Jean-Claude Trichet: Developing the work and tools of CEIOPS: the views of the ECB

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the CEIOPS Conference "Developing a New EU Regulatory and Supervisory Framework for Insurance and Pension Funds: The Role of CEIOPS", Frankfurt am Main, 16 November 2005.

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1. Introduction

Ladies and gentlemen,

I accepted with great pleasure the invitation to speak today at this conference organised by CEIOPS and to share with you the views of the ECB about the work and tools of CEIOPS within the Lamfalussy framework in which the Committee is an essential element.

Indeed, CEIOPS and the ECB have a common interest in safeguarding financial stability. I would like to express my gratitude to the organisers for providing me with the opportunity to explain why I consider the role of CEIOPS to be very important in achieving this objective.

The ECB considers financial stability as an important precondition for an effective transmission of monetary policy and for a smooth operation of payment systems. Moreover only a stable and healthy financial system fosters economic growth through an efficient allocation of savings to investment opportunities. The strengthening of the regulatory and supervisory frameworks of the insurance and pension fund sectors contributes to this aim.

I would like to start by discussing the importance of insurance and pension funds for financial stability. I will then highlight the potential role of the CEIOPS against the background of creating the Single Market, also bearing in mind the current debate about how to further develop the Lamfalussy framework.

2. Insurance and pension funds and financial stability

Let me start by telling you that I am impressed by the recent strong interest in the activities, and financial conditions, of insurance and pension funds. With a predominantly bank-based financial system in Europe, until some years ago some may have argued that it was not so obvious that the condition of insurance companies and pension funds mattered for financial stability.

I think that two main points have to be understood in this respect. First, it is important to recognise that these financial institutions, owing to their balance sheet structure and their long-term horizon may play a positive role in safeguarding the stability of the overall financial system. Second, they may also be sources of vulnerabilities through their increased interdependences and linkages with the banking sector.

2.1 The positive role of insurance companies and pension funds for financial stability

Insurance companies and pension funds are sub-components of the financial system and their linkages with the banking sector and the securities markets have grown significantly over the past decade. In the euro area, together their assets now represent slightly less than 60% of GDP, with the insurance sector accounting for more than two thirds of it. They are thereby the second most important group of financial institutions after banks which represent close to 270% of GDP.

It is likely that the size of insurance companies and pension funds will continue growing at a rapid pace as ongoing public reforms in pension funds will encourage an ageing population to allocate an increasing proportion of their savings to these institutions. Currently, insurance companies and pension funds manage more than a quarter of all household financial wealth in the euro area. Hence in the assessment of the resilience of the financial system it is important that financial risks in these institutions are accurately assessed, priced and efficiently managed. As central banks have a strong and natural interest in safeguarding financial stability, they also tend to extend their financial stability monitoring of financial institutions beyond the sole banks.

Let me now turn to the positive role of insurance companies and pension funds for financial stability.

These institutions are traditionally considered to be a stable segment of the financial system. Just as banks, they mobilise savings from household and firms - although the savings vehicles are different - and they finance investment in the corporate sector. However, the main difference with the banks lies in their balance sheet structure. The liabilities of life insurers and pension funds have a long maturity and are significantly less liquid than bank deposits. They are therefore less vulnerable to customer runs. The possibilities of savings withdrawals are clearly restricted in most insurance contracts and are also more costly for customers. Regarding possible contagion effects from financial distress arising in one insurance company or one pension fund, they also appear to be limited a priori. These institutions are not directly connected to the interbank market or the payment system. With the exception of course of the bancassurance, these institutional investors are less likely to generate a liquidity crisis in the interbank market.

In the medium term we could also expect insurance companies and pension funds to play a growing role in the financing of the corporate investment. Due to their long-term liability, they may have a larger role in the development of bond markets. They would possibly be a more stable source of funding when compared to the highly cyclical patterns seen in bank lending.

Furthermore over recent years insurance companies and pension funds, as net sellers of credit risk protection instruments, have increased the capacity of the banking system to absorb adverse shocks. This example illustrates how a better risk sharing among financial institutions, in this case through a risk spreading, may lead to a potential reduction of the overall risk and to a strengthened resilience of the financial system. A better risk sharing may also been achieved via risk diversification; this is one of the arguments underlying the rapid expansion of the bancassurance model in Europe, and another potential benefit of tightening relationships between banks and the insurance industry.

Therefore, the increased linkages between banks, insurance companies and pension funds might have positive implications for financial stability. However, this may also increase potential vulnerabilities and I would like to share with you some of my thoughts about the possible channels through which these linkages may endanger financial stability.

