BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

8 June 2015

Quarterly Bulletin pre-release articles: 'The prudential regulation of insurers under Solvency II' and 'Banking sector interconnectedness: what is it, how can we measure it and why does it matter?'

On 1 January 2016 a new regime for the prudential regulation of European insurance companies will be implemented under Solvency II. **"The prudential regulation of insurers under Solvency II"** begins by examining the business model of an insurer, gives a condensed history of insurance regulation to date and draws out the key features and benefits of the new legislation.

Insurance companies perform a key function in the economy. If the industry is not sufficiently resilient to financial shocks then both policyholders and the economy could suffer. There is a need for effective, risk-based regulation and supervision of this important industry – Solvency II marks a substantial move forward in this regard.

Solvency II is the culmination of a 13 year modernisation project to introduce a forward-looking, risk-based capital regime that provides greater incentives for firms to improve their understanding and management of the risks they face – marrying together risk and capital. However, for the UK, Solvency II should be seen as more of an 'evolution' – rather than 'revolution'. UK insurance firms should be well prepared for these transitions as they already operate to a risk-based capital regime under the remit of ICAS.

What is the purpose of Solvency II? At its core, Solvency II aims to secure a consistent and appropriate level of protection for consumers throughout Europe. The new regime will harmonise an EU framework that has, over time, become increasingly fragmented.

Its intent is to create a safer and more resilient insurance industry, reducing the probability of firms failing. However, in addition to these overarching principles, Solvency II introduces several key features, the collective impact of which is to ensure firms identify, quantify and manage risks on a forward-looking basis, in addition to providing greater transparency:

- market-consistent valuation of assets and liabilities;
- enhanced quality of capital;
- a forward-looking and risk based approach to capital requirements;
- improved governance and risk management requirements;
- a rigorous approach to group supervision; and
- strengthened market discipline through increased firm disclosures.

These features, and the anticipated impact they will have, are explained throughout this informative, explanatory article.

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During the 2008 financial crisis, many banks ran into difficulties at the same time as shocks spread rapidly across the financial system. One of the main reasons for this was that the global financial system had become highly interconnected. As the title suggests, **"Banking sector interconnectedness: what is it, how can we measure it and why does it matter?"**, explains the different ways in which banks can be interconnected, discusses how this can be measured and explores the implications for financial stability.

Banks can be directly and indirectly interconnected. Direct interconnectedness occurs via bilateral transactions or relationships, such as interbank loans. In such cases, the greater the degree of direct interconnectivity between banks, the greater the likelihood that a default by one bank could trigger contagion to other banks. Banks may also be interconnected indirectly, for example, fire sales by a distressed bank may lead to falls in asset prices and associated mark-to-market losses for other banks.

The article shows that while direct interconnectedness between banks from interbank credit exposures has declined since the crisis, indirect interconnectedness, as monitored by correlations in banks' CDS premia, may have increased.

Since the financial crisis, a number of regulatory initiatives have been introduced to mitigate the financial stability risks posed by interconnectedness between banks. A key measure has been to oblige banks to clear all standardised over-the-counter (OTC) derivative contracts through central counterparties (CCPs). Though this has made banks more interconnected with CCPs, regulators are taking a number of actions to mitigate risks from this, including the introduction of resolution tools for CCPs. In addition, authorities have tightened limits on direct exposures between systemically important financial institutions, while stress testing or macro-prudential tools can also tackle risks arising from direct and indirect interconnectedness. Furthermore, the Financial Policy Committee includes measures of bank interconnectedness in the set of core indicators it monitors regularly.

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