Changing regulatory capital regimes: implications and market reactions

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In the last decade, the financial services sector has experienced a sea change in regulation and supervision. Local, regional, and global authorities enacted a host of requirements intended to modernize supervision and prevent many of the problems associated with the financial crisis. However, many of the most significant insurance requirements are just beginning to take shape. The European Union's revised prudential regime for insurers, Solvency II, came into force on January 1, 2016. And the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB) continue to advance the global supervisory agenda through the drafting of capital requirements for systemically important insurers and the insurance capital standard (ICS). Each of these regional and global work streams will profoundly affect the largest insurers and are likely to prompt even more changes in existing local regulatory regimes.

On December 8, non-executive directors, executives, and supervisors met in London to discuss Solvency II's pending implementation, the evolving IAIS agenda, and how markets may react to new solvency requirements and metrics. For a list of participants in this meeting and related discussions, see Appendix 1. This *ViewPoints*[1] provides a summary of these discussions and is guided by the following questions:

- How might Solvency II evolve in the next few years?
- How are insurers translating value to investors in light of new solvency requirements and metrics?
- How might the global regulatory agenda evolve, and what challenges does it face?

How might Solvency II evolve in the next few years?

As implementation of Solvency II begins, insurance groups and their supervisors will also start the next phase of a long learning period. In the future, elements of Solvency II may require adjustment. Furthermore, as global capital standards are developed and implemented in 2020, policymakers may wish to better align the two regimes. Participants identified important questions for supervisors to answer in the coming months and years and highlighted areas where Solvency II may require adjustment.

How will equivalence be addressed?

Solvency regimes outside of the EU must apply and be assessed for equivalence with Solvency II. To date, Switzerland has received a full equivalency determination and a handful have obtained provisional equivalence.[2] This raises questions about how capital in those jurisdictions will be evaluated by group-level supervisors in the EU. One supervisor noted, *"We are in a halfway house on equivalence. Some equivalence is not fully in place yet, so countries will continue to apply various fixes until they are not necessary."*

Participants also questioned whether some jurisdictions are truly equivalent. In response, one supervisor, noting that so-called third countries (supervisory regimes outside of Solvency II) open their books to obtain equivalency decisions, said, *"Third countries have made many reforms – especially to valuation – in order to obtain equivalence. I see room for further improvement, but there have been great strides. It used to be if it comes from Europe, it must be bad, but that is changing."* All participants noted that reconciling the European and US solvency systems remains exceedingly challenging, but they were hopeful that, in spite of accounting differences, the ICS might be part of the solution. However, with the introduction of the ICS, some third countries may question whether their regimes need to be Solvency II equivalent or simply follow the ICS.

"Gold plating is not the solution. We need a sound basis and an understanding by all parties of how regulation should be implemented."
– Supervisor

Can supervisors ensure consistent application of Solvency II?

Despite the overarching framework, Solvency II allows for some national variation and for the largest firms to determine capital levels according to individual internal models. Given this variation, achieving meaningful cross-border consistency in regulation may prove challenging. In the extreme, the allowance for local differences has provoked charges of "gold plating" as certain local supervisors employ add-ons that increase standards or adjust policies, rules, or procedures in ways insurers find overly restrictive. The European Insurance and Occupational Pensions Authority (EIOPA) has a number of tools to encourage cross-border consistency, including guidelines, opinions, benchmarking of internal models, and, in the future, development of a supervisory handbook. Sector participants are keen to see how these tools, as well as direct conversations with authorities, will work in practice.

How will supervisors balance enforcement with the need for a learning period?

Both firms and supervisors face execution risk as Solvency II begins in earnest. Firms have much work to do; however, as one director said, *"There is a big risk in the supervisors themselves. Are they really ready for Solvency II? Are they ready to manage these firms? Will they be able to cope on an efficient basis?"* Insurance groups also wonder whether authorities will move quickly toward enforcement or be somewhat lenient and employ forbearance as authorities and firms adapt to the new regime. One director said, *"I hope supervisors view the first year as a learning process and they don't jump on us, demanding lots of audits. There has to be some adjustment period for both sides."* Firms and supervisors seem to agree that ample time will be needed for all parties to get up to speed.

"There is a pendulum in the history of financial crises. In this year, we have reached the outside of what can be agreed. We are now entering a calming period. Supervisors may be on defense."

– Supervisor

How will Solvency II affect adaptability and business agility?

