

Basel (II+x) ↔ Solvency II

Task:

- develop Solvency II and Basel (II+x)

Goals as in integrated FSA:

- ensure level playing field between sectors
- avoid unintended incentives for risk transfer between sectors
- avoid reinvention of the wheel; use synergies

Q-RM, Feb 2005

Questions

- (A) What similarities and differences exist between Basel II and Solvency II?

- (B) What kind of consistency needs to be achieved?

(A) Similarities and Differences

Similarities:

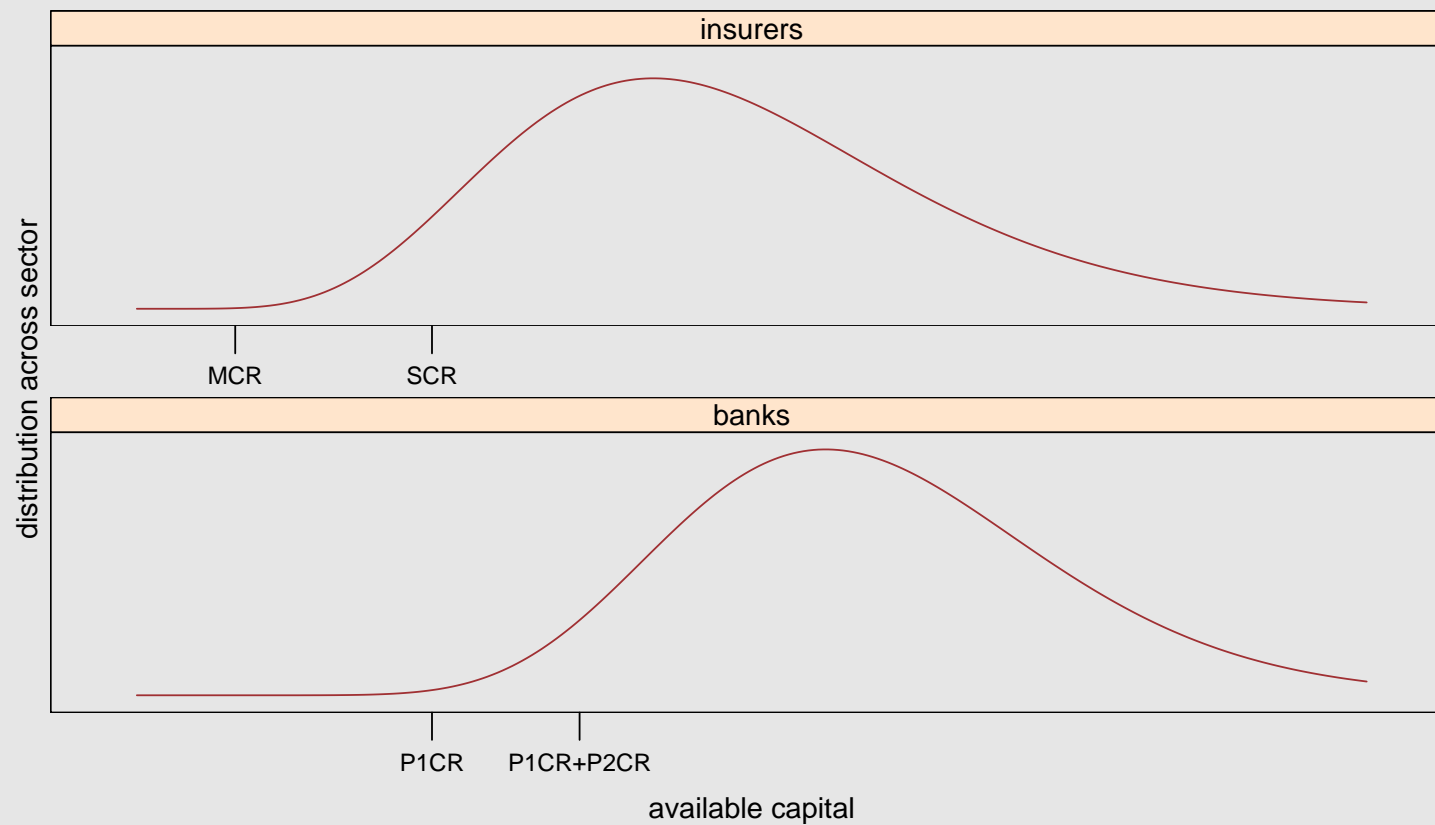
1. renew relatively outdated regulations
2. ambitious in terms of the improvement/resources
3. more risk-sensitive regulatory capital requirements
4. three-pillar structure

