

EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

Insurance Supervision in Europe: Is Solvency II Appropriate?

Statement No. 24

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In October 2006, the European Commission is due to propose an amended directive outlining a framework for regulation and supervision of the European insurance industry. The Commission has announced¹ that the new framework, “Solvency II”, will depart drastically from the current Solvency I Directive by creating a common capital adequacy framework for insurance companies in all EU member states. According to the Commission, Solvency II is to be modeled on the Basel II and CRD (Capital Requirements Directive) framework for banks and takes as starting point the three-pillar structure of Basel II/CRD. These pillars are quantitative requirements (Pillar 1), supervisory activities (Pillar 2), and supervisory reporting and public disclosure (Pillar 3). Solvency II seeks to provide supervisors with the appropriate tools and powers to assess the overall solvency of insurance companies.

In this statement the European Shadow Financial Regulatory Committee (ESFRC) recommends that:

- Insurance supervisors should be careful not to implement the three-pillar approach of Basel II/CRD to insurance without significant modification due to the fact that the interaction of the three pillars has proved to be unbalanced in the case of banking, as the ESFRC has pointed out in several previous statements² and as detailed further below;
- When designing capital requirements for insurance companies the Commission should take into account that banks and insurance companies are so different in terms of their contributions to systemic risk that the same principles of capital adequacy cannot apply;
- The types of insurance companies (re-insurance, life and non-life) are sufficiently distinct to warrant significantly different supervisory treatment.

¹ European Commission, Internal Market and Services, Letter by Alexander Schaub (Director-General) to Henrik Bjerre-Nielsen (Chairman of CEIOPS).

² European Shadow Financial Regulatory Committee, Statements No. 16 (Basel and Zurich, May 2003) and No. 19 (Brussels, October 2004).

While the insolvency of a bank could have systemic effects in the form of bank runs and contagion through payment and settlements systems, the insolvency of an insurance company is unlikely to have a significant systemic impact, not least owing to the lesser liquidity of its liabilities. The Commission, however, fails to address this important insight when it explicitly states that Solvency II should avoid “regulatory arbitrage between and within financial sectors.” In other words, it seems to be the intention of the Commission to require insurance companies and banks to hold similar amounts of capital against assets with similar risk. This would prevent the shifting of, for example, credit risk from banks to insurance companies based on different capital requirements, in spite of the economic benefits of such risk shifting. Specifically, the Commission’s failure to take into account differences in systemic effects may hinder improvements in the ability of the financial system as a whole to carry risk without threatening financial stability.

Risk and Market Discipline in the Insurance Industry

Insurance companies basically offer three types of financial products. Life insurance companies specialize in selling long-term insurance policies permitting their holders to benefit from either guaranteed benefits or from the returns on a pre-determined asset allocation. Property and casualty (non-life or P&C) insurance companies focus on covering the loss resulting from specific events, such as theft, accidents, and manmade or natural disasters. Re-insurers, for their part, reduce primary insurers’ exposure by providing indemnification or allowing for risk transfer.

The need and desirable scope for regulatory intervention depend on the nature of risk and the extent to which markets can discipline insurance companies. This requires a differentiated approach. For example, the proper matching of duration and other sources of risk on assets and liabilities is of crucial importance in the life insurance business, whereas it is a less critical factor in the non-life sector.

With respect to market discipline, product demand and cost of funding in the re-insurance business is likely to vary with the information a re-insurer discloses to market participants, since reinsurance firms deal with sophisticated counter-parties which are typically not protected by governments. Thus, if there is excessive risk taking in this area of insurance, it would be the result of a lack of transparency, and supervisory intervention ought to be limited to disclosure mandates.

By contrast, life and non-life insurance firms tend to deal with relatively unsophisticated customers who are less likely to be well informed about risk associated with insurance policies from different issuers. Furthermore, there is often a social dimension to these types of insurance

policies, with the consequence that governments tend to protect the insurance holders against losses. Thus, the incentives of buyers of life and non-life insurance policies to consider the riskiness of the issuing firms are weak. Therefore, customers of these types of insurance companies are unlikely to induce managers to consider risk sufficiently in their investment decisions, and transparency requirements alone may not prevent excessive risk taking.

The reasoning implies that a “one-size-fits all” approach to a capital adequacy regime for insurance companies will prove inadequate.

Blueprint for a Regulatory Framework

In previous statements the ESFRC, as well as other independent observers, have criticized Basel II and the European CRD for 1) complexity; 2) discretion given to national supervisors to implement capital requirements in an arbitrary manner across institutions; 3) scope for gaming and manipulation of internal ratings based risk models; 4) institutionalizing an excessively close relationship between supervisors and the banks (possibly leading to “regulatory capture”); and 5) failure to include credible and strong mechanisms for market discipline.

By contrast to the current Basel II approach, which focuses on capital adequacy requirements in Pillar 1 and supervision in Pillar 2, Solvency II should emphasize enhancing market discipline (Pillar 3) and adopt a more differentiated regulatory strategy to Pillars 1 and 2. In the table below we summarize the (limited) extent to which the three pillar approach could be applied in the insurance industry.

Market discipline should be enhanced by addressing the insurance market’s major imperfection, its opacity. All insurance firms should provide market participants and supervisors with market value balance sheets and relevant risk-measures to the extent possible. This should improve the ability of wholesale market participants such as analysts, insurance agents, and external capital providers to understand sources of risk for different firms. Furthermore, on the life and non-life level, insurers should be required to provide their retail policy holders with easy-to-understand product information (in particular regarding functionality, suitability and pay-out conditions).

Market discipline could also be enhanced by a subordinated debt issuance requirement as has been suggested for banks³ but rejected by the Basel Committee. Subordinated debt is already a current feature of insurance company balance-sheets. Mandatory issuance would reinforce market discipline, because its existence implies that there are some claim holders that most certainly will never be bailed out in case the firm becomes insolvent.

³ European Shadow Financial Regulatory Committee, Statement No. 7 (Brussels, February 2000).

Capital adequacy requirements (Pillar 1), as distinct from technical provisions, should only be imposed upon primary insurers – market discipline being sufficient for re-insurers. For non-life insurers, capital should be set aside largely for the main unexpected liability, extreme events. For life insurers, capital should be set aside to minimize the risk of insolvency from significant asset-liability mismatches, that might also result in disruptive political intervention prompted by the social importance of stable retirement benefits. For both types of insurers, the capital requirements should reflect the lack of systemic risk consequences of an insurance company’s insolvency, and the ability of the firm to adjust in response to losses. For these reasons we believe that the capital requirements should be substantially lower and more straightforward than under Basel II.

The above-mentioned social dimension of life insurance implies that supervision (Pillar 2) of asset liability management models and procedures can be particularly justified for this type of insurance activity as shown in Table I. This supervision would be additional to examination of firm’s compliance with requirements for capital and technical reserves set in the framework of Solvency II.

Table I

Requirements	Re-Insurance	Non-Life Insurance (P & C)	Life	Basel II Pillar
Asset/Liability Management			○	Pillar 2
Capital Adequacy		○	○	Pillar 1
Transparency	○	○	○	Pillar 3