Firms are worried about two specific issues: (1) model error, where models misestimate important risks, resulting in poor or slow decision making at the group level, and (2) the slow process of updating models, which could inhibit good decision making as well. As one director noted, *"There are big seismic events that could make the model wrong. My concern is that models don't react quickly. You could underestimate the risk and hide behind rules and models, which may be too procyclical."* In addition, changes to models require regulatory approval, which may slow an insurer's reaction times to a host of situations ranging from capital events to mergers and acquisitions.

How will existing weaknesses in Solvency II be addressed?

Regulators and industry participants widely acknowledge that elements of Solvency II will need to change in the future. Lessons will emerge from implementation. Further, as one supervisor noted, *"Solvency II is 15 years old. When it was first thought about, it did not contemplate ultra-low rates, focus on conduct versus prudential risks, technology, changing customer behavior ... Is it still fit for purpose?"* Participants made the following suggestions for early revisions to Solvency II:

"Solvency II has a number of weaknesses. How will regulators address those?"
– Director

- **Reduce complexity.** Supervisors and insurers agreed that Solvency II may be ripe for simplification. One director suggested, *"Reducing complexity is in the interest of all groups – insurers, regulators, etcetera. We should compare important matters, not small rules. At the end of the day, what counts from a capital perspective is that you are above the regulatory standard."* A supervisor agreed, noting that insurers and supervisors were likely to find common ground on the issue of complexity, whereas regulators may be less willing to adjust capital rules. One director suggested that reporting and metrics might be an area in which to seek simplification: *"Solvency II figures will take over for market-consistent-embedded-value reporting … Results will be similar. It would be helpful to get rid of one set of metrics."* However, another participant cautioned, *"If you are just going to report Solvency II and not embedded value, you are not going to show the true value creation of some of these business models. I'm cautious about giving up some of these metrics."*

- **Adjust the risk margin[3] to minimize volatility.** The consensus among IGLN participants is that markets and insurer balance sheets will be more volatile in the future. Solvency II, itself, is more volatile than previous regimes. Observers point to the risk margin and swap spread as areas of particular concern with respect to volatility. The margin is sensitive to interest rates, creating challenges for insurers with exposure to longevity risk. Insurers are exploring strategies such as hedging (via derivatives) or reinsurance to manage the risk margin.[4] *"The risk margin is bigger and more volatile than expected,"* said one director. *"It creates a need to hedge volatility, and that's strange because you don't typically hedge your own capital."* Another said, *"You are either hedging something that doesn't exist, which creates earning-statement volatility, or you don't hedge and you have huge capital-base volatility impacting your ability to make dividends."* Several supervisors, including Sam Woods of the Bank of England, have suggested that modifying the risk margin calculation may provide some relief.[5]

"Volatility in the system is not artificial. It is there. It is the market reaction to the perceived volatility that can be artificial. What is the best way to address that?"
– Policymaker

- **Address specific weaknesses.** IGLN participants raised a number of technical concerns, including the unrealistic basis for forward curves, the treatment of periodic payment orders,[6] accounting for reinsurance premiums,[7] capital treatment related to credit risk and corporate bonds,[8] and a host of other issues that are ripe for discussion and, perhaps, adjustment in the future.

- **Refine internal-model governance.** Boards continue to adjust expectations for governance of internal models. Participants discussed a number of common practices, including intensive risk and audit committee model reviews, external validation by experts, deep dives into model elements, and including actuarial talent on the board. A supervisor also cautioned that leadership should be sensitive to whether models become less accurate over time. This is *"the analytical question of drift. Does the model drift* *over time?"* As insurers and regulators adjust to internal models, firms may continue to revise model governance.

- **Address possible procyclicality.** On December 16, the European Systemic Risk Board (ESRB) – a group widely known for its work in banking, not insurance – published a report arguing that insurers contribute to systemic risk via procyclical investment behavior.[9] To offset procyclicality, the report calls for countercyclical buffers, which would accumulate capital in healthy markets and release it in periods of stress. The report also calls for enhanced liquidity supervision. Insurers have disputed the findings of the report.[10] The ESRB does not have formal regulatory authority, but the report may demonstrate how regulators are thinking – namely, that the synchronized behavior of smaller institutions may create risks just as the so-called too-big-to-fail institutions can. The report was published just weeks before implementation of Solvency II, a regulation that many say may worsen procyclicality via the use of mark-to-market accounting and one-year value-at-risk capital charges. These requirements and others may encourage firms to hold similar assets and have shorter investment horizons.

