

Changes in financial regulation and accounting standards in Europe¹

by

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1. INTRODUCTION

This background paper provides a concise description of the major changes, both recent and prospective, in accounting rules and solvency and other supervisory regulation in Europe. Chapter 2 discusses changes at the European level. One of the most noticeable recent changes has been the adoption of IFRS. The paper particularly focuses on the implications for the insurance sector. Subsequently, the possible impact of the future Solvency II directive is discussed. Paragraph 2.3 focuses on legislative changes in the European investment industry. Chapter 3 deals with regulatory changes at the national level. On the accounting side, FRS17 in the UK is singled out as a major development. Paragraph 3.2 describes recent initiatives in a number of European countries, notably the UK, the Netherlands, Sweden and Switzerland to set up risk-based solvency regulations for insurance companies and pension funds.

2. EUROPEAN LEVEL

2.1 Accounting regulation

Background information on IFRS

The International Accounting Standard Board (IASB) has been working on a model for the valuation of assets and liabilities with the aims of harmonising financial accounting rules and enhancing transparency and comparability in company accounts. The European Commission endorsed the International Accounting Standards proposed by the IASB in July 2002.² This means that from 1 January 2005 onwards, all companies listed on stock exchanges in the European Union have had to shift from reporting under national accounting rules to reporting under International Financial Reporting Standards (IFRS)³. EU Member states have the

¹ The views expressed in this paper are those of the authors alone and do not represent those of the European Central Bank, Netherlands Bank or Central Bank of Luxembourg.

² The IAS Regulation ([EC/1606/2002](#)) concerning the application of international accounting standards was adopted on 19 July 2002 by the European Parliament and the Council.

³ See Fitchratings, "Accounting and Financial Reporting Risk: 2005 Global outlook", 2005.

option to extend this requirement to unlisted companies, allowing them to report their consolidated account in accordance with IFRS, if they want to do so.

IFRS and insurance sector

Owing to the complexity of the insurance business⁴, the IASB decided in May 2002 to adopt a two-phase approach. It released IFRS 4 on March 2004 to apply as an interim standard starting in January 2005. IFRS 4 was adopted by the EC on September 2004 and, as such, is compulsory for the consolidated accounts of listed insurance companies during phase I. Although IFRS 4 implements some enhancements to existing accounting standards together with expanding disclosure requirements, the plans set out in IFRS 4 are relatively modest in comparison with the overhaul of insurance accounting which is envisaged under Phase II. According to the IASB, this initial phase is designated for making “limited improvements to accounting practices” and for providing “key insights into the key risk drivers and sensitivities of insurance contracts.” Phase I will last until the IASB has achieved its objective of producing a final standard on the measurement of, and accounting for, insurance contracts, while Phase II will focus on the highly controversial issue of measuring liabilities. Initially forecasted to be implemented in 2007, this second phase is likely to be delayed after 2008 or 2009. IASB in 2003 reached the following tentative conclusions for Phase II: “The approach should be an asset-liability approach that would require an entity to identify and measure directly the contractual rights and obligations arising from insurance contracts, rather than create deferrals of inflows and outflows... Assets and liabilities arising from insurance contracts should be measured at their fair value... an undiscounted measure is inconsistent with fair value.”⁵

Key issue with IFRS 4: expected increase in volatility of earning and equity

The key issue with IFRS 4 is the mismatch between the method used for valuing the assets and that used for valuing insurance liabilities. In Phase I, the change in the treatment of the assets side is the direct result of the implementation of IAS 39, which was endorsed by the EC in November 2005.⁶ Under IAS 39, assets “held until maturity” have to be reported at amortised historical cost, while assets classified as “available for sale” or “held for trading” have to be marked-to-market. Regarding the valuation of liabilities, Phase I requires only

⁴ The fair-value measurement of insurance liabilities is delicate from an accounting perspective for at least two reasons. First, the level and timing of future payments to policyholders are not known and have to be forecasted on the basis of assumptions, some of which are subjective in nature. Second, estimates of the fair-value of financial assets with limited or no traded markets are more subjective and hence have a lower level of reliability.

⁵ See Tentative conclusion for Phase II- BC6, in International Accounting Standard Board (IASB) (2005), “International Financial Reporting Standards (IFRSs), London, p421.

