Solvency II – potential consequences for customers and competition in Norway (chapter 3 in speakers note)

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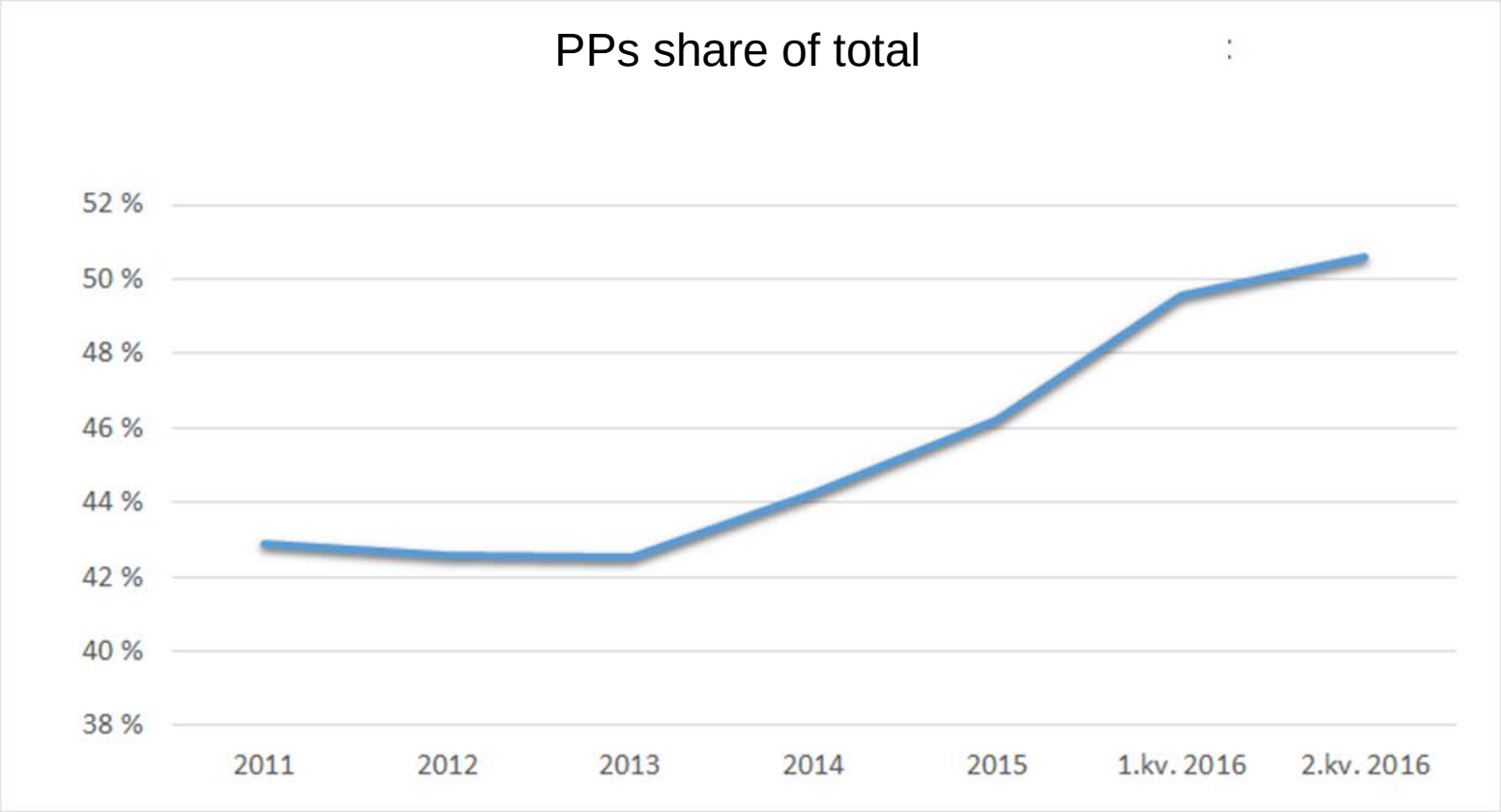
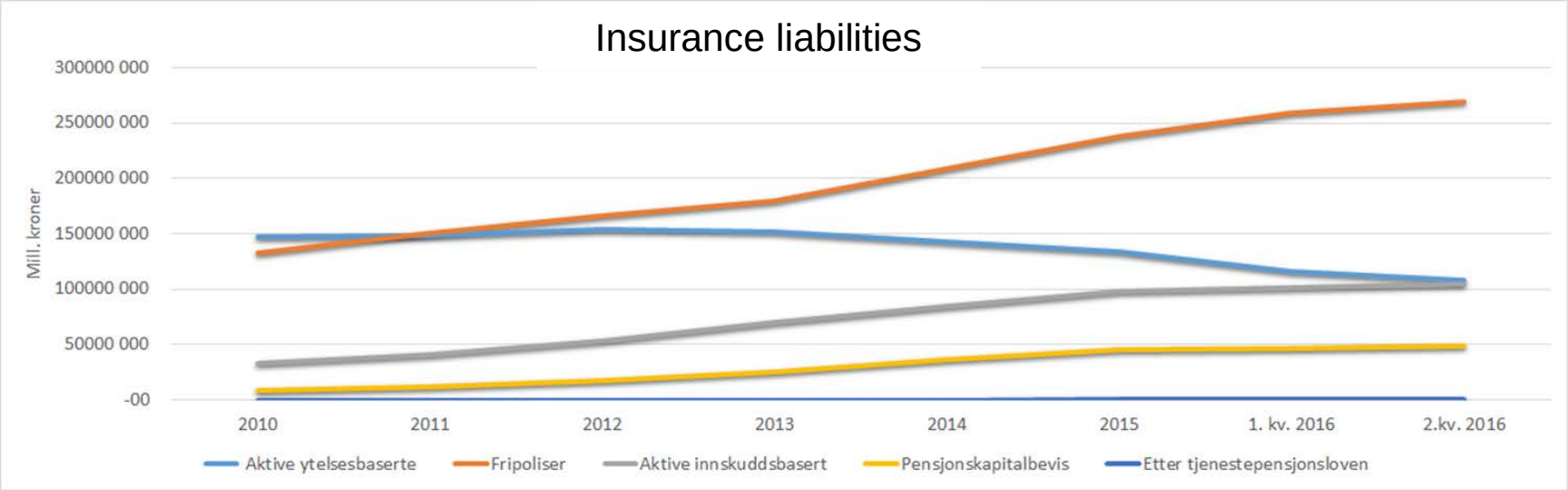
The volume of Guaranteed Defined Benefit Paid-up policies (PPs) has grown by 78 % from 2011, and now accounts for 51 % of the total private sector insured occupational pension market, and more than 70 % of the total Defined Benefit market



