Dissolve Solvency II’s capital requirements?

By Editor Test *Wed, Mar 7, 2012*

The Dutch Social Affairs minister, a phalanx of pension-sponsoring industry associations, and European insurers are all protesting the stringent capital requirements proposed under Solvency II, the regulatory regime that would harmonize Europe's insurance standards.

As if Europe Union’s debt crisis isn’t causing enough anxiety, much of the EU’s insurance and pension community is alarmed over the potential impact of the stringent capital requirements proposed under Solvency II, which would harmonize insurance regulations across Europe.

Under-capitalization and excessive leverage helped cause the financial crisis, but Europe’s pension funds and financial institutions say that the remedy—higher reserves—might be worse than the disease, especially if that remedy led to more conservative investing, smaller profits, and higher pension contributions. Finding a balance between risk and safety appears elusive.

Here are summaries of three reports on the issue from *IPE.com* over the past week:

Industry associations say Solvency II will hurt pensions

A group of eight industry associations from across Europe has called on the European Commission to reconsider plans to apply Solvency II measures to pension funds. The group emphasized that occupational pensions are often bound by collective agreements and labor laws and are therefore obliged to protect members’ benefits and interests.

In the run-up to a recent public hearing on the revised Institutions for Occupational Retirement Provision (IORP) directive in Brussels, the group warned of the impact Solvency II rules would have on the pensions industry.

The group included BUSINESSEUROPE, the European Association of Craft, Small and Medium Sized Enterprises, the European Association of Paritarian Institutions (AEIP), the European Centre of Employers and Enterprises providing Public Services, the European Federation for Retirement Provision (EFRP), the European Fund and Asset Management Association, the European Private Equity and Venture Capital Association and the European Trade Union Confederation (ETUC).

Matti Leppälä, secretary general at the EFRP, said: “More workplace pensions are needed to guarantee adequate retirement benefits for citizens across Europe. The European Commission is in a position to enable good-quality workplace pensions, [but] if it imposes capital requirements on IORPs, then it jeopardizes the future of pensions in Europe because IORPS will de-risk their assets, and employers will find it very expensive to continue funding their pension schemes.”

Adopting the quantitative Solvency II rules to workplace pensions, the group said, would produce three important adverse effects:

- Risk-based capital requirements and valuation methods would force pension funds to build up higher reserves, raising the cost to employers of providing occupational pensions.
- Pension funds would likely de-risk their asset allocation, making less capital available to companies to create growth and jobs.
- Solvency II rules would be particularly damaging if all investors with long liabilities had to invest under the same rules, even if their structures were very different.

The group also reiterated its demand for a full impact assessment before a final version of the revised IORP directive is implemented.

“The impact of any new proposals must be measured through high-quality quantitative impact studies, including assessment of the social, financial and economic effects of any proposed rule changes, and their macroeconomic effects. A high-level political debate is also required with involvement from all the relevant stakeholders, most notably the European social partners,” the group said in a statement.

Bruno Gabellieri, secretary general at the AEIP, added, “Occupational pension schemes are in most cases compulsory as a part of the national labor law or collective labor agreements. Therefore they are not involved in any level playing field and do not compete with other providers.

“The goal of the regulation should consist in facilitating the existence of good pension schemes for European workers and citizens, and, therefore, social partners should be allowed to steer the promises they make rather than have extra capital costs imposed, which are a burden for the employers.”

Claudia Menne, confederal secretary at the ETUC, agreed.

“We have growing concerns regarding the possible plans of the EU Commission to propose a new solvency regime for occupational pensions,” she said. “The proposals will significantly change investment patterns, restricting capital flows to business, resulting in lower benefits for pensioners. Occupational pensions are part of collective agreements and are restricted by labor and social laws to a legal obligation to protect members’ benefits and interests.”

Dutch parliament “up in arms” over Solvency II

In a letter to the Dutch parliament, Social Affairs minister Henk Kamp said: “If the Solvency II accounting rules for insurers are also made applicable to pension funds, Dutch schemes will have to increase their financial buffers by 11%.

“The proposed increase of the certainty level for benefits from the current 97.5% to 99.5% will mean an unnecessary increase in contributions, further postponement of indexation and possibly additional discounts of pension rights.”

Kamp added that, for the Dutch government, it was “all hands on deck” to “turn the tide.”

The European Commission is set to hold a public consultation later today on proposals for a revised Institutions for Occupational Retirement Provision (IORP) directive.

