ComFrame: Lessons Learned from Solvency II

Part 2) Lessons from Solvency II

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Building a better working world

Contents

Earlier Insurance Regulation in Europe
1973 to 2000

- Development of prudential regulation – motivated by facilitating "single market for insurance" in European Union
  - Regulation works on the basis of 'subsidiarity' (of each EU member state) to prudential regulation legislated for by European Directives
  - Individual member states must "comply" with Directives:
    - National-level 'member state' statutory legislation –
    - Or national regulation / rulebooks
    - And the practical implementation by national supervisors ('national competent authorities')
- Freedom of establishment
- Freedom of services – "single EU passport"
- 'Level playing field' is sought – whether national entity / branch / passporting
- 'Harmonisation' of solvency margins:
  - Very simplistic
  - Nationally – should require harmonised EU minimum – should NOT require more

Understanding European development
2000 to 2009

- Regulators - motivation / drivers in this period:
  - European regulators wanting risk sensitive prudential regime to protect policyholders more effectively against company failures (tended to say, though, that they did not seek zero-failure regime)
  - Focus on enforcing ERM and Systems of Governance (Pillar 2) – origins in ‘Sharma committee / report’ in 2000 and 2001
  - Application of Basel II into insurers
  - Ambition to harmonise valuation of balance sheet (overcoming considerable variance between European states) – a prerequisite before European solvency margins could be truly harmonised
  - Some regulators enthusiastic for market consistency / economic balance sheet

- Market view and motivation:
  - Simplistic European solvency margin formula was viewed as out-of-line with increasing sophistication and modelling – asset and liability modelling, quantification of uncertainty, cat modelling, etc.
  - Largest insurance groups believed regulation needed to “catch up” with their ERM-based capital management. This also ‘voted for’ market consistency / economic balance sheet.
  - Ambition to modernise prudential supervision for insurance groups – potentially lower capital due to recognising strength from geographical and other diversification in large multi-nationals

Solvency II emerged in this period against a back-drop of national regulators running local modernising agenda, rather than waiting for Europe to modernise in harmonised fashion

Solvency II in its current form
2009 to 2014

- Financial crisis 2008 / 2009 – sub-prime, Lehmann, AIG, etc.
- Solvency II Directive adopted in 2009 – but group supervision clauses curtailed.
- But then political deadlock:
  - Because sectors of life insurance rendered insolvent in post 2009 conditions
  - Matching adjustment / volatility adjustment / risk-free discount rates / liquidity premium
  - Compromise brokered in November 2013 between national governments by EU Commission
  - Certainty of January 2016 full implementation of Solvency II
- The Solvency II version we'll see in 2016 is mostly as was envisaged in 2008 – the exceptions are risk-free discount rates and group supervision which are significantly altered.
- In the case of risk-free rates there are transitional concessions which 'waste' over 10 / 15 year transitional periods.

Solvency II and Global developments
2009 to 2014

- IAIS's Insurance Core Principles (from 2009) very similar to Solvency II (could be argued to have reversed into SII).
  - But pre-financial crisis there was not urgency to political / governmental drive for global prudential supervision or global capital standard.
- Solvency II viewed in some quarters as over-complex:
  - Viewed as having made supervision more difficult.
  - Viewed as having caused great expense and uncertainty without improving the running of companies – without benefitting the customers / policyholders
- Solvency II – its design pre-dated the new focus on systemic global risk
- Comframe emerged from G8 (major player - the United States) taking prioritised action cascaded down through – (i) globally significant banks (some with insurance activities) (ii) G-SII's (iii) IAIGs
- G8 has looked to the IAIS as the appropriate global expert authority and thus has 'given the brief' to the IAIS to push forward global prudential insurance supervision
- Now EU national governments (some of them are G8), the EU Commission and EIOPA give their inputs into Comframe development
- Large groups will have to comply with Comframe and Solvency II

Comparing Solvency II with ComFrame
Constitutional

Solvency II	ComFrame
Principles and architecture were nearly all designed pre-2008/9 crisis	Created in response to crisis (banks then insurers)
Complex European Union legislative and consultative process. 28 member states. National supervisors defensive of their local autonomy	Ad hoc in legal terms – driven by G8 consensus and reliant on willingness of national governments around the globe
Supra-national European regulator EIOPA created in 2011 during the process	No equivalent 'global' supra-regulator – IAIS is a standard setter only
Design tended to be theoretical – idealistic – not driven pre 2009 by any urgency to 'remediate' an urgent situation	Pragmatic (so far?)
Tendency to elaborate not countered by need to be practical / cost-effective	
Goals for 'single market' and harmonisation	
'Blanket' approach – applied to small / medium / large; more/less complex; etc.	Cascade reflecting prioritisation – G-SII's; then IAIGs
Long history of QIS3, QIS4, QIS5, LTGA	Field-testing (shorter time elapsed)

Comparing Solvency II with ComFrame
Groups Supervision

Solvency II	ComFrame
Solvency II ethos starts with ‘solo’ and attempts to build an approach for ‘groups’	The ethos for ComFrame starts from consider the ‘group’ as the regulated organisation
…. but SII in 2009 abandoned fungibility criteria which would have tested that capital can move around a group and would have allowed solo available capital to be less than solo SCR	ComFrame is seeking a practical assessment of fungibility
Regulatory colleges – complex with checks and balances - effectiveness of these is as yet ‘not-proven’	Simpler approach through lead regulator of parent of group (also college concept)
	Focus on crisis management and recovery & resolution process
	…. including capital available in wind-up or otherwise

Comparing Solvency II with ComFrame
Complexity

Solvency II	ComFrame
Diversity of European valuation bases – leads to Solvency II producing its own valuation basis. Introduction of best estimates and Risk Margin	ComFrame defines some element of the valuation basis. Discussions over Margin Over Current Estimates (MOCE)
Optionality of SCR via Standard Formula or Internal Model (or Partial Internal Model)	BCS as proposed is simple but only for G-SIIs with HLA. Then likely to be replaced by ICS when developed
Internal Model – has spawned a large superstructure and high overheads with validation, documentation, 'use test'	Route not taken explicitly by ComFrame although the requirement for ORSA begs the question how to assess your own capital
Standard Formula – in fact a large and complex set of formulae for each risk module. Its design and parameterisation (it can be argued) caused the overall complexity because it tried to achieve consistency with SCR by Internal Model	BCR – similar – but simpler. Doesn't face comparison with internal model