⁶ The European Commission has adopted a Regulation endorsing the amended International Accounting Standard (IAS) N° 39 on Financial Instruments: Recognition and Measurement, the “Fair Value Option”, on November 15, 2005.

relatively limited changes to the accounting methodology. Under IFRS 4 insurance liabilities will continue to be valued according to local accounting guidance, which prescribes methods that are akin to amortised cost valuation. Only derivatives embedded in insurance contracts, such as life products offering a guarantee of minimum equity returns on surrender or maturity, have to be recorded at fair value.⁷

Such accounting asymmetries between the valuation of assets and liabilities will lead to increased volatility in equity and earnings - as unrealised investment gains and losses are recorded in the profit and loss account in a fair-value system - during the transition from Phase I to Phase II. Changes in interest rates will produce fluctuations in the value of assets as the majority of assets will be measured at fair value, while liabilities will be measured at amortised cost. Hence, resulting volatility in financial accounts will be driven by accounting principles rather than by underlying economics. This brings with it the possibility of mispricing of insurance company shares. This would affect life insurance companies to the greatest extent, owing to the long duration liabilities on their books.

Portfolio reallocations and the dampening of excessive volatility

Insurers have several options to respond to the potential mismatch issue, its corresponding increase in earnings volatility together with a higher cost of capital and to avoid the risk of negative assessments by financial market participants.

- Although European insurers have significantly lowered their exposures to equity markets in recent years – responding to the losses incurred from the slump in equity prices from 2000 to early 2003 - they may still reduce their equity investments further in favour of fixed-income securities. According to a survey undertaken by the Accounting Task Force of the Geneva Association⁸ in 2003 about the possible impact of the new accounting rules, the vast majority of respondents considered that there would be a “significant or major effect” on asset reallocation.⁹ Furthermore, insurers expect that the accounting reporting change will have a lasting effect on portfolio shifts over time.¹⁰ The most common response was that there would be a

⁷ Another change is linked to the equalisation and catastrophe reserves that were used for absorbing exceptional losses in certain jurisdictions and which will have to be recorded as capital within the new accounting rules.

⁸ Dickinson G. and P.M. Liedtke, 2004, “Impact of a fair value financial reporting system on insurance companies: a survey”, The Geneva Papers on Risk and Insurance, Vol. 29, N°3, p540-581.

⁹ About 86% of life insurers considered that there would be a “significant or major” effect on asset allocation decision, while 68% of non-life insurers shared this view. This difference can be ascribed to the fact that life insurers hold much longer-term investments. Since non-life insurers have shorter duration of the liabilities and hence hold investment portfolios with shorter durations, there is a lower volatility of asset values under a mark-to-market accounting system.

¹⁰ 57% of life insurers considered that there would be a major reallocation over time, 34% felt that there would be some reallocation. For the non-life insurers, these figures were respectively 19% and 68%.

shift out of equities and into bonds in order to avoid extra volatility of equities in balance sheets and thus in the profit and loss accounts.

- In order to **reduce their investment risk** after the collapse of the equity market, insurance companies have been favouring long-duration assets. Such portfolio reallocations have allowed them to reduce the sensitivity of their balance sheets to changes in interest rates, i.e. to reduce the negative duration gap. At one extreme, if the duration of both the assets and the liabilities of insurance companies is perfectly matched, the value of the liabilities and the assets would move in parallel, leaving balance sheets immunised against interest rate risk. Insurance companies have increased their bond holdings also because corporate and government bonds are less volatile investments than equities and they provide more predictable returns. With the new IFRS accounting rules, further portfolio shifts away from equities seem very likely for both life and non-life insurers. However, the investment in very long-dated bonds may be less probable from non-life insurers.¹¹ This is because one direct consequence of IFRS is a reduction of the time horizon of insurers: while activities of the insurance industry are long-term by nature, the change to a mark-to-market system for assets may lead insurers to reduce their risk exposure by writing less long duration business or by adjusting product design and thus they may favour investment in more short-dated bonds. Such pressures to move towards shorter durations would also be relevant for life insurers, but to a far less extent owing to their asset-liability matching constraints. In short, a move away from shares towards longer-dated bonds would help to stabilise reported earnings and dampen the volatility in equity.
- **Classify more assets as “held-to-maturity”**. Bonds that are held-to-maturity are accounted at amortised cost and therefore their value does not move with market interest rates. Insurers may be inclined to increase the proportion of their bond holdings classified as such in order to dampen the volatility in earnings. This could work quite well, provided a company is not required to sell financial assets classified as held-to-maturity prematurely (which may well be the case if a substantial loss were to occur). However, insurers may be rather reluctant to do so due to the so-called “Tainting rule”. According to this rule, if an insurer decides to sell a held-to-maturity investment other than in insignificant amounts, or in response to an unexpected event, all the company’s other held-to-maturity investment must be reclassified as “available-for-sale” for the current and next two financial reporting years. Furthermore, the insurer would not be allowed to classify any

¹¹ Since there are no explicit interest rate guarantees in non-life insurance contracts, a move towards shorter-dated bonds could be achieved more easily than in the life insurance. Furthermore there was not the same degree of concern with asset-liability matching.

financial assets as held-to-maturity for the following two years. Hence, the ability to hold assets at amortised cost may be severely restricted by such a clause. The amount of bonds that are likely to be reclassified as held to maturity may not be important.