How are insurers translating value to investors in light of new solvency requirements and metrics?

Among the goals of the solvency capital requirement (SCR) under Solvency II is to make firms more comparable. Insurers and supervisors believe that, over time, ratios and new reporting requirements will improve comparability, even if the SCR is not yet fulfilling this goal. One participant summarized the current situation: *"It may be a bit of apples to oranges, but at least we are all consuming fruit."* Currently, however, investors, analysts, firms, and supervisors recognize that there is a lot of confusion about what solvency ratios mean and how markets will respond.

"The market is nervous. There is uncertainty on Solvency II and how the market will respond."
– Director

One participant asked, *"Does a ratio of 200% mean the same thing in France and Germany? Clearly, that is not the case."* Another asked, *"Is a high ratio a good thing because you are in a good capital position, or a bad thing because you are overcapitalized?"* Some stakeholders wonder if ratios could presage cost reductions, special dividends, or other actions. Insurers have expressed concern that, as one director put it, *"investors boil things down to one number and make snap judgments."* Insurers will need to make their cases to analysts and investors, the ultimate interpreters of these measures, about why their ratios are appropriate.

Important messages from the analyst community

On January 19, Prudential joined Allianz, AXA, and Aegon in announcing its SCR.[11] In the coming weeks and months, many firms will follow. Firms are keen to understand how markets may view these ratios. Discussions with several analysts and investor relations professionals raised the following themes:

- **Firms should expect scrutiny but not be too concerned by it.** *"Headline risk exists, but it is short term … the SCR is not the 'be all, end all,'"* said one participant. Furthermore, markets have always struggled with insurance balance sheets: *"Balance sheet complexity is reflected in a discount in the share price,"* argued another participant. Markets will react to SCR reporting but ultimately will look to more than a simple number to understand a group's value.

- **Analysts are focused on each organization's value drivers.** Participants agreed that, at the highest level, investors want clear disclosures on how capital is generated and how it is used (e.g., organic growth, mergers and acquisitions, dividends). Furthermore, markets will want a clear sense of future value creation, not just a point-in-time view. One participant asked, *"Is value front loaded in the SCR now, or will it come out over time?"* Share price will favorably reflect future value, which may also be a function of business model flexibility. Those insurers who can reprice or change terms may be in a better position than those who cannot.

- **A firm's trustworthiness and reputation will influence market reactions.** One participant cautioned, *"If you don't have credibility, it will take years to build. Consistent communication helps the market to understand. Analysts can't recalculate Solvency II numbers. You can't just update something and say, 'This is how much capital a company should have.' It is a bespoke calculation. Markets will look at what companies do, not just what they tell you. It tells you more about their capital position than the actual number."* Investors will look at how companies act (i.e., dividend policy, mergers and acquisitions, or divestment decisions) to confirm the narratives that groups put forth.

- **Disclosures are simplistic but will evolve quickly.** *"As we move from the lab to the real world, we will learn quickly – firms, analysts, and supervisors,"* said one executive. Currently, typical disclosures reflect the quantum, not the quality, of capital and this may change over time. *"Quality of capital is not yet thought about. We don't have that level of disclosure. We are lucky if we get Tier I, Tier II, and Tier III. That is the level of granularity. At some point, that will improve*," said one participant.

"What sort of surpluses is everyone expecting? We are required to take care of the 1-in-200-year event. What do the regulators or the markets really expect?"
– Director

- **Diversity may not counter volatility sufficiently.** Some market observers caution that the assumed diversity benefit may be insufficient in times of stress when different assets can become more correlated. One participant noted, *"One issue with Solvency II is that diversification may get pushed to the extreme. Analysts worry that insurers are given too much credit for diversification and accept volatility. Analysts worry when they see diversification on capital market risks. If you look at the Asian crisis, the dotcom burst, 2008, you start to question diversity credit."*

- **Variations in the use of transitional measures and accounting standards will complicate disclosure.** The transitional measures allow insurance groups up to 16 years to phase in technical provisions of Solvency II, allowing for a smoother transition. There is some disagreement among geographies as to the merits of transitionals. For example, UK insurance groups and the Prudential Regulatory Authority (PRA) are generally supportive of their use, while many insurers and supervisors in continental Europe are less supportive. IGLN participants questioned how firms should disclose the use and value of these measures, and how markets will react. One director asked, *"Does your solvency number include transitional measures or exclude them? If you exclude them, the result could be completely different. This should matter to the market as well. Investors don't know enough to evaluate this."* In speaking to this point, Sam Woods recently noted that the PRA will include use of transitionals in calculations of capital adequacy and ability to dividend:

> With rates where they are, the risk margin is currently large for UK life insurers. In the near-to-medium term, transitional measures absorb the impact of this – and I would like to repeat what I said in July: the Bank will allow full use of transitional measures by those firms that qualify to use them. And when we consider whether or not firms are in a position to pay dividends, one of the main quantitative yardsticks we will use is capital levels after the benefit of transitionals.[12]

Insurers also worry that they will have to reconcile performance and capitalization under many different accounting and solvency regimes. One director said, *"Solvency II, the [ICS], IFRS [International Financial Reporting Standards], GAAP [generally accepted accounting principles] – there are dozens of required formats explaining the same companies with different metrics and realities."* Another agreed, noting, *"Perhaps there is an issue of claims reserving, assets, or premiums – local GAAP versus IFRS. Then the public asks for alignment at the shareholder meetings, and it is impossible to provide."*

Steps stakeholders can take to improve market understanding of SCR

Insurers operating under Solvency II are now focused on improving communication with the market. As metrics change and firms feel less able to anticipate market responses, IGLN participants identified activities different stakeholders can undertake to improve outcomes for individual firms and the sector:

- **Individual firms need to articulate the specifics of the business and internal models.** To meaningfully explain value drivers, insurers will need to help markets understand how internal models work and how business model choices affect the solvency ratio. One supervisor suggested, *"Companies should do the same exercise with investors as with regulators. Explain how the models work. What are strengths and weaknesses?"* So-called "outlier firms," or those with more unique business models (e.g., significant closed books of business or banking operations), may have the most work to do in this area.

> *"Everyone wants to understand – will it affect the dividend? Do you need to raise capital? It is not black and white."*
> – Director

- **Firms should collaborate to underscore broad principles.** Firms will need to explain their own SCRs, but they also should collaborate to communicate key themes to the markets. *"There are a few key principles: one size does not fit all; you can't rank and stack groups; and it is not an arms race – you do not get a gold star for a capital ratio of 250%,"* said one participant.
- **Insurers should clearly define the board's role.** *"Direct communication falls to management, but the board should be closely following market communications as we transition to new regimes,"* said one director. Several directors indicated their boards are involved in developing, approving, or advising on new communications strategies. When asked about how individual board members can add the most value, one director suggested, *"Good questions for the board are 'What challenges does your CFO have? Are you aware of the main issues around capital? Do you understand the basics of the various methodologies?'"* One participant cautioned, *"It is important for the board to stay on top of this. Don't let the tail wag the dog. Mechanics need to be understood. There are huge amounts of technical information."*

- **Supervisors have a role in explaining the regime to the market.** Participants agreed with one supervisor who observed*, "We do have a responsibility to explain the regime. We pick a few messages and try to hammer them home. We make sure analysts understand what we are thinking, but it is not a job for us to do the investor relations for a firm."* Specifically, participants agreed that supervisors could underscore that solvency ratios will move for two reasons, with very different implications for investors. Ratio movements due to market swings may be far less significant than movements related to underlying weaknesses in the business.

How might the global regulatory agenda evolve, and what challenges does it face?

Insurers with European operations have been extremely focused on the implementation of Solvency II; however, the IAIS agenda, including the development of the ICS and additional regulations for global systemically important insurers, also continues to move forward. Participants broadly agreed with the need for an international capital standard and, to a lesser extent, new requirements for systemically important insurers. One participant observed, *"Because insurers are global, we need a global solution. It is in insurers' interest to have a comparable standard because they are only becoming more global."*

"Is safety and soundness of the group relevant? If you believe that, it is hard to say you are against a global standard."
– Supervisor

However, directors have many questions and ideas about standards development. Over the discussion, participants discussed tactical implementation questions and shared concerns about new standards. The following themes emerged:

- **ICS implementation will begin in 2020, with a long transition period.** The first basic standards will be developed by 2017. More concrete standards, which consider internal models, will be developed by 2019, and implementation begins in 2020. Participants and other observers have noted that while implementation is several years off, this timeline is far shorter than timelines used to develop comparable banking standards or Solvency II measures. Insurers are somewhat concerned that quick development could inhibit meaningful debate and industry engagement in the process.

