Groupe Consultatif Actuariel Européen

Solvency 2 in Europe

Discussion – Society of Actuaries in Ireland

23 June 2010

Alexander Hotel, Dublin

The Groupe Consultatif Actuariel Europeen

- The *Groupe Consultatif Actuariel Européen* was established in 1978
- It represents actuarial associations in the countries of the European Union.
- Its purpose is to provide advice and opinions to the various organisations of the European Union (EU) - the Commission, the Council of Ministers, the European Parliament, CEIOPS and their various committees – on actuarial issues in European legislation.
- The *Groupe* currently has 35 member associations in 32 countries, representing almost 18,000 actuaries.
- The actuarial associations in 26 of the 27 Member States of the European Union (Malta does not yet have an actuarial association) are currently members of the *Groupe*, along with associations in EEA countries, Switzerland, and a number of EU candidate states.

The Groupe Consultatif Actuariel Europeen

- Through its Core Syllabus for actuarial education, Mutual Recognition Agreement, and code of professional conduct, the Groupe has in place a robust governance framework which ensures the objectivity, integrity and independence of actuaries.
- Advice and comments provided by the Groupe on behalf of the European actuarial profession are totally independent of industry interests.
- The Groupe regularly publishes, via its web site (http://www.gcactuaries.org), surveys amongst its member associations on issues of topical relevance in pensions, insurance and investment and financial risk.
- The Groupe is in links with the EU institutions, the CEIOPS / EIOPA, the Industry associations (CEA, CRO Forum, CFO Forum, Amice).
- The Solvency 2 project team is divided into 5 teams with approximately 50 actuaries in all : Pillar 1 (life), Pillar 1 (non life), Pillar 5 (Pillar 2 + Pillar 3!), Groups, Internal models. It responds to most consultations on behalf of its members.

Experience

- Insurance and retail banking
- Actuarial and general management
- UK, Ireland etc.
- Conception of Solvency 2 – 2001/02
- UKAP – ERM PEC; IAA – E&FRC
- Privileged to lead for European actuaries as Solvency 2 stakeholder
- Director (non-executive) of several insurers

Europe in the world

- *Ageing is accelerating: our working age population will be reduced by about 2 million by 2020, and the number of 60+ is increasing twice as fast as before 2007*
- *Productivity levels are lagging behind: two-thirds of our income gap with the US is due to lower productivity*
- *Our public finances are very severely affected: deficits at 7% GDP on average and debt levels at over 80%; 2 years wiped out 20 years of consolidation*
- *Global competition is fierce: EU share of global exports is declining relative to China and India*
- *We must face up long-term realities – globalisation, pressure on resources, ageing, technological trends – and tap our full potential*

Presentation of J.M. Barroso to the Informal European Council, 11 February 2010

Europe at a crossroads

- Weak public finances in several countries have exposed the inadequate underpinnings of monetary union
- Remains to be seen how far convergent economic governance can reach
- Reconfiguration will
  - Cause significant pain to some financial sector balance sheets
  - Affect progress towards development of the single market

Commissioner Barnier

"the essence of the internal market is about those who live in it on a daily basis: the citizens, consumers and businesses."

Key questions

- Will the introduction of Solvency 2 overall increase financial requirements or conversely allow capital to be released? If so, how?
- Will the introduction of economic valuation and risk-based capital requirements for solvency purposes result in an increase or decrease in insurance prices?
- Will the introduction of economic valuation and risk-based capital requirements for solvency purposes encourage particular types of insurance business model (e.g. specialisation vs diversification, joint-stock companies vs mutual associations, branches vs subsidiaries, groups vs isolated entities)?
- What impact will the introduction of Solvency 2 have on third country (re)insurers?
- What is the impact on the access to, and effects on, social protection and health systems?
- Does it contribute to improving the conditions for investment and the proper functioning of markets? If so, how?
- Will the new risk-based regime contribute to financial stability? If so, to what extent?

A contrary view!