Source: Finance Norway

PPs are still growing rapidly, and dominates compared to the other segments; Active Defined Benefit (DB), Active Defined Contribution (DC) and DC- Paid Ups. PPs and DB-schemes still dominates the total pool of private pension assets in Norway



Active DB **DB PPs** **Active DC** **DC- paid up policies**

Source: Finance Norway

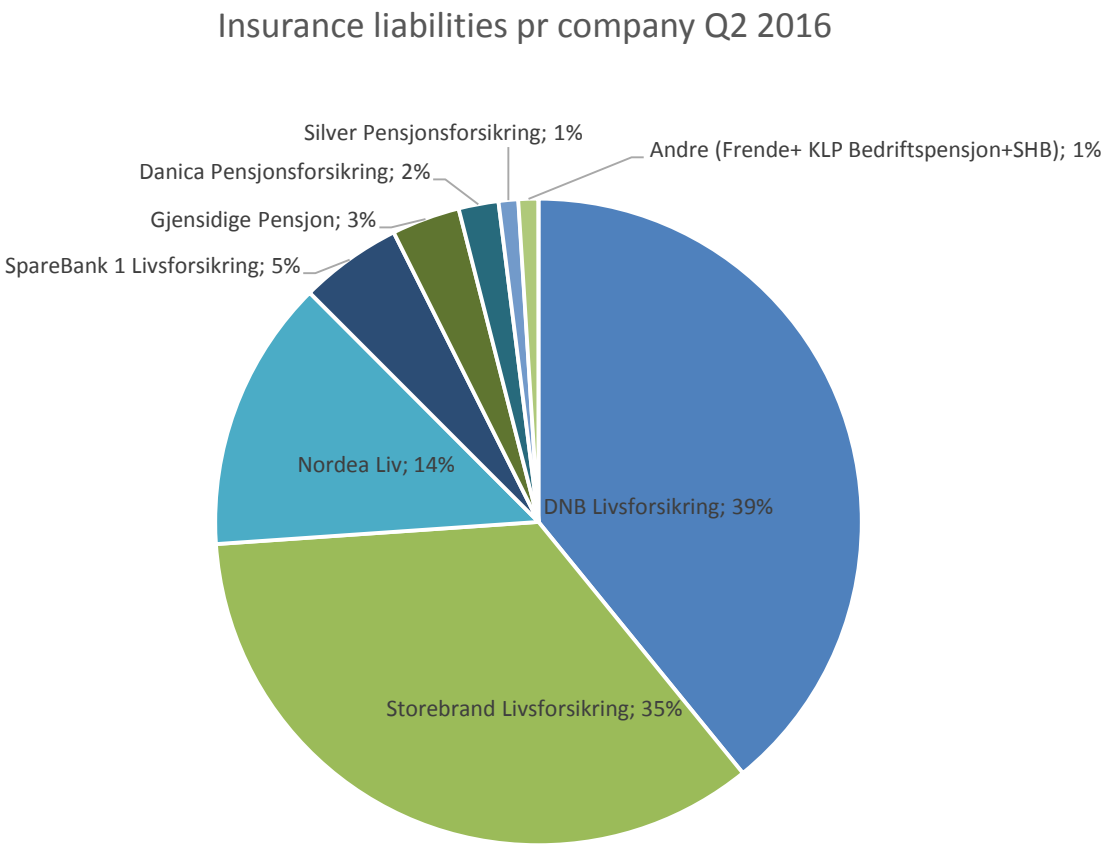
Norway Life & Pensions Insurance market; the most concentrated and dysfunctional market in the EU/EEA ?

The following extract of a mail sent late 2010 from a new Defined Contribution pension provider to the Confederation of Norwegian enterprises (NHO) explaining why they refused a tender to offer, tells about the unsound structure of the Norwegian market ;

Quote; *"Let me remind you that the Norwegian life& pension market is a heavily oligopolistic market totally dominated by 2(3) companies. The entry barriers/complexities in this market are so high that the influx of new entrants and subsequent strengthening of the competition is absent, especially in the traditional market. When the DC-pension market was introduced, It was a pleasure to see that many new providers entered the field, but unfortunately do we now see that this diversity is in the process of fading away because the dominant players were allowed to set prices that were and still are meaningless. This was only possible because they at the same time charge high and protected margins in the DB-market.";* ***Unquote***

Sadly the situation and outlook may have worsened since 2010, especially because of Solvency II.

