



International Association for the
Study of Insurance Economics

Études et Dossiers

Extract from

Etudes et Dossiers No. 350

**5th Insurance and Finance Seminar of
The Geneva Association**

8-9 December 2008
London

This document is free to download from The Geneva Association website, www.genevaassociation.org

February 2009

**Working Paper Series of
The Geneva Association**

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Layout & Distribution: Valéria Kozakova


Solvency II: Current Developments and Unresolved Issues

Jo Oechslin

Enterprise Risk Management (ERM) – Litmus test passed successfully?




- The insurance industry is not immune towards the effects of the current crisis
- Nonetheless, the insurance industry as a whole has managed to navigate through the crisis, although there are exceptions.
- Is this because ERM is strongly embedded into the genes of the organisations?
- Insurers have been more cautious in terms of taking on structured credit risk.
 - This has certainly also been driven by lessons learnt in the past which triggered large scale improvements in ERM
 - CRO Forum confident that ERM has helped the insurance industry coping with the crisis.
- This crisis, which is characterized by a complete dry-out of credit and a subsequent collapse of liquidity, naturally hits the insurance industry to a lesser extent
 - Insurers primarily funded by policyholders, which is a naturally more resilient source of funding
- Nevertheless, just like the rest of the financial industry we do rely on risk models and hence there is a need to carefully analyse the reasons for risk management failures in financial institutions, and draw the conclusions for our models and ERM approaches.


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“Quo vadis, Risk Management?” – What has been learnt in the light of the crisis

- Risk management is much more than models
 - Risk models are indispensable for managing the business
 - However risk models must be complemented with Internal Controls, such as risk concentration limits on a notional gross and net basis, Probable Maximum Loss (PML) limits, or stress and scenario testing.
 - No substitute for deep understanding of risks – and for common sense.
- Every crisis of this dimension is associated with fundamental changes of business models and hence implies changes of basic parameters.
 - Parameter values estimated from pre-crisis times may no longer be adequate during and maybe even after the crisis.
 - Risk management is just as much about preparing for what has not happened as it is for understanding and preparing for what has been experienced in the past
- In terms of valuation, market consistent valuation approaches that are the basis for risk models have proven to be a suitable approach in times of crisis.
- Given the huge market value losses in certain financial institutions, Risk Management must be viewed as an investment into the company's future rather than simply as a cost factor.


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The impact on regulation – Solvency II on the right track

- Financial market crisis demonstrated that a principles based, economic and risk based regulatory framework is essential for the stability of the financial industry, and hence reinforces the case for Solvency II
 - Absence of appropriate risk-sensitive capital charges for sub-prime related lending and for CDOs has contributed to the current crisis.
 - Traditional regulatory approaches did not identify and mitigate these critical risk concentrations.
 - Differences between regulatory regimes create arbitrage opportunities
- In many respects, Solvency II is a reflection of the advances the insurance industry made in terms of ERM in the aftermath of the 2000/2003 crisis.
- EU legislators should adopt the Solvency II directive as soon as possible, and not postpone the legislative process. Insights resulting from the crisis shall be addressed through the implementing measures (level 2 of the legislative process).
- Necessity for the group supervision and the group support regime has also been reinforced
 - Clear need to supervise holding companies
 - Group supervision stimulates communication on all levels

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Frequent misunderstandings of Solvency II concepts...

Statement	Wrong because...
Solvency II reflects a BBB standard of security because of its 99,5% confidence level...	VaR applies to market consistent balance sheet, which is much more volatile than GAAP balance sheets...
1 year time horizon is insufficient because of long term nature of certain insurance businesses...	Combination of time horizon and confidence level is relevant...
Solvency II based on risk models, which have just proven to be ineffective...	Solvency II has 3 pillars... Risk models is all about calibration...
Group Support Regime (GSR) marginalizes local regulators...	Only few clearly defined competencies shift to the Group Supervisor in the context of the GSR...
Solvency II is a European plot to establish competitive advantages in the global insurance industry...	Solvency II reflects best practice risk management approaches...

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Open Issues and Political situation

- Two major open issues:
 - Treatment of equities
 - Group Support regime
- Co-legislators have taken diverting positions:
 - EU council (based on a proposal of the French Presidency) supports an uneconomic treatment of equity risk charges, and abolished the Group Support Regime
 - EU Commission and Parliament support economic treatment of equities and Group Support Regime
 - EU council needs unanimous vote, given that Commission opposes the majority vote. This is very unlikely
- Trilogue between Council, Commission and Parliament necessary to resolve differences of opinion – may lead to delay of Solvency II because of upcoming Parliament elections

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Potential solutions to open issues...



- Treatment of equities
 - CRO Forum has proposed a Pillar 2 approach to address the equity issue
 - Approach allows insurance companies time to recover from a severe market distortion – recovery time linked to duration of liabilities
 - Picks up on an essential element of the French proposal (the duration of liabilities) and incorporates it in the overall framework in a consistent way
 - Pillar 1 remains undistorted
 - Very broad support amongst membership for this approach
- Group Support regime
 - Opt-in rather than opt-out?
 - Introduce possibility of Group Support in recital to the directive?
- There are solutions to both issues!

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