CRO Forum

Addressing the pro-cyclical nature of Solvency II

November 2008

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Introduction

Equities are volatile investments and require sufficient risk capital as a buffer for adverse developments. Risk capital charges in the Solvency II context reflect the 99.5% quantile on a 1-year horizon. The consistent application of risk capital charges in Solvency II to all sources of risk is imperative. Inconsistent application of risk charges creates perverse incentives for certain asset classes or insurance products.

Nevertheless, attention shall be paid to the potentially pro-cyclical nature of the Solvency II regulation. In particular, forced sales of assets in market downturns should be discouraged. A decrease in available capital due to distressed market prices for assets shall not require immediate regulatory intervention.

The CRO Forum also believes that addressing the potentially pro-cyclical nature of (any) regulatory regime is a more effective way of preventing insurance companies from reducing their exposures to risky assets, in particular equities, compared to an artificial incentive in terms of lower risk capital charges in Pillar 1. For example, the "duration approach" to reduced capital charges for equities in the context of Pillar 1 may still force writers of short-term liabilities out of their equities immediately.

Nevertheless, the duration of the liabilities is an important indicator in the context of pro-cyclicality – in the sense that a long-term business may also be given a longer time to recover from temporarily distressed markets.

The CRO Forum therefore proposes an approach to address both these issues: the pro-cyclicality and the equity treatment, simultaneously through a Pillar 2 solution.

Approach to address pro-cyclicality and equity treatment

The capital requirement (SCR) in the context of Pillar 1 is determined consistently on the basis of the 99.5% quantile over a 1-year time horizon for all sources of risks or asset classes.

In times of distressed markets for certain assets, the SCR is temporarily complemented by a separate reduced capital requirement SCR* (Shadow-SCR) in the context of Pillar 2, which reflects the distressed market prices for the affected assets. The SCR* shall gradually revert back to the SCR over a time period linked to the duration of the liabilities which are covered by the assets in question. Also, the SCR* shall revert back to the SCR in case the distressed markets recover.

Under Pillar 2, the SCR* shall determine a reduced threshold for regulatory intervention, including determining disclosures associated with non-compliance. The decision about the application of SCR* is with the local regulating authority and shall be co-ordinated across the EU. Both the SCR and the SCR* should be disclosed under Pillar 3.

The SCR* would be determined as follows: If a certain asset class is in distress, the original risk charge of the respective asset class is reduced by an amount related to the market value losses, subject to a certain floor. The reduced charge would gradually revert back to the original risk charge for the respective asset class over a time period linked to the duration of the liabilities those assets cover, or immediately in case of a recovery of the market.

This treatment shall only apply in case management intends to hold these assets over the duration of the liabilities it covers. Management shall document this intent.

While this treatment seems intuitive for distressed equity markets, any other risky asset class, as well as insurance risks shall be treated the same way.

Next steps

The CRO Forum believes that this approach addresses the real issue of pro-cyclicality and equity treatment, without providing for a material distortion of risk charges. Also, the approach outlined is consistent with the principles of Solvency II, and with previous CRO Forum positions on the treatment of equities in the context of Solvency II.

We recognize that work is needed to bring this proposal in the Solvency II directive. Also, further implementation guidance on this approach is needed on level 2 and 3 of the legislative process. The CRO Forum is prepared to support policymakers in these tasks.

The CRO Forum also wants to reiterate its view that the Group Support Regime is one of the key elements at the heart of the economic risk-based approach which underpins the whole Solvency II regime. It represents an essential move forward in the way groups are supervised and managed. Under the Group Support Regime the economic reality of groups is taken into account under stringent prudential conditions.