2.2 Interplay with the banking sector

The first contagion channel involves the credit risk exposure of banks to insurance companies and pension funds; the second is related to specific risks associated with the bancassurance model. In the third contagion channel, the link with the banks is rather indirect as it concerns the potential destabilising impact of these institutions on financial markets.

1- Direct credit risk exposures

Let me consider now the first contagion channel: the credit risk exposures of banks to insurers and pension funds.

Over the last few years, the increasing exposure of banks to insurance companies through credit risk transfer instruments as well as the incomplete transparency on the nature and the amount of risk effectively transferred had fuelled some concerns for the stability of the banking sector. However, such credit risk transfers appear to be somewhat less a source of concern than was previously thought. In most cases the effective transfer of risk appears to have been limited to the less risky parts of structured products, with the riskiest parts being kept by banks. Moreover since the end of 2003 there have been signs of a retrenchment of insurance companies from the credit risk transfer market possibly related to the new accounting and regulatory environment.

However, if we look at the concentration of credit risk exposures of some banks to the insurance and pension fund sector in the euro area – through direct lending and securities holdings -, which is the adequate measure to assess risks to financial stability, then the credit risk represented by institutional investors appears to be significant. To a certain extent this reflects the development of the bancassurance model, with the acquisition of majority and minority shareholding between banks and insurers being a frequent form of cooperation.

2- Bancassurance

This brings me up to the second potential source of vulnerability. Growing linkages between banks and insurance companies via the bancassurance model could under certain conditions present a threat to financial stability.

In the euro area, the significant presence of insurers in the capital of some large banks constitutes a potential contagion channel to the banking sector. Increasing cross-capital interlinkages could potentially provoke a negative contagion spiral if equity prices were to fall, putting both sectors under pressure, thus reducing the diversification benefits for bancassurance undertakings.

A second concern may be related to accounting and regulatory arbitrage between the two subcomponents of the conglomerate. As insurance companies are under a different regulation than banks, risk transfers from the banking entity to the insurance part may lower the capital charge of the group without reducing the overall risk, thus potentially increasing the fragility of the group.

3- Impact on financial markets

Turning to the third channel through which insurance companies and pension funds can affect the banking sector, I would like to highlight that significant portfolio reallocation or unwinding of major derivative positions by such entities might have a potential destabilising impact on asset prices. This source of vulnerability may arise as institutional investors hold a growing proportion of overall financial assets. In the euro area, their possible impact on equity market appears so far rather limited as their equity holdings only represent 14% of total euro area stock market capitalisation. However, some years ago there has been some evidence that the slump in equity prices led some insurance companies to liquidate part of their equity portfolios in order to reduce regulatory capital need. Such forced sales would have contributed to adverse market dynamics by driving down equity prices even further, thereby also affecting banks' equity portfolios.

By contrast, insurance companies and pension funds in the euro area may have a more significant influence on long-term interest rate as their bonds holding is about 40% of the amounts of long-term euro area government bonds outstanding. Against the background of the introduction of new accounting standards and the envisaged move to Solvency II, the recent risk rebalancing of insurers and pension funds in favour of bonds is likely to have put downward pressures on long-term interest rates in the euro area.

These three sources of vulnerabilities create the potential for problems in the insurance and pension fund sector to significantly disrupt the smooth functioning of the financial system. This of course calls for an adequate regulatory and supervisory framework so as to avoid the vulnerabilities to materialise in the future. We therefore welcome from the financial stability point of view the project of the European Commission to provide a new prudential framework for insurance companies to which the CEIOPS is currently contributing.

3. The role of CEIOPS

3.1 General consideration on the state of achievement of the internal market in the different financial sectors

Let me now turn to the current regulatory and supervisory framework at the European level. More specifically, today I would like to make some reflections: first about the existing differences in the EU regulatory framework among financial sectors; second, on the Lamfalussy framework and the specific work carried by CEIOPS in the insurance sector; thirdly, on cross-sectoral issues.

I will start with the remark that the pace of the harmonisation process had a different speed among the three sectors. Although the general principles enshrining the internal market for financial services, namely the mutual recognition and the home State control as basis for the European passport, have been common to all the three sectors, the level of Community-wide harmonisation has been different.

This was due to both historical and political reasons. For the banking sector the role and contribution of the Basel Committee which provided an internationally accepted common framework is to be acknowledged. As we all know, the European capital adequacy rules for banks – which in the EU are also applied to investment firms – draws largely on the Basel framework. To also note that the recent revision of the Basel Accord had prompted the review of the European prudential framework, and the

new Capital Requirements directive has been adopted in a quite short time considering the technical complexities involved. The Committee of European Banking Supervisors (CEBS) is now working on a number of projects related to the implementation of the new regime.

