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COMMENTARY

Solvency II Capital Interventions May Need to Be Tempered by Awareness of Firm Conditions

Alberto Corinti, head of Promontory Financial Group's Brussels office and former secretary general of the Committee of European Insurance and Occupational Pension Supervisors, says Solvency II ratio analysis should weigh the measurement's volatility and firms' conditions.

Solvency II aims to align risk management best-practice with regulatory compliance. To succeed, however, its theoretical soundness should be reconciled with sufficient pragmatism.

The financial crisis has highlighted that prudential regimes should be risk sensitive and transparent enough to provide effective early warnings and allow supervisory interventions before risks turn into losses.

Even though Solvency II was not initiated as a response to the financial crisis, these objectives are certainly main drivers of the regulation. Yet, the project seems now in trouble because of the effects of its risk sensitivity and market consistency.

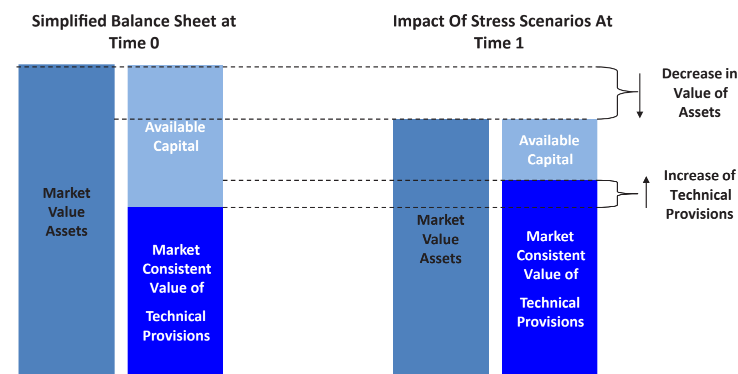
Solvency II fully reflects current market conditions in valuing assets and liabilities, influencing the determination of available capital. It calculates capital requirements, or SCR, based on a potential loss scenario that depends on a predetermined probability, 99.5 percent value-at-risk, and time horizon, 1 year.

Being the best solution or not, this approach intends to provide supervisors an early warning about a firm's solvency based on its ability to dismiss liabilities to policyholders at market value before the firm's available capital breaches minimum thresholds. More generally, the approach also allows harmonization and transparency of the solvency measurements, in line with best-management practices.

At the same time, the approach inevitably allows the solvency ratio to vary over time and potentially leads to signals of solvency stress when the market is functioning abnormally, sometimes not truly reflecting the solvency of the company, which may be able to absorb short-term market volatility. The 2008 financial crisis and the emerging Eurozone crisis would in fact be compliant with Solvency II rather than problematic.

These volatile signals could trigger supervisory interventions, which might not always be proportionate to the solvency of the company, in particular when they depend on short term market stress. Such disproportionate interventions, applied across the European insurance market, may lead to further market deterioration. As a consequence, companies could be pushed to hold a capital buffer over the requirement to absorb such volatility.

EU regulators have included mechanisms to soften the market-induced volatility of solvency ratios. One method is to adjust the SCR, through the so-called "equity dampener"[1] or by adjusting discount rates used to calculate insurance liabilities[2] when assessing available capital. It remains to be seen whether these mechanisms will achieve the desired outcome. It is easy to predict that whatever the design of the adjustments, volatility of the solvency ratio cannot be fully avoided. It is therefore important to create formal and substantial conditions to enable supervisors to correctly interpret volatility, which distinguishes short-term market-induced effects from firms' solvency gaps, avoiding ineffective interventions. In other words, the Solvency II solvency ratio, as any other stress-test result, should be analyzed considering its assumptions and in combination with other information on the company. Interventions should depend on the reasoning behind the ratio rather than its absolute level. Solvency II already includes some provisions which allow, within certain limits, supervisors' flexibility, though uncertainties remain about how they will be implemented. It remains to be seen how other readers of Solvency II reports will react to such volatility. This has the potential to produce distorting effects on the financial markets and even to disadvantage the insurance sector as compared to other financial services. It is necessary to enable a correct and unequivocal interpretation of Solvency II reports, taking duly into accounts their assumptions and objectives.



Source: *Alberto Corinti*

[1] Through this mechanism the capital charge for equity risk also depends on the current level of equity market and is softened in periods of a depressed market.

[2] In particular, the addition of an appropriate "premium" to the rates used to discount liabilities would offset abnormal widening of assets' spreads, reducing the overall impact on available capital in stressed market conditions.

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