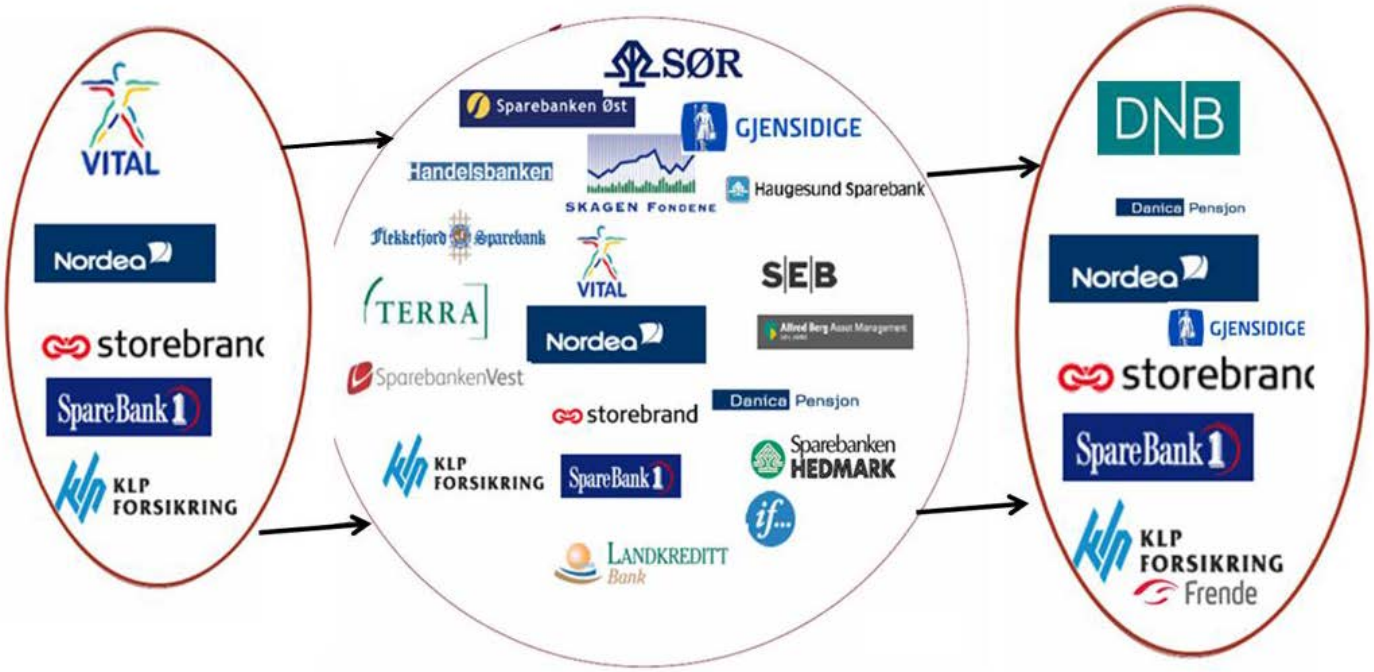
Market concentration



Source: Finance Norway

Substantial amounts were successfully used to shake out new entrants from the DC-market

Defined Contribution providers 2001-2006-2015



Source: Aon Norway

Also Silver was met by aggressive price cuts on the PP-market. When Silver entered the market in 2005 the product mix on the market was 70 % Active DB and 30 %.PPs. Now the mix is the opposite.

The following extract from Silvers Chief Actuary's report for 2009 to the FSA illustrates the cost benefits to PP-customers because Silver created competition in this market;

«It is the Actuary's opinion that todays low margins are a result of the competition. Some companies have reduced their margins to as low as 13 Basispoints per year, and Silver is experiencing losing tenders to offer because the prices have been lowered to 10 Basispoints per year.

These prices are conspicuously much lower than for comparable traditional products, including individual pension policies. The Actuary cannot ignore the that this may be an attempt to exclude Silver from the market, and It's uncertain how long the competitors can sustain such low prices»

The unexpected strong growth in unprofitable and capital intensive DB Paid-up policies has created a major problem that needs to be financed by high prices on most other products. Solvency II makes this necessary, and the lack of competition and transparency makes it possible.

