# *Importance of good regulation, Why consumers should be interested in capital and A few items of SII review explained*

IRSG meeting 29 March

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# Contents

- Reminder that Good regulation is vital, but bad regulation can be as damaging as too little regulation
- Why consumers should be interested in too much capital as well as too little capital
- Some SII Discussion Paper issues discussed

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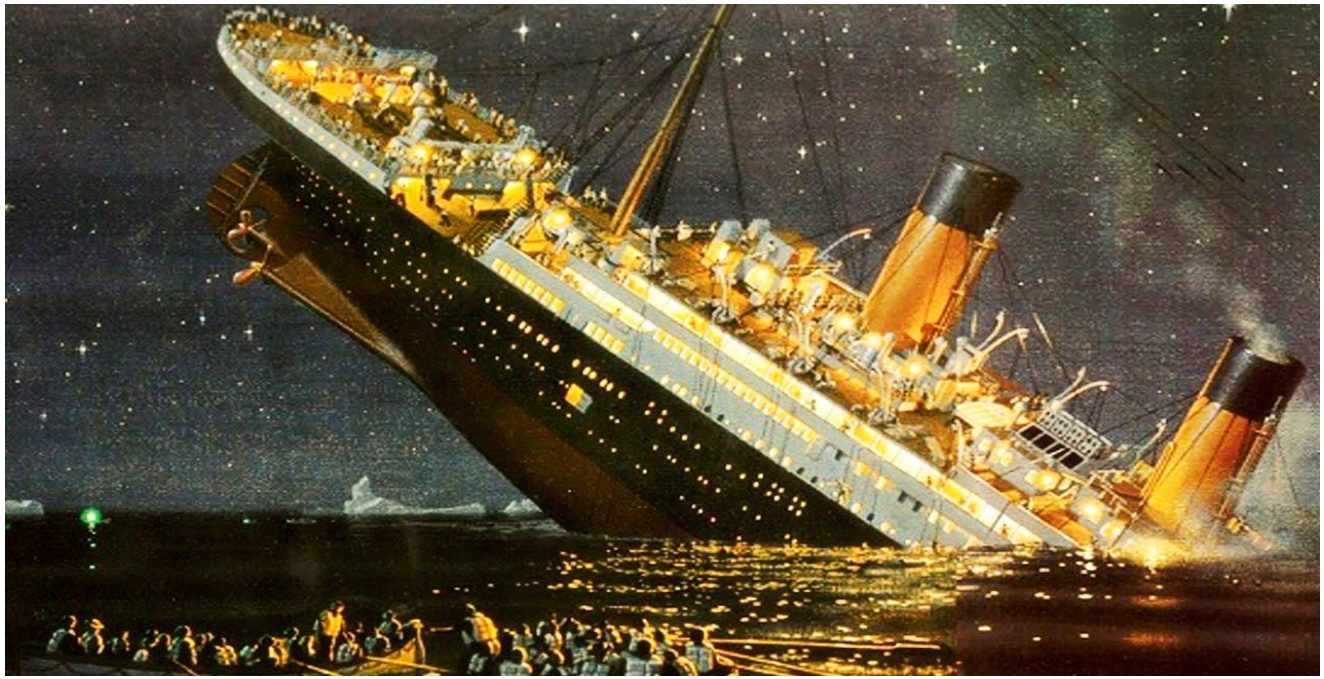
# Good regulation is vital, but bad regulation can be as damaging as too little regulation

# Good regulation is vital

- Prudential regulation needed to ensure a very low risk of an insurer failing to meet its obligations to its customers
- Conduct of business regulation ensures customers are well informed and protected from inappropriate practices
- Financial stability regulation ensures markets operate efficiently and minimise risk of systemic problems
- Good European regulation also ensures
  - Healthy competition and level playing fields
  - Efficiency through harmonised European approach

# But bad regulation can be worse than too little

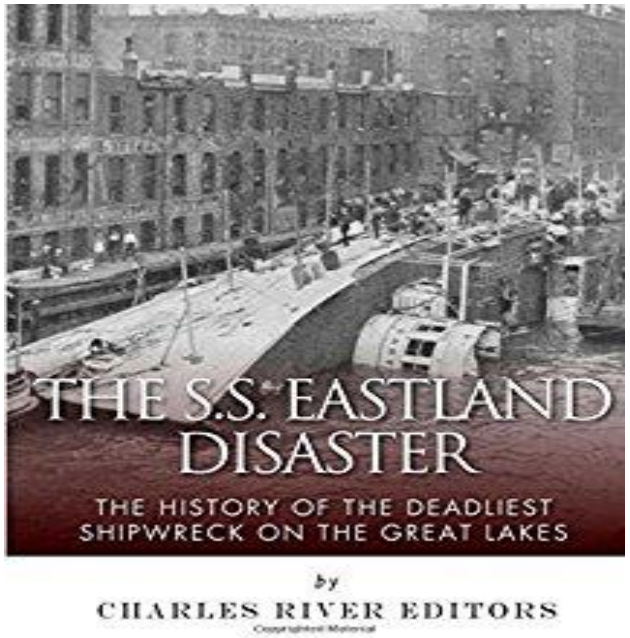
- Titanic sank in 1912.



- Over 1500 died. Not enough lifeboats key cause for deaths
- The ship was in compliance with regulation at the time
- Led, understandably, to "lifeboats-for-all" movement and new regulation came into force in March 1915

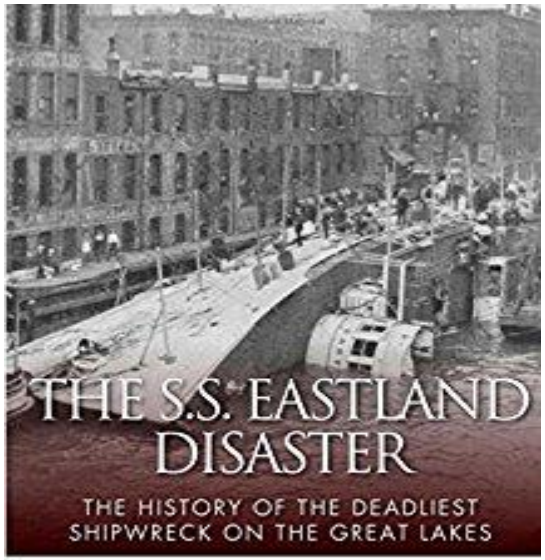
# But bad regulation can be worse than too little

