MIREILLE AUBRY

Head of Prudential Regulation Standards & Foresight, Covéa

Long-term business risk profiles differ from raw market downside fluctuations, their resilience should be plainly recognized

The Solvency II "2020"review should not be a missed opportunity to improve the framework and regulators should focus on the pressing need to render prudential regulation more fair to economic valuations of long term business models and their true risk exposures.

The resilience of long term business models to short term financial movements stems from their stable resources that allow a long term stance to investment choices and strategies. The stable resources are not uniquely sourced from the duration of insurance products based on the cash flows of their insurance guarantees. As important is the ability to pursue business as a going concern (renewals, future premiums, new clients). Own funds also contributor to the stability and length of resources. Their amount can even exceed the amount of the technical liabilities with a duration potentially infinite.

Against the backdrop of the stable resources of long term business models, insurers put in place ALM policies and actions that seek performance over time while commanding to all possible vulnerabilities, the main one being the forced sale of assets with market losses. For that, ALM warrants adequate coverage of cash outflows with cash inflows including buffers to cover possible deviations. This is proved by the Solvency II quantitative data reported by insurers.

One year of inforce business cash outflows on average typically represent 8% of the total value of technical liabilities. This shows the limited exposure to the total sale of investments of a business model receiving premiums before paying any claims. This exposure is then further reduced due to ALM techniques by which a significant share of investments is fixed income with regular redemptions forming highly predictable cash inflows immune to changes in market values. Additionally, a significant share of the liabilities in the balance sheet is made of own funds of the greatest quality. These own funds have durations far beyond those of the insurance contracts liabilities and commensurate with the duration of the undertaking.

Consequently, risk exposure to short term movements is on average nil. With fixed-income average durations across sovereigns and corporate securities of 8 years, and considering a proportion of fixed income of 70% among the total investments, a typical average amount of highly predictable asset inflows immune to market fluctuations makes for almost 9% of the total value of the technical liabilities, and even 12% in the case of general asset portfolios making use of cash in-flows derived from assets backing own funds. These secured and immune to short term market movements cash inflows show their excess above cash outflows.

These features command a review of the Solvency II framework that makes the entire way towards offsetting spurious volatility and appreciating the low risk to short term market movements of long term business models. A stronger focus to going concern is also required. Last, despite the current strong bias towards low for long interest rates, insurers cannot be left totally unprepared in their balance sheet against other pathways such as interest rates revivals. The risk free interest rate curve needs to be sufficiently stable to be reflective of these cases.