In the securities sector the pace of regulatory harmonisation accelerated thanks to the political impetus given for the completion of the ambitious agenda laid down by in the Financial Services Action Plan (FSAP). Also the Committee of European Securities Regulators (CESR) has been very effective in helping the Commission to settle difficult technical issues. With the adoption of the remaining Level 2 measures for the MIFID and the Transparency directive, a brand new regulatory framework will be in place.

The FSAP was initially less focused on other financial sectors, such as insurance and pension funds. However, harmonisation is quickly gaining speed.

Just few weeks ago the EU Council adopted a directive on reinsurance supervision. This directive fills the gap in current European insurance legislation which does not provide for regulation of specialised reinsurers whilst activities of reinsurance carried out by direct insurers are subjected to regulation. As the reinsurance industry is considered as a potential source of systemic risks, the new directive is expected to contribute to financial stability. This development is very welcome from the ECB's point of view.

As regards insurance, the Commission with the important contribution of CEIOPS will put in place a new solvency system to be applied to life assurance, non-life insurance and reinsurance undertakings (the so called Insurance Solvency II).

Finally, as regards the occupational pensions sector, the recent directive on the activity and supervision of occupational pension funds represents the first step in the construction of a harmonised EU regulatory framework. I just recall here that upon request of G10 Governors the Joint Forum has recently released a report in which it is highlighted that regulatory and supervisory developments should aim at influencing and supporting the trend towards more rigorous risk management, greater transparency, and better governance at private pension funds[1].

Thus, it is clear that every financial sector has been developing an EU harmonised framework within a different schedule. However, I note that with the establishment of the Lamfalussy committees for all the three sectors, there has been a clear acknowledgment by the Council that the three sectors should be on equal footing as part of an integrated European financial market. Indeed, the links among the different financial sectors are such that nobody could doubt regulatory and supervisory convergence should be pursued with the same vigour and in a consistent way across them.

3.2 The Lamfalussy framework and the role of CEIOPS

Turning to the Lamfalussy framework, I would like to start by highlighting that the Eurosystem has from the outset supported the adoption of this approach.

The Eurosystem's position is that the present institutional arrangements established on the basis of the Lamfalussy framework can provide the appropriate setting to achieve the degree of supervisory cooperation required in the present market environment. In particular, striving towards effective supervisory convergence would play an important role, as the developments of common standards and guidelines will provide a consistent framework for financial supervision and reduce the respective compliance burden for cross-border institutions.

In order to get the best out of the Lamfalussy process, there is a need for a strong commitment from all involved parties, and *in primis* by national supervisory authorities. This model could work effectively only if all authorities endeavour to allocate enough resources and contribute to enhancing the effectiveness of the Level 3 committees.

There is currently an on-going debate on how to better exploit all the potentialities of the Lamfalussy approach, by further developing existing tools. I note that in some directives recently issued for the securities sector new methods of supervisory cooperation have been introduced, such as the possibility to delegate responsibilities (in the Prospectus directive) and the role of Level 3 committee

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[1] Joint Forum, Ageing and pension system reform: implications for financial markets and economic policies, September 2005.

as mediator (in the Market Abuse directive). The potentialities of these new instruments have to be still tested, and it is under discussion whether some of them could be introduced in other financial sectors.

I note that each one of the Level 3 committees is at the moment mainly working - let me put it in this way - at a different level of the Lamfalussy approach. To be more precise, the CEIOPS is currently focusing on finalising the advice to the Commission for the preparation of the Level 1 Solvency directive; CESR so far has been very busy with the preparation of the Level 2 implementing measures in the securities field; CEBS is working hard mainly on finalising Level 3 guidelines for the implementation of the EU capital requirements framework. Therefore, given the different focus and orientation of its main stream of work, each sectoral committee might have different experience and possibly views as regards both limits and strengths of the Lamfalussy approach.

Overall, I think that the experience gained so far by each committee may benefit the others as regards both the added value and the possible limits of the Lamfalussy approach. Thus I consider very important in the current discussion that all stakeholders share openly their concrete experience gained so far and benefit from each other's views as to the potentialities and possible limits of the Lamfalussy framework. I hope that the conference of today about the role of CEIOPS could bring important and thoughtful elements to the on-going debate.

Let me now express my considerations as regards your committee, the CEIOPS.

I think that CEIOPS is presently at the same time in a very challenging and quite privileged situation.

It is in a very challenging situation because it is preparing, as requested by the Commission, the advice on the development of a new solvency system to be applied to life assurance, non-life insurance and reinsurance undertakings. This work will lay down the foundation for the preparation of a completely new prudential framework, to be enshrined in a framework Directive and subsequent implementing measures.