- Many ships had to be retrofitted with more lifeboats to comply, including SS Eastland, a US passenger ship used on the Great Lakes




- Eastland sank in 1915, a few meters from the dock. Nearly 850 died.
- Too many lifeboats, making ship top heavy and prone to capsizing, key cause for deaths

# But bad regulation can be worse than too little




- During the development of the regulation, the shipping industry had warned that some vessels "would turn 'turtle' if you attempted to navigate them with this additional weight" – concerns were not heeded
- For the SS Eastland, even though stability was already known concern - no tests were conducted to determine how the additional weight affected the boat's stability

# Consequences of bad insurance regulation not as dire but can be significant

- Unnecessary costs – leading to higher premiums or lower benefits
- Information overload or duplication leading to confused rather than informed customers
- Good, useful products withdrawn or reduced availability
- Sub-optimal investment strategies, leading to
  - lower benefits
  - Shift from long-term to short term investing, impacting the economy
  - Pro-cyclical behaviour so insurers potentially add to a crisis rather than help provide stability
- Unnecessarily constraining innovation and efficiency

# Good prudential regulation

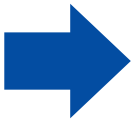
**Strong industry support SII's objectives of risk-based regulation**

- The importance of all three Pillars harmonised across Europe:
  - 1. Strong Solvency Capital, 2. Strong Risk Management 3. Strong Disclosure Requirements
- Covers all risks
  - About 30 different risks covered by Standard Formula
  - Nothing is "off-balance" sheet
  - Group and solo requirements
- Two levels of capital allowing early supervisory intervention
  - "Target" SCR and real minimum MCR
- Very high level of protection
  - 1 in 200 for Solvency Capital, but protection even greater in practice with other Pillars & powers of early supervisory intervention
- Internal model included because no standard formula can work for every company

# Solvency II: huge change and improvement…
# … but huge cost too.. and too conservative

## Solvency I

- Cost **accounting** valuation, **limited rules on assumptions** for liabilities
- **Very simple** factor-based approach for measuring risks
- **Solo**-based regime
- **Relatively low minimum** solvency requirements
- **Little governance and risk-management requirements**
- **Limited reporting** requirements
- **Limited powers** to intervene before failure
- **199 pages** covering 14 directives



## Solvency II

- **Economic** market valuation of assets & **best-estimates** liabilities
- Risks measured by standard formula with **28 risk types** or sophisticated approved **internal models**
- **Solo and group** based regime
- **Minimum capital (MCR) & much higher Solvency Capital Requirements (SCR)**
- **Very extensive governance and risk management**
- **Massive reporting**: **>150 templates**
- Ladder of **intervention**: **before actual failure**
- **>3000 pages**

# Solvency II

- Huge cost…
  - The UK supervisor estimates SII has cost about 4bn Euros to implement for UK insurers alone
  - Costs make it especially difficult for smaller insurers

- Conservative…
  - While having enough capital is very important but currently SII can be very conservative particularly for long-term business…

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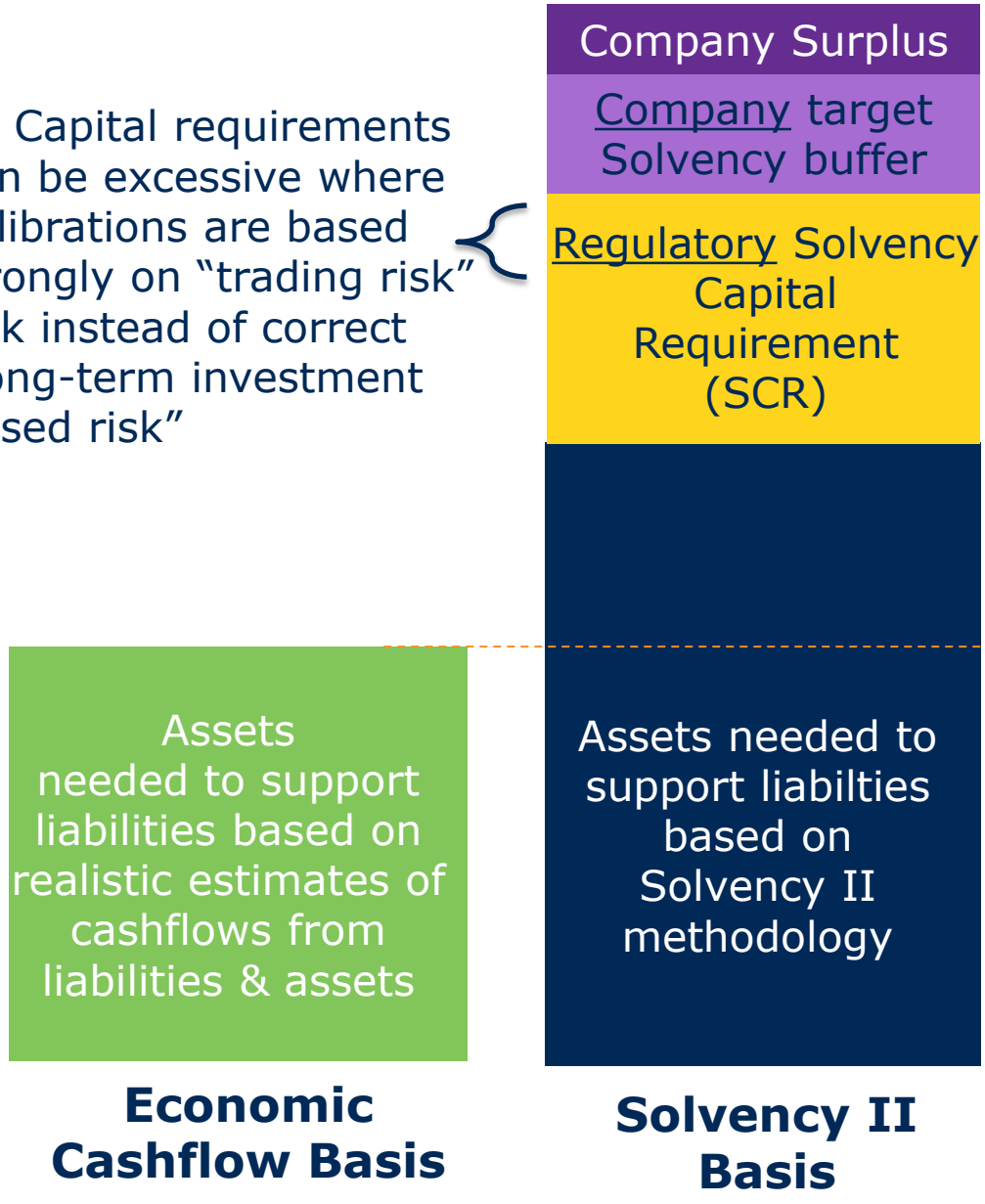
# Three reasons why SII is conservative - excessively so for long-term business & investment