According to Kamp, the UK, Ireland, Germany and the Netherlands – countries with similar pensions systems – have all agreed to show a united front against proposals to apply Solvency II rules to pension funds.

"Other European countries, such as France, don't want competition for their pension insurers from Dutch pension funds because they want to keep a level playing field," he added.

However, Kamp also said he had received a "positive response" from his French counterpart when discussing the Dutch position, adding that he planned to visit his Swedish counterpart again for support.

Almost all political parties in parliament have voiced concerns about the consequences of what they believe will be the European Commission's proposals for the Dutch pensions system.

BNY Mellon study reflects resistance to Solvency II

A survey sponsored by BNY Mellon and conducted by the Economist Intelligence Unit, found that a majority of institutions surveyed believe that Solvency II "oversteps the mark."

Almost three quarters of survey respondents (73%) agree that insurers will pass the cost of compliance with the new regulations on to policyholders, and that both non-financial institutions and individuals may choose to be under-insured to avoid the higher costs.

Set for implementation in January 2014, Solvency II aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements.

The Economist Intelligence Unit conducted a survey of 254 EU-based companies, including insurers, other financial institutions and corporates (non-financial institutions). The research, *Insurers and Society: How Regulation Affects the Insurance Industry's Ability to Fulfill its Role* – is available at www.bnymellon.com. Paul Traynor, head of Insurance, Europe, Middle East & Africa at BNY Mellon, said in a release:

"There is an understandable tendency on the part of regulators to focus more on protection than risk-sharing, but that presents the insurance industry with a challenge. The public wants insurers to fulfill three key roles for society: provide individuals with saving and pension products and to insure them against specific risks; provide corporations with an efficient mechanism to transfer risk; and to be a source of debt and equity capital to industry.

"However, the survey suggests there is a real concern that the cost of regulation may raise the cost of life cover and annuities, perhaps beyond a tipping point. It also suggests that, as currently calibrated, the regulations will inadvertently crowd out debt and equity capital for industry in favor of EU sovereign debt and unproductive cash holdings. That will make it ever more difficult for insurers to make those positive contributions to society."

Monica Woodley, senior editor at the Economist Intelligence Unit, said: "A majority of respondents favor an overhaul of insurance regulation in the EU and recognize the importance of the sector to society. Indeed, 86% of insurers surveyed believe the industry must contribute positively to society. Our survey findings indicate that, although there is a perception that something should be done to improve the current situation and that harmonisation should bring its own benefits, the proposed regime could be seen to be overly cautious. The findings suggest that while the industry welcomes the broad thrust of the regulation, certain calibrations are wrong."

"The demands of the new regime threaten to disrupt the key role played by insurers as investors in the capital markets, by pushing them towards 'safer' assets with lower capital charges, and away from the equities and non-investment grade debt on which much private industry depends for financing," BNY Mellon said in a release.

Only 16% of respondents agreed that the proposed legislation strikes the right balance when it comes to ensuring insurers have sufficient capital to meet their guarantees. Insurers and financial institutions are more critical of Solvency II than non financial institutions, with 55% of the former but only 39% of the latter saying the directive "goes too far." Less than one in five insurance respondents (18%) believe that most insurers are currently under-capitalized.

Over half of survey respondents (51%) believe the shift to unit-linked policies, which put the investment risk on the policyholder, will have a negative long-term affect on pension and long-term savings provision, with life insurance and annuities considered the products most likely to be negatively affected.

Other key findings were:

Insurers expect to further de-risk their asset allocations. A clear shift down the risk spectrum is anticipated by respondents. Assets expected to attract more interest include investment-grade corporate bonds, cash and short-dated debt, at the expense of non-investment-grade bonds, equities and long-dated debt.

Corporates seem less aware of the impact Solvency II will have on debt issuance. Among insurers and other financial institutions there is a strong consensus that Solvency II will make the tenor and rating of bonds from corporate issuers more significant, as insurers, driven by capital charge considerations, are increasingly pushed towards investment-grade debt.

Regulators should revisit their capital charge levels. Overall, less than a quarter of respondents (22%) believe that regulators should maintain the current capital charges.

Solvency II may create a 'squeezed middle' among insurers. Only 16% of respondents expect no material impact from Solvency II on the structure of smaller member-owned insurers ("friendlies") and mutuals, and 54% believe the pressures of the new capital requirements will result in industry consolidations.

BNY Mellon has $2 trillion in insurance assets under custody and its clients include three-fourths of the top

100 life insurers and 70% of top 50 non-life insurers worldwide. The company manages over $83 billion for insurance companies.