



Overinsuring the Insurers

By **BERNARD SPITZ**

Uniting British, French, and German industry groups may sound an impossible task. But European Union regulators have managed it quite neatly by threatening the entire insurance business model.

EU Commissioner for Internal Markets and Services Michel Barnier decided earlier this month to delay to January 2013 the implementation of the Solvency II Directive, which would introduce tighter capital rules for insurers. The public hearings in Brussels pitting insurance companies and consumer groups—who fear the new rules will be crippling—against the seemingly immovable front of European watchdogs and bureaucrats, will continue through Thursday.

First mooted five years ago, the new directive will replace the old, one size-fits-all Solvency I regulation, and introduce a modern risk-based system aiming to reward the best-managed companies. Initially it was hailed as a clever answer to an increasingly sophisticated business, as it would allow companies more flexibility with capital requirements if they invest in less risky assets. But today, even consumers' associations, not usually prone to siding with insurers, fear the consequences of Solvency II enough that they are for once reading from the same page.

The reason is simple: Still smarting from the fallout of the financial meltdown, the national regulators who drafted Solvency II's implementation processes overburdened it with excessive capital requirements in an attempt to shield themselves as broadly as possible from any crisis. This disregards efficiency and value, and is a danger to the overall economic recovery.

It's important to stress that European insurers are in solid financial shape. Practically no European

insurance company has had to be bailed out during the crisis. Many European insurers had already years ago voluntarily adopted more prudent capital ratios, well beyond the Solvency I requirements, and close to what was expected to be required in the new system. This informal self-regulation is one of the reasons for the industry's remarkable resilience during the recent turmoil. It can be argued that the recent crisis was the best, life-sized "stress test" to which the European industry could be subjected, and that it passed with flying colors.

When Europe's finance ministers signed on for Solvency II in May 2009, they had this fact firmly in mind. The ministers' broad agreement was based on the capital requirements derived from an industry-wide impact study. Yet the latest consultations include advice papers from European regulators in which the capital requirements stand as much as 75% higher than previously expected. By narrowing the scope of eligible capital—subordinated debt, for example, would no longer be acceptable—capital sources may decrease by up to 50%. The most conservative estimates foresee that the new Solvency II requirements would lump insurance companies with an additional capital burden of 30% to 50%.

This completely disregards the fundamental differences between the insurance and the banking models. Not only are insurers long-term investors, but the very structure of their cash flow is the opposite from that of banks. While bankers need to make an upfront outlay of capital for loans they will only recover over time, and which risk default, insurers only need to provide for possible liabilities in the future—for paying out liabilities on contracts that have already been paid into.

The costs for Solvency II's proposed, excessive prudence will have to be paid by consumers and

the economy as a whole. Insurance premiums will rise, while coverage and benefits for policyholders may have to be reduced. The cost of life and pension insurance products in particular could rise by up to 30%, since higher capital requirements and higher funding costs would be compounded by the reduced investment income derived from choosing safer, but low-return vehicles. Consumers who rely on this income to fund their retirement may be forced to lower their standard of living. Given the lower profit margins, some insurers might be tempted to exit whole areas, such as automotive or medical liability insurance, there again leading to higher rates from the remaining actors.

Projections show that non-life product prices would increase by 5% to 20% for more capital-intensive products, such as those with greater exposure to natural catastrophe risks (for instance, homeowners' insurance in regions with a high risk of windstorms or floods) or those with a long claim tail (general liability, but also products such as third-party automotive liability).

This doesn't even begin to take into account the bearish effect on the equities market, as the new regulation will incite insurers to neglect commercial shares and bonds because of the high capital requirements they entail.

Insurers hold about €7 trillion in assets under management in the European economy, equivalent to half the EU's GDP—far more than could be provided by even the most ambitious stimulus plan. Undermining such a key industry with excessive regulation is not a recipe for recovery but for a lasting depression.

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