Matthew Elderfield: Solvency II – the impact in Europe and Bermuda

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, at the Insurance Day Summit, Hamilton, 12 June 2012.

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Thank you to Insurance Day for the kind invitation to join you at this event. It's a great pleasure to be back in Bermuda to have this opportunity to speak and also to spend a bit of time meeting the Bermuda firms and my former colleagues at the Bermuda Monetary Authority. In addition to my obvious personal interest in Bermuda, there are clearly close ties between Bermuda and the Irish insurance market. A number of Bermuda insurance companies have a significant presence in Ireland which they use as their base for pan European activity. And more broadly, wearing my hat as a member of the European Insurance Regulators or EIOPA Management Board, there are very close ties between Bermuda and the EU. Bermuda is an important source of risk capital and insurance services into the European Union, and as such it is an important source of diversification of risk and provides benefits to wholesale and ultimately retail consumers across the European Union. For example, 37% of EMEA property cat risk was placed with Bermuda companies according to the most recent Aon Benfield data. France, Germany, Spain and Benelux each place between 18–25% of their total premiums with Bermuda companies.

It is therefore encouraging to see that in spite of difficult operating conditions last year the Bermuda Insurance market is continuing to play an important role internationally and that the Bermuda Monetary Authority is continuing to make good progress in its drive to enhance its regulatory regime.

What I propose to do today is to start with a brief update on Solvency II implementation. Secondly, I want to choose 3 particular aspects of Solvency II to consider in a bit of detail. And, finally, I would like to take an opportunity to say a word about the equivalence process and what it means for Bermuda.

By this time almost everyone in the Insurance Industry from chairmen to secretaries, underwriters to loss adjusters and indeed not just in Europe but in Bermuda, the US and elsewhere, will have heard about Solvency II. It is the new regulatory framework for setting risk based solvency requirements for insurance and reinsurance companies operating within the European Union. It is organised around three pillars: a first pillar setting quantitative solvency requirements covering all aspects of insurance business, including asset risks and prescribing eligible forms of capital. The second pillar is aimed at qualitative requirements concerning risk management and governance standards. And a third pillar is designed to encourage market discipline by requiring a high level of transparency and disclosure from regulated firms. This framework is a clear improvement on the current European Solvency I rule book. Unlike Solvency I, it is risk based, covers the asset side of the balance sheet and provides an incentive for investment in risk management, including the use of internal models. Importantly, it is founded on a balance sheet based on market consistent economic value.

Solvency II is not a single piece of legislation but rather an interconnected group of laws and European rules. The Solvency II directive itself has been adopted but a supplemental piece of legislation known as Omnibus II is concluding the process of approval in Europe and makes important amendments to the core Solvency II law. In addition the directive framework will be supplemented by a significant raft of so called level 2 regulations and EIOPA, the European Insurance Authority, will promulgate a wide range of binding technical standards, guidance and other materials to flesh out the detail of this regulatory framework, often known as level 3 measures.

This all adds up to what will certainly be a highly complex corpus of rules. While Solvency II has many benefits and is a distinct improvement on the current European Framework, that complexity is certainly a source of concern. Regulators, large firms and certainly small firms will each struggle to some degree to assimilate and implement this significant scale of change. This complexity is indeed impacting the implementation timetable of the directive. The process of finalising Omnibus II has unfortunately been delayed in the Brussels process, which has the knock on effect of squeezing the time available for consulting on, issuing and then implementing the range of secondary rules. The current target is that member state governments will domestically implement the European framework by 30th June 2013 and then the directive will come into force for insurance firms themselves at the start of 2014. While this timeline is certainly challenging even if it does slip a little, it is certain that Solvency II is getting very close and will have significant implications for the insurance industry not just in Europe but globally.

There are a lot of dimensions of Solvency II which could be discussed and which will impact on the industry, but I would like to take an opportunity to focus on just three in the brief time available.

First, a word on the impact of Solvency II on the life industry, as this is the biggest open issue that remains in the final negotiations on the directive and its related rules. At question here is the impact of the market consistent economic valuation principle on the life industry business model, particularly with respect to the provision of long term guarantees. Industry has expressed concern that by prescribing a fixed common discount rate while at the same time requiring mark-to-market changes in asset values, then long term guarantee products in particular could be exposed to spikes in solvency requirements in times of short term market volatility. Similar but related concerns exist regarding the impact of mark-to-market requirements on assets more generally and in light of recent experiences on sovereign debt in particular. Again: short-term the concern is that volatility that drives mark-to-market changes in the fixed income portfolios of insurance companies could lead to volatility in solvency buffers. This has caused concern among some observers on a number of fronts. First there is the worry that this framework will discourage the provision of long term guarantee products, which provide a useful source of savings and investment for retail consumers. Second there is a worry that the framework may be inherently pro-cyclical by exacerbating pressure to dispose of assets in times of increased market volatility.