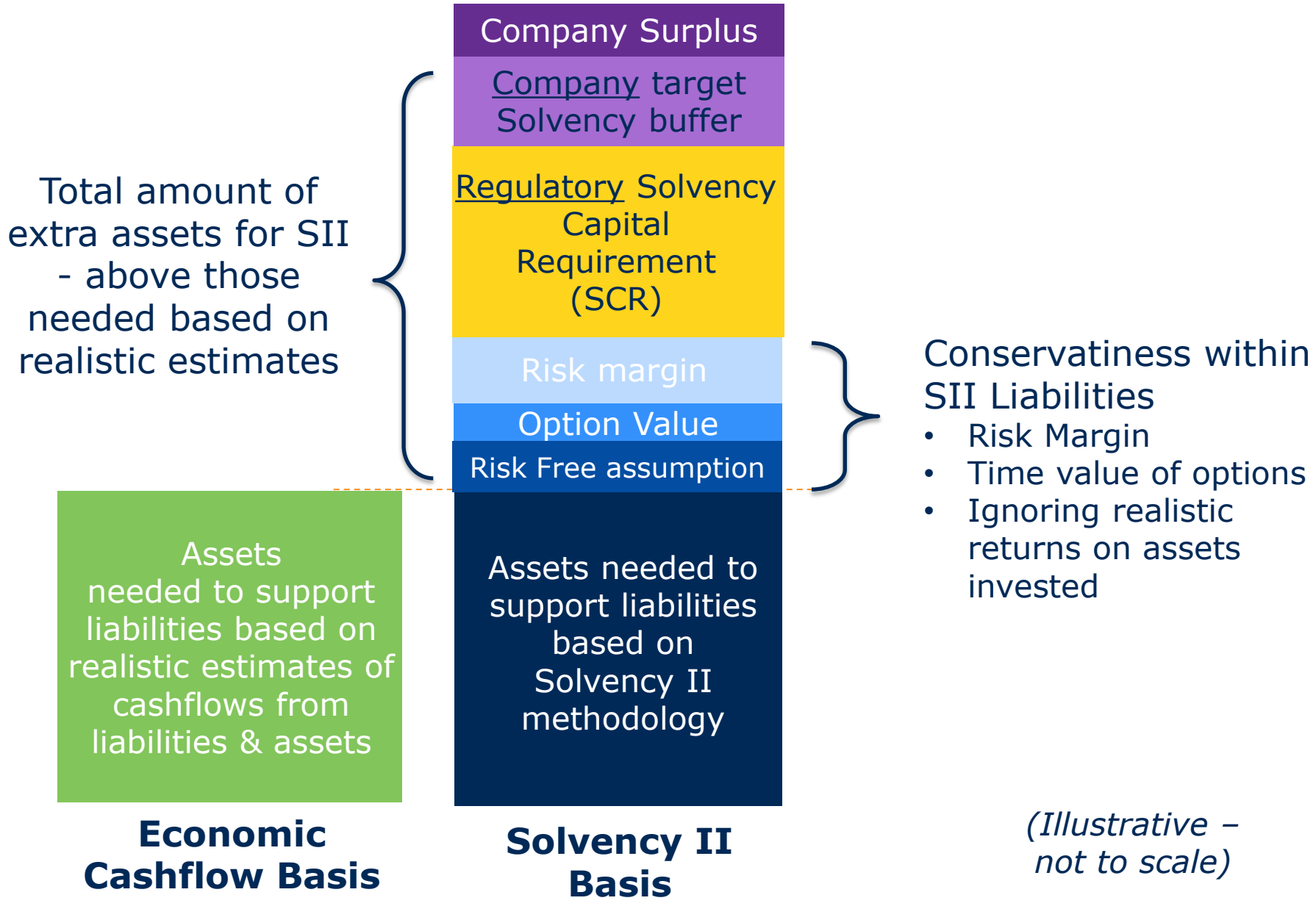

**1.** Very large buffers held by companies because of artificial balance sheet volatility

**2.** Capital requirements can be excessive where calibrations are based wrongly on "trading risk" risk instead of correct "long-term investment based risk"

