



Solvency II

CEA Key Messages on Level 2 Implementing Measures

I. High level messages

The economic crisis has triggered a phase of profound reflections for all — European institutions and industry — on the lessons to be learned from the financial crisis. A key lesson is that financial supervision must be improved.

A first reminder seems, however, necessary: the financial crisis was not triggered in any way by the insurance industry. And the causes, as well as the reactions, to the crisis are fundamentally different, as are the business models of banks and insurers.

Finalising the Solvency II project in line with its agreed principles must remain the absolute goal

- In the insurance sector, thankfully, we now have Solvency II, which European insurers are convinced is the timely and appropriate answer to the crisis. It not only contains the necessary elements to construct an effective regulatory framework, but grants a harmonised economic risk-based prudential regime for the EU, incentivises internal risk management and — as a consequence — increases policyholder protection. This is the very aim of the Directive which European insurers have long supported and promoted.
- For these reasons, the CEA believes that the best response to the recent turmoil is to complete and put in place the Solvency II regime in line with its agreed principles and economic-based approach.
- We are also convinced that Solvency II will be a benchmark internationally. The EU will be the first region in the world that has brought supervision in line with economic reality.

Solvency II being such an important milestone, it is, however, facing worrying challenges that could seriously jeopardise the entire project

- European insurers want to express their deep preoccupation about the consequences that excessively prudent, prescriptive and complex requirements would have on consumers, industry and the economy as a whole.
- The Committee of European Insurance and Occupational Pensions Supervisors' (Ceios) advice is in contradiction with the objectives underpinning the Solvency II Framework Directive in a number of respects. Ceios advice suggests an increase of financial requirements beyond the level stated in the Directive. This injection of quantitative and qualitative elements of conservatism leads to measures which are inconsistent with the Solvency II principles.
- The CEA is concerned about the cumulative effect of these measures, which have the clear potential to undermine the good functioning of the market, leading to a wave of consolidation and reduced competition.

Consequences of over-capitalisation

... on European consumers

- European insurers are convinced that adding prudence on top of prudence could create serious obstacles to the sound functioning of insurance business and have unavoidable negative effects on consumers, without delivering significant incremental benefit in terms of policyholder protection.
- Unjustified increases in capital requirements will inevitably increase costs for policyholders, as they would pay much more than they need to for all classes of insurance.
- The real economy would also suffer. Substantial increases in capital requirements would reduce insurance capacity. Such extreme measures are even less justified considering that it is the insurance industry that has the capacity to provide long-term security to citizens and the European economy, even more so in times of crisis.
- We believe these measures are not an appropriate response to the crisis and surely are not the best way to protect policyholders.
- Better protection of policyholder interests would be achievable by creating a more balanced implementation of the Solvency II Directive across all its three pillars, in line with the original spirit of the regulation.

... on European insurers

- The unreasonable cost of compliance for the whole European industry would place an unjustified burden on insurers: this would lead to a limitation of insurers' capability to carry out their business at a reasonable cost and provide their services at a fair price.
- This would in turn lead to a reduction in the market for insurance products and increasing difficulty for insurers to attract new funding and to support the economy through their investments.
- These requirements could result in serious problems for the sound functioning and development of the insurance market and undermine the competitive position of European insurance companies.

The European insurance industry is committed providing its input to bring the Solvency II project back on track

- The European insurance industry will continue to cooperate with the European Commission, Ceiops and all relevant institutions to design implementing measures in line with the spirit and objective of the Solvency II Framework Directive to provide insurance companies and policyholders with an appropriate state of the art prudential framework.
- It is also important that the advice of Ceiops is revised before the final test of the regime in the Fifth Quantitative Impact Study (QIS5).