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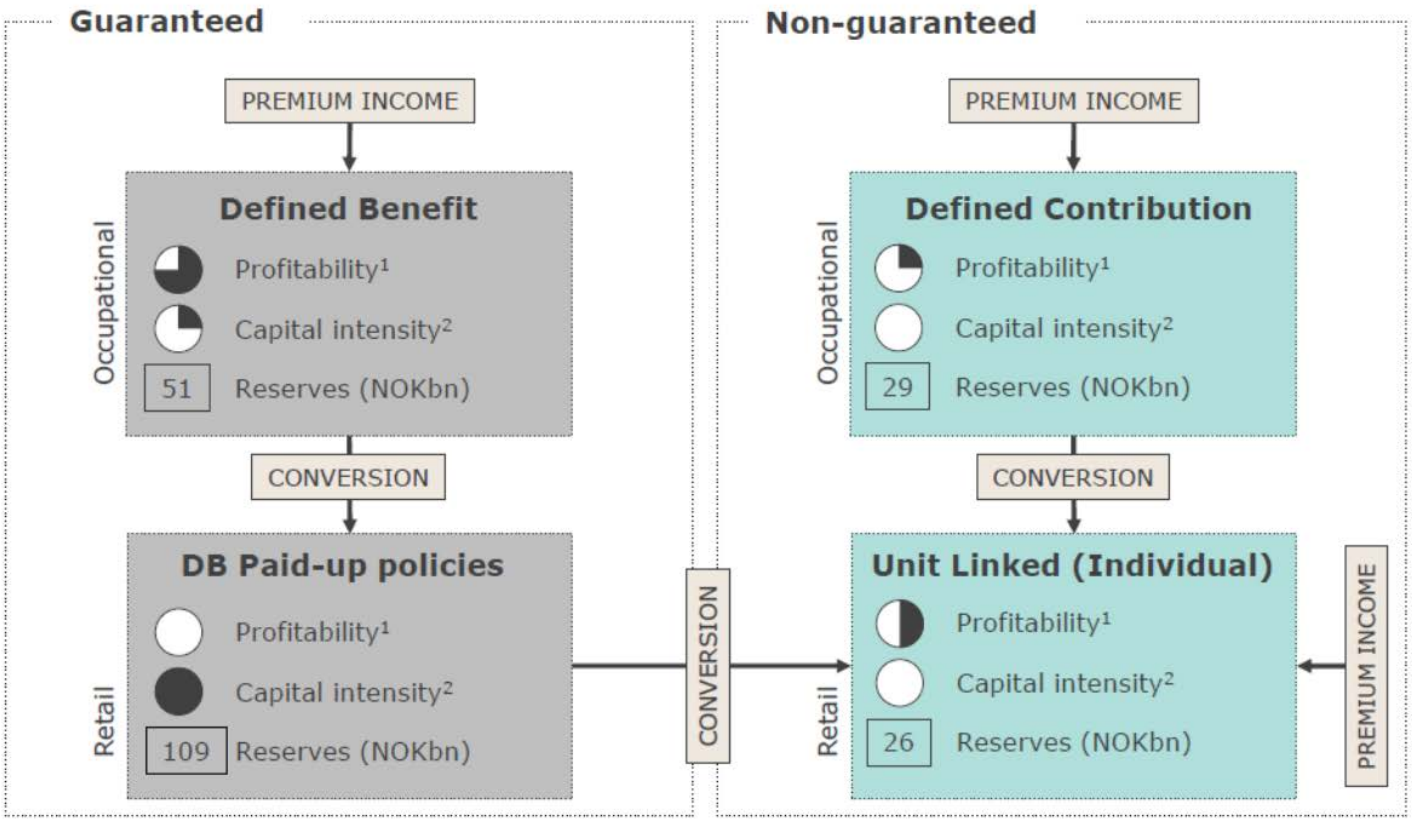
Life & Pensions Norway - Balance Sheet Dynamics