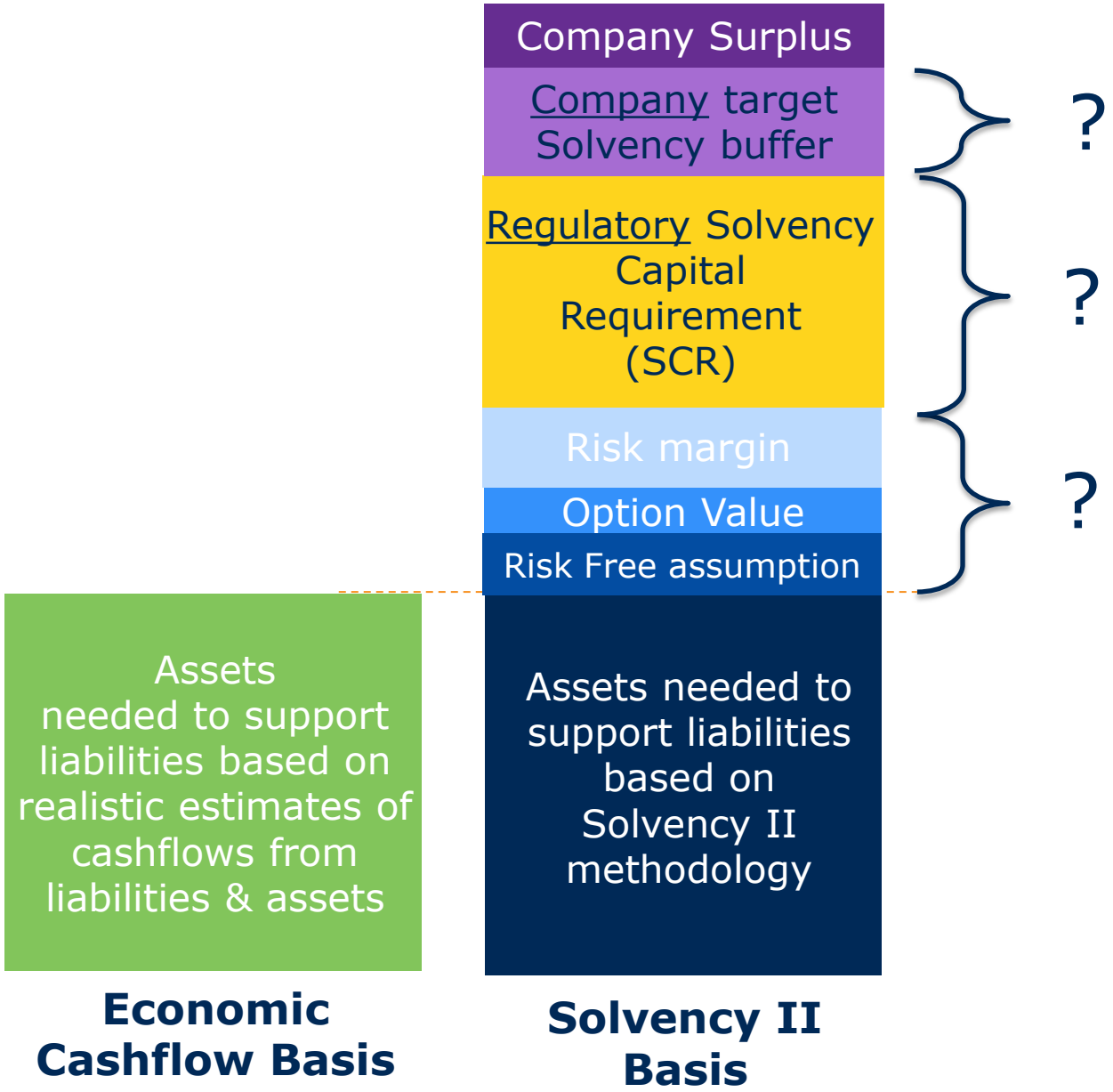
**3.** SII valuation of liabilities leads to poorly understood "hidden" layers of conservativeness which need to be analysed, quantified and better understood

*(Illustrative – not to scale)*

# The conservative nature of Solvency II needs to be analysed and more widely understood



# Data from SII reporting will allow EIOPA to assess if and how it may be too conservative as well as identify where capital may be too low

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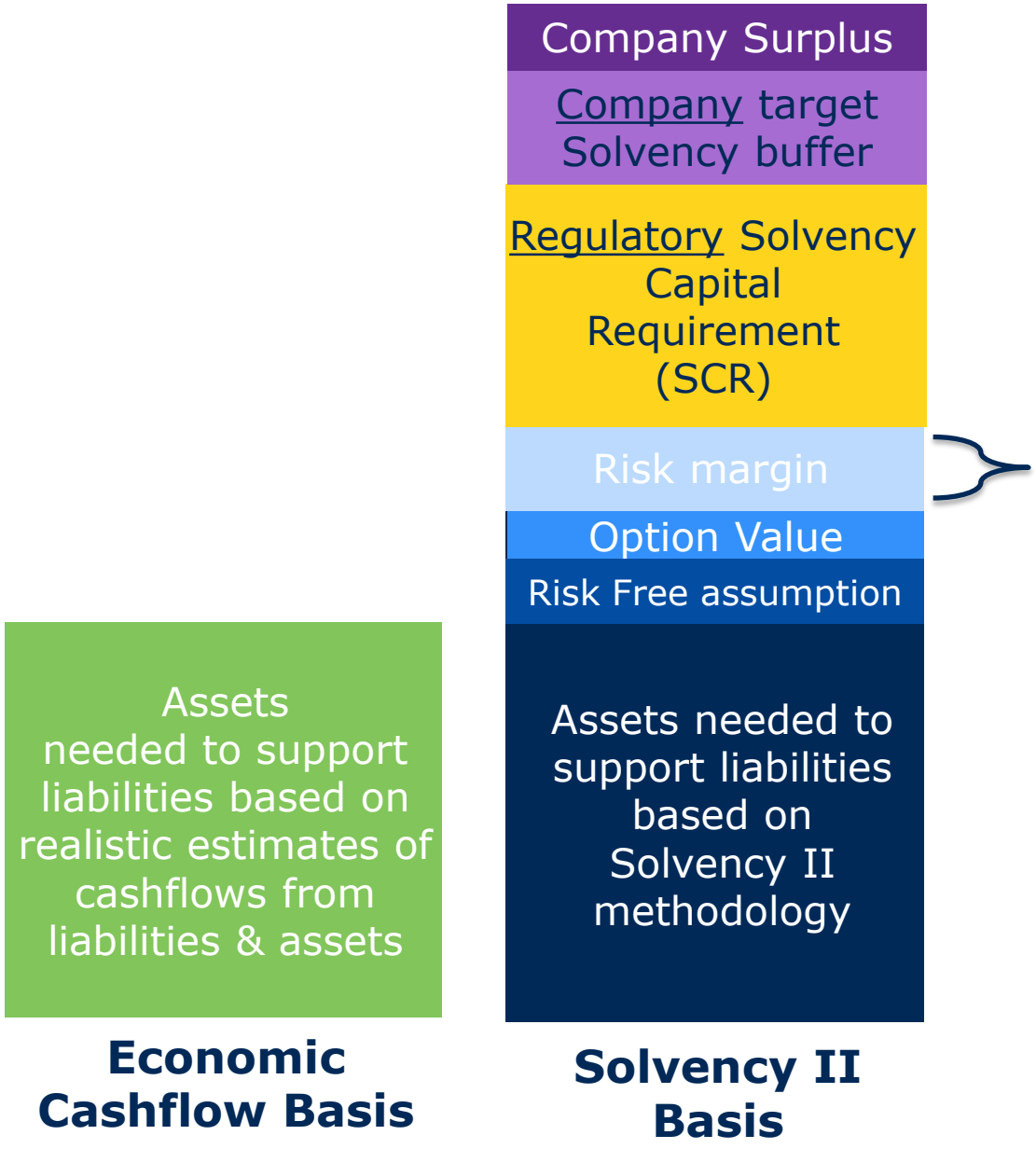
# But emerging data and estimates indicate that there is cause for concern . . .