II. Key technical messages

II.1 Own funds

Key messages

- The economic market consistent balance sheet must be the starting point in defining 'own funds'. Accordingly, to classify expected future profits and deferred tax assets in tier 2 or 3 would be contrary to the overall economic risk based approach of Solvency II.
 - It is of paramount importance that attention is drawn to the dramatic consequences the proposed approach can have on the ability for insurers to market their capital instruments and provide efficient protection at a reasonable price.
- In line with the Framework Directive, a market consistent balance sheet is to be used as the valuation basis for Solvency II.
 - No hidden or implicit prudency layers should be included in excess of the market value of assets and liabilities
 - It is the purpose of the SCR (Solvency Capital Requirement) to explicitly cover in a transparent and harmonised way, the risk that future values vary from the current market value estimates.
 - Failing to recognise the excess of assets over liabilities as Tier 1 is in contradiction with the overall economic risk based approach of Solvency II and has the potential to dramatically reduce the amount of eligible own funds to cover the SCR.
 - The classification criteria set in article 93 (1) (b) (Main criteria for the classification into tiers) are intended solely for the classification of debt and contingent capital.
 - There is no rationale for applying the classification criteria to assets and liabilities, such as expected future profits and deferred tax assets, calculated in accordance with the economic valuation principles set out in the Solvency II Framework Directive.
 - Imposing stringent classification criteria and tier limits for subordinated debt and contingent capital will seriously hamper the capability of undertakings to raise capital at reasonable cost.
 - Classification criteria and tier limits are not only much more restrictive than specified in the framework Directive, but, in practical terms, they could seriously damage the capability of undertakings to attract any capital other than ordinary equity.

Key message

- There must be comprehensive arrangements for grandfathering existing instruments. This will remove uncertainty and avoid the risk of significant disruption to insurers' balance sheets and a "dash for cash" as insurers all seek to replace capital items facing premature obsolescence.

- There is a need for transitional provisions for hybrid capital to ensure a smooth transition with the new regime.
 - Grandfathering should apply on the basis of the classification criteria defined by the Solvency I regulatory framework as it is the only possible way for ensuring a level playing field.

II.2 Risk free rate, extrapolation and liquidity premium

Key messages

- Swap curves should be the basis for the basic risk-free yield curve
 - Extrapolation should be based on a long-term macro-economic rate
 - The illiquidity premium should apply to the valuation of insurance products based on the predictability of their cash-flows and/or the ability of the insurer to pass on any loss of the illiquidity premium due to a forced sale.
- The swap curve is the appropriate basis for the basic risk-free yield curve.
 - Although swaps do contain a small amount of credit risk, this is minimal due to collateralisation mechanisms. Government bond curves also cannot always be assumed to be risk-free (e.g. recent down grade of Ireland).
 - Government bonds are issued based on government funding requirements — therefore there can be significant supply and demand imbalances across the curve. Whereas swaps can be created to meet demand.
 - Swap rates are used by markets to price financial instruments.
 - The basic risk-free curve for each currency should be published by a central EU institution.
 - For the points in the swap curve where the market is not liquid, it should be extrapolated to a long-term macro-economic rate.
 - Depending on the different market data available in each market, as well as whether the illiquidity of the market is caused by temporary or permanent illiquidity, this long-term rate could be based on either: a forecast of long-term central bank targets or an average of historically observed rates.
 - The extrapolated curve for each currency should be published by a central EU institution and apply in a transparent way across all (re)insurers.
 - An illiquidity premium should in principle apply to the valuation of all products with a different magnitude depending on the predictability of cash flows, and/or the ability of insurers to pass on any loss of the illiquidity premium due to a forced sale.
 - The illiquidity premium is a beneficial anti-cyclical mechanism — it is expected to be material under stressed market conditions whereas it is expected to be close to zero in normal conditions (thereby acting to reduce technical provisions under stress).
 - The illiquidity premium for each currency should be published by a central EU institution and apply in a transparent way across all (re)insurers.