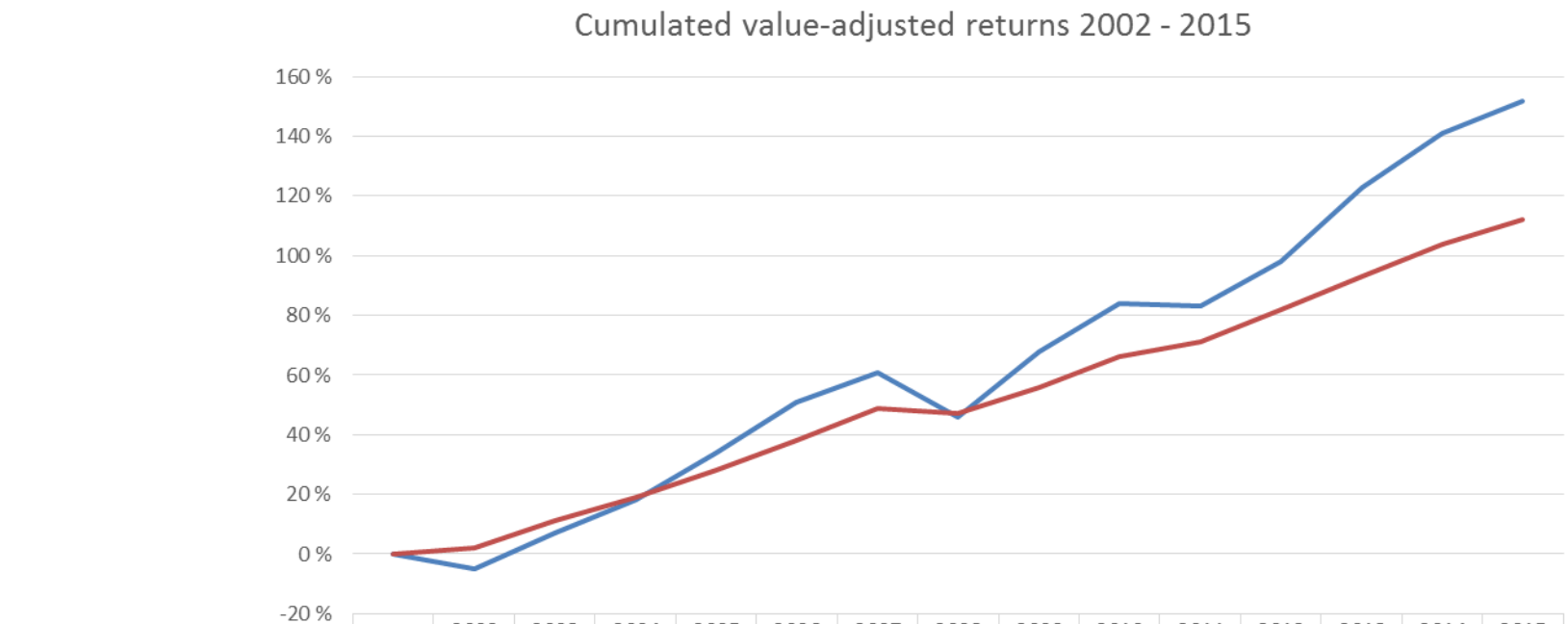
¹ Indication of income margin on reserves, from low (<0,5%; ◯) to high (>1,50%; ●)

² Indication of economic Solvency II capital requirements, from low (~0%; ◯) to high (12-20%; ●)