- http://www.stopsolvency2.com/index.php
- On the whole, in its current form Solvency II will be counter-productive and harmful, given the incentives it contains:
  - It will be harmful to consumers because, for example,
    - It favours short-term guarantees,
    - It penalises the holding of assets, such as shares and property, by the insurers, even though this serves to protect policy-holders against **inflation**
  - Harmful to the stability of the economic system, since it favours the exteriorisation of margins and profits as quickly as possible, at the risk of creating cycles and false expectations regarding results
  - Damaging to democracy, since its extreme complexity makes the results entirely dependent upon the values used for the parametering of the models and therefore it will be impossible to check if the company's supervision , particularly that of the multinationals, has been correctly carried out. This will have two consequences: there is a risk, for the policyholders, of the company going bankrupt and an unlevel playing field between the insurers and the different countries.

Solvency 2 – overall financial requirements

- Little appetite on the part of global investors to commit capital investment to support insurance business within Europe
- Basel 2 experience and natural caution – especially post-crisis – mean that any significant outflow of capital from the overall industry was never likely
- So for an 'average' or 'typical' firm the overall financial requirement will not be much changed (even if some big issues continue to be controversial)
- However:
  - Larger diversified international multiline firms using internal models may see some reduction in requirements;
  - Smaller monolines – often mutuals concentrating on non-life in (part of) a single country – may see an increase in requirements
- Likely to add to overall consolidation dynamics
- QIS 5 a solid data point?

Solvency 2 – impact on prices

- Pure life protection business may be less expensive
- Some indications that unit-linked may become relatively less expensive than with-profit, so some change in mix of insurance-based savings likely
- Cautious approach to definition of illiquidity premium may increase annuity prices to some extent
- Some indications that certain non-life lines may be more expensive – not clear why
- Increases in bank capital requirements probably improve relative competitiveness of life insurance products
- Substantial implementation burden is a significant frictional cost (~€10bn plus ongoing element).
- Different impacts by country?

Solvency 2 and business models

- Solvency 2 probably favours proprietary undertakings with access to capital as compared with mutuals. Not clear that this will of itself lead to another demutualisation wave.
- Mutuals are significant in some countries in lines such as motor and health – loss of diversity may be regretted.
- Solvency 2 acknowledges diversification imperative – geographic, line of business. Remains to be seen whether will stimulate trading of partial interests in blocks.
- Already seeing trend towards consolidation of EU books in single entities to optimise flexibility under Solvency 2.

Solvency 2 and third countries

- Dimensions of equivalence:
  - Article 66 – Professional secrecy
  - Article 172 – Reinsurance supervision
  - Article 227 – Group solvency calculations
  - Article 260 – Group supervision
- Regimes either deemed (by Commission) to be equivalent for purpose or no determination
- Positive Commission decision binds; otherwise rests with member states
- US NAIC solvency arguably equivalent 'through the cycle' but less so at market peaks or troughs
- Extensive political negotiations in prospect
- Key issue for e.g. Bermuda

Solvency 2 and social insurance

- **Strength of social safety nets (ill-health, unemployment, retirement) varies considerably within EU for historical and cultural reasons**
- **Capacity of states to sustain promised benefits doubtful leading to longer working careers and/or private provision**
- **Application of Solvency 2 concepts to insurance-based savings probably broadly neutral in this context**
- **Specific health insurance difficulties:**
  - Long-term / short-term (SLT, non-SLT)
  - Both heterogeneous
  - For non-SLT, distinguishing medical from remainder is important
  - Even within medical, there are considerable variations depending on the positioning in relation to State provision

Solvency 2 and pensions schemes

- Considerable differences in form of schemes across EU
- Trade-off – harmonisation vs subsidiarity
- Difficult to resist application of valuation concepts to assets and ‘best estimate’ technical provisions
- Effects of discretionary actions may be significant, analogous to with-profit business
- Concepts of minimum and target solvency and of risk margin in provisions are not necessarily the same as for insurance business
- Need to take account of sponsor commitment where relevant, also security arrangements etc.
- Level playing field with insured arrangements is desirable