- There are **other strategies** that insurers may follow in order to reduce the volatility of earnings.
 - Discount rate: Under IFRS 4, insurers are permitted but not forced to take into account changes in interest rates to value their liabilities. Indeed, IFRS 4-§ on current market interest rate stipulates that: *“An insurer is permitted, but not required to change its accounting policies so that it re-measures designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit and loss.”* In order to limit the volatility in financial accounts, earning and balance sheets, a flexible discount rate may be chosen. Indeed, if interest rates increase, the marked-to-market value of the assets will tend to decline. If insurers use a higher market interest rate to discount future liabilities, then the decline in the present value of the liability may possible match that of the assets, depending on a judicious choice for the discount rate to counterbalance the effect of the negative duration gap. However, once the insurer has opted to measure financial liabilities at a discounted value, the decision cannot be reversed and *“it shall continue to apply current market interest rates consistently in all periods to all these liabilities until they are extinguished”*. (IASB, 2005, IFRS-§24).
 - Insurers are also likely to pursue more unit-linked business, which essentially moves investment risk and volatility from the insurer’ earnings to the policyholder’s return.
 - Credit derivatives may play a useful role in the risk management process, particularly in areas where the market for corporate credit is less developed.

These shifts in asset holdings towards more long-term bonds in life insurers’ balance sheet and possibly shorter-term bonds in non-life insurers’ asset, which may be expected from the implementation of IFRS will probably lead to a lower risk-return outlook for the shareholders and participating life policyholders in the longer term.

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2.2 Solvency II and potential impact on portfolio reallocation of EU insurers

Aim of Solvency II: The European Commission is currently revising the solvency standards for EU insurance undertakings (“Solvency II” project).¹² The key objectives of Solvency II are to enhance the protection of policyholders, to deepen integration of the EU insurance market and to improve the competitiveness of European insurers. Solvency II will promote a solvency regime that better matches the true risk profile of insurance companies, and which reflects market developments through the adoption of new market-based valuation rules for the assets and liabilities, and risk-based capital requirements., Furthermore Solvency II aims at consistency of prudential supervisory requirements across financial sectors (banks, insurers and investment firms) in Europe and will involve a significant harmonisation of national legislation and convergence of supervisory practices.

Time schedule: The adoption of the proposed Solvency II Directive is forecasted in July 2007 for implementation by 2010. It will replace the Solvency I Directive which was implemented in 2004,¹³ and which was temporary in nature. Solvency I only set out both the required solvency margins and the “guarantee fund” amount sometimes referred to as the absolute minimum capital requirements for EU insurers. Being based on claims and premiums, it was perceived as an insufficient risk-based regulatory capital regime.

General features of Solvency II: The new regulatory system will cover life, non-life and reinsurance companies¹⁴ and will have a three-pillar structure in the same way as Basel II for banks. The focus of Pillar 1 is to create a more risk-sensitive and risk responsive capital requirements system. It will contain two quantitative capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). While Basel II only covers risks arising from the asset side (credit and market risks) together with the operational risk, Solvency II will cover a larger range of risks. In addition to the risks mentioned, it will account for risks on the liability side, which are typical of the insurance activity such as mortality, longevity and catastrophe risks, and for the risks arising from the interaction between the assets and liabilities (ALM risk). Pillar 2 will encompass supervisory

¹² The European Commission issued in a consultative document in February 2004 on the possible shape of Solvency II requirements. http://europa.eu.int/comm/internal_market/insurance/docs/market-2543-03/market-2543-03_en.pdf.

¹³ Directive 2002/12/EC of The European Parliament and of the Council Amending Council Directive 79/267/EEC as regards the Solvency Margin Requirements for Life Assurance Undertakings and Directive 2002/13/EC of the European Parliament and of the Council Amending Council Directive 73/239/EEC as regards the Solvency Margin Requirements for Non-Life Insurance Undertakings.