## Risk Margin (Issue 19 DP)

The UK supervisor recently stated that the total Risk Margin for the UK was as high as £51bn at end 2016, which was 50% of the total SCR and had increased during the year by £15bn due to interest rates

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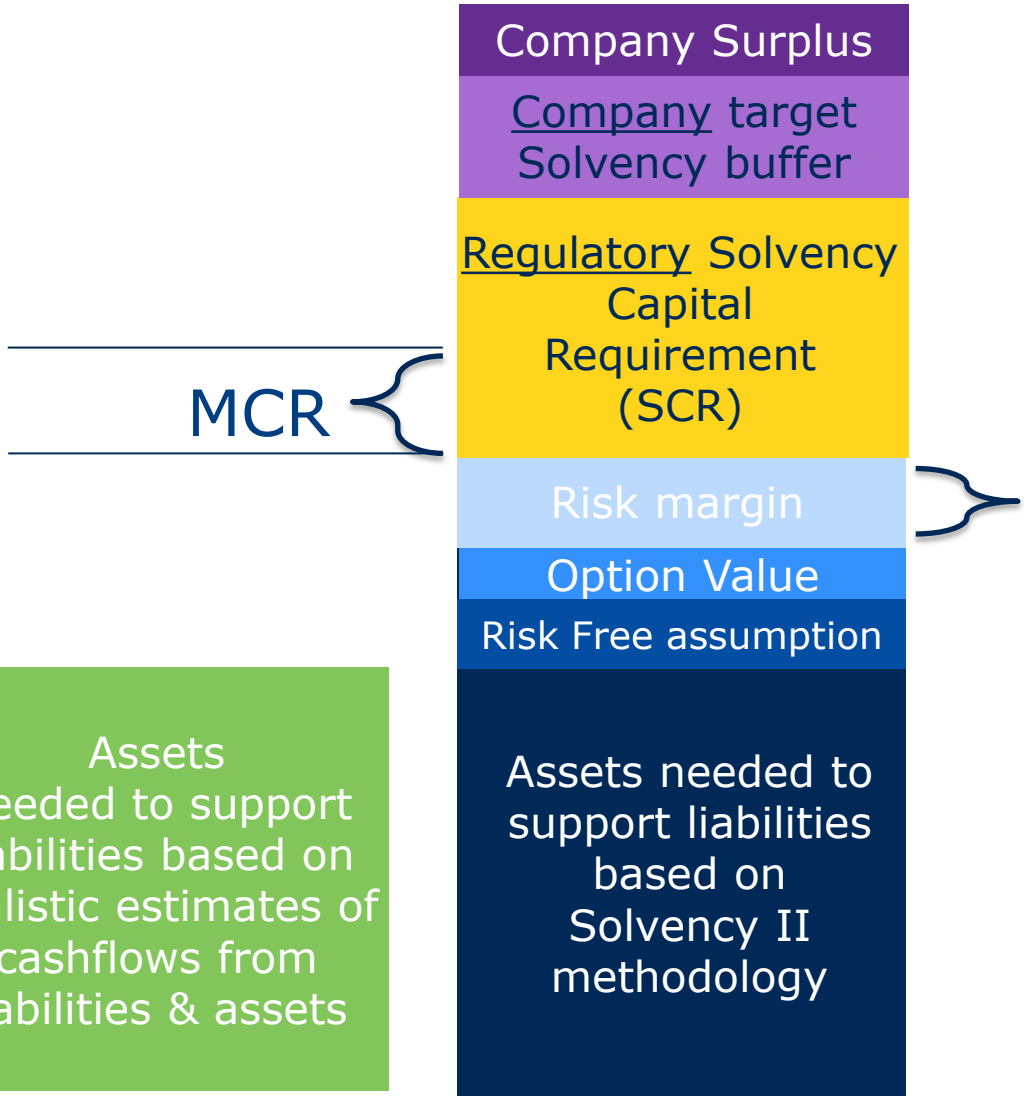


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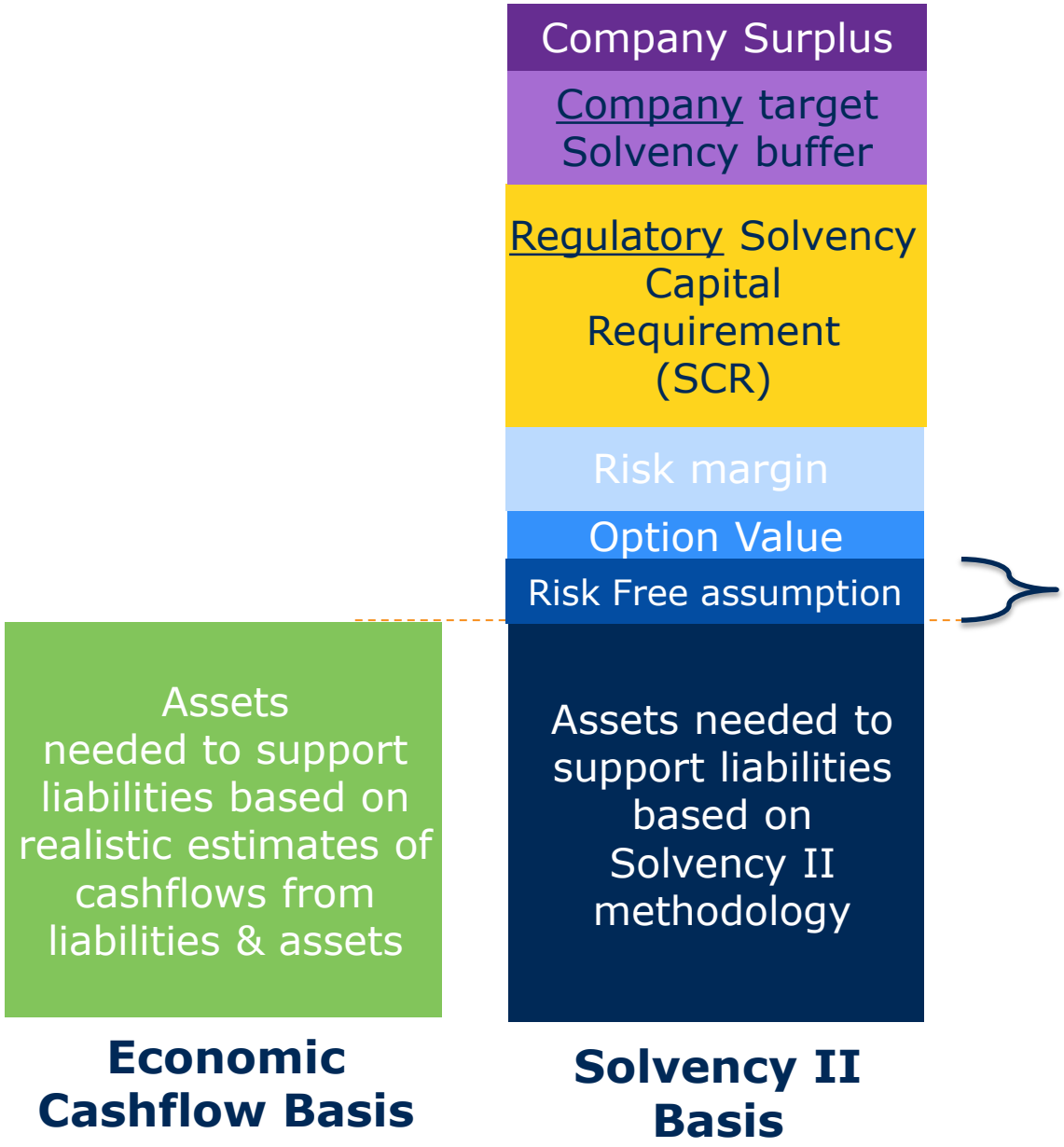


