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What is at stake with the EU Solvency II reform?

Philippe Trainar

INTRODUCTION

Insurance “Solvency I” had just been transposed that the European Commission launched Solvency II. It was in 2002.

One has to remember that the scope of “Solvency I” has been voluntarily limited because of the huge debates raised at the time by more ambitious goals.

To address these goals is the ambition of Solvency II. Not to say how difficult could be the task, not only because there is currently no consensus on the subject.

1. Why and how to reform solvency ?

2. Main orientations for this reform

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1. Why and how to reform Solvency

1.1. Motivations of the reform

1.2. Importance of an open process

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1.1. Motivations of the reform

- **Three pillars of current solvency rules**
 - **Provisions adequate, sufficient and prudent**
 - **Assets of quality, liquid, profitable, diversified & dispersed**
 - **Minimum required solvency margin**

- **Main limits of current solvency rules**
 - **Too simplistic approach of risk**
 - **Insufficiently discriminating according to financial situations**
 - **Not taking into account the complex effects of groups**
 - **Confronted with Basle II in banking industry**

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1.2. Importance of an open process

- **Regulation can no more be imposed from outside**
 - **Markets are becoming more and more complex**
 - **Interests of sound companies and consumers converge**
 - **Cooperation of markets' participants is therefore crucial**

- **There are many "stakeholders"**
 - **European companies through CEA**
 - **Competent authorities (Cf. Commission, CEIOPS & EIOPC)**
 - **Actuaries through IAA (cf. its global framework)**
 - **Supervisors through IAIS (cf. principle of risk sensitivity)**

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2. Main orientations for this reform

- 2.1. balance between security & efficiency**
- 2.2. Solvency margin as shock absorber**
- 2.3. Supervision proportioned to situation**
- 2.4. Standard formula more risk based**
- 2.5. Legitimacy of internal models' use**
- 2.6. Solvency appreciated at group level**

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2.1. Balance between security & efficiency

- **Need for an efficient use of capital**
 - **Capital is a costly resource, paying a rising risk premium**
 - **Insurance is not the sole industry needing capital**
 - **Choice of security level is a macro-economic question**
- **Need to find the right balance**
 - **Industry mean level of security seems to be right in EU**
 - **Priority to external supervision of internal procedures**
 - **Applying a cost / efficiency methodology for defining rules**
 - **Using a comprehensive approach of solvency**

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2.2. Solvency margin as shock absorber

- **Capital is needed for absorbing unanticipated shocks**
 - Cf. Corporate finance theory and Value at Risk calculations
 - Anticipated vs unanticipated shocks => provision vs solvency
- **Solvency margin requirement \neq dead sentence**
 - Should be used in case of exceptional shock
 - Reasonable time should be left for its reconstitution
- **Usefulness of a comprehensive approach of capital**
 - Including securitization
 - Including super subordinated debt

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2.3. Supervision proportioned to situation

- **Global financial situation of company is crucial**
 - Current rules do not take into account global risk of insurer
 - Elements of “graduated response” introduced by Solvency I
 - Solvency margin is the best indicator of global resilience
- **Proportionality of supervision should be systematic**
 - Control should be proportioned according to margin level
 - Above a certain level, strict limitation of supervisory power: interest of company and consumer converge optimally
 - Under a minimum, extensive supervisory power
 - In between, supervisory power should increase progressively

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2.4. Standard formula more risk based

- **Standard formula should be more sophisticated**
 - **Current formula is oversimplistic & non discriminating**
 - **Main risks could be easily integrated**
 - **It is necessary in order to proportionate supervision**
- **Avenues for a risk based formula**
 - **The RBC family formulae and their limits**
 - **The ALM family formulae = RBC + indicator of ALM**
 - **Parameters should be selected on the basis of internal models**
 - **Formula should remain manageable even if sophisticated**

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2.5. Legitimacy of internal models' use

- **Advantage of internal models in insurance**
 - **Incentive for insurers to get a better knowledge of their risks**
 - **A flexible instrument, modular and evolutionary**
- **Current debate on the “risk of model”**
 - **Difficulty to validate empirical estimations of models**
 - **No consensus on standards for insurance internal models**
- **Nevertheless a useful instrument**
 - **Standard formulae are oversimplified internal models**
 - **Legitimacy of models when used by top management**

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2.6. Solvency appreciated at group level

- **Advantage of solvency appreciated at group level**
 - **Allows to take into account group diversification**
 - **Gives a better knowledge of the relative weight of risks**
- **Current debate on group level supervision of solvency**
 - **Contracts are legally constraining at individual level**
 - **Sound parts of groups have no support obligations for others**
- **Ways out of this dilemma are twofold**
 - **Support's guarantee given by the head of the group**
 - **End of the facility in case of insufficient group's margin**

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CONCLUSION

All these questions should be considered in view of the current fragmentation of the insurance "single" market.

This fragmentation, largely due to supervision practices, points to the necessary deeper harmonisation of supervision around Europe.

Not only should the future directive harmonize rules throughout Europe, but it should also promote a coordinated implementation based on clear and constraining procedures.

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