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A Prudential Regulatory Issue at the Heart of Solvency II

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Summary: A delicate regulatory question is under consideration on the capital (reserve) requirements at the heart of Solvency II. Solvency II is the insurance industry equivalent of Basel III, a major regulatory reform process scheduled to come into effect by 2013. This decision will have implications for both regulation of insurers and for macroprudential stability. The six authors of this article were invited to discuss the issues, and concluded that more public scrutiny over this important question is urgent.

National insurance regulators drafting rules on capital (reserve) requirements, analogous to the Basel III capital requirements for banks, have been under intense industry pressure on the proposed ratio calculation principles.

Recently, senior members of European insurance regulators and EIOPA (the European Insurance and Occupational Pensions Authority, one of the three European Supervisory Authorities) met with insurance and banking academics at the Dutch Central Bank to discuss a controversial new methodology for prudential insurance reserve requirements. A key proposal, on the use of illiquidity premia to discount liabilities, came under intense criticism. As all participating academics agreed on the conceptual analysis, we decide to present our common arguments and main conclusions.

Under Solvency II, insurers will compute the present value of their insurance liabilities under the actual risk free interest rate term structure curve. This transition in valuation methods has a major impact on some insurers with long term liabilities.

The industry argument states that as long term liabilities are predictable and stable and thus "illiquid", their discount rate should also contain a market liquidity risk premium. This would enable significantly lower reserve ratios.

In our opinion, this argument has no sound scientific basis.

Capital (reserve) requirements are prudential buffers to back future nominal promises to policyholders. To compute such requirements, promises should not be discounted at a risk premium. The illiquidity of insurance liabilities cannot be treated as equivalent to asset liquidity, as asset owners can sell at their discretion, while this is not usually possible for insurance policies.

Risk free discounting cannot be questioned as a basis to compute the present value of insurer liabilities. Illiquid assets held to maturity do not constitute a riskless hedge. Different valuation schemes, market-consistent valuation and hold-to-maturity view, cannot be mixed in an inconsistent way.

Using a liquidity premium to discount liabilities is in essence a fudge discount rate that is financially unsound and economically indefensible. It would induce risk arbitrage and risk reallocation, e.g. from banking to insurance.

There are, however, good economic arguments and legitimate concerns for long term insurers to be addressed under Solvency II's transition to market-consistent valuation. The change leads in many countries to a higher value of longer term promises, in particular at the time that massive monetary support and a flight to liquidity has led to very low risk free rates.

The monetary expansion has had the effect of transferring value from savers to borrowers. Both insurers and pension funds see the effect on their balance sheet, when properly valued at lower rates. In itself this loss does not justify lower prudential ratios.

However, there is a sound rationale for a gradual transition to market-consistent reserve requirements for firms with longer liability maturities, provided the transitional phase be recognized as such. The insurer ability to honor longer term promises is less affected by asset liquidity risk, as longer liabilities enable them to hold longer on to the illiquid assets.

To be absolutely clear: the maturity of liabilities should not alter the required capital calculation (the net effect on reserves anyway depends on net duration), but may affect the desirable speed of the adjustment depending on the duration of the liabilities. Longer term funded insurers have the ability to earn over time more liquidity premia to consolidate their reserves.

As a final macroprudential consideration, the recent crisis has signaled a need to move the financial sector to a longer term funding basis. It is unreasonable to demand a rapid adjustment by very stable intermediaries with long term liabilities, not the least after the monetary bail out of short term funding.

Yet favoring stable funding should be achieved by other means than by manipulating a discount factor, which is an intransparent, financially unsound solution, distorting maturity choices and inducing risk shifting.

Other measures may include a regulatory buffer on the asset side of the balance sheet or a ladder of intervention. Insurance companies with long term liabilities should not be heavily penalized at stress times of flight to quality.

Granting them more time to adjust would seem particularly reasonable at a time when the market value of illiquid assets is depressed and long term risk free rates are arguably abnormally low.

Editor's note: The authors represent the full academic panel at the recent workshop on Solvency II organized by the Dutch Central Bank with EIOPA and EU insurance regulators. Enrico Perotti's statements are his personal opinion and not an official position of the Dutch Central Bank, where he is an independent advisor.