



The Financial Crisis and Insurance: Lessons Learned and how CEIOPS is Implementing them within the Solvency II Project

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"Experience is the name we give to our mistakes"
(Oscar Wilde)

Introduction

The crisis we are still in originated and developed in the banking sector and subsequently spread to the insurance sector. What started in 2007 as a subprime crisis, affecting insurers mainly in the area of monolines, turned in 2008 into a global crisis of unprecedented effects, first for the financial sector, spreading afterwards to the rest of the economy.

Such a situation has affected insurers, but to a lesser extent, when compared with other actors within the financial sector, namely banks. This is, among other reasons, due to the fact that the insurance sector entered the crisis from a position of strength, with record solvency ratios, and a sound portfolio of investments, already shaped by lessons it had drawn from a similar situation it faced in 2002 and 2003.

The insurance sector found itself in a better position to face the crisis, but still 2008 and 2009 have brought about a deterioration in solvency positions and a reduction of profits, as both the assets and liabilities side of the business have been affected, with some risks that may affect the future solvency situation of insurers, for example the low interest rates which we are currently facing. Steps have to be taken to ensure future sustainability of the insurance business, in a competitive environment.

Solvency II is a project that aims at introducing and developing a risk-oriented supervisory framework for the insurance sector, in the sense that undertakings will have to hold capital on the basis of the risks they are facing and the way such risks are managed by the undertaking. In such a framework, the appropriate treatment of risk becomes a core issue for the soundness and effectiveness of the whole system.

CEIOPS has developed its advice on Solvency II over the past five years. Ongoing field testing has shown that the overall architecture of the future system is a sound one. However, in the light of the unprecedented crisis, with its spill-over effects for all financial sectors, CEIOPS launched a "lessons to be learned" project in autumn 2008. Its working groups have looked at the current crisis, analysed different aspects relating to the insurance sector and identified potential areas for improvement to ensure that Solvency II can operate in both normal and stressed times. The main findings and possible conclusions for Levels 2 and 3 are reflected in a report published in March 2009. This text summarises the report and tries to go further, at least from an institutional point of view, by looking at the future changes in the structure of financial supervision at EU level.

Our main lesson of the current events is that Solvency II must be implemented. In crisis situations, supervisors have an even stronger need for harmonised and risk-oriented information on the financial soundness of the insurance entities we supervise. *Harmonised*, because that increases transparency and consumer protection. At the crossroads we are at, such transparency is clearly lacking and comparing insurers' solvency ratios is a tricky exercise. The economic valuation principles underlying Solvency II will largely resolve such inconsistencies. *Risk-oriented*, because that allows us to make

meaningful inferences with respect to insurers' available financial resources relative to what they actually need in order to protect their policyholders.

To better analyse the lessons that need to be taken on board for the Solvency II project, we will follow an approach that mirrors the Pillar structure of Solvency II: Pillar 1 (quantitative requirements), Pillar 2 (qualitative requirements and governance-related issues) and Pillar 3 (transparency and disclosure). The risk profile of a given undertaking should take into account both the internal and external risks that it faces, whether quantifiable or not. In order to do so, an appropriate interaction between Pillar 1, Pillar 2 (to incorporate those that, in principle, are deemed as non-quantifiable, e.g. risks arising from strategic decisions or reputational risk) and Pillar 3 (directly linked to one of the main drivers of any crisis, namely market confidence) needs to be in place.

Lessons from Pillar 1

Perfect solvency regimes do not exist, if only for the simple reason that any form of regulation creates new distortions in itself. In a rapidly evolving sector like the financial sector, there will be a recurrent demand for refinements at levels 2 and 3 of the Lamfalussy structure. The crisis has highlighted the need for a further refinement of the existing Solvency II calibrations, both at modular and sub-modular levels. For instance, in light of the highly correlated nature of current stress events, we may want to strengthen the dependency structures underlying the standard formula. Also, developments in various asset classes have provided fresh insights on the amount of volatility the system will have to absorb and the resulting calibration of the market risk module. Finally, experience has taught us that in real crisis situations, only high quality capital elements can truly be a first line of defence in the sense of absorbing losses without taking the insurer into full bankruptcy.

Regarding personal funds and its quality, the crisis has shown us that capital quality matters...when you really need the capital. Capital requirements's objective is the absorption of losses and we need to look at the banking experience to learn from it and see how markets decided that not all capital (not even all Tier 1 capital) had the same quality and reacted accordingly by asking for capital above the regulatory requirements. Currently, the Basel Committee has stated that

"The key building blocks of the Committee's strategy are the following: [...]"

- *enhancing the quality of Tier 1 capital;*
- *building additional shock absorbers into the capital framework that can be drawn upon during periods of stress and dampen pro-cyclicality..."*

and we should aim for a consistent approach, looking at own funds and their real loss absorbing capacity.

