

The CEA's written contribution to the de Larosière group

1. Introduction

The CEA made representations to the de Larosière group on 7 January. The exercise was extremely useful and the CEA was encouraged by the transparent, thorough and incisive way that M. de Larosière and distinguished colleagues have approached this extremely important review.

We have reflected further on that discussion and would like to offer you a brief summary of our views. This is set out below.

Please also see the attached annex for our more detailed comments on insurance regulation.

2. Current financial crisis

The insurance industry has been less affected by the current financial crisis than the banking industry. The larger European insurance firms and groups in particular have implemented sophisticated risk management systems and controls over the last few years in response to stakeholder pressures; from investors seeking stable returns, analysts, rating agencies and regulators. These systems have stood up well in the current turmoil, and with few exceptions insurers have avoided major losses, although of course they cannot be immune from general falls in equity values and investment returns.

However, the current financial turmoil has underlined the importance of reforming the prudential regulation of the financial services industry and of strengthening supervisory architecture.

3. Regulation of the financial services industry

The regulatory framework for insurance in most EU member states has fallen significantly behind developments in the industry over the last few decades and is not harmonised. This is particularly true with regards to the supervision of groups. Cooperation between supervisors over the supervision of groups is incomplete and limited in scope.

In our view, Solvency II, as designed in the original proposal by the European Commission, would address the shortcomings of the current regulatory framework for insurance. Solvency II would give us a harmonised risk-based and economic prudential regulatory regime. Importantly, it would also improve the way groups are supervised and introduce the group support regime, which is an innovative way of facilitating capital management within groups provided that they meet certain requirements to enter the regime. At the moment group supervision is supplementary to solo supervision. A key benefit of Solvency II is that group supervision becomes complementary and groups are recognised and supervised as economic entities.

It is therefore important that key principles of the original proposal are not compromised in the political negotiations and that we maintain the momentum to effect change. The insurance industry is concerned that substantial amendments to the proposal will jeopardise the benefits that Solvency II is expected to bring to both industry and consumers.

4. Supervisory architecture

We support the strengthening of the role of CEIOPS. We believe that CEIOPS has done a great deal to foster supervisory cooperation and convergence and should be complimented for its good work. It is, however, limited by the Solvency I approach to group supervision, which is merely supplementary, and by the current framework of voluntary agreements. What we need are binding decisions, more resources, a possibility for CEIOPS to mediate in case of diverging views from supervisors, and a clear framework for supervisory cooperation. The group support regime introduced by Solvency II would address the latter issue by giving the supervisors concrete tasks and responsibilities on which to cooperate.

We would, however, not support merging CEIOPS and CEBS or the creation of a single regulator covering all sectors of financial services. This is because there are significant differences between the insurance and banking industries. In particular, the business model of insurance is different and inherently less subject to market systemic issues of the magnitude recently encountered by banks. The primary aim of insurers' investment activity is to cover liabilities with appropriate and well diversified assets. The fact that insurers do not use leverage to enhance their investment returns makes them less exposed to fluctuations in financial markets. In addition, insurers are primarily funded by policyholders' premiums, making them less exposed than banks to liquidity risk and to any problems accessing credit markets.

An integrated approach to supervision does not necessarily mean that cross-sectoral supervision would work in practice or that there will be better cooperation between supervisors. In our view both issues can be addressed equally well by reinforcing the role of Level 3 committees. If it is decided to proceed with an integrated approach, a number of issues need to be considered carefully. There should be a sufficient number of supervisors with insurance knowledge and their independence should be ensured.

5. International dimension

If Solvency II is adopted without compromising its key principles, it has the potential to be a role model internationally. The European Union would be the first region in the world that has brought supervision into line with economic reality.

6. Concluding remarks

We understand that the de Larosière group is considering a number of ideas for the future of EU regulation and supervisory architecture. The CEA is very open to considering any forward thinking proposals coming out of the work of the de Larosière group.

Annex to the CEA's written contribution to the de Larosière group

We would like to make a number of further remarks on insurance regulation. The regulatory framework in most member states has fallen significantly behind developments in the industry over the last few decades. This is partly due to the growing complexity and sophistication of the industry and partly a comment on the growth of the single market, such that insurance groups trading across borders account for approximately 80% of the European market.

Regulation of complex firms and groups under the current insurance directives is clearly lacking. What holds regulators back? To some extent it is a shortage of resources and expertise.

However the key constraint is not having access to the appropriate powers and tools. The main shortcomings are:

- There is no consistent approach to balance sheet valuation. It is impossible, therefore, to make an informed assessment of the financial strength of a firm or group or to compare that with other firms in different member states
- Capital is set on the basis of crude ratios with no distinction made for the risk posed by the firm
- There is no consistent approach to the management of risk
- Cooperation between supervisors over the supervision of groups is incomplete and limited in scope.

In the insurance sector, thankfully, we have the Solvency II proposal. This has been under discussion and development for a number of years and has the full support of the industry. In our view it contains the necessary elements to construct an effective and contemporary regulatory framework.

The key proposals are:

- A fully harmonised framework of prudential regulation with the possibility of developing agreements with other regulators outside the EU
- A strong emphasis on effective internal governance and control frameworks
- Common valuation principles, encouraging a level playing field and improved comparability
- Regulatory capital set to a high confidence level based on a standardised and accurate assessment of risk
- Effective arrangements for the regulation and supervision of groups, including provisions for mutual reliance and cooperation between supervisors. Under Solvency II groups are recognised as economic entities and group supervision is not merely supplementary to solo supervision.
- A role for CEIOPS in providing guidance and advice
- Enhanced disclosure and transparency

What further measures do we therefore see as necessary to ensure regulation is equal to the task?

- We must have a speedy adoption of Solvency II without compromising the key principles of the original proposal from the European Commission.
- Key aspects of Solvency II are the provisions relating to groups. These are crucial if we are to maintain a level playing field and avoid distorting competitive pressures.
- The effectiveness of the groups proposals could be enhanced by a stronger role for CEIOPS, for example by giving it more resources and making decisions binding. It is critical that the directive is applied consistently and that national supervisors can rely on other supervisors acting fairly according to the rules even during a crisis. This requires CEIOPS to have the power to make directions and to enforce a degree of compliance.
- The directive may require some amendment to avoid unintended procyclicality arising from market valuation and the value at risk based capital requirement. Some smoothing across the cycle might therefore be desirable.

We believe therefore that Solvency II provides the essential ingredients, together with an enhanced role for CEIOPS, to put the regulation of insurers on a sound and effective basis.

It is absolutely critical, however, during this period of unprecedented turmoil in the financial sector, that the directive is adopted and implemented without delay.

If the directive were to be delayed into the next parliament or significantly compromised during negotiation, then policymakers would be taking a significant risk with the stability and future prosperity of a vital pillar of the financial system.

About the CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA, which is based in Brussels, represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 122bn, employ one million people and invest more than €7 200bn in the economy.