Solvency II and the CMU: unlocking contractual savings' investment

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Even though the free movement of capital has been a legislative reality in the European Union since the Treaty of Rome, the markets for most financial services and products remain largely divided. One of the main reasons for this is Europe's over-reliance on bank funding, which has made the EU's economy unstable and procyclical. In 2015, the European Commission presented the Capital Markets Union Action Plan, which includes a comprehensive set of financial reforms attempting to reduce the dependence on banks and expand and integrate Europe's capital markets.

The Commission has been clear about its intention to accelerate said reforms, launching a public consultation in January ahead of a midterm review in June. Although generally they are on the right track, they do not consider the reform to contractual savings regulation needed to form more robust and integrated capital markets. The Solvency II Directive, which came into effect last year, unnecessarily restricts insurance and pension fund market activity, and therefore goes against the Capital Markets Union's goal of increasing the role of alternative sources of finance.

Insurance companies and pension funds are crucial players in capital markets. Moreover, they traditionally hold a high proportion of foreign assets. Because of this, rethinking their regulation to unlock their investment will prove crucial to integrate Europe's financing markets.

The right general direction

There any many reasons for the lack of integration of banking services across the Union, like language barriers and cultural differences, which preclude the possibility of banking unification through policy changes. Regardless, the fact that banks in the EU provide around 75% of corporate funding as opposed to 25% of that the US proved extremely damaging to the European economy during the credit crunch of the financial crisis. Moreover, since long-term bank lending remains the least integrated banking product in Europe (Sehgal, Gupta and Deisting, 2016), the Commission is correct in pointing out that Europe's reliance on bank funding must decrease in order for corporate financing markets to unify and become more stable. There are also economic reasons for the CMU, since increasing the amount of options available to companies will increase competition and decrease the cost of their funding (European Commission, 2015).

The Commission has discussed venture capital, private equity, peer-to-peer lending and other sources to fulfil the need for alternative sources of funding. However, besides an already implemented reform decreasing some capital charges to encourage infrastructure investment, and a mild review of the capital requirements later this year, they have not considered reforming the regulation of the most crucial of these potential sources: that of contractual savings.

The importance of contractual savings institutions

Since insurers and pension funds are central in promoting the long-term growth of capital markets, the Commission cannot claim to seek alternative sources of finance while leaving out major discussions on them. Studies show that insurance market activity fosters overall economic growth (Arena, 2008), so if an ambitious plan is to be devised regarding economic growth and capital markets, insurance and pension fund regulation must be tackled in the same ambitious way. This being especially true when the focus is on long-term growth since long-term sustainable and secure investing is essential to insurers and pension funds – having the capacity to hold securities to maturity and being generally risk averse. In this line, capital markets with a more prominent insurance market activity tend to increase the average length of securities in a given market (Impavido, Musalem & Tressel, 2003).

These industries should play a crucial role in integrating capital markets on top of expanding them given their tendency to hold a large proportion of their assets in foreign countries. For example, pension funds in countries like Portugal, Luxembourg, and Estonia invest over 50 percent of their portfolios abroad (OECD, 2014), while in the UK pension funds hold more money in international than in domestic equities.

The Solvency II Directive, passed in 2009 and implemented at the beginning of 2016, prevents these types of financial institutions from fully participating in capital markets. Regulating insurers and pension funds as banks, as the Directive deliberatively intends, is not only misguided it its attempt to safeguard the plans and pensions of European citizens, but goes against the EU's much needed plan of expanding its capital markets.

Solvency II

For decades since the end of the 19th century, the UK insurance market remained largely unregulated and maintained a 'freedom with publicity' approach, with most regulation involving the government asking for information and managing specific contingencies, and the market rewarding sustainable and safe investing (Booth, 2016). At the EU level, although there were some Directives concerning the harmonisation of the common market, it was not until the financial crisis and the implementation in 2016 of the Solvency II Directive that regulation took the risk-based character it has today. Maintaining the same approach as the Basel regulations, it sought to regulate insurers and pension funds as banks (HM Treasury, 2008). The experience of AIG convinced regulators that the entire industry had to be controlled, and with the idea of contagion, they justified the same regulation as that of banks on the basis that contractual savings posed systemic risks to Europe's financial system (Arthur and Booth, 2010). However, the recession was only a banking crisis. The case of AIG was exceptional, not systemic, and the solvency of insurers during the crisis was never at risk (Schich, 2010).

Bank-like regulation was imposed regardless, and with EIOPA reporting that almost all insurance companies have met both the Minimum Capital and the Solvency Capital Requirements, the effects have been the ones predicted. The capital requirement pillar of Solvency II mandates that firms hold solvency capital based on considerations of multiple kinds of risks beyond that of their assets' credit risk – including operational, market, interest rate, inflation, and many others. The need to account for all these risks discourages the purchase of long dated securities (Wehinger, 2012) and therefore corporate debt, since the longer the duration the larger the costs of long-term risks will be.

By giving a favourable weighting to sovereign bond exposure, the requirements encourage that funds hold on to government debt (Booth, 2016) as opposed to corporate debt. In the EU, non-financial corporate debt only amounts to around 3% of insurance and pension fund assets (Novick et al., 2016). Exacerbated by the adjustment to encourage infrastructure investment, systemic risks are increased by an incentive structure that encourages a concentration in these two kinds of bonds. Lastly, the requirements incentivise funds to seek out covered bonds, which are much harder to provide and construct by small firms (which provide around two thirds of European employment).

Rethinking the approach

Even if we assumed that all insurance companies pose a major risk to the stability of our economy, other regulatory systems prove to be more effective at securing that citizens' insurance policies and pensions will not vanish; whether these might include pension guarantee funds or sponsor support (Broeders and Chen, 2012). Moreover, having established that insurers and pensions do not contribute to systemic risk in the same way banks do, it should be clear Solvency II should be overhauled.

For example, an agency to analyse specific contingencies and dynamics has been shown to be more effective at identifying financially weak firms than risk-based capital requirements and their stress tests (Grace, Harrington and Klein, 1998). Moreover, this would be a more cost effective regulatory system (Booth, 2010). If the Union was to maintain the Solvency II approach, an opt-in passport system for operating across the entire EU would be beneficial, where firms could abide only by specific countries' regulatory frameworks where they operate. This approach would circumvent the negative effects of regulatory harmonisation, allow for trial and error with different approaches across countries, and avoid punishing small firms that operate in only one or two countries.

Conclusion

The Solvency II directive overregulates contractual savings, distorts investment, and prevents the development of the Capital Markets Union, a necessary effort to promote economic growth. The Commission will have to rethink the regulation more drastically than the SCR Review does, or it will develop a half-built unified capital market without the full potential of insurance companies and pension funds. Fortunately, Brexit provides an opportunity in this respect. Although the departure of the UK will constitute a significant loss of potential capital for the rest of the Union, Solvency II was an initiative spearheaded and executed by the British (Quaglia, 2017), so an EU without the UK might be able to redesign these regulations without the influence the British exerted in the ones we have now.

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