The calculation of the SCR (Solvency Capital Requirement) aims at quantifying risks and allocating a capital charge to them, consistent with a confidence level of 99.5 per cent. The directive has identified some concrete modules and sub-modules to reflect such risks. Different risks should be reviewed in the light of the existing turmoil, as lessons can be drawn to help improve the final outcome of Solvency II. Among these risks to be reviewed, credit risk, market risk, concentration risks, or operational risks are to be included.

- Credit risk: affecting both the asset and liability side of insurers's balance sheet, the main issue to be considered in this area is linked to the need to guarantee that an effective risk transfer has occurred. There is clear room for ART (Alternative Risk Transfer) mechanisms in Solvency II, but the transfer of risk has to be an effective one.
- Market risk: right calibrations, correlations and further refining are needed. The crisis has shown that the treatment of some assets, for example Asset-Backed Securities (ABS), was not prudent enough (a capital charge of 45 per cent was tested in QIS4), so CEIOPS is working to make sure that this is corrected, consistent with the 99.5 per cent confidence level settled in the directive.
- Operational risk: many players have identified this as the main risk during the current crisis, and Solvency II is perhaps not providing sufficient incentives for insurers to improve in this core area. At the same time, the treatment in the standard formula, with a 30 per cent cap, should have to be reconsidered to be consistent with the aforementioned idea and with the setting of the right incentives to move ahead in the area of internal models.

Lessons from Pillar 2

As in the financial sector at large, governance, risk management, and internal controls in the insurance sector need to be strengthened. These elements are key to Solvency II's underlying philosophy of a risk-sensitive system, where the ultimate responsibility for risk identification, monitoring and steering lies with the firm's management, thus requiring of them an understanding of the rationale underlying either the standard formula or internal models. Solvency II is not just about risk measurement and quantification; rather it is about effective governance and risk management.

Again, within this overall architecture, the crisis has highlighted some elements that may need to be reinforced. Also, in the insurance sector, we have observed insurers investing in structured products they did not sufficiently understand. 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. Likewise, liquidity risks will need more attention, to be followed by a higher reporting frequency in stressed situations. For the application of internal models, key success factors relate to model governance (checks and balances, proper documentation) and the involvement of, as well as proper understanding and steering by, board and senior management, much more than fine-tuning the ultimate risk metrics.

Lessons from Pillar 3

One of the main drivers of the current crisis has been directly linked to the combination of lack of disclosure and inappropriate valuation of complex products. The principle of not buying or selling an asset you cannot value or understand was constantly left aside. Reliance on external ratings, inappropriate valuation techniques, wrong remuneration incentives could be named as drivers of this trend.

Valuation is of utmost importance, not just for accounting reasons, but also for risk management purposes or the calculation of the level of personal funds (as it should be embedded to decisions on whether to invest or not in an asset), the Asset Liability Management (ALM) policy of an undertaking (e.g. using Special Purpose Vehicles (SPVs) to match durations) and its overall investment policy. Inadequate valuation has been linked to overpayments and underestimation of underlying risks.

CEIOPS considers that the economic valuation of assets and liabilities should be considered as valid and necessary for a project like Solvency II. It welcomes additional work to be done on valuation by the IASB and would like solutions to be adopted to bring consistency within the financial sector.

During the current crisis, markets' reactions regarding insurers has shown that there is a lack of clarity, understanding and comparability of the financial situation to these undertakings. The consequence has been a reduction in their share price, due, amongst other things, to the perception that something is hidden or unclear. It has additional negative effects regarding large cross-border groups, as they will have to deal with different requests that are neither consistent nor uniform, while at the same time producing internal information.

CEIOPS has committed to the highest political levels to come up with common definitions and formats that would be implemented within the new Solvency II regime requirements. Consistency among sectors is another goal, so joint work and appropriate coordination with the Committee of European Banking Supervisors (CEBS) will be needed.

Internal models

Put into question in the banking sector, we deem internal models to be a cornerstone in a risk-oriented system like Solvency II. The Solvency II approach to internal models is more advanced and comprehensive than the banking approach and should provide a framework that improves management and understanding of risk in a sensible manner, with right incentives to go towards full modelling.

Still, there is significant room for improvement in areas such as quality of data or appropriateness of testing. Supervisors' key areas of concern are the challenging of the results of models, the use of model results in management decisions and the understanding of the models and their outcomes by the people making the decisions within companies.

Holistic approach to supervision and regulation

We need to rethink the scope of regulation and supervision, focusing more on consolidated entities rather than only on solo entities. Solvency II already puts more emphasis on group-wide supervision. Within this context, better functioning of supervision at a group level, and better cooperation among supervisors (including timely exchange of relevant information) is urgently needed. When taxpayers' money is at risk, successful cross-border rescue operations by national authorities need to be built upon a joint assessment of the risk situation as carried out by an existing supervisory body.