- **Stakeholder pressure will facilitate ICS adoption.** The ICS must be adopted locally, so full adoption will take time and be subject to local pressures. One director observed, *"You have to get regulators to agree. You need to get political buy-in country by country. You could get a lot of opposition on accounting standards. You need to get parliaments to approve. They have to have a reason to get behind it. To get them to abandon an existing regime is quite an endeavor."* To help facilitate broad adoption, one policymaker said, *"The intention is not just reporting to regulators, but to the markets, including credit rating agencies and investors. They will create market pressures to use the measures."*

"The ICS will come. There are a lot of difficulties in how it comes. The target is 2020."
- Policymaker

- **The ICS will be lower than some national standards.** Unlike Solvency II, which raised capital requirements, the goal of the ICS is to create a new global minimum standard. Accordingly, the standard will be lower than some existing national standards. One supervisor said, *"The goal is not raising capital; it may be lower in some areas, but globally harmonized. Consistent capital is the goal … Standards will be low and up to the national regulators to add on. A higher bar would make approval harder. Minimum capital is the goal."*

- **Valuation differences are the biggest hurdle to ICS implementation.** A global standard must accommodate the methodologies and principles that guide Solvency II, as well as US valuation of liabilities and risk-based capital standards. Participants widely agreed that this is the largest hurdle to development of a meaningful ICS. Unfortunately, given the lack of convergence in accounting standards, some participants view a global capital standard as all but impossible. One policymaker acknowledged, *"There is an enormous challenge when regulating accounting issues. If you could agree on US and European accounting convergence, then more than half of the work is done."*

  To resolve this challenge, the IAIS is not committing to a single valuation approach but to, in the words of a policymaker, *"trying to make a more comparable valuation … The goal is to make GAAP and market-adjusted data converge and make them reconcilable."* One director asked, *"Does the IAIS engage with accounting authorities? Your supervisory authorities need to speak."* Supervisors acknowledged that supervisory regimes do communicate, but given different mandates, agreement can be difficult to achieve. Like Solvency II, *"ICS will not wait for accounting convergence. It would be helpful, but the agenda is the agenda. The IAIS will not wait,"* a policymaker said. One supervisor noted the challenging environment but concluded optimistically, *"It is a bit unfortunate that the debate on global 'systemic-ness' got bound up with the ICS debate. The bigger prize is ICS. The globally systemic approach is bringing fears that banking regulation is coming across to insurance. We have broadly managed to get to convergence in banking - Basel III, Capital Requirements Directive IV - so it must be possible for insurance."*

- **Insurers support a global standard but worry about the proliferation of multiple standards.** Insurers are concerned that in 2020, as a result of the ICS and other regulatory changes, they will face even more standards, as well as greater complexity and expense. One audit chair noted, *"There is Solvency II, ICS, and also [IFRS 4 Phase 2] coming into place by 2020. These are at least three new standards and separate reporting requirements at that time. Then add to that ratings agencies, [market-consistent embedded values] … How many measures are enough?"* Another participant asked, *"So when does Solvency II cease? If the ICS is relevant and has teeth, it should replace what's there."*

- **Local standards, including Solvency II, may shift to accommodate the ICS.** It is too early to predict areas where existing regimes may conflict with the proposed ICS. However, many observers note that local regulatory regimes may have to adjust to accommodate the global standard. Insurers and local supervisors will be somewhat resistant to this given the sunk costs associated with Solvency II and other regimes. However, one European policymaker remarked, *"We want to be part of the solution. We are willing to make adjustments to Solvency II for the convergence of local, regional, and international standards, but we have some red lines."*

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As insurers become more global, boards find themselves in the unique and challenging position of having to understand the entire global regulatory picture. Prudential regulators are focused on policyholders and taxpayers within their jurisdictions. Even at the level of the

"The key challenge is accounting and valuation, valuation, valuation."
– Supervisor

"Transatlantic convergence is the key to global convergence. If we address transatlantic convergence, it is a huge accomplishment."
– Policymaker

IAIS, the main stakeholders are local regulatory authorities. As Solvency II demonstrates, boards must balance the interests of supervisors, shareholders, and the broader public. Balancing these interests while building competitive, sustainable insurers is a significant task. In theory, as regulations and supervisory expectations converge across jurisdictions via regional and global standards, the functioning of insurance markets as well as opportunities for sectoral and economic growth will improve.