¹⁴ Pension funds will not have to comply with Solvency II as the “Pension Fund Directive” (Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision) which should have been transposed into national law by September 2005, has not been implemented yet in all EU member states.

activities, the aim of which is to provide a qualitative assessment of risks that have not been measured under Pillar 1. Pillar 3 will be devoted to supervisory reporting and public disclosure in order to reinforce market discipline and risk-based supervision.

Characteristics of Solvency II that may impact asset reallocation

- As some options of Solvency II regarding the new valuation rules and the formula to calculate regulatory capital requirements have not been agreed yet, it is difficult, at this stage, to gauge precisely what could be the most likely impact on the capital needs of insurers together with the impact on portfolio reallocation decisions.
- Solvency II will involve more risk-based capital requirements, capturing mortality risk, interest rate risk, credit risk, market risk, catastrophe risks etc far better than the current regime. Portfolio shifts may be motivated by the need to lower investment risk exposures to gain some immediate relief from capital pressures, especially from those poorly capitalised insurance undertakings with limited access to capital markets. However, the final impact on the amount of capital effectively held on insurers' balance sheets is not straightforward. Many insurers hold more capital than that currently required by regulators. The main reason why they do this is because they often aim at obtaining a certain credit rating, or because national regulations are often stricter than the EU directives. On the one hand, a better awareness of risks and an improvement in risk management may reveal some capital in excess. On the other hand, for certain insurance companies, increases in regulatory capital may prove necessary to face potentially new identified risks from a better risk management and better risk pricing.
- The change in technical reserves valuation on the liability side of insurers' balance sheet is likely to be a key factor driving portfolio reallocation at least for some life insurance companies. Solvency II will introduce new rules regarding the calculation of technical provisions.
 - The main policy options that are currently being used are 1- the “prudent approach” with no benchmark confidence level, 2- with a benchmark confidence level of 75% or 90% and finally 3- Discounting or not of technical reserves.
 - As these new rules must be compatible with the expected outcome of International Financial Reporting Standards (IFRS) for listed insurance, they

will involve the adoption of a more market-based approach for the valuation of the assets and liabilities.¹⁵

- Another important element in the valuation of technical provision is the choice of the discount factor to value future liabilities. A risk free interest rate is likely to be used as a discount rate to value future liabilities.¹⁶ This choice of a market rate to value liabilities will prove to be more important for life insurers given the long-term nature of their liabilities. This is because any change in interest rates will likely induce higher volatility in earnings and equity, as their balance sheets typically display negative duration gaps. Hence, in order to reduce volatility, this may encourage a better matching in the duration of assets and liabilities by promoting portfolio reallocation toward more long-term bond holdings. The extent to which a move towards bonds has or will have occurred as a result of Phase I of IFRS is part of the “Baseline scenario” against which Solvency II impact has to be assessed.
- If the implementation of the new valuation rules reveals insufficient technical reserves, then insurers may decide to bump up provisions using capital. This may especially be the case in the life insurance business, where products containing embedded guarantees have often not been properly valued in the past. Some of the guarantees have not even been priced at all. In such a scenario, insurers may not necessary be able to meet the potentially higher regulatory capital and they may aim at reducing investment risk in their balance sheets.
- Because Solvency II will probably involve the adoption of so-called “Prudent Man + regulation” it is likely to reduce existing binding quantitative limits that are imposed on the different asset categories. Greater flexibility regarding the types and composition of the investment portfolios backing insurance liabilities may be expected. As a result, the new Directive may in principle allow insurance companies to take on more investment risk. Such scenario appears plausible only for large insurers that are able to demonstrate risk reduction in their portfolio through asset diversification using their sophisticated internal models.

Remarks on portfolio reallocations

- One important issue related to Solvency II emphasises potential impacts on market prices - equity prices, long-term government yields and property prices - arising from

¹⁵ It is a challenge to design an accounting basis for Solvency II, when IASB has not yet decided on the final solution for the second phase of its project. The implementation of the Phase II, initially forecasted for 2007 is likely to be postponed after 2008 or 2009.

¹⁶ CEIOPS, 2005, “Answers to the European Commission on the second wave of calls for advice in the framework of the Solvency II project”, October, CEIOPS-Doc-07-05.

possible significant portfolio reallocations. In most European countries, insurers are the largest institutional investors. Hence any radical change in their investment behaviour may have a significant impact on the pricing of bonds, equity and potentially also real estate.