We should take a similarly holistic approach to insurers' exposures to special purpose vehicles such as off-balance value-in-force securitisations, in order to provide supervisors with a consolidated perspective on the risk to which policyholders may be exposed. Where insurers apply complex holding structures, possibly involving non-regulated entities, supervisory powers should also include monitoring, data collection and intervention at the holding level. Mirroring the Capital Requirement Directive (CRD) amendment with respect to own retentions of banking risk securitisations, we may also want to contemplate a minimum risk retention requirement for insurance companies that originate insurance risk securitisations.

The aforementioned idea of consistency in the regulatory treatment should also be extended to the treatment of Credit Default Swaps (CDS), as it would have a positive impact in avoiding regulatory arbitration between banking and insurance. The principle of substance over form should apply to CDS as compared to alternative mechanisms such as credit insurance and a similar regulatory treatment, in particular regarding capital charges, should be introduced.

The crisis has also raised the issue of pro-cyclicality of regulatory regimes. The potential for excessive pro-cyclicality of solvency requirements is clearly less pronounced in insurance than in banking. One main driver of cyclicality is credit risk, which is more prominent in the risk profile of a typical bank than in a typical insurance company. Another important driver is market risk. Any "point-in-time" assessment of an insurer's actual solvency position will therefore also entail some element of cyclicality, and it is important that the Pillar 1 (SCR) assessment is complemented by a rigorous stress testing requirement under Pillar 2 (Supervisory Review Process). For an inherently cyclical line of business such as credit insurance, we may want to think about a form of through-the-cycle ("dynamic") reserving, while at the same time respecting the need for transparency of any such equalisation mechanism.

Several high-level work streams outside the Solvency II project have dealt with the lessons to be learned from the crisis, like the Financial Stability Forum (FSF) and G-20 recommendations, various EFC Working Groups, or the expected follow-up to the de Larosière report. CEIOPS together with its sister committees has in the past and continues in the present to contribute to these work streams. To ensure consistency between financial sectors (for example, with the revision of the CRD), additional conclusions—for example on pro-cyclicality or on remuneration as a long-term rather than short-term incentive for senior management—will have to be further analysed from a cross-sectoral view point.

Financial innovation

One of the main aspects of the financial crisis is the treatment of financial innovation and its regulatory treatment. The question we need to ask ourselves is twofold: first, is financial innovation still needed, and secondly, can Solvency II adequately deal with financial innovation, i.e. does it accurately assess the risks involved?

Regarding the first question, CEIOPS has recently issued a paper dealing with Insurance Linked Securitizations (ILS) and recognises room for it as an Alternative Risk Transfer (ART) mechanism, whilst at the same time drawing particular attention to areas such as pricing or data imputing.

On the second one, the most important aspect for CEIOPS to look at is the impact on the insurer's risk profile: does the securitisation come with a clean break or is implicit or explicit support still needed? What is the operational risk involved? What incentives does this kind of innovation give for individual companies and for the market as a whole? Are there other risks? Do we capture these risks appropriately under Pillar 1? Does Pillar 2 consider the management and complexities of some of these products? The response given to all these questions should ultimately be consistent with another lesson derived from the crisis that has already been mentioned in this paper: don't buy or sell an asset you cannot understand or value.

What next? de Larosière report and follow up

As part of the changes that Council and Commission, on the basis of the de Larosière report, are considering for improving financial supervision at the macro- and micro-levels, three Authorities will be created based upon the existing Level 3 Committees, together with a European Systemic Risk Board (ESRB) that will allow for a better link between micro- and macro-prudential supervision.

The main message to be sent is support towards the approach chosen and willingness to contribute to the process.

The new Insurance and Occupational Pensions Authority (EIOPA) will face new challenges and tasks, and will require additional powers and resources to deal with them, as it has up to now dealt with the tasks it had been mandated to undertake. Binding powers will be given, in areas such as mediation and the issuance of technical standards. A single European Rulebook is foreseen and we can only see positive points to the very ambitious idea underlying this.

All this is good news, provided that two outstanding areas are dealt with appropriately, as they are of critical importance to the 3L3 Committees, namely:

- Independence arrangements relating to the financial and operational structure of the European System of Accounts (ESAs); and,
- Governance of the ESAs as regards their composition and operational structure and accountability.

It is the 3L3 Committees' view that independence *vis-à-vis* the EU political institutions must be the cornerstone of any future supervisory framework as it is fundamental to offering objective technical input to the Commission. In line with this evolutionary approach, the 3L3 Committees welcome a governance structure that builds upon their current structures and is lead by an independent Chair and Board.

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