

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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**Solvency II: dragging insurance into the 21<sup>st</sup> Century? A round table discussion of a revolutionary piece of supranational regulation. With Isaac Alfon (Prudential), John Bowman (Aviva), and Elizabeth Larkin (ABI) held on Thursday, September 25, 2008, at the City Marketing Suite, Basinghall Street, London, EC2P 2E, from 12:30-2:15pm.**

### **CSFI/Generali Programme in Insurance**

The current regime governing insurance companies is, frankly, designed by cavemen, the organiser said. Capital requirements bore no real resemblance to a company's risk profile, failing to differentiate between the risks of a household policy against insuring an explosives manufacturer. The European Commission, to its credit, is trying to create a supranational regulation in Solvency II in response to requests from industry.

The first speaker said Solvency II (SII) brought many benefits. It looked to introduce group treatment and to supersede parallel regimes. Of course one such is the UK's Individual Capital Adequacy Standards (ICAS), a scheme for assessing capital requirements, which since 2004 has applied to all UK insurers. However the UK is seen as a length ahead of Europe on regulation and UK companies are perhaps better prepared for SII.

The Commission wants to iron out the bumps in Solvency I and establish a revised set of EU-wide capital requirements and risk management standards. It has adopted the Basel model of three pillars, in this case looking at: valuation standards; a supervisory review process for capital adequacy and risk management; and disclosures. One member asked how SII would treat liquidity, given that, post-AIG, analysts were combing the accounts to uncover banking transactions masquerading as insurance contracts. The speaker said insurers had liquid assets and illiquid liabilities, which meant that liquidity was not an issue compared with banks who had illiquid assets but liquid liabilities. One member said that was fine as long as one did not mix them up as bancassurers did. The member said the problem was that the distribution channel could often change the mix of an insurer's business. The first speaker said that ultimately liquidity was difficult to regulate therefore the priority with SII was to get solvency right.

In terms of the politics, the draft directive was on its way to the European Parliament and Council of Finance Ministers (Ecofin) who would vote on it on 7 October. If that goes smoothly then it will become law by the end of the year and avoid running into MEPs' elections and a new Commission. The second speaker said there was a determination in Brussels and by the French presidency to get it done. It is a key part of the Financial Services Action Plan and essential to the growth of cross-border sales. Charlie McCreevy, the Internal Markets Commissioner, sees it as a chance for the EU to lead the world.

He said group supervision was contentious because some of the 27 supervisors, which were home only to subsidiaries, would become irrelevant. The EU has dealt with this by ensuring they can feed concerns through to the college of supervisors. There are political objections to the directive but they are being picked off one-by-one. For example pensions

funds – a key concern to the UK – will be part of a separate directive. Meanwhile the French have a concern over rules on equity risk that might force them to sell equities, creating a risk of greater foreign ownership of French companies. Another issue is surplus funds where the Germans, Austrians, Danish and Swedes want to be able to use these as part of their capital requirement. The solution is to allow that but only within their national boundary i.e., not to enable to compete unfairly across Europe.

The third speaker said the CEA, The European insurers group, ran a questionnaire of insurers as part of the EU's fourth quantitative impact survey (QIS IV). It found that UK insurers said the calculation for operational risk did not allow for diversification and was not risk sensitive enough. Most though the idea of an equity dampener approach – the idea that equity prices revert to the mean – was a departure from the economic model and most did not test for it. They were worried about the use of future premiums as many policies in the UK ran for only a year and failed that test.

Looking forward the first speaker said there were three groups of challenges. The first was to defend the positives, namely treatment of groups and a framework that allows for capital mobility between parts of the group. Second was clarification on issues such as equity risk and surplus funds. In addition there was a need for treatment of with-profits funds, details of benefits for group diversification, and the valuation of liabilities. The last group was the implementation, which will only begin once the directive becomes law and will require pragmatism.

What one element would the speakers want progress on? The third speaker highlighted a workable definition of a risk-free rate for calculating liabilities and assets. The first speaker said he wanted his three key issues – with-profits, diversification and valuation – clarified. The second speaker gave a rhetorical flourish, saying regulation cannot go back to the 20<sup>th</sup> century model. Politicians bear a heavy responsibility to see this get through as the current turmoil tells us we need SII and a 21<sup>st</sup> century supervisory regime.