- Some portfolio shifts are likely in response to the new solvency regime. However, it remains to be seen whether or not the reallocations will take place within the industry between the poorly and over-capitalised insurance companies, with potentially no impact on financial markets. Several elements may be considered for gauging the potential magnitude of portfolio shifts that from European insurers. A first set of factors focuses on possible alternative solutions to asset reallocation that individual insurers may choose to face new solvency requirements. A second set of factors highlights how the structure of the European insurance markets and the difference in national current regulatory frameworks... may influence the magnitude of the expected changes in the assets' composition.
- The extent of reallocation in investment portfolios by each individual insurance undertaking may be limited by strategies consisting of increasing or “saving” regulatory capital:
 - The issuance of equities,
 - The issuance of subordinated debt and hybrid capital as Solvency II will enlarge the elements of eligible capital to these innovative funding instruments
 - Securitisation as an alternative source of funding, will also lead to capital relief in the new regulatory regime.
 - An increased incentive to transfer investment risks to the household sector in converting the outstanding amount of traditional life policies with guaranteed return into unit-linked products, for which very limited regulatory capital will be required as financial risk is fully borne by policyholders.
 - The liquidation of some business lines to a specialised run-off provider.
 - The increased use of reinsurance, as risk mitigation benefits will be recognised and due credit will be given in terms of capital relief in the new regulatory regime - especially regarding the use of reinsurance.
- The magnitude of aggregated portfolio reallocations linked to Solvency II will furthermore depend on the following factors:
 - The prevailing market conditions facilitating the issuance of fresh capital.
 - The number of jurisdictions in the EU that are far from a risk-based solvency regime and from fair-value accounting standards. In the UK, Switzerland and

the Netherlands, the expected impact of Solvency II may certainly be lower than in countries such as Germany, France and Italy.

- The relative size and the degree of diversification in EU insurers' balance sheets are key as Solvency II will recognise risk diversification benefits in relation to their economic merits, so that large and diversified undertakings may benefit from significant capital relief in the new solvency regime.
- The number of listed insurance companies in the EU together with the number of EU countries which will choose to allow non-listed companies to adopt the new accounting IFRS rules. In order to dampen the expected increased volatility in earnings and in equity, the companies which will be required to disclose their financial accounts according to the new accounting rules may be more predisposed to reducing the amount of marked-to-market equity holdings in their balance sheets. However so far, the implementation of IFRS has had very limited impact on portfolio reallocation by EU insurers.
- Another element that may be considered is whether the reallocation may affect the split between on- and off- balance activities. Insurance companies that would need to increase regulatory capital may prefer to reduce their off balance sheet exposures to diminish risk rather than cutting equities holdings. For instance, this could lead to a reduction of their net seller position of credit protection instruments. The impact on CDO prices may be significant as those credit risk derivatives issued by banks tend to be rather customised products so that market segment is rather illiquid.
- The proportion of small insurance undertakings. It is likely that these companies will be the most affected by the implementation of Solvency II and that they will have to undertake major portfolio reallocation in order to reduce their investment risk. It remains to be seen whether these portfolio shifts may be significant at an aggregated level.
- The M&A activity may dampen the magnitude of portfolio shifts by small insurance undertakings, as especially in the life sector they may be absorbed by larger groups with excess capital.

2.3 Recent legislative initiatives in the investment funds industry (including hedge funds and private equity funds) in the European Union

The revision of the UCITS Directive (UCITS III)

The activity of investment funds¹⁷ in the European Union is regulated by an ‘old’ directive of 1985¹⁸ which was, however, amended on several occasions over the past few years.

Most prominently for the possible impact on the asset allocation of investment funds, in late 2001 the Directive was amended to allow for investment in financial derivatives for investment and hedging purposes.¹⁹ This possibility extends, with additional caution, to over-the-counter OTC derivatives. The new Directive (UCITS III) made explicit the principle that the potential loss resulting from the use of derivatives in no way can exceed the value of the fund. The new Directive also allows for tracking financial indexes explicitly. Finally the new Directive permitted the investment in bank deposits and money market instruments.

The new Directive had to be adopted in all Member States by 13 August 2003 and the measures had to be applied by no later than 13 February 2004. Therefore, overall, the potential impact on the markets could have been perceived only relatively recently.

The Committee of European Securities Regulators (CESR) is working to clarify which assets may actually enter the portfolio of investment funds. Among other issues, it is currently discussed whether shares of closed-end funds are covered under the amendment to the 1985 Directive. The Commission is expected to provide a draft proposal to clarify the list of eligible assets in September 2006, based upon the advice of the CESR.

