

European Parliamentary Financial Services Forum 10 Sept 2008 meeting
Solvency II - Group diversification, group support regime and group Supervision
Speech by Philip Long, Head of Group Risk, Prudential plc.

Ten years ago, Alan Greenspan made a speech to commemorate the 10th anniversary of Basel I. The speech was entitled: 'The Role of Capital in Optimal Banking Supervision and Regulation.'

Greenspan set out four core principles which interestingly enough, even 10 years later, are consistent with the thoughts I want to share with you today:

First of all, Greenspan said that regulation should "Act much as the market would if there were no safety net... and all market participants were fully informed".

Second, he said that there should be an emphasis on "Constantly improving supervisory techniques." "Supervisors should incorporate the risk analysis tools being developed and used on a daily basis within industry itself."

Third, he said that "Adding more and more layers of arbitrary regulation would be counterproductive" and that "Regulators should look for ways to harness market tools and market-like incentives whenever possible."

Greenspan's final point was: "Supervision and regulation can never be a substitute for a bank's own internal scrutiny or for the market's scrutiny of the bank."

I'd like to echo what Greenspan said by saying two things:

First, that Prudential is very supportive of the Solvency II recommendations because it's an economic, principles-based framework and they put the emphasis on the insurer's own risk management tools and practices.

My second point is: We are keen for there to be as little change as possible with the recommended economic approach. In particular I mean when it comes to implementing Solvency II.

So, we are very supportive of Solvency II recommendations because they are consistent with what many leading European insurers have been doing over the last few years.

What we're talking about here is understanding your business: The risk and value drivers and making good business decisions. If you do not measure and manage your risk appropriately, then you should wonder why you are writing it in the first place. So, clearly it really helps when the regulatory framework incentivises you to do the right thing. This applies to both small and large firms.

This economic approach enforces effective capitalisation of insurers and better protection for the policyholders. Also, the efficient pricing and management of risk will reduce any excess regulation. That will translate directly into reduced costs for society.

So, my second point: We are keen for there to be as few changes as possible to the framework. Even with the right principles-based framework there are implementation challenges that can potentially limit the benefits of this forward-looking approach towards regulation.

Within this context, I wish to address three major issues:

First, we need to make sure there is a level-playing field in Europe.

Second, it is critical that regulation gives the right outcome for European insurers in the global insurance market.

Third, applying a principles-based approach will change the expectations about the nature of regulators.

So, we've got to have a level-playing field across Europe: It's not so much first a product competition issue but more one of financial resources. **I'm talking about the group support regime here.**

We must have a consistent approach across Europe. We can't have a situation where solvency requirements and surplus financial resources depend on the legal structure of a group rather than the risks faced by the group. Remember, what the Commission has proposed for Solvency II is an economic treatment for solo entities, which is also being replicated for groups using their group support proposals.

There are good reasons why some groups have a subsidiary structure. Some groups find it more helpful for measuring responsibility and incentivising local management. And local regulators like it.

Changing to a branch structure just to access the economic reality of diversification benefits will be costly for insurers and policyholders. There will be a transfer of powers to the Head Office supervisor with little or no involvement from the local supervisor I am not sure this is what we really want.

And while I'm talking about that let me address a few concerns we continue to hear about the group support proposals:

We've heard people say that Groups will transfer funds to the parent as soon as group support is approved. And run subsidiaries with just enough to cover the technical provisions and MCR.

But then even under Solvency I the requirements are to cover technical provisions and solvency requirements. It's very unlikely that any group will want to hold just enough to cover the technical provisions and MCR. It would be incredibly irresponsible for a group to run the risk of non-compliance with the MCR because of the normal day-to-day volatility of asset values or losses. Today, most companies hold a buffer above the required solvency margin.

And in practice, Groups are driven by business considerations. They hold surplus funds in subsidiaries for strategic reasons. For business growth or M&A. For tax and ratings agency reasons.

Another worry people have had is that should financial meltdown occur, Groups will give preferential treatment to a subsidiary in its home country.

Again this will not be the case. Reputation is incredibly important to companies. It is in our interests to ensure that policyholders in every country we operate in trust us to do the right thing. And as I said before, groups hold surplus assets in subsidiaries for business reasons, and as a buffer.

The second reason why we are keen for there to be as few changes as possible to Solvency II is that **it's critical to make sure that regulation does not hamstring European insurers in the global insurance market. I am talking about group diversification here.**

A lot has been said about a level playing field in Europe between EU and non-EU groups. We support an economic treatment for all groups operating in Europe whether they have EU parents or not. We support supervisory convergence within the EU, and also outside the EU.

But what often seems to be lost in the debate is that there is an insurance market outside the EU and North America. It is an important and growing market - in Asia, Latin America and now the Middle East.

It has been suggested by some that for European groups, it would be necessary to notionally apply Solvency II requirements to subsidiaries outside Europe. But then bizarrely restrict diversification benefits only within Europe.

That inconsistency has profound implications for groups operating outside the EU. If we have to hold more capital than the other non-EU players or if we price rationally when others are pricing irrationally we just get driven out of the market. Everybody will be the poorer for it.

So we welcome the adoption of the consolidated approach to calculate the group SCR as the default and we welcome the recent clarification by the Commission that the intention is for diversification benefit to include both EU and non-EU entities. But we remain deeply concerned by some of the entrenched attitudes on this matter. We know that this is still a very live issue, looking at the aggregation approaches tested under QIS4.

This is not industry asking for *special treatment* - we are asking for the *correct treatment* - within Europe and outside Europe.

My last point is that in applying a principles-based approach **we'll change the expectations about the nature of regulators and also group supervision.**

It's often a challenge for regulators and perhaps policy-makers to stay principles-based. There is a tendency to want to gravitate towards simple rules or arbitrary add-ons. These don't address the issues. Instead they distract. They force companies to spend resources on finding ways of aligning the *regulatory* requirements to the *economic* requirements and they encourage, and I say this carefully, an unnecessary 'arms race of rules and arbitrage'. The consequences have always been disastrous.

What we really need are regulators with the right skills to focus on the key issues. Paying regulators well for these skills will help too! Regulators must also have teeth with the weight

of the political establishment behind them. It's no use having a system that cannot be enforced because that introduces 'moral hazard'

And regulators need to trust and work with one another. Perhaps the fear about preferential treatment of home country subsidiary I spoke about earlier is more a reflection of a lack of trust between regulators from different member states, rather than of groups. The Commission's proposals for group supervision and College of Supervisors help. Solo supervisors gain much more information on the workings of the group than they receive now. But ultimately, member state regulators and policymakers must trust each other to do the right thing.

Industry supports what are essentially excellent proposals from the Commission on Solvency II. In particular on diversification, group support and group supervision. We are grateful to the European Parliament for their detailed scrutiny on clarifying the key issues.

But to make it work, and for consumers, industry and regulators to reap the full benefits, we must respect these proposals and not stray too far from them.