(A) Similarities and Differences

Differences:

1. In Solvency II there are two distinguished levels of intervention, while Basel II has only “one and a half”:
 - P1CR \approx SCR: level of prudence, standard formula + more advanced options, risk based, additional input than balance sheet data
 - P1CR \neq SCR: intervention stricter for P1CR
 - no analogue to MCR in Basel II; functions: run-off-level, floor for internal models, easily verifiable, litigation-proof
 - P1CR+P2CR: only “half” of an intervention level in Basel II; similar option of P2CR likely in Solvency II

Intervention levels



(A) Similarities and Differences

2. An important goal of Solvency II is to also harmonize the valuation of liabilities (technical provisions). Basel II does not harmonize the valuation of the banking book (loan provisions).
 - technical provisions: extremely important boundary on capital redistribution

(A) Similarities and Differences

3. Solvency II supports principle-based and goal-oriented regulation while Basel II is more input-oriented and more rule-based.

- fragmented use of internal models in Basel II
- detailed prescriptions of methodology even in “advanced internal ratings based approach” instead of defining goal

“Consequently, [...] the scope for allowing insurance companies even greater latitude than that enjoyed by banks in drawing up their models is a priority issue” [Markt/2056/01]

- goal of SCR defined once; internal models “based on the same explicit general principles as the standard formula”
- unlimited use of internal models

(A) Similarities and Differences

4. Internal portfolio risk models that companies use for their own capital allocation processes play different roles in Solvency II and Basel II.

- Basel II: fragmented internal modeling for P1CR -> significant differences between “regulatory internal model” and “real internal model” (looked at in pillar 2) may exist
- Solvency II: SCR directly based on “real internal model” for economic capital, possibly using different level of prudence or different risk measure

(A1) Convergence of Solvency II towards Basel II difficult.

(A2) Unique advantages of Solvency II

Lamfalussy process:

- three levels of regulation
- potential for faster decision making: work in parallel
- better treatment of national differences
- main principles fixed while adapting details on lower levels more frequently to market developments
- unique potential for Europe to lead the international standard setting in insurance regulation

- advantages of Lamfalussy process do not come to the fore in banking as long as all important decision are made in Basel

Conclusion A

- **If Solvency II was forced to converge towards Basel II, then this would give up the unique potentials of Solvency II.**
- **Copying credit risk regulation from Basel II to Solvency II is difficult due to the fundamental differences between the two.**

(B) What consistency?

(B1) Absence of regulatory arbitrage does not mean “same financial product, same risk weight”, but “same portfolio management, same risk model”.

from Solvency II discussion:

“It should be apparent that any given bond attracts the same capital requirement regardless of the sector of the undertaking holding it.”

- not true from an economic point of view
- economic capital depends on (a) how well it diversifies with the rest of the portfolio and (b) how its risk can be managed

(B) What consistency?

(B2) Convergence of valuation (of assets and liabilities) is at least as important as convergence of risk measurement.

“It should be apparent that any given bond should have the same value regardless of the sector of the undertaking holding it.”

- absence of arbitrage implies law of one price

(B) What consistency?

(B3) Most important examples of regulatory arbitrage seem to have occurred within banking supervision, not between sectors.

1. sell corporate loans to OECD bank -> reduce charge from 8% to 1.6%
2. lower capital requirements in the trading book than in the banking book (securitizations)
3. higher qualitative requirements for the trading book -> move some contracts to banking book

(B) What consistency?

4. numerous rumours that insurance companies have been taking credit risk through securitization products sold by banks: 2003-study by the IAIS comes to the conclusion, however, that

"The paper highlights that regulatory arbitrage does not appear to be the main driver for credit risk transfer activities, but that they are driven more by general commercial reasons, such as insurers seeking increased yields and diversification of portfolios."

- similar conclusion by Joint Forum report Oct 2004

(B) What consistency?

(B4) If convergence between Solvency II and a future “Basel (II+x)” is achieved by introducing an analogue to the MCR to banking regulation, consistency has to be achieved at both intervention levels: MCR and SCR.

- MCR: few companies effected, but strict intervention
- SCR: many companies effected, soft intervention
- conflict of interest; especially for credit risk
- MCR: convergence more difficult to achieve if solely based on balance sheet data

Conclusion B

Given the **conflict of interest between convergence and tailoring the standard formulas** for MCR and SCR to the specific sectors, the **goals for convergence** need to be prioritised and **carefully quantified**.