Cyril Roux: Reflections on the good, the bad and the ugly of Solvency II

Address by Mr Cyril Roux, Deputy Governor (Financial Regulation) of the Central Bank of Ireland, at the Central Bank of Ireland Solvency II Forum, Dublin, 20 April 2015.

Mr Bernardino, ladies and gentlemen, it is my pleasure to welcome you this morning to the Central Bank of Ireland Conference on Solvency II. It is the brainchild of Sylvia Cronin, Director for Insurance, and of her team; I hope you will find it thought-provoking and informative.

Solvency II has been long in coming, and at times seemed as if it would be abandoned or postponed indefinitely. Certainly in the previous decade the 2012 deadline may have been felt far in the distance, and even more so the postponement to 2016. But here we are, less than a year away from its entry into application. Internal model applications have been filed throughout Europe since the beginning of the month. Dry runs of Solvency II reporting are being prepared for submission to the supervisors. Capital injections, here and there, are planned or processed so that insurers are ready for the new solvency requirements.

Maybe it is a time as good as any to reflect on the good, the bad and the ugly of Solvency II. Solvency II puts to the fore good governance of insurance undertakings. It delineates the role and responsibilities of the AMS Board. It lists a host of control functions and aims to ensure their independence. In doing so, Solvency II builds on the experience of several countries, including Ireland. We have developed here a strong body of regulations in this regard, with our corporate governance code and our Controlled Functions (CF) and Pre-Approval Controlled Functions (PCF) roles. The governance framework that Solvency II requires of insurance undertakings is very familiar to Irish insurers. It is a tribute to the good work of the Irish regulator to see its approach to good governance being generalised across the EU. However, Ireland can fain forget that in the matter of governance of banks or insurers, as in other matters, the issuance of regulations, however well meaning, is no guarantee that their spirit will be observed or that their aim will be achieved. Solvency II can be commended for bringing out governance requirements. It will be up to the insurance firms to live up to them.

In this governance framework, Solvency II requires insurance undertakings to conduct their own risk and solvency assessment. Such a requirement will be familiar to Irish insurers, through the Central Bank of Ireland insistence that boards define their risk appetite and formulate an explicit statement around it. Sylvia will soon tell you more about our expectations as regards FLAOR and ORSA, a welcome development brought about by Solvency II.

Finally Solvency II brings a common approach across Europe to regulatory returns of insurers. Some countries, such as France, had long developed a strong framework of regulatory returns under Solvency I. French general insurance companies have for decades submitted to the supervisor detailed templates of claims and reserves development by underwriting year and by accident year, while life companies have submitted to the French supervisor the granular decomposition of their insurance liabilities for a very long time as well. Supervisors there are used to pouring over line by line asset templates to measure the rise and fall of intragroup group financing or repos, and to plot the unrealised capital gains or losses by asset classes. Solvency II’s greatest gift to insurance supervision in Ireland is the provision of detailed, standardised reporting templates. The Central Bank of Ireland calls on insurers to devote the resources necessary to fill them accurately, as these templates are set

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1 Forward Looking Assessment of Own Risks (FLAOR) and Own Risk and Solvency Assessment (ORSA), respectively.
to become a central tool in our effort to better understand Irish insurance firms and challenge
constructively their management.

Governance, risk assessment and reporting appear to me the three manifest improvements
brought about by Solvency II to the European regulation of insurance.

Solvency II also brings greater freedom for insurance undertakings to invest policyholders’
money in a variety of asset classes. The debate over capital charges for infrastructure assets
and securitisation has been so fraught that it may have obscured the much greater principle
of free investing, that supersedes the forced diversification rules of Solvency I. I will turn to
capital requirements in a moment, but the greater issue for supervisors should remain the
ability of insurers to define knowledgeably their investment risk appetite, to set their own
diversification rules, and to invest in asset classes they understand fully. Solvency II brings to
insurance firms the potential to invest where they couldn’t before. The future will tell us
whether the capital allocation of these institutional investors will have led to greater
sustainable growth in Europe, or more numerous failures due to investment mistakes. At the
Central Bank of Ireland, we will challenge Irish insurance companies to demonstrate they
have defined and implemented investment policies commensurate with their knowledge of
the investment universe and their ability to sustain investment losses. We expect that the
prudent person principle that is introduced by Solvency II will be given the weight it needs by
insurers in Ireland.

