EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL INSTITUTIONS
Insurance and pensions

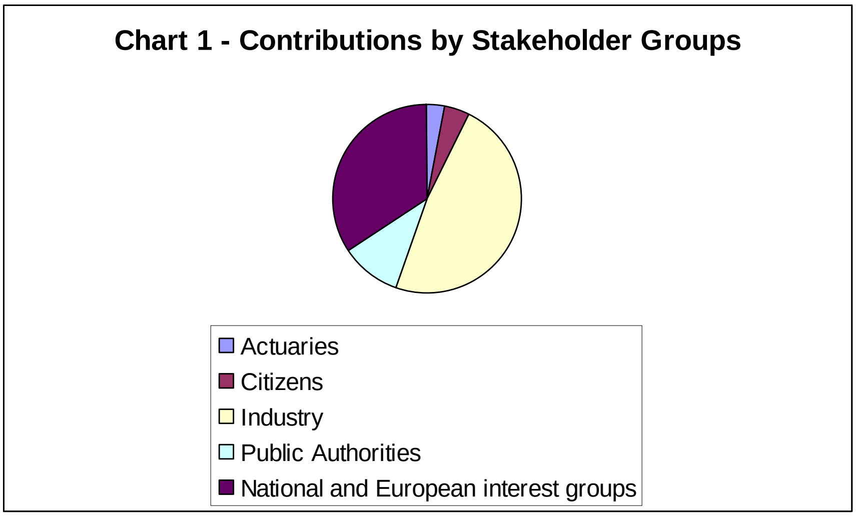
Brussels, 5 May 2011

SUMMARY OF RESPONSES TO THE CONSULTATION ON THE LEVEL 2 IMPLEMENTING MEASURES FOR SOLVENCY II

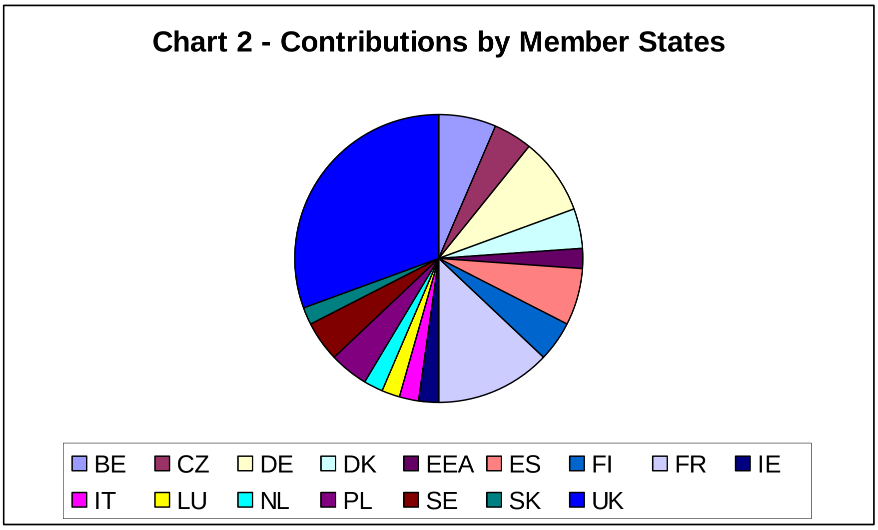
1. Background

On 24 November 2010, the European Commission published a Consultation on the Level 2 implementing measures for Directive 2009/38/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). Stakeholders and interested parties were invited to submit comments on the Commission Services' suggested approach to a number of policy issues by 26 January 2011.

The European Commission received 68 responses to the public consultation[1]. Respondents can be classified into 5 categories: Actuaries, Citizens, Industry, National and European interests groups and Public Authorities. The chart below shows the percentage of responses received from each category. The category "national and European interests groups" encompasses organisations representing the wider financial services. Industry includes the trade associations representing the interests of EU insurer and reinsurance undertakings ((re)insurers or undertakings).



Contributions were received from stakeholders in 15 Member States, 1 EEA country and 1 third country.



[1] A list of the contributions authorised for publication is included in Annex 1.

2. Executive Summary

While comments were received on all of the policy issues discussed in the consultation paper, it is clear from the nature and the volume of the comments received that stakeholders' concerns relate to a small number of key issues - the impact on long-term products, volatility and pro-cyclicality, proportionality and limiting the reporting burden and the need for transitional measures in certain areas. These issues which were raised in a large majority of the responses received are summarised in this section. The Commission Services intend to focus its impact assessment on the Solvency II level 2 implementing measures on the policy issues relating to these issues.