About the Insurance Governance Leadership Network (IGLN)

The IGLN addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages members of senior management, policymakers, supervisors, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy insurance institutions. The IGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the IGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multistakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the insurance industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix 1: discussion participants

Over the autumn of 2015, Tapestry and EY held conversations with directors, executives, regulators, supervisors, and other thought leaders on the implementation of Solvency II and the evolving global capital agenda as led by the IAIS. These discussions culminated in the meeting on December 8 in London. Insights from these discussions informed this *ViewPoints* and quotes from these discussions appear throughout. The following individuals participated in IGLN discussions:

IGLN participants

- Alastair Barbour, Audit Committee, Risk Committee, Investment Committee, Nomination and Governance Committee Member, RSA
- Paul Bradshaw, Customer Interest, Audit, Actuarial and Finance, Risk and Compliance Member, Sanlam
- Richard Burden, Managing Director, Credit Suisse
- Marcia Campbell, Audit Committee, Risk Committee Member, CNP Assurances
- John Fitzpatrick, Risk and Capital Committee Chair, Audit Committee Member, AIG
- Raghu Hariharan, Director of Investor Relations, Prudential plc
- Ingrid Johnson, Group Finance Director, Old Mutual
- Yoshi Kawai, Secretary General, IAIS
- Sue Kean, Chief Risk Officer, Old Mutual
- Monica Mächler, Audit Committee, Risk Committee Member, Zurich
- Roger Marshall, Audit Committee Chair, Risk Committee, Remuneration Committee Member, Old Mutual
- Carlos Montalvo, Executive Director, EIOPA
- Andrew Palmer, Audit Committee Chair, Direct Line Group
- Sabrina Pucci, Non-Executive Director, Generali
- Raj Singh, Group Chief Risk Officer, Standard Life
- Kory Sorenson, Audit Committee Chair, Strategic, Risk, Crisis Management Committee Member, Scor
- Terry Stone, Regulatory, Compliance, and Public Policy Committee Chair, Audit Committee Member, AIG
- Tim Tookey, Risk Committee Chair, Nationwide Building Society
- Ben van der Veer, Audit Committee Chair, Nominating Committee Member, Aegon
- Sam Woods, Executive Director of Insurance Supervision, Bank of England

EY

- Martin Bradley, Global Insurance Finance, Risk, & Actuarial Leader
- Shaun Crawford, Global Insurance Leader
- Ed Jervis, Partner, EMEIA Financial Services, Insurance

Tapestry Networks

- Leah Daly, Principal
- Colin Erhardt, Associate
- Peter Fisher, Partner

Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

[2] Switzerland has received a full equivalence determination. Australia, Bermuda, Brazil, Canada, Mexico and the US received provisional equivalence for a period of 10 years.

[3] The risk margin is a capital buffer designed to cover the cost to pay a third party to take on a failed insurer's liabilities if put into runoff.

[4] Callum Tanner, "Hedge, Reinsure or Restructure: Insurers Mull Risk Margin Fixes," *Risk.net,* December 11, 2015.

[5] Sam Woods, "Solvency II: Approaching the Try Line" (speech, Association of British Insurers, London, November 3, 2015).

[6] Periodic payment orders are typically court-awarded, annuity-like arrangements for individuals who become permanently disabled. For a number of years, their use has been growing in several jurisdictions, including the United Kingdom. They require property-casualty insurers to provide for long-term liabilities. Treatment under Solvency II requires insurers to shift between property-casualty and life insurance capital requirements.

[7] Some participants worry that there is a mismatch in the treatment of reinsurance premiums. Primary insurers pay for the upcoming year and anticipate a degree of recovery. However, under Solvency II, insurers must expense occurring premiums with no matching adjustment or allowance for recovery. As a result, some primary insurers are asking for shorter reinsurance terms. In addition, for reinsurers the premium becomes a capital buffer.

[8] For more information, see Danielle Myles, "Solvency II Treats Insurers Like Traders," *International Financial Law Review*, November 11, 2015.

[9] European Systemic Risk Board, *Report on Systemic Risks in the EU Insurance Sector* (Frankfurt, Germany: European Systemic Risk Board, December 2015).

[10] Callum Turner, "UK Insurance Association Slams ESRB Report," *Risk.net,* January 13, 2016.

[11] Prudential, "Prudential plc Solvency II Capital Position," news release, January 19, 2016.

[12] Sam Woods, "Solvency II: Approaching the Try Line."