## Risk free assumption

E.g. If real investments are expected to earn just 1% more than risk free, then a life company using the VA may be holding 15% more in liabilities due to only this

*(Illustrative – not to scale)*

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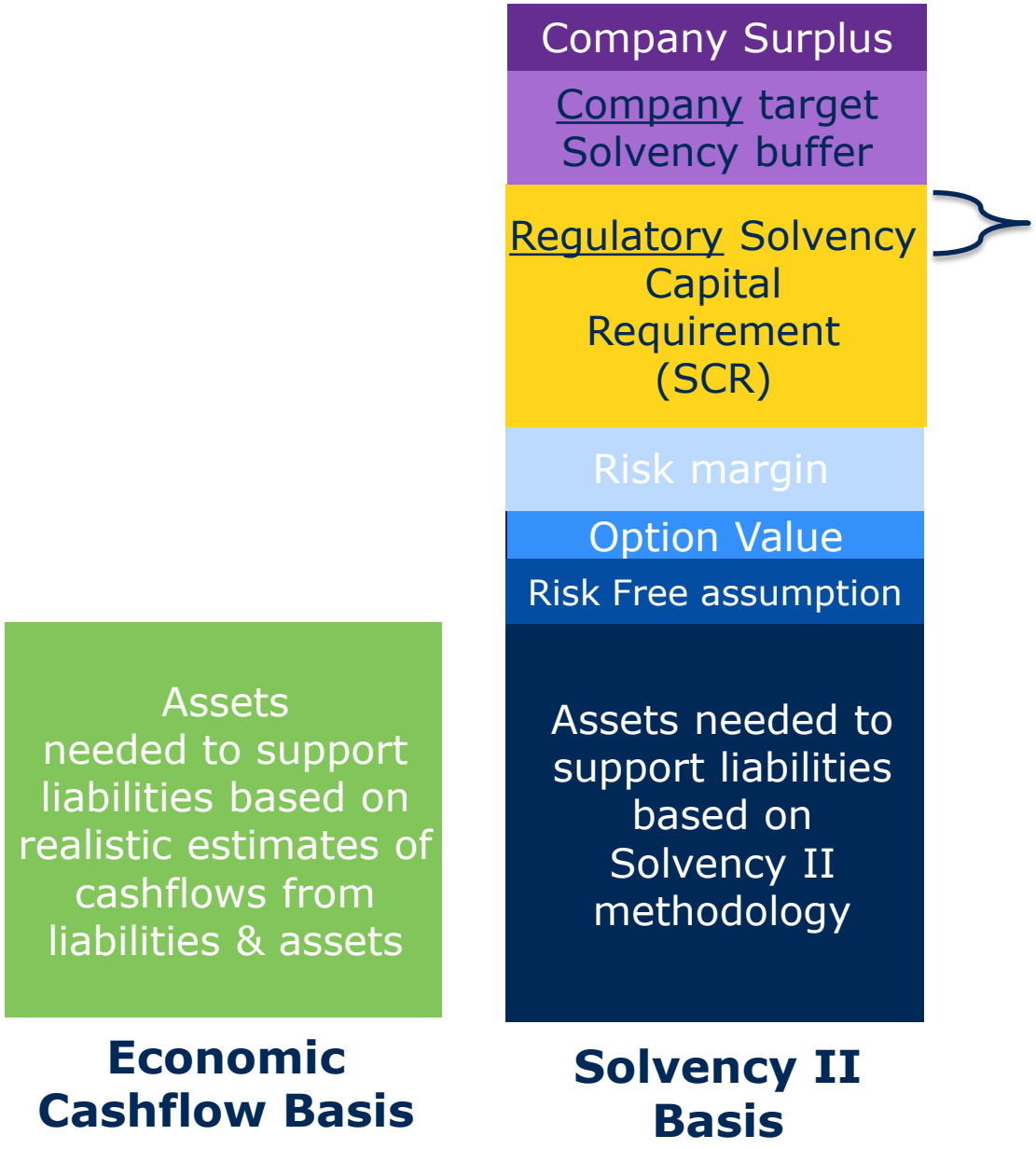



## SCR (Equity)

The charge for quoted equity (Type 1) is 39%. This was calibrated based on the assumption that insurance companies would have to sell their entire portfolio at the worst moment like a trader. If a long-term (eg 10 yr) approach is taken, then the impact of dividends alone could reduce capital requirements by maybe 20% over 10 years

# Unnecessarily high capital can have significant impact on consumers

*Scenario 1*

**Regulators take care** to estimate the risks correctly, and results in the insurer having to hold Capital equal to **5% of the funds**

*Scenario 1: Correct Capital*

Capital 500

Return required to pay for capital = 50

Impact on charges to policyholder = +50

Impact on annual charges = **+0.5%**

*Scenario 2*

**Regulators take an overly simplistic and/or conservative approach** which results in the insurer having to hold Capital equal to **15% of the funds**

