HOUSE OF FINANCE

SAFE

POLICY CENTER

Helmut Gründl

Solvency II at the Gates: Benefits and Risks of the New Insurance Regulation

Policy Letter No. 48

SAFE | Sustainable Architecture for Finance in Europe
A cooperation of the Center for Financial Studies and Goethe University Frankfurt

House of Finance | Goethe University
Theodor-W.-Adorno-Platz 3 | 60323 Frankfurt

Tel. +49 69 798 33684 | Fax +49 69 798 33910
policy_center@safe.uni-frankfurt.de | www.safe-frankfurt.de

This article was previously published, under the same title, in the ICIR Annual Report 2014-2015, pp. 34 – 36.

Solvency II at the gates:

Benefits and risks of the new insurance regulation

Helmut Gründl

20 November 2015

Investors and insurance policyholders are often confronted with complex products and providers' opaque organisational structures. At the same time, the possibility that their claims will not be honoured often poses an existential risk. Financial regulation therefore aims to put in place a financial services framework that will safeguard market processes whilst also protecting consumers. The issue of consumer protection is addressed not only by product regulation but also, in particular, by the fact that providers are able to deliver the promised benefits and services as a result of regulation and market supervision. However, these benefits of regulation are accompanied by certain risks, which I have described below using the example of insurance regulation.

The deregulation of insurance markets and products in the mid-1990s intensified price competition among providers. It soon became apparent that – given the potentially greater insolvency risks involved – non-risk-based solvency regulation was unable to meet these challenges. Solvency II – which comprises risk-based solvency regulations – will come into effect throughout the European Union on 1 January 2016. These regulations stipulate that insurance companies must provide capital that is sufficient in order to limit the likelihood of their insolvency to 0.5 per cent per year. Appropriate risk management structures and processes must be firmly embedded within these companies to guarantee the desired level of safety and reliability. And, last but not least, the duty to submit comprehensive reports to both regulators and consumers is intended to create transparency about providers' risk situation. These measures are good as far as they go. The problem is that implementing these three Solvency II objectives poses a number of risks that should not be underestimated.

Insurers caught between hope and fear

Even the timing of Solvency II's introduction is problematic because the persistently low level of interest rates poses a significant challenge for many life insurers who are obliged to deliver previously guaranteed returns to their policyholders. The market-consistent Solvency II balance sheet – coupled with risk-based capital requirements – ruthlessly exposes this problem, unlike under the current regulatory system based on German accounting standards (HGB). The hope that interest rates will start to rise again helps to explain why the insurance industry has been keen for the introduction of Solvency II to be postponed and for lengthy transitional periods to be agreed. Insurers have also been insisting that insurance liabilities should not be subject to a market-consistent valuation. This means that lower and less volatile values can be reported for these liabilities, which reduces the risk of institutions being forced to sell financial assets. The aforementioned measures will no doubt achieve their aim of temporarily averting a crisis. If interest rates remain low for much longer, however, these measures will merely conceal further emerging problems.

The risk of various interest groups seeking to influence regulation was also demonstrated when the 'standard formula' used to determine capital requirements was being devised. Throughout the years when Solvency II was being developed, numerous suggestions for the parameters of this standard formula were put forward. These proposals often reflected the vested interests of the lobby group concerned and made the standard formula into an over-complicated mechanism. This problem of 'regulatory capture' is exemplified by the plans for government bonds issued in the European Economic Area (EEA) to be subject to capital requirements of zero per cent, which in many cases would not constitute a risk-based approach. The objective here is quite simply to make it easier for governments to borrow at the expense of the safety of insurance policyholders' claims. However, the current political debate gives us cause for hope that it might never come to this politically motivated inconsistency, which would also distort competition among providers and jeopardise customers' entitlements.

One regulatory risk that should not be underestimated is regulators' fear of their own responsibility. This phenomenon, known as 'regulatory forbearance', appears to provide a compelling explanation for the fact that the introduction of Solvency II has been postponed several times and that the requirement for market-consistent valuations on the solvency balance sheet has been watered down. Regulators do not want to be seen as the ones responsible for any premature insolvencies if, for example, interest rates were to rebound swiftly from their current low levels and this triggered a general recovery. Regulatory capture and regulatory forbearance can therefore be mutually complementary.

The delegated legislation dated 17 January 2015, which contains detailed rules and regulations on the introduction of Solvency II, runs to almost 800 pages. The highly complex and bureaucratic supervision and regulation revealed therein constitute a further serious risk. The tricky problem for entities being monitored is not just for them to ensure that they are complying with the rules. More importantly, there is a danger that firms come to regard regulatory compliance as a mere box-ticking exercise and thus lose sight of the real objective of Solvency II, which is to instill in insurance companies a risk management culture that is based on a holistic view and, in particular, can identify any threats to their performance at an early stage.

Complexity is becoming a problem

However, the complexity of regulation poses the risk that supervisory authorities might not be up to the task of ensuring that regulatory requirements are being met. A case in point is the possibility for companies to use internal risk models to determine their capital requirements. Although these models are supposed to be more accurate than the standard formula, there is a risk that regulators are unable to assess the details of their composition and structure and how their parameters are determined. This, in turn, enables the regulated companies to exert improper influence on the presentation of their risk position, thereby increasing their business risk.

The complexity of regulation – coupled with the fact that different regulatory standards have been developed for banking and insurance – also provides opportunities for regulatory arbitrage, which enables companies to relocate their business to jurisdictions that have the weakest capital requirements or product regulation, for example. However, regulatory arbitrage poses the risk that customers might purchase products that are less safe or reliable.

Risks arising from product regulation also play a part in the measurement of regulatory risk. The deregulation carried out in the mid-1990s often resulted in less transparent insurance products. The wide range of vehicle insurance rates available is a case in point here. Regulators have sought to address this lack of transparency by imposing more stringent disclosure requirements on providers. A pertinent question, nonetheless, is whether the greater amount of paper that customers receive when taking out a policy necessarily means that they are also better informed. What is certain, however, is the higher costs, which are ultimately passed on to the customer. One thing definitely missing from the current political debate is a cost-benefit analysis of this aspect.

In conclusion, then, we can say that well-meaning financial regulation is certainly not the same thing as good regulation. The ongoing development of financial regulation should therefore factor in economic incentives and the resultant outcomes and risks to a greater extent than it has in the past.