II.3 Insurance, market and operational risks calibration

Key messages

- The financial crisis cannot justify the excessive capital increases proposed by Ceiops, in particular for the non-market risks: insurance and operational risks. This would undermine the underwriting capacity of insurers.
 - Any excessive capital charge for market risk could force the industry, as a major institutional investor in the financial markets, to de-risk their balance sheet by selling off part of their portfolios. This could affect the still fragile economic situation.
 - If the current proposed calibration is maintained, then policyholders will face heightened costs and the lack of a competitive market from which to buy insurance and savings products.
- The calibration of market risks needs to be reviewed ahead of QIS5.
 - Ceiops proposed significant increase in capital requirements for spread risk, which 3.5 times larger than QIS4, cannot be justified by the crisis.
 - As per Article 111 of the Framework Directive, the equity risk module calibration should take into account of the likely reduction of the volatility in the value of those related undertakings arising from the strategic nature of those investments and the influence exercised by the participating undertaking.
 - The data and the methods used by Ceiops for the calibration of non-life and health insurance risks presented a number of flaws which resulted in inappropriate factors being proposed.
 - The industry stands ready to work closely with Ceiops on deriving appropriate calibration factors for Non-Life and health risks

II.4 Recognition of diversification effects and reinsurance

Key messages

- Diversification, in all forms and at all levels, are an integral part of how undertakings manage their business and as such should be given due recognition in the SCR and in the risk margin for technical provisions.
- Failure to recognise diversification benefits would lead to:
 - capital requirements exceeding the 99.5% VaR over one year target required by the Framework Directive for the SCR.
 - market-consistent valuation of technical provisions not being achieved as additional prudent margins are incorporated into the risk margin
- Due recognition should be given to risk mitigation techniques such as non proportional reinsurance which is particularly important for small and medium-sized enterprises (SMEs) as it allows them to spread their risk and make a more efficient use of their capital.

- A market consistent valuation of technical provisions requires the recognition diversification effects in the risk margin.
 - The risk margin represents the amount needed to run the portfolio - it is not appropriate to ignore diversification between lines of business as this is based on a line by line transfer assumption which is not in line with the spirit of the Framework Directive and with how transfers take place in practice.
- The degree of diversification across risk, which is explicitly recognized by correlation matrices in the Standard Formula, should be calibrated to 1/200 year event.
 - Independent risks should have a zero correlation.
- Geographical diversification is a key risk mitigating tool for undertakings and as such should be given due recognition in the standard formula for the SCR.
 - The fact that a winter storm in Sweden is independent from the claims experience in Portugal should be recognised in a truly risk based regime.
- Due recognition to diversification effects should also be given at group level.
 - Any limitations of the transferability/fungibility of capital should be recognised in the groups eligible own funds as per Art. 222 (4) of Directive 2009/138/EC which refers to solo SCRs rather than solo SCRs adjusted for diversification benefits.
- The risk mitigating effects of non proportional reinsurance needs to be given appropriate recognition in the standard formula for the SCR.

II.5 Undertaking specific parameters

Key message

- The use of undertaking specific parameters (USP) is particularly important for SMEs who specialise in certain areas leveraging their historic ties, their specific understanding of their customer base and their expertise within particular products. Their “specialisation” should be recognised and the requirements to use USPs should not be made overly demanding.
- The use of USPs put forward in recent Ceiops advice is restricted. This is because:
 - They are still many risk modules for which the use of USPs is still not foreseen (eg life risks)
 - For the risks where the use of USP is foreseen, companies will be required to meet very demanding data criteria before they are allowed to use USPs and the extent to which USPs will count in the formula will be very limited compared to how much the standard factors weight in the formula will be.



The CEA is the European insurance and reinsurance federation. Through its 33 member bodies — the national insurance associations — the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 100bn, employ one million people and invest €6 900bn in the economy.

CEA aisbl
Square de Meeûs 29
B-1000 Brussels
Belgium
Tel: +32 2 547 58 11
Fax: +32 2 547 58 19
www.cea.eu