globalised world in which we are living generates new risks that we need to be able to recognise and manage. Therefore it is no longer possible to be content with flat-rate calculations in setting the prudential equity capital levels required of financial institutions. Hence it becomes the task of the supervisors to ensure that:

- internal models are subject to adequate precautions at the time that they are being drawn up (appropriate cover of relevant activities, appropriateness of technical options, quality of the historical data, stress-testing scenarios, etc.);
- there is regular monitoring of these tools in order to ensure that they can rapidly take account of new activities or financial innovations implemented by financial institutions being supervised.

Finally, it must be stressed that the best guarantee for the reliability of the models resides in their not being used solely for the purposes of prudential regulation but also in day-to-day management of the company’s risks and in their being fully integrated into the company’s strategy and governance.

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¹ See the Eurofi note: ‘Speeding up integration of prudential regulation and supervision of cross-border financial groups’.