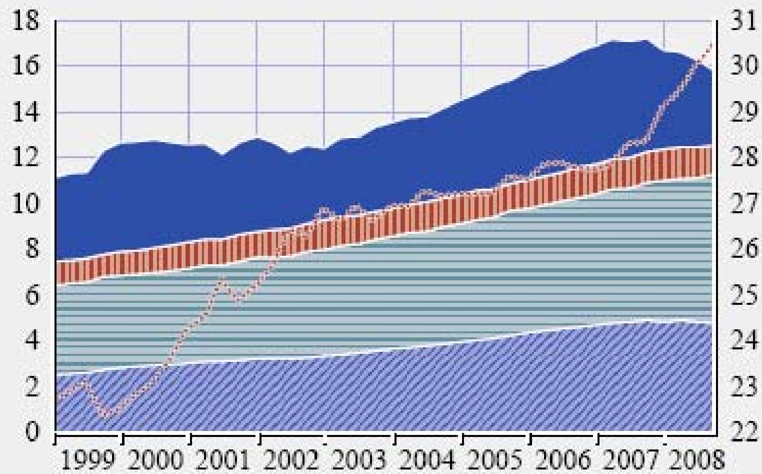
Solvency 2 and investment markets

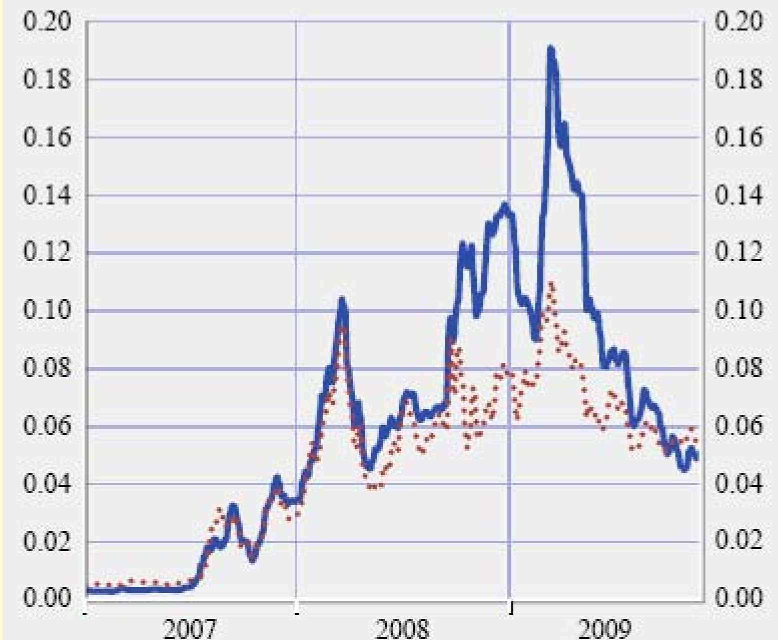
- Traditional life insurer business model of aggregating small savings / investment in order to make capital available for long-term investment
- This has changed:
  - Fewer insurers now invest in illiquid assets such as real estate
  - Insurers account for a reduced proportion of equity ownership in certain markets such as UK (with hedge funds etc. taking up the slack
- Solvency 2 has potential to accelerate these trends
- French advocacy of reduced charge for long-term holdings not a bad idea!

Solvency 2 and financial stability

- Growing chorus of criticism of Basel accords on grounds of procyclicality
- Accounting, including incurred loss provisioning, identified as contributing to this leading to changes to ‘expected loss’ or ‘through the cycle’ approaches
- Long-standing insurer concerns that application of fair value would not be understood and would threaten confidence
- Original concept of Solvency 2 failed to take account of relative illiquidity of most life insurer liabilities
- Doubts surfaced during 2008
- Does insurance raise systemic risk concerns?