storebrand

Source; Storebrand capital markets day May 2016

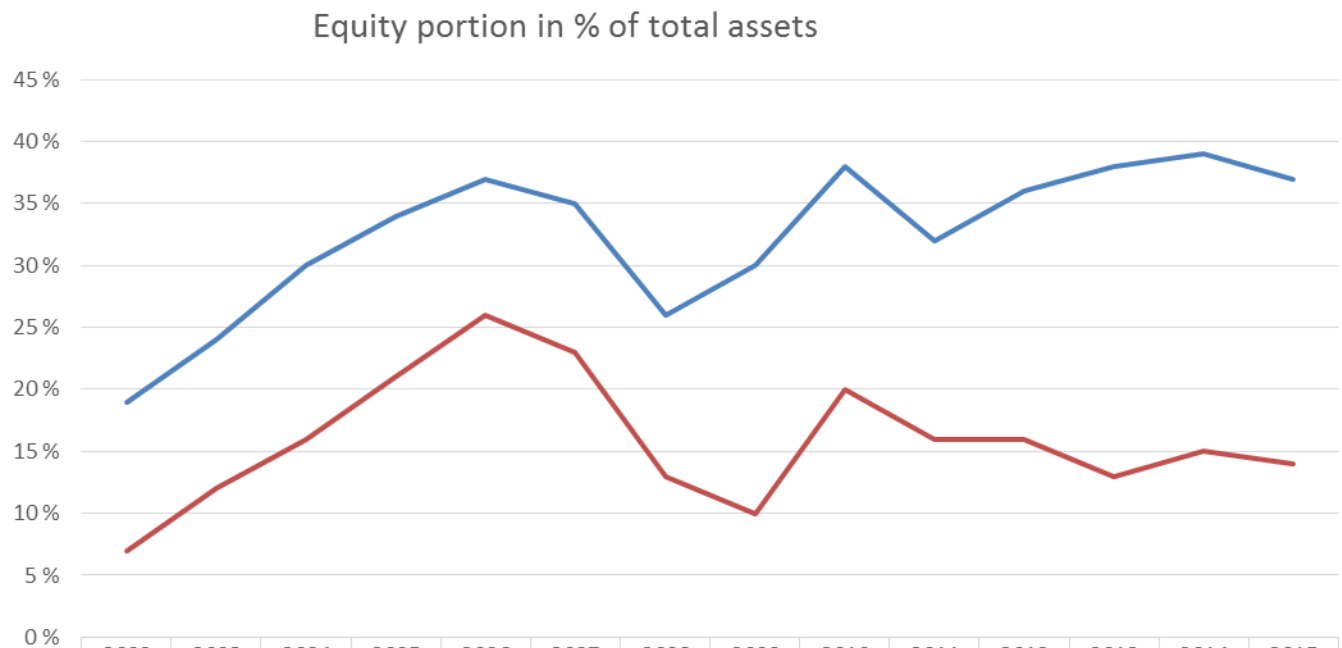
Norwegian Private Pension Funds (pure IORPs), accounting for 30 % of the DB-market, have outperformed the Life Insurance Companies by far, both in terms of higher yield on assets and lower administration costs. And they have managed to keep the traditional mix of 70 % DB and 30 % PPs, to the benefit of policyholders



		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Private Pension Funds (IORPs)	0 %	-5 %	7 %	18 %	34 %	51 %	61 %	46 %	68 %	84 %	83 %	98 %	123 %	141 %	152 %
Life Insurance Companies	0 %	2 %	11 %	19 %	28 %	38 %	49 %	47 %	56 %	66 %	71 %	82 %	93 %	104 %	112 %

Source: Aktuarene, Aktuarfirmaet Lillevold & Partners

Their outperformance is mainly explained by their higher proportion invested in euquities



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Private Pension Funds (IORPs)	19 %	24 %	30 %	34 %	37 %	35 %	26 %	30 %	38 %	32 %	36 %	38 %	39 %	37 %
Life Insurance Companies	7 %	12 %	16 %	21 %	26 %	23 %	13 %	10 %	20 %	16 %	16 %	13 %	15 %	14 %

Source: Aktuarene, Aktuarfirmaet Lillevold & Partners

The Norwegian pension funds are worried about the risk that the regulators will introduce Solvency II type of absolute capital requirements also for them. This may eliminate much of their proven value creation, at the expense of sponsors and members.

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Peterson Institute for International Economics

Policy Brief

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How Not to Regulate Insurance Markets: The Risks and Dangers of Solvency II

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With more than $50 trillion in assets worldwide, investment funds run by the insurance industry and pension system are one of the most systemically important elements of the global financial system (Bank of England 2014). In March 2014, following the global and euro area financial and economic crises, the European Parliament adopted a new directive, Solvency II, which codifies and harmonizes insurance regulations in Europe, in order to reduce the risk of an insurer defaulting on its obligations and producing dangerous systemic side effects. Solvency II tries to achieve these aims primarily by setting capital requirements for the assets of insurers and pension funds based on the annual volatility of the price of these assets.

The extraterritorial reach of the new directive, which is scheduled to take effect January 1, 2016, is significant, particularly for the United States.[1] US subsidiaries of insurance companies headquartered in the European Union, such as Allianz, Aviva, ING, and Mapfe, fall within the scope of Solvency II compliance. The EU subsidiary of a non-EU insurance group like MetLife, Canada Life, Travellers, and Tokio Marine will also have to comply with Solvency II as stand-alone entities.[2] US insurers with European subsidiaries or European parents are angry about what they see as an additional, unnecessary, and inconsistent level of regulation. As a result, the EU Commission, the US National Association of Insurance Commissioners (NAIC), and others are engaged in a discussion to ensure equivalency between US and European regulation. Perhaps because the European Union is the single largest insurance jurisdiction, the direction of travel has been for US state regulators and other non-EU jurisdictions to change their regulations to be more in line with Solvency II.