*Scenario 2: Excess Capital*

Capital 1 500

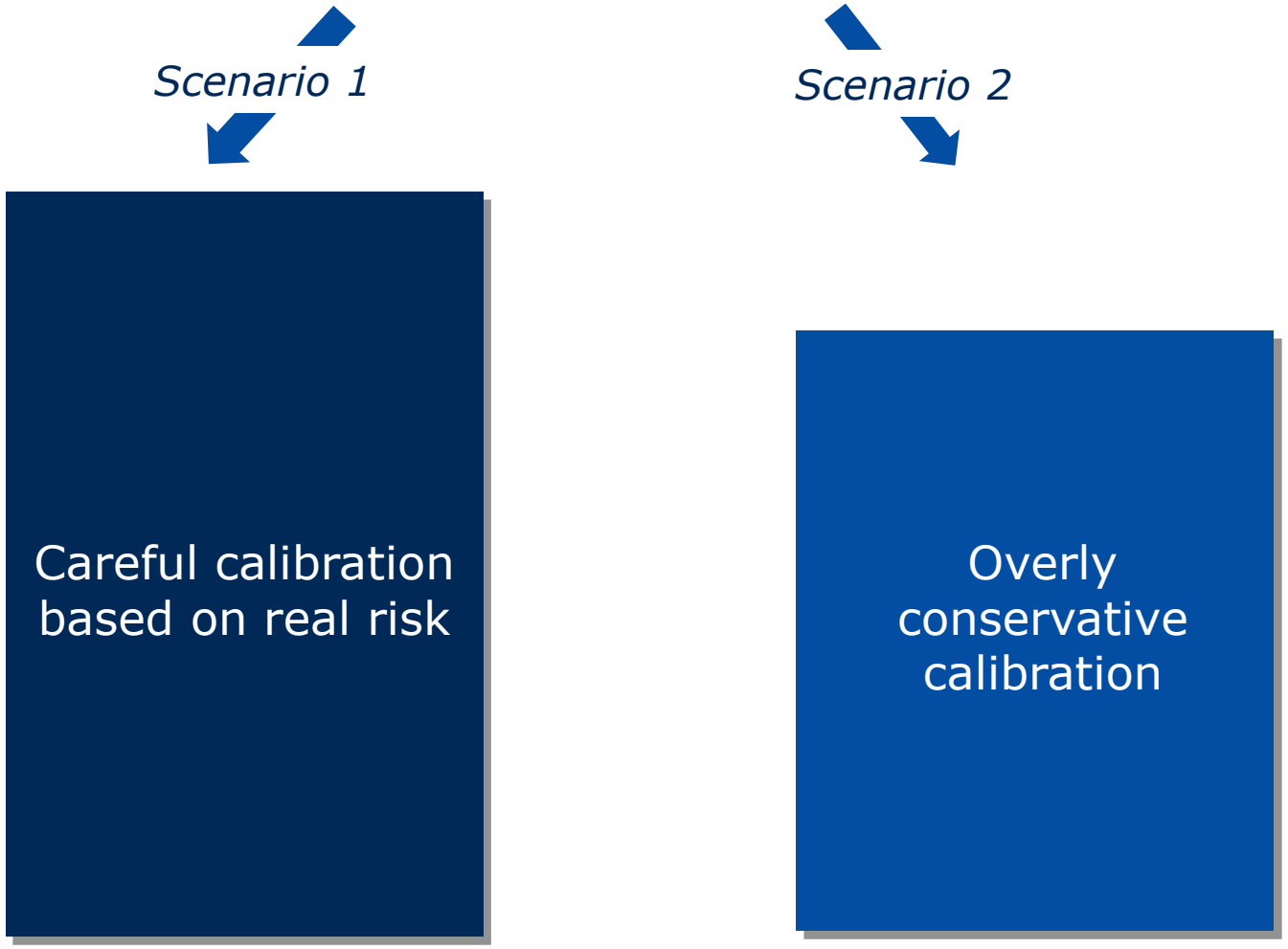
Return required to pay for capital = 150

Impact on charges to policyholder = +150

Impact on annual charges = **+1.5%**

**Charges to policyholders 1% higher due to excessive capital.**

# Unnecessarily high capital can have significant impact on consumers




**20% smaller pension pot after 25 years**

# Unnecessarily high capital can have significant impact on consumers


**Too high Solvency Capital**

**Higher Premiums or Charges**

**Less of the optimal long-term investments e.g. Equities**

**Procyclical behaviour**

**Lower Benefits paid**

**Less products available**

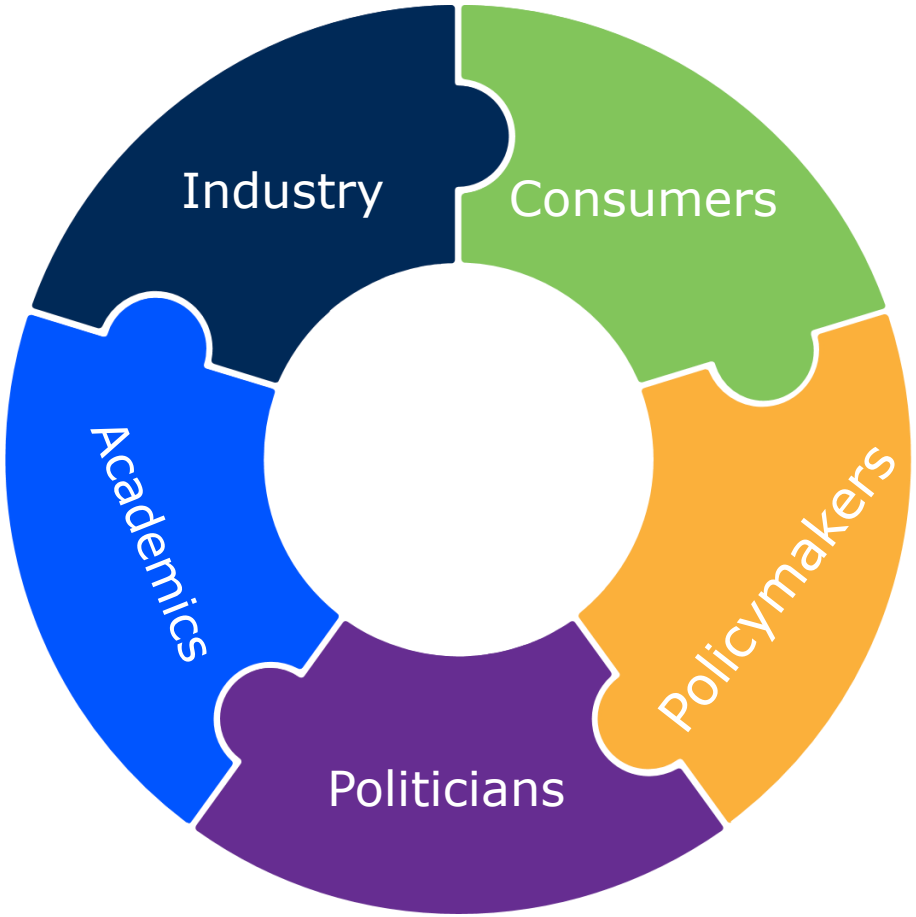
If higher capital is needed because of real risks then the impacts can be accepted, but because not enough when due to poor reglatory design or calibration