The Green paper of 2005

In July 2005 the European Commission issued a consultative Green Paper (On the enhancement of the EU framework for investment funds) to launch a consultation regarding the current state of legislation of investment funds and possible improvements to it. The Green paper reviews several ‘hot issues’, such as the need for more consumer protection. In particular after the amendment which was been mentioned above and which will lead to investment in derivatives, investors probably need additional safeguards regarding the information on performance and fees. The CESR is actively working on this issue.

¹⁷ The Directive refers to undertakings for collective investments in transferable securities (UCITS).

¹⁸ Directive 85/611/EEC.

¹⁹ Directive 2001/108/EC.

Second, the Green paper touches upon the fragmentation of the investment fund industry when compared to the United States,. The Green paper identifies difficulties caused by different corporate law and tax regimes as a major impediment to the consolidation of the industry.

Another issue, which may have potentially an impact on the asset allocation of investment funds, relates to a possible change in the basic philosophy of investment funds regulation. The EU legislation has, so far, safeguarded against excessive risk by putting limits to investments in single assets or classes of assets. The Green paper poses the question of whether in the long-run the regulation should move towards a risk management approach, where investors are protected by cap to the risk undertaken by the fund. This is an issue currently under investigation in the IOSCO.

Finally, the Green paper asked for contributions regarding the regulation of alternative investments such as hedge funds and private equity funds, which are currently not regulated by EU Directives. On the one hand, it wonders whether market access to this form of investment is hampered by the lack of homogeneous legislation. On the other, it raises the issue of the possible risk associated with the activities of such investment activities.

Possible future developments

The Commission on 31 January 2006 established three groups of experts to further investigate some of the issues which were raised in the Green paper. The groups were made up of persons having direct relevant commercial experience in respect of the matters covered by the mandates of the groups.

The first group analysed the way forward to improve market efficiency of the investment fund industry. The second and third groups analyzed the possible regulation of hedge funds and private equity funds.

The three groups produced the report in July 2006. The report on investment fund market efficiency provided operational suggestions on how efficiency improvements can be delivered. Several of these may require amendments to the UCITS Directive. The report calls on the EU to deliver these improvements within three years.

Meanwhile, the report on hedge funds identifies a number of alternative approaches - which do not call for new EU legislation - to make hedge funds available to different categories of investor. It stresses the need to remove barriers to investment in hedge funds by institutional investors and to cross-border provision of essential support services to hedge fund managers.

Finally, the report on private equity funds describes the role of private equity in nurturing new enterprises and re-energising existing companies. Member States control most of the tax and regulatory levers needed to provide a private-equity friendly environment, and the report urges

them to make effective use of these powers. The report highlights a number of cross-cutting EU initiatives that have had unintended consequences for the private equity industry and identifies useful EU-level improvements that could facilitate cross-border investment and capital-raising by private equity funds.

The reports represented an input to the on-going work of the Commission. In November 2006 the Commission published a White Paper detailing the actions it proposes to take to facilitate the efficient development of the European funds sector. According to the White Paper, the proposed changes would be: simplify the notification procedure; create a framework for the cross-border merger of funds; create a framework for asset pooling; enable fund managers to manage funds domiciled in other Member States; improve the quality and relevance of the key disclosure documents to the end investor; and strengthen supervisory cooperation to monitor and reduce risk of cross-border investor abuse. The White Paper also proposes to review options for establishing a European 'private placement regime', allowing financial institutions to offer investment opportunities to qualified investors across the EU.

3. NATIONAL LEVEL

3.1 Accounting regulation

Key accounting developments in the UK: FRS17

The main accounting change for DB schemes in the United Kingdom and in the Republic of Ireland is Financial Reporting Standard 17 (FRS17) "Retirement Benefits". First issued by the Accounting Standards Board (ASB) in November 2000, FRS17 was amended in 2002²⁰ and its introduction deferred until January 2005 in order to coincide with the adoption of new standards by the International Accounting Standards Board (IASB). The standard only became mandatory in January 2005, though earlier adoption was encouraged and before 2005 companies have had to disclose their FSR17 amounts in notes to their financial statements relating to accounting periods ending on or after 22 June 2001. A review of financial reporting for pensions (including FRS17) was announced by the ASB in October 2005.