These are real and reasonable concerns and are being tackled in the final negotiations on the directive. Discussions are underway to adapt the framework by allowing adjustments to applicable discount rates for certain matched assets and liabilities. Also, a so called counter cyclical premium is being developed – again to allow an adjustment to discount rates to offset excess short-term volatility in certain aspects of the fixed income portfolio. There are a number of different technical approaches to achieve this end and as ever the devil is in the detail, but the desired outcome is a framework that seeks to square the circle of providing a more risk sensitive solvency framework, while at the same time permitting the continued provision of guaranteed products and avoiding dangerous pro-cyclical effects. While this is a highly technical debate about the detail of discounting and valuation requirements on particular portfolios of assets backing certain insurance products, I think it is important to highlight it as one of the key outstanding issues because of the significant impact it will have on the development of long-term savings products and its relevance to the current turbulence in the euro sovereign debt markets.

The second subject I would like to mention briefly is that of internal models. Solvency II permits insurance companies to propose the use of their own internal model as an alternate to the directive’s standardised formula for calculating solvency requirements. The framework is calibrated to provide an incentive for firms to invest and develop more sophisticated risk management. This is to be welcomed and encouraged. But there are risks to manage as well. Solvency II’s use of internal models is broadly similar to that of the Basel Framework but in fact provides even greater scope to firms in their modelling, as Basel set certain minimum correlation assumptions for models but Solvency II does not. There is clearly a strong incentive for insurance companies to optimise their use of capital under the directive and to do so through the adoption of models. This is perhaps stronger in the general insurance market than in the life market due to the anticipated relative strengthening of solvency standards. Internal models are, however, subject to supervisory approval, and of course approval by the insurance company's own board. To my mind it is important that the approval process doesn't get bogged down in detail such as endless documentation reviews but stays focussed on the key drivers of the overall solvency calculation arising from the use of a model.

Regulators and industry spend a lot of time arguing about the detailed calibration of very specific risk factors under the Solvency II Framework. But it is when the solvency requirements for different lines of business and different aspects of risk are combined that the overall solvency requirement can swing significantly as a result of the judgements that are made regarding correlation and diversification. If this is where the big swings in numbers can occur, it should be at the forefront of the regulatory approval process and above all in the challenge from insurance companies' boards.

Diversification is of course an inherent part of the insurance business model but as you are aware, the risk is that diversification in times of stress is more apparent than it is real. The assessment of correlation and the level of diversification that is recognised is not a matter for a black box or a theoretical formula. It is inherently a matter of expert judgement for an insurance company's senior management and boards, not just its quants and risk team. It is right and proper that boards should be expected to challenge vigorously the amount of diversification benefit being claimed in internal models even if they don't know the internal plumbing of copulas or correlation matrices. Regulators should expect them to take a prudent and conservative approach and to ask challenging questions about how the models will hold up in times of stress.

The third dimension of Solvency II I would like to mention briefly is the impact of the directive on business models or, more narrowly, corporate structures. As I have mentioned, capital optimisation will inevitably be a key theme for the management of companies impacted by the directive. In addition to the use of models, revisions to corporate structures are to my mind likely to be a further avenue of exploration. In particular, in Ireland we see considerable interest in the so called Hub and Spokes Model. This involves choosing a single European jurisdiction as the location for the Hub operating company and conducting pan European insurance business on a branch basis throughout various EU countries. As necessary, existing subsidiaries outside of the hub country are therefore transferred into branches. This has the dual advantage of consolidating operations, thereby reducing costs through economies of scale, and also crucially of optimising capital, as capital is no longer fragmented in each individual subsidiary.

