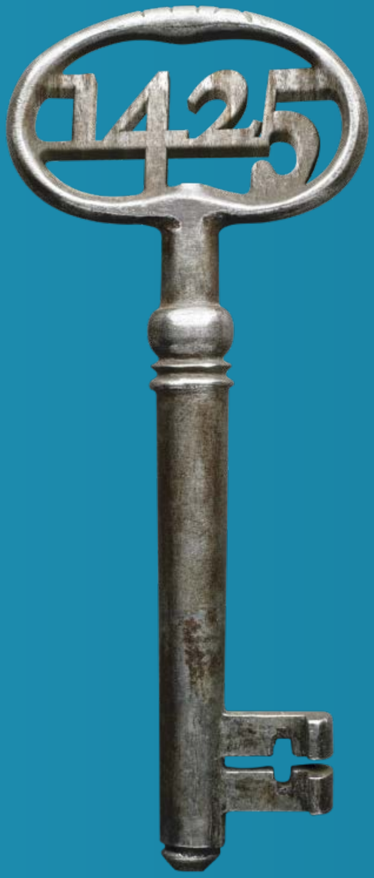
KU LEUVEN

ICIR
International Center for Insurance Regulation



Risk Disclosure in the European Insurance Industry: Implications for Occupational Pension Funds

Prof. Karel Van Hulle
KU Leuven and Goethe University Frankfurt (ICIR)
Chairman IRSG – EIOPA

2015 PRC Symposium
Wharton School, University of Pennsylvania
Philadelphia, 30 April 2015

Why solvency reforms?

- In the EU, the last major solvency reform took place about 30 years ago
- A regulatory update of Solvency I in the EU was prepared after the capital market crisis that hit the world at the beginning of this century
- Absence of international “guidance” both in accounting and in solvency, i.e. the insurance sector has not followed the reforms that have taken place in banking (Basel reforms)
- After the last financial crisis, pressure is increasing for the insurance sector to update its regulatory regime

Is there a problem?

- The present solvency regime is not sufficiently risk sensitive, i.e. it does not contain an incentive to improve risk management
- Unless the regulatory framework is changed, it is unlikely that the insurance industry will fundamentally change present practice
- Risk of regulatory arbitrage with the banking sector, i.e. more non-traditional insurance activities are being carried out by insurance undertakings
- Total lack of comparability between insurance undertakings both within the EU and internationally

Solvency II: 3 pillars and a roof

Group supervision
& cross-sectoral convergence

Groups are recognised as an economic entity
=> supervision on a consolidated basis
(diversification benefits, group risks)

Pillar 1: quantitative requirements

1. Harmonised calculation of technical provisions
2. "Prudent person" approach to investments instead of current quantitative restrictions
3. Two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR)

Pillar 2: qualitative requirements and supervision

1. Enhanced governance, internal control, risk management and own risk and solvency assessment (ORSA)
2. Strengthened supervisory review, harmonised supervisory standards and practices

Pillar 3: prudential reporting and public disclosure

1. Common supervisory reporting
2. Public disclosure of the financial condition and solvency report

(market discipline through transparency)

Main characteristics of Solvency II

- Market consistent valuation of assets and liabilities
- Total balance sheet approach
- Two capital requirements: SCR with confidence level of 99,5% VaR over a one year time horizon and MCR with absolute floor
- Possibility to calculate the SCR using an internal model approved by the supervisor
- Three pillar approach introduced by Basel II for banks
- Extended and fully harmonised supervisory powers
- Group supervision on equal level with solo supervision

Where are we now on Solvency II?

- Solvency II Framework Directive will apply from 1 January 2016
- Omnibus II Directive amending the Solvency II Directive was adopted on 16 April 2014 (financial crisis, powers of EIOPA, transitional measures, long term guarantees, proportionality, equivalence)
- Level 2 implementing measures were adopted by EC on 10 October 2014 and were published in the Official Journal of the EU on 17 January 2015 as a Commission Regulation supplementing the Framework Directive
- Level 3 and Level 4 implementing measures under preparation by EIOPA: Implementing Technical Standards & Guidelines
- Two sets of ITS delivered by EIOPA to EC after consultation with stakeholders; both sets are accompanied by Guidelines.

Pension Funds Directive of 3 June 2003

- First EU measure concerning occupational pension funds
- Heavily contested by a number of MS (EU competence)
- Main objective: Facilitation of cross-border structures
- Matters covered:
  - Registration + governance rules
  - Cooperation between home and host Member States
  - Limited harmonisation of solvency rules (technical provisions, investment rules, regulatory own funds)
  - Prudential supervision
  - Information to members and supervisory disclosure

Revival of pension debate in the EU

- Structure of pension provision is sole responsibility of MS but the EU can no longer ignore the way in which MS have dealt with this matter (for instance, budgetary crisis in Greece)
- Green Paper on adequate, sustainable and safe European pension systems (7 July 2010)
  - 1700 responses from across the EU
  - Includes proposed review of Pension Funds Directive
- White Paper on adequate, sustainable and safe European pension systems (16 February 2012)
  - Confirms review of Pension Funds Directive

Solvency rules for Pension Funds

- Pension Funds not included in scope of application of SII
- Solvency debate only relevant for Pension Funds that offer DB pension schemes
- Holistic balance sheet proposed by EIOPA tries to capture the various types of structures of pension funding in EU
- First QIS by EIOPA shows important funding gaps
- EU employer and employee organisations oppose the introduction of solvency rules for Pension Funds
- New Commission Proposal (2014) concentrates on governance, risk management and transparency

Importance of risk dislosures by IORP's

- More and more pension plans move from DB to DC
- For members with a DC pension plan, it is important to know that they bear the risk, how their assets are being invested and what their pension is likely going to be
- For members of a DB pension plan, it is important to know to what extent the pension fund will be in a position to pay their entitlement
- The planned reforms in the EU are likely to be of benefit to the members with a DC pension plan but are unlikely to provide the members with a DB pension plan with the information they need

Concluding observations

- It is not because pension funds bear the ultimate responsibility to pay their members the agreed benefits, that risk disclosure is no longer relevant
- Risk disclosure does not mean much if it is not based on agreed valuation standards
- There is no level playing field between insurance undertakings providing life insurance and pension funds offering defined benefit plans
- Risk based solvency standards for pension funds will have to provide long transition periods for the existing book of liabilities

Prof. Karel VAN HULLE
Research Center Insurance
Faculty of Economics and Business
KU Leuven
Naamsestraat 69 Box 3525, B-3000 Leuven
karel.vanhulle@kuleuven.be

International Center for Insurance Regulation
Faculty of Economics and Business Admin.
Goethe University – House of Finance
Grüneburgplatz 1, D-60323 Frankfurt am Main
VanHulle@finance.uni-frankfurt.de

ICIR International Center for Insurance Regulation

KU LEUVEN