Many respondents raised the concern about the effect of the Solvency II level 2 implementing measures on long-term products, particularly those with guarantees. There is a concern that the level 2 implementing measures as set out in the technical specifications for the fifth quantitative impact study (QIS5) will not make it viable for insurers to continue to offer these types of products. The problem is in large part related to the volatility of the value of assets and liabilities under a market consistent valuation framework and the measurement of the specific risks that undertakings offering these products are exposed to. The policy issues most relevant to this issue are the risk-free interest rate curve for technical provisions and the Pillar I dampener. Comments on this issue were also raised in the context of stakeholders' comments on the impact on insurance markets and products and social and economic impacts. Following these comments the Commission Services has set up a working party. This working party is analysing the issues related to these products and the necessary measures will be taken in order to ensure that the characteristics and risks of these products are adequately reflected in the implementing measures.

Another related issue, which was raised by several respondents, is the issue of pro-cyclicality. Respondents highlighted the need to ensure that mechanisms designed to address pro-cyclicality, such as the Pillar I dampener, work effectively and do not create artificial volatility. The merits of the illiquidity premium as an anti-cyclical measure were also observed and it was suggested that a similar mechanism should be found for addressing distortions in the government bond market. Respondents raised the issue of pro-cyclicality in relation to the policy issue on the limits for own funds where it was noted that applying the limits to total own funds, rather than the own funds being used to meet the Solvency Capital Requirement (SCR), could have pro-cyclical effects.

Many responses, particularly those from public authorities, made reference to the new supervisory architecture and stressed the importance of EIOPA in ensuring a harmonised application of requirements. The need for a harmonised approach between supervisors was specifically mentioned in relation to the policy issues on capital add-ons, supervisory reporting and the actuarial function.

A large number of responses were received on the policy issues on supervisory reporting and public disclosure. Many responses cited the need for a concrete application of the proportionality principle in relation to the Pillar III requirements, for example through exempting certain undertakings from the quarterly reporting based on the size, nature and complexity of the risks in their business. More generally, the need to have concrete applications of the proportionality principle across all three of the Solvency II pillars was stressed.

Finally, the need for transitional measures in certain areas to ensure a smooth transition to the new Solvency II regime and to avoid market disruption was noted. Specific areas where respondents deem transitional measures to be necessary include own funds, reporting requirements and third country equivalence.

3. Policy Issues

1. Technical provisions

Best estimate – risk-free interest rate curve

A couple of respondents pointed out the potential volatility in own funds caused by the reference to risk-free rates in the calculation of technical provision, an option already decided in the Framework Directive[2].

Most of the respondents agreed with the Commission Services' choice of the two stage approach where the starting point are the interest rate swaps adjusted to take account of credit and basis risks, as tested in QIS5, and the allowance of an illiquidity premium for all insurance liabilities in situations of stressed liquidity in the financial markets. However, a couple of industry respondents do not favour an adjustment to the swap curve other than the inclusion of an illiquidity premium or consider that the illiquidity premium should be granted on a permanent basis. Some respondents called for greater certainty on the value of the illiquidity premium, in particular through the specification of the method to calculate it using a mathematical formula.

Diverging views were expressed on the relevance of the classification of insurance liabilities into 3 buckets for the allowance of the illiquidity premium. Some respondents from the supervisory or auditing sectors oppose the inclusion of an illiquidity premium as a potential double counting of the liquidity characteristics of insurance liabilities. Many others welcome the inclusion of the illiquidity premium as a countercyclical measure, some calling for similar measures to mitigate the distortions in the government bond market. A few respondents from one Member State highlighted the risk of asset-liability mismatch for insurers invested largely in government bonds under the Commission Services' suggested approach.

Respondents noted the publication of the discount curves by EIOPA was crucial to ensure harmonisation.

Although not an issue discussed in the consultation paper, some respondents pointed out that the extrapolation of the discount curve was a crucial point and potentially more important than the choice between swaps or government bonds.

Risk margin – Cost-of-Capital rate

All responses of public authorities support the Commission Services' suggestion to set the Cost-of-Capital rate at 6%. Some of responses refer to the analysis of the cost of capital

[2] Directive 2009/138/EC

included in the technical advice provided by CEIOPS[3]. CEIOPS concluded that the Cost-of-Capital rate should be at least 6%. Responses also mention that the application of a rate of 6% has lead to satisfying outcomes in the Quantitative Impact Studies on Solvency II carried out.