One topic that was given no thought it seems in designing Solvency II is the revision of the
conditions for authorisation. Solvency I conditions for authorisations have been maintained in
the new regime, and so their deficiencies have not been addressed. However the matter has
become more acute since Solvency I was a minimum harmonisation regime, which could be
complemented by Member States, whereas Solvency II is a maximum harmonisation regime,
which cannot. In particular, there is no explicit provision for supervisory judgement on the
proposed business model of applicants. In some jurisdictions, this is seen by supervisory
authorities as legally preventing them from refusing authorisations or putting stringent
conditions on them, even when their experience tells them otherwise. These problematic
applicants, once authorised, can then avail of the single market to operate everywhere in the
EU. European legislators should revise the insurance directives to give national supervisory
authorities the leeway they need to protect European policyholders by denying or limiting
authorisation when this is the appropriate course of action.

Let me now turn to the new and problematic elements of Solvency II.

Capital requirements of Solvency II have come, rightly or wrongly to define the new
regulatory regime which will come into play in 2016. At least we haven’t gone to the extreme
of banking regulation, where the overarching directive is called a Capital Requirement
Directive, or CRD. But I contend that the emphasis given in European insurance regulation to
quantitative requirements has gone overboard, and that the particular quantitative
requirements of Solvency II are ill conceived.

The capital requirements set up by Solvency II are clearly too complex. Even the standard
formula is in fact as complex as a default internal model. To what purpose, however? When
one looks at the failures of insurance companies in Europe over the past decade, or more
narrowly, at those that befell Ireland, which of these failures would have had a different
course had the Solvency Capital Requirement (SCR) of Solvency II been in place in lieu of
the solvency margin of Solvency I? I’m afraid the answer is plain. One might argue then that,
even if the SCR may not be a better tool to prevent failures than the simple and robust
solvency margin of Solvency I with its accompanying prudent reserving principle and
compulsory asset diversification, the SCR favours the proper capital management of an
insurance undertaking. But we know that the mathematics of normal distributions, on which
Solvency II is based, bring a veneer of science that ill fits reality. Yes, normal distributions
are easy, or easier to handle, than other probability distributions, but they do not reflect what
happens in market crises, nor do they accommodate non-proportional reinsurance. The
quirks of the SCR calculation make this requirement an unlikely, unreliable tool to manage capital. Credit rating agencies, large brokers, reinsurers and counterparties are unlikely to rely on the SCR, or on the SCR alone, to assess the risk they take when dealing with insurance companies, and certainly the supervisor will not be using it for more than it is worth.

The complicated inadequacy of capital based regulation would be less severe had Solvency II not dispensed with the cornerstone of Solvency I reserving, i.e. the principle of prudence. In its place we find an ideological construct, where technical reserves are supposed to be valued at exit prices, even though these exit prices aren’t observable. The worst of Solvency II would be the distortion of investment incentives coming from the zero credit risk charge that Solvency II assigns to sovereign bonds, if pride of place wasn’t of course reserved to the Solvency II valuation of long dated life insurance liabilities. There, one achieves a seemingly impossible feat, namely to state that they are to be market consistent, and at the same time to use interest rates that are several hundred basis points over market rates. The end result is a massive prudential understatement of these liabilities and a gross misrepresentation of the solvency position of the firms that sell these contracts.

Fortunately Irish firms are not among the European firms that have to contend with such a failing of regulation, due to the structure of their insurance liabilities. In Ireland our challenge will be to use the good that Solvency II offers to bring non-life insurance management and supervision better tools and one hopes better outcomes than the experience of the past decade.

The opportunity to share my thoughts with you on Solvency II was too good to pass, even under the guise of these welcome remarks. Who better to tell you what Solvency II will mean for the whole of Europe than Gabriel Bernardino, Chair of EIOPA, the European regulator in charge of developing level 2 rules on foot of the Solvency II directive, together with the European Commission? Gabriel Bernardino has had an extended and distinguished career in insurance regulation in the Portuguese Insurance Authority (Instituto de Seguros de Portugal), where he was director for development and international affairs before he came to Frankfurt as Chair of CEIOPS, and then elected to chair its successor organisation, EIOPA. He has kindly agreed to come to Dublin to address you in that capacity, and it is with great pleasure and gratitude that I now hand over to him.