ECB reviews insurance





CEIOPS – March 2009

- Our main lesson of the current events is that Solvency II must be adopted.
- The crisis has highlighted needs for a further refinement of the existing Solvency II calibrations, both at module and sub-module levels.
- As in the financial sector at large, governance, risk management, and internal controls in the insurance sector need to be strengthened.
- Effective risk management requires a strong emphasis on own risk assessment, for example where the use of external ratings by Credit Rating Agencies is contemplated.
- We need to rethink the scope of regulation and supervision focusing more on consolidated entities rather than on solo entities only.
- We should take a similarly holistic approach to insurers' exposures to special purpose vehicles
- The aforementioned idea of consistency in the regulatory treatment should be extended as well to the treatment of Credit Default Swaps (CDS),
- The crisis has also raised the issue of procyclicality of regulatory regimes.

Procyclical or not?

- Pillar 1 probably procyclical as originally conceived
- Significant mitigation
  - Symmetric risk adjustment
  - Lower charge for long-term equity holdings (at least for France)
  - Illiquidity premium
  - Longer ‘exceptional falls’ recovery period
- Some recalibration of shocks for QIS 5 is probably an implicit acknowledgement of liability illiquidity
- Potential for use of internal models to reintroduce some procyclicality?
- Pillar 2 should be at least as important as Pillar 1!

Current CEIOPS developments

- EIOPA
  - Council and Parliament at odds on independence and authority;
  - Parliamentary amendments to strengthen (consumer-oriented) stakeholder input;
  - Single (insurance and pension) stakeholder group preferred;
  - Continuing uncertainty (e.g. location)
  - Target still 1 January 2011
- New 'omnibus' insurance directive to appear early in 2011 – will include where EIOPA can develop binding standards
- Satisfactory stress test exercise on large firms
- Controversy – insurers say they are not contributors to systemic risk but want to be at ESRB
- Consumer protection issues:
  - IMD revision on MIFID lines
  - Insurance guarantee scheme harmonisation
  - Packaged Retail Investment Products (PRIPs)
    - Aim to achieve consistency of consumer protection across (UCITS and non-UCITS) investment funds, retail structured products and insurance-based investment products
    - Focus on disclosures and selling practices
    - Divergent views at Level 3 mean that Commission will have to take lead
- Commission keen to progress on pensions

Activities

- Third wave consultation responses
- Discount rates task force
- Comments on selected Level 2 drafts
- Level 2 stakeholder meeting(s)
- Impact assessment steering committee
- QIS 5 technical specification
- Health task force
- ORSA
- Reporting templates
- Groups fungibility and transferability
- Level 3 guidance on internal models
- Actuarial ‘guidelines’
- etc. etc.

QIS 5 – Key issues as seen by Commission

- Relevant risk-free interest rate term structure
- Group solvency: approach to availability of solo own funds in groups
- Treatment of participations in own funds and in the SCR standard formula
- Calibration of market risk in the SCR standard formula
- Proportionality in the calculation of technical provisions and the SCR standard formula
- Definition and treatment of ring-fenced funds in the SCR standard formula and in own funds
- Treatment of health insurance in the SCR standard formula
- Treatment of non-life catastrophe risk in the SCR standard formula
- Design of the non-life premium and reserve risk sub-module in the SCR standard formula (geographical diversification, non-proportional reinsurance, undertaking-specific parameters)
- Calibration of non-life premium and reserve risk in the SCR standard formula

Looking forward

- Exchanges with CEIOPS on actuarial function and technical standards
- Discussion of ORSA
- Remaining Level 2 measures
- Fungibility, transferability and equivalence
- QIS 5 joint seminar with CEIOPS
- EIOPA stakeholder arrangements
- Review of financial reporting templates
- More taskforces?
- Etc. etc.

Some professional issues

- Standards and guidance applying to the actuarial function
  - Scope
  - Due process
  - Interaction with national approaches
- Dovetailing actuarial function with residual ‘responsible actuary’ functions
- Fitness and propriety
- Defining ‘independence’

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Thank You

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