# Good regulation

- Addresses consumers' real needs, rather than perceived ones
- Measures real risks and not theoretical ones
- As efficient as possible, avoids unnecessary/excessive costs and not unnecessarily conservative
- Tested!: On consumers/On past data and future scenarios
- As simple as possible, as complex as necessary
- Identify assess and avoid unintended consequences including cumulative impact – avoid overlaps as well gaps

# Understanding objectives of good regulation and the real concerns, we can achieve good regulation

- Getting it done is not more important that getting it to work
- Compromise can be important but not if that means what is agreed no longer works as intended



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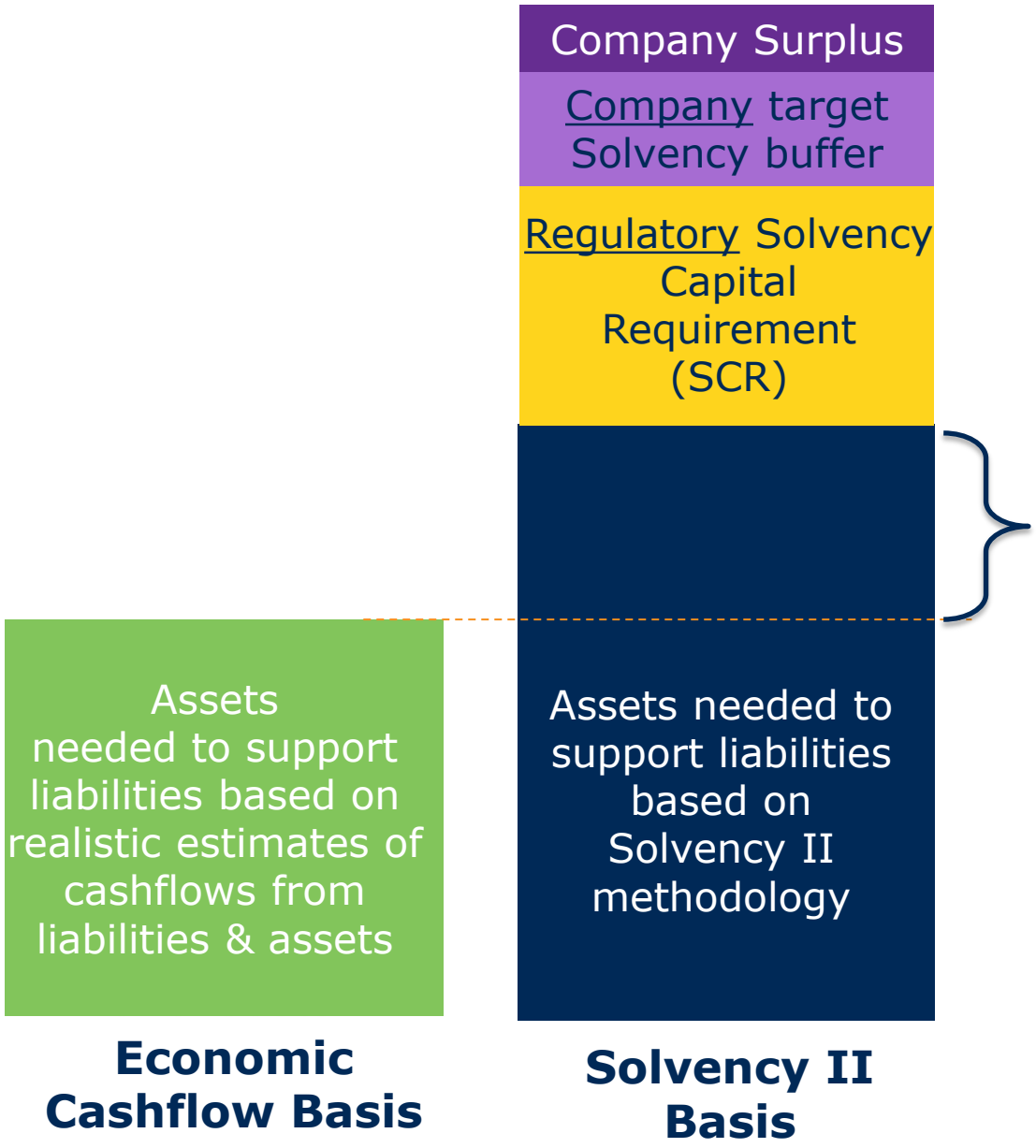
# Issue 3: Guarantees

- Guarantees can transform the risk of investing in debt instruments (ie lending money)
- Normally the risk depends very much on the capacity of the borrower to repay. However, a guarantee means that not only would the borrower have to fail to repay but the guarantor would have to fail too
- If the guarantor is a sovereign this is considered amongst the strongest type of protection, with effectively zero risk within Europe due to the mechanisms put in place since the crisis
- Currently SII ignores certain guarantees - partial guarantees and those from regional and local government – and so is overestimating the risk
- This is why the IRSG recommended to recognise the economic impact of a wider set of guarantees

# Issue 18: Deferred taxes




Taxes are included as a liabilities because in SII all liability cashflows are projected and valued including taxes.

If taxes reduce under an adverse scenario then this helps absorb risk.

If the adverse scenario results in a loss then a Deferred Tax Asset can be created.

This tax asset will be recovered against future income.

As long as the company can demonstrate that it can continue to generate sufficient profits after the shock to make use of the tax asset then it should be recognised by SII.

The local tax rules (eg carry forward limits) will have an impact

# Issue 15: Currency risk

- The current methodology presents the following flaws:
  - It creates a capital charge when companies manage FX risk well
  - It does not properly charge those who have FX risk
- It therefore penalises good FX management and encourages FX mismatches
- The problem is that when measuring FX exposure, the current method

  a) ignores the fact that companies need to hold assets in local currency to cover their local solvency capital needs - in fact companies doing this will currently be given an FX risk capital charge

  b) assumes that only centralising surplus in your home currency is optimal for currency risk - but in fact spreading your surplus across the different currencies is just as legitimate, because you do not know which currency will move in which way.
- Therefore the IRSG supported changes to the methodology which fixes this problem