FRS17 replaces Statement of Standard Accounting Practice 24 (SSAP24), the previous UK accounting standard for pension costs. The change was largely motivated by the significant fall in equity prices between 2000 and 2002: as the value of the pension scheme assets was eroded at the same time as the fall in interest rates increased pension liabilities through the discount rate, many DB pension funds were left underfunded. SSAP24 was widely perceived

²⁰ The amendment essentially extended the transitional arrangements for accounting periods prior to 2005.

as having a number of significant drawbacks the new reporting standard attempts to address. For instance, under the old accounting standard, the cost of the pension contributions was averaged over the remaining working lives of the members of the scheme; the historic accumulation of expenses was then charged against profits in the published accounts, entailing that there would often be no direct connection between pension assets or liabilities reported on the balance sheet and the actual funding position of the scheme. While SSAP24 was a profit and loss driven standard, FRS17 takes a balance sheet approach, requiring companies to value their assets and liabilities at the balance sheet date. Moreover, FRS17 leaves less room regarding the choice of the underlying actuarial assumptions and methodologies; the new standard also imposes more onerous disclosure requirements than SSAP24.

Under the new accounting standard:

1. pension scheme assets are measured at fair (or market) value at the balance sheet date
2. a more market-based discount rate is used for pension scheme liabilities, which are now discounted at the current rate of return on an AA-rated corporate bond of equivalent term and currency to the liability; this is the same yield used in the corresponding US and international accounting standards, i.e. Financial Accounting Standard 87 (FAS87) and International Accounting Standard 19 (IAS19)
3. pension scheme liabilities are valued using the “projected unit method”, an accrued benefits valuation method which takes into account projected earnings up to the retirement date
4. the pension scheme surplus or deficit is recognised in full on the sponsor’s balance sheet
5. movements in the scheme surplus or deficit are analysed into periodic and non-periodic costs; these include:
 - current and past service costs, recognised in operating profits
 - the net of interest costs and expected return on assets, recognised as other finance costs (or income)
 - actuarial gains and losses, recognised immediately in the statement of total recognised gains and losses; thus, actuarial gains and losses are no longer smoothed over time
6. full actuarial valuations should be obtained at intervals not exceeding three years, updated at each balance sheet date.

3.1 Solvency regulation

United Kingdom

The key regulatory change of recent years was the adoption of the Pensions Act in November 2004. This came into force in April 2005, when the new Pensions Regulator (PR) was established and the Pension Protection Fund (PPF) was launched.

The Pensions Act introduced new funding regulations, which took effect from the end of December 2005. The PR has required defined benefit (DB) pension fund trustees and company sponsors to address issues of under-funding and has indicated that most schemes should aim to eliminate deficits within ten years. The desired outcome is that, by the end of 2009, all DB schemes will have completed scheme funding valuations and those with a shortfall will have agreed a recovery plan. The PR also has powers to make the reduction of a pension deficit a condition of any takeover or leveraged buyout. This may provide an incentive for firms involved in such deals to take steps to address deficits.

The PPF is a statutory fund established to protect members of DB pension schemes by paying compensation if their employer becomes insolvent and the pension scheme is underfunded. To assess the level of funding for a pension scheme, the discount rates used by the PPF to value a scheme's liabilities are generally linked to yields derived from long-maturity index-linked government bonds. The PPF will be financed by charging compulsory levies on pension schemes, with 80% of a fund's levy to be related to the risk of it not being able to meet its liabilities. So firms with large deficits will be required to make larger contributions to the PPF than those with smaller deficits, providing a financial incentive for firms to address funding shortfalls.

Netherlands

In 2007 a new regulatory framework, which seeks to ensure that pension funds remain fully funded at almost all times, will come into force in the Netherlands.

In October 2004, De Nederlandsche Bank (DNB), the prudential supervisor of financial institutions in the Netherlands, published a consultation document on a new Financial Assessment framework (hereinafter referred to as nFTK, the acronym for the Dutch equivalent: *nieuw Financieel ToetsingsKader*). The nFTK is intended to offer a tool for assessing the financial position and financial policy of pension funds. Under the nFTK the financial positions of these institutions and, in particular, the relationships between available

assets and liabilities will be more transparent and comparable than the methods currently in use. In addition to a better insight into the financial position of a pension fund nFTK introduces risk-sensitive solvency requirements. Furthermore, the nFTK promotes professional risk management by giving incentives for the use of internal risk models. Finally, the nFTK enables structured early intervention by the supervisor.

For the calculation of solvency requirements, both assets and liabilities have to be reported on a mark-to-market basis. Unconditional liabilities are valued by discounting the associated cash flows using a term structure of interest rates which has to be based on default-free capital market instruments.