However, CEIOPS is somehow in a privileged position. It can benefit from the experience of the other sectoral committees (already active in level 2 and level 3 measures) and help the Commission to prepare the Level 1 Solvency directive in a way that can optimise the use of different supervisory tools according to practical needs and the best state of art supervisory practices.

Also from a different perspective the work made by other Committees could be helpful for CEIOPS.

I understand that the new solvency system for the insurance sector takes its starting point in a three-pillar structure inspired by the Basel II regime: quantitative requirements (Pillar 1), supervisory review (Pillar 2) and supervisory reporting and public disclosure (Pillar 3). Indeed I think that it is important that the new prudential regimes in the two sectors will be inspired by the same principles to the extent possible.

In this vein, CEIOPS might benefit from the important work under way by banking supervisors to set-up the new standards for capital requirements. A consistent treatment of the same risks among the two sectors will ensure the level playing field and help to avoid any regulatory arbitrage, although structural differences among the two sectors should be carefully assessed and taken into account.

Furthermore, I recall that the Capital Requirements directive will strengthen the role of the authority responsible for supervision on a consolidated basis – the "consolidating supervisor" – which will be entrusted with specific tasks related to the approval of group-wide advanced approaches for risk measurement and will also be responsible for gathering and disseminating information regarding the group and for planning and coordinating supervisory activities. The legal provisions concerning the exchange of information and coordination between the consolidating supervisor and the host (subsidiary) supervisors are also significantly enhanced, inter alia by specifying items of relevant and essential information to be shared and by requiring written coordination and cooperation arrangements. Notwithstanding the importance of ensuring that this provision should be consistently and effectively implemented in practice, I think that they could represent a useful point of reference for the CEIOPS' work under way.

3.3 Cross-sectoral issues

I will now turn to make some considerations on cross-sectoral issues. I have already mentioned the direct and indirect channels through which exposures in insurance sector may have an impact on financial stability.

I note here that the blurring of boundaries between financial sectors in terms of financial institutions' activities, markets and financial instruments – which represents a major development of financial integration – constitutes an additional challenge for the authorities both for supervision and for financial stability monitoring.

From the supervisory point of view, I note that in the last years there has been an increasing attention on a number of challenges affecting more than one financial sector, such as outsourcing, the development of hybrid financial products and credit transfer activity. It is very important to minimise potential inconsistencies in the supervisory treatment across the three sectors to avoid that allocation of risk would be decided simply on the ground of lower cost for compliance, and not for sound business considerations. Therefore, close cooperation among sectoral committees and authorities is important to ensure an effective and consistent supervisory response.

Furthermore, close cooperation is required for the "supplementary supervision" of financial conglomerates. I note here that the three Level 3 committees have recently made a proposal for carrying on the work needed to implement the Financial Conglomerates directive, without the need for establishing an ad-hoc level 3 committee. I just recall here the main principles underlining the Lamfalussy approach, namely full transparency and accountability towards all political institutions and market participants, which should be always in the forefront and fully respected whatever arrangement is going to be put in place.

As regard financial stability monitoring, in the ECB Financial Stability Review, produced twice a year, the monitoring of risks to financial stability includes also a review of the relevant developments in the insurance sector. This assessment benefits extensively from the close co-operation between the ESCB Banking Supervision Committee (BSC) and the CEIOPS, through mutual participations in the committees. The analysis of risks of a cross-sector nature is set to take advantage as well of the recent agreement among the Level 3 committees to intensify their co-operation in a more organised way through a joint structure.

4. Concluding remarks

Ladies and gentlemen, let me summarise my main messages today.

First, insurance companies and pension funds play a positive role for financial stability. Any new regulatory projects should recognise the long-term horizon of these institutions if we want them to remain the historically stable segment of the financial system and to enable them to act as possible shock absorbers. However, insurance companies and pension funds can also be sources of vulnerabilities. They have the potential to impact on asset price dynamics and circumstances could arise where they could also destabilise the banking sector owing to the tightening of links with banks. This explains to a large extent the recent interest of central banks in these institutions and the extension of their financial stability monitoring frameworks to them.

Second, the Eurosystem is fully supportive of the Lamfalussy approach, whose potentialities should be fully exploited. I noted that the current debate about how to further develop existing supervisory tools is partially influenced by the different pace of regulatory harmonisation across sectors and by the different and rich experience of the Level 3 committees so far. CEIOPS, which is working on the formidable task of advising on a new solvency framework, might profit from the experience gained in other sectors.

Finally, a well-established cross-sector exchange of information is essential for a comprehensive monitoring of potential risks to financial stability and possible channels of contagion. I acknowledge that a good network of co-operation already exists between the BSC and CEIOPS and that the interplay between the three Level 3 committees is planned to be more structured.

Thank you very much for your attention.