There are some prominent examples of the Hub and Spokes structure in Europe involving Ireland as the choice of Hub. We will have to see whether this trend continues or not, although as I say there appears to be a compelling logic behind it. A challenge for the supervisor is the effective supervision of such structures. For our part, our starting proposition that the Hub must have substance and be able to deploy effective controls over the operations of its branches. Then, as a supplement, as a supervisor we too will assess branch operations directly or through the use of skilled persons such as auditors and consultants. Finally there is a significant challenge of coordination between both home and host supervisors to ensure that all interested stakeholders are kept well informed. At the Central Bank of Ireland we are very committed to ensuring that the appropriate regulatory framework is in place for Hub and Spoke operations and that our supervisory resources are adequate to the task of overseeing such operations. It will be interesting to see whether this model will grow as Solvency II gets closer to implementation.

I have by now given you a sense of where Solvency II stands in the implementation process and a few of the key issues that are currently being debated or considered. Let me conclude with a few words about the equivalence process and where Bermuda stands. Solvency II requires that insurers from third country jurisdictions must be subject to a regulatory framework that is broadly equivalent to that within Europe itself. Absence of such an equivalence finding provides the prospect of a more punitive solvency treatment for firms from such jurisdictions.

Bermuda, along with Switzerland and Japan, is in the first wave of countries being assessed for equivalence and is making extremely good progress. The first assessment of Bermuda by EIOPA was largely very positive, albeit with some further work to do in some areas. The protracted process of Solvency II implementation in Europe has in fact given more time for Bermuda and other countries to adapt their framework in order to be ready.

Following a further assessment by EIOPA the ultimate decision will rest with the European Commission, in consultation with other EU institutions. My view is that Bermuda is very well placed for this assessment process and is to be commended for the work that Jeremy Cox and his team have undertaken to drive forward enhancements to the Bermuda regulatory framework. These are by no means insignificant and have included the development of a risk based solvency framework and introduction of group solvency requirements. This is a significant accomplishment, although clearly more remains to be done.

It may seem odd that recently Europe has proposed a transitional equivalence regime which will allow the benefits of the directive to be enjoyed on an interim basis, allowing other jurisdictions to take a longer route to reforming their regulatory frameworks to broadly match that in Europe. I wouldn't be distracted by those developments. By being in the first wave of the equivalence assessment process and by hopefully winning a favourable outcome, Bermuda will be in the enviable position of having definitively cleared the EU process before many other competitor jurisdictions are able to do likewise. That provides absolute certainty to the Bermuda Market as to the treatment it will receive under the EU rule book and unlike other countries means that the risk of adverse regulatory developments will not be hanging in the background. Moreover, full equivalence recognition will cement Bermuda's reputation as a financial centre that is committed to high standards of regulation.

There will, however, be continuing challenges in implementing the new framework on the ground. A regulatory framework is only effective as the supervision system that implements it. In Bermuda, the three issues that I have flagged earlier will have local ramifications that need to be worked through. The Bermuda solvency framework for life companies' remains to be finalised and the implications of a market consistent economic valuation approach on balance sheets still needs to be fully developed. The internal model approval process will, as in Ireland and Europe, be a big challenge for Bermuda and will require some tough supervisory calls. And the new complex group structures of the post Solvency II world will require adequately resourced and high quality supervisors. Let me reinforce that last point in the Bermudian context, given the likely significant number of groups for which the BMA will be responsible. Group supervision is a major task and requires high quality dedicated supervisors who understand the business models of the firms they supervise, are able to periodically test governance and control frameworks, have a good understanding of complex intercompany transactions, can oversee the assessment of group solvency requirements, closely monitor the performance of internal models and ensure effective coordination and information flow between all relevant supervisors with an interest in the group. It is important that the Bermuda Market continues to provide support to the BMA as it builds up its capacity to undertake effective group supervision in practice, as the various tasks come on line and need to be executed. The Central Bank of Ireland is committed to working closely with the BMA to ensure effective cooperation in the supervision of those Bermuda groups with a presence in Ireland and across Europe. There is also a good working relationship between EIOPA and the BMA on questions of Solvency II cooperation and implementation.

Solvency II – while its implementation is not yet directly upon us – will have profound implications for the shape of the insurance market in Europe and beyond. The new regulatory standards will have implications both subtle and profound for insurance pricing, investment strategy and risk taking. It will encourage investments in risk management capability and ever more sophisticated modelling. It may provide incentives for fundamental reshaping of corporate structures. These are big challenges for regulated firms and for supervisors too. It is essential then that Ireland and Bermuda, and indeed Europe and Bermuda, work closely together through this process. It is encouraging to see the progress that has been made so far and I am confident that it will continue in the future.