In the solvency test two steps will be applied. The first one requires a pension fund to maintain at least a 105 percent funding ratio, even if its assets and liabilities are perfectly matched. If the ratio is below 105 percent it must be put back above this floor within a year. The second step in the solvency test determines a risk-sensitive solvency requirement on the basis of the risk profile of the pension fund. It is basically a stress test, which requires pension funds to hold a sufficient financial surplus to withstand an adverse market scenario with a 2,5% probability over 1-year time horizon. In other words, based on the risk parameters of the assets and liabilities, the required funding level is only expected to fall below 100 percent once every 40 years. Thus, the size of the required funding level depends on the surplus at risk. If the actual funding level falls below the required level, the pension fund would be granted a period of 15 years to address this gap (e.g. through increased contributions or reduced investment risk). It is estimated that a pension funds invested 50/50 in bonds and equities, and with a typical bond duration profile of 5 years, could be expected to have a minimum risk-based required funding level of 130 percent. For the calculation of the required solvency, pension funds can use their own internal risk model. DNB employs general requirements regarding the quality of internal models. As an alternative, institutions can use a standardised method for calculating their required solvency, provided by DNB. As a second step, a pension fund has to carry out a continuity analysis. The continuity analysis assesses the financial position against the background of realistic long-term scenarios and the associated risks, the fund's strategic policy and the management and adjustment mechanisms such as revising the investment, indexation and contribution policies. Each institution is free to structure the analysis as it wishes provided it is realistic. The analysis allow the board of an institution itself and also DNB to identify at an early stage whether the institution will be in a position to continue meeting its solvency requirements in the future. If necessary, the board of the institution can then take early action or, if it fails to react to such signals, DNB can intervene.

Pension fund boards would also be required to state whether they have a conditional or unconditional inflation indexation policy for pensions. If the indexation policy unconditional – which is rarely the case in the Netherlands –, the 105 percent regulatory floor for the funding level will be based on inflation-linked liabilities. However, if the indexation policy is conditional, liabilities need only be measure in nominal terms. Most pension funds have indicated they will opt for the conditional form. In that case, pension funds have to be consistent in their indexation promises, the financing thereof, and the allowed indexation. The above mentioned continuity analysis can also be used as a tool to determine the expected realisation of conditional liabilities and will thus provide more insight for the pension fund members.

Sweden

In 2006 *Finansinspektionen* (FI), the Swedish prudential supervisor, introduced the traffic-light model. The aim of the traffic-light model is to identify life-insurance companies and occupational pension funds that could encounter problems if equity or real estate prices, or interest rates, change sharply. The new supervisory tool will identify with great accuracy companies with exposure to financial risk that is excessive in relation to their capital buffer. All life-insurance companies and occupational pension funds must use the traffic-light model in their reporting.

The model measures how both assets and liabilities are affected by asset price changes, which means that it is the companies' net risks that are being studied. Furthermore, the model assumes zero correlation between the various asset classes, which means that it takes into consideration diversification effects between asset types. The traffic light model is only one of several supervisory tools used by FI. Since not all financial risks are measured by the model, it is supplemented by other forms of supervision.

The traffic-light model is supervisory tool and measures the companies resistance to sharp asset price changes over the short term. The traffic-light is not an ALM model or a portfolio optimization model. Neither is the model designed to be used as an internal risk management tool. The companies are themselves responsible for developing models for these purposes that take their own operations into consideration.

In the traffic-light system, all assets and liabilities are to be valued at fair value. It subsequently specifies scenarios for asset-price changes, involving interest rates, equity prices, property prices, currencies and the price of interest-rate instruments with credit risk, that fall within a 99,5% confidence interval. Based in these specified asset-price changes, the companies calculate how their capital buffer is affected. If it is completely eroded by the scenario, this is signalled with a red light in the model.

The number of institutions that reported a red light in the first quarter of 2006 represented less than one percent of the industry's assets. FI is now developing a model that as of 2007 will also measure insurance risks and will be used in the supervision of non-life insurance companies.

Switzerland

As of 1 January 2006 the Swiss Solvency Test (SST) has come into force as part of the new insurance supervision act. The goal of the SST is to ensure that the claims by policyholders on Swiss insurance companies are protected and to enhance the company's risk-management within a more transparent system. The SST is a risk-based solvency standard, which is based on the actual risks run by insurance companies.

The key elements of the SST are the marking-to-market valuation of assets and liabilities including embedded options and guarantees. Of particular interest is the calculation of the minimal capital needed in order that the probability of default is below a certain level within one year. The calculation of this so-called target capital is based on a hybrid analytical-scenario approach where stochastic models are supplemented with scenarios. In this approach, the SST takes into account market, credit and insurance risks. Insurance companies can use their own internal models for the calculation of the target capital, provided they satisfy regulatory requirements.