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This Policy Brief argues that the capital requirements of Solvency II, while not particularly onerous at an aggregate level, will impose an asset allocation on life insurers and pension funds that does not serve the interests of consumers, the financial system, or the economy. Apart from the Solvency II initiative, the Financial Stability Board (FSB)—the international body of finance ministers, central bankers, and other agencies established in 2009 after the global financial crisis—is seeking to set up an international standard for the regulation of what it considers to be systemically important insurance companies.[3] The move was prompted in part by the failure of AIG in September 2008.

1. Solvency II was initially scheduled to be implemented on January 1, 2013. Concerns over its impact caused that date to be pushed back to January 1, 2016, when implementation will be phased in.

2. Early on there were concerns that the entire group of a non-EU insurance company with an EU subsidiary would have to comply. It does not. Non-EU groups will complain that having the EU subsidiary comply with Solvency II as a stand-alone entity, with its own capital adequacy requirement, reduces the scope for its customers to benefit from efficiencies in capital management.

3. Whether insurance companies are systemic in the same way that banks are is an interesting question. Space constraints preclude it from being addressed here.

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CONCLUSION

Using an estimated once-every-200-years decline in annual asset prices to measure the risk of a life insurance and pension fund is flawed on many levels. The return and price of assets already reflect the risk of the asset to the average holder. Consequently, the starting point for the regulator ought to be whether the risks to life insurers or pension funds from holding the asset are lower or higher than already reflected in the market price. The riskiness of an asset is not independent of what it is used for or who owns it. Private equity funds are risky for a casualty insurer and safer for a life insurer with liabilities beyond the redemption period of the fund. To a life insurer, what matters is not the price of an asset or the risk of holding it tomorrow or at the end of the year but the risk at the point of maturity of the policy (shortfall risk).

Better matching the capital requirements of insurers to shortfall risk would allow insurers, consumers, the wider financial system, and the economy to establish a superior risk-return equilibrium. It would provide consumers with cheaper but no less adequate insurance; make the financial system safer, as risks flowed to where they are best spread or diversified; and reduce the cost of capital, boosting investment and economic growth. In its current form, Solvency II is likely to achieve the opposite.

A forceful Group of key stakeholders has therefore commissioned an independent impact study, the first and only in Norway. The result was presented 9. September 2016

Main conclusion; The new solvency requirements will have a considerable Social Loss that will have to be weighted up against the potential benefits from the same requirements. These benefits are not estimated by the regulator, but It's hard to see that they are as considerable as the loss.

Key Findings;

1. If all pension funds (private and public)are forced out of equties the estimated loss will be NOK 400 Billion over 20 years

2. If their equityportfolio is reduced by 50 % the loss is estimated to NOK 192 Billion over 20 years

Source: Samfunnsøkonomisk analyse AS

Remarks from Silver; These are <u>estimated</u> future income losses for the <u>Pension Funds</u>, but more sadly the figures points to the <u>actual</u> losses to date for the customers in the <u>Insurance companies</u>.

Final Q & A

- **Question;** Will the mixture of 1) Solvency II 2) the special Norwegian product regulation 3) the product mix heavily loaded with DB Paid-up policies and 4) the high market concentration; now become a Poison Cocktail for Private Sector in particular ?

- **Answer;** The Gordian knot can be cut if the politicians follows the advice from the FSA in their risk outlook for 2012 ? ;

  - **Quote; "**Any change in the regulatory framework that improves insurers' ability to handle rate-of return risk will facilitate the increase of equity capital. This will benefit policyholders in the form of expectedly higher long-term return on pension assets."; **Unquote**

- **But,** may Silver add; such a change must be based on and stimulate a common interest between the Insurance company and the customers.