

EZA Briefing Note:

EZA 583/20Feb04: EU Regulatory



Capital adequacy needs of UK and European life companies to continue to increase demand for government and corporate bonds relative to equities. EU gender neutral life insurance proposals likely to sustain the trend leading to a flattening or potential inversion of the Eurozone curve at longer dated maturities.

- Solvency and capital adequacy pressures on UK life companies have become familiar in recent years. The FSA's new financial rules for UK life insurers (Consultative Paper, 195, August 2003) make these pressures more urgent, despite the rally in equity markets over the last year.
- Even if the announcement from Standard Life of large equity sales in recent weeks is an extreme example, this type of portfolio switching out of equities and into bonds, both corporate and government, will likely become more common as the FSA's capital adequacy requirements are implemented fully over the next 1-2 years.
- Although UK life companies have been given more time to comply with the new rules, the net impact of the changes will likely be to increase the capital adequacy requirements for all life insurers. The essence of the FSA's approach is the so-called twin peaks approach where **UK life firms are required to make a realistic assessment of their with-profits liabilities to see whether they need to hold additional capital on top of mathematical reserves *, to cover expected discretionary bonus payments.** Mathematical reserves are required by the existing EU life assurance Directive.
- The capital adequacy problems of UK life companies are now well known, but it is less well known that (1) **a regime like the FSA's regulatory and capital adequacy requirements is likely to be implemented more broadly around the EU life insurance industry to ensure systemic stability (the Solvency 2 process) and (2) there is currently a European Commission proposal to introduce gender-neutral life insurance, which will be voted on in the European parliament in April. But this is not a "single market" measure so the key requirement is unanimous approval in council.** The proposal may not get unanimous support – we understand that the UK may veto it this time around – but is unlikely to go away as an issue.
- Should gender-neutral life insurance be introduced, it would require **“that the use of sex as a factor in the calculation of premiums and benefits for the purpose of insurance and related financial services is prohibited”**. Thus benefits to policy holders would be paid equally to males and females, and life companies may struggle to recoup the higher premiums required to match increased liabilities to females on annuities, for example, as a result of greater life expectancy.

- Putting these factors together – increased capital provisions for regulatory reasons for life companies around the EU, extended pay-out risks on annuities - it is easy to build the case for increased demand for less risky and longer-dated assets, with a known maturity profile, like longer dated government and high grade corporate bonds with low default and counter-party risk. To the extent that this phenomenon extends to the EU, **as capital adequacy provisions are tightened for life insurers, it may also mean that the Eurozone yield curve flattens or inverts at longer maturities, particularly if, and when, gender-neutral insurance conditions are introduced.**
- The scale of the potential portfolio adjustment was shown by the announcement from Standard Life this week that it had sold £7.5 bn. in equities in recent weeks to reduce its equity weighting in the with-profits fund from 59% to 35% (Standard Life's equity weightings were up around 80% just a few years ago). **EZA**

** Mathematical reserves are calculated by discounting future cash flows from current business back to a net present value reserve requirement. “. The EU's existing life assurance directive requires an additional capital requirement of 4% of mathematical reserves to be held by life companies (sometimes known as margins on margins). The discount rate is adjusted for re-investment and other asset related risks, like counterparty default risk.*

For further information on this topic please contact: Robin Marshall / Graham Bishop

Discussion Partners:

Allan Saunderson: ECB / Brussels
Tel: +49 172 67 23 938
saunderson@ezadvisors.com

Robin Marshall: Euro Economy / EU Accession / ECB / Brussels / FX Strategy
Tel: +44 7801 67 95 74
marshall@ezadvisors.com

Dr Michael Clauss: Germany Politics / Economy
Tel: +49 89 64254045
clauss@ezadvisors.com

Jacques Lafitte: France Politics / Brussels
lafitte@ezadvisors.com

Graham Bishop: Euro-Sterling / FSAP / Brussels / Regulatory
bishop@ezadvisors.com

Dr Dieter Wermuth: Euro Area Economy
wermuth@ezadvisors.com

Marc de Scitivaux: Asset allocation strategy
descitivaux@ezadvisors.com

Eric Barande: France Economy
barande@ezadvisors.com

Miranda Xafa: Euro Economy / Greek Economy
xafa@ezadvisors.com

Subscriptions & Client Services:

Richard Betts

Tel: +44 (0) 20 8340 4328

Email: rbetts@ezadvisors.com

This research is confidential and intended solely for the named person or entity to whom it is addressed. If you have received this e-mail in error you are not permitted to disseminate, copy or take any action in reliance on it, and are requested to please notify the sender by return e-mail or telephone. No part may be reproduced or passed on without permission. Neither the information nor the opinions herein constitute or are to be construed as an offer or solicitation of an offer to buy or sell investments. EZA information is based on sources believed reliable. Their accuracy cannot however be fully guaranteed. Copyright Eurozone Advisors Ltd 2004