Most industry responses favour a rate lower than 6%. Some suggest a rate in the range of 2.5% to 4.5%, while others are more specific and prefer 4%. Some responses refer to a study carried out by the Chief Risk Officer Forum that recommended a rate in the range of 2.5% to 4.5%[4]. Other stakeholders refer to market observations or analyst assumptions to support their view. Some industry stakeholders favour a lower rate for longer maturities, for example a rate of 4.5% for the first five years and a rate of 2.5% subsequently. This is justified based on the characteristics of long-term insurance business and the expectation that a lower rate would be more appropriate in the future. Other responses oppose a Cost-of-Capital rate that depends on the maturity. A minority of industry responses support a cost-of-Capital rate of 6%.

Several responses, in particular those of accountants, mention that a fixed Cost-of-Capital rate is not compatible with the draft international accounting standards for insurance contracts[5]. According to these drafts no methodology for the calculation of the risk margin is prescribed. Some responses express the view that the rate depends on the risk profile of the undertaking, partly acknowledging that a common rate is an acceptable simplification and ensures harmonisation. Some responses explicitly reject the use of undertaking-specific rates or note that they have no evidence of a dependency of the rate on the type of insurance business.

Several stakeholders note that the determination of the appropriate Cost-of-Capital rate is complex and difficult. Some stakeholders consider further research in that area is necessary. Many responses support a regular revision of the Cost-of-Capital rate. It was pointed out that the rate changes over time depending on risk-aversion in financial markets. One stakeholder mentioned that the cost of capital depends on the level of interest rates.

Some industry stakeholders point out that the choice of the Cost-of-Capital rate has a significant impact. While an increase of the rate from, for example from 4% to 6%, only results in a low relative increase of the insurers technical provisions, the impact may amount to up to 20% of an insurer's SCR.

Risk margin - diversification

Most responses received from public authorities favour option 3 which does not allow for diversification between lines of business. A number of reasons were given for this view. Option 3 better reflects reality because transfers of single lines of business occur in practice. Undertakings that allow for diversification between lines of business incur a loss when they transfer a line of business to another undertaking because the risk margin for the remaining portfolio increases. This is particularly problematic where a transfer needs to be made under stressed conditions. It was also noted in one response that composite insurers were usually not

---

[3] CEIOPS: Final CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions – Article 86(d) Calculation of the Risk Margin, pp38-44 (https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP42/CEIOPS-L2-Final-Advice-on-TP-Risk-Margin.pdf)

[4] Chief Risk Officer Forum: Market Value of Liabilities for Insurance Firms (http://www.croforum.org/assets/files/publications/croforummvlpaperjuly2008.pdf)

[5] International Accounting Standards Board: Exposure Draft - Insurance Contracts (ED/2010/8) (http://www.ifrs.org/Current+Projects/IASB+Projects/Insurance+Contracts/Exposure+draft+2010/Exposure+draft+and+Comment+letters.htm)

able to transfer all their business to a newly established undertaking. It was concluded that at least no diversification between life and non-life business should be taken into account in the risk margin. The risk margin calculation under option 3 was considered to be more practicable than under option 2. Some authorities point out that option 2 is not in line with the draft international accounting standards for insurance contracts. According to the draft no diversification between different portfolios[6] should be taken into account.

The vast majority of industry responses recommend option 2. These stakeholders consider it economic and most realistic to allow for diversification between lines of business because the accepting insurers of a transfer of insurance portfolio would be able to benefit from that diversification and this would therefore be taken into account in the transfer price. Some responses consider option 1 to be even more appropriate from a theoretical perspective, but prefer option 2 for reasons of practicability. A few industry responses prefer option 1 because it ensures comparability of results. One industry response suggests applying option 3 because it is closest to transfer value, while option 2 permits cross-subsidisation between lines of business and hinders comparability of results.

Many industry responses call for allowance of group diversification in the calculation of the risk margin at group level. That was considered to be again the most realistic assumption given the consolidated approach for the determination of own funds at group level. It was pointed out that a restriction of group diversification would incentivize the establishment of branches instead of subsidiaries. Moreover, no allowance for group diversification was considered to hamper the development of cross-border companies. On the other hand, it was noted that allowing for diversification could be considered complex by small groups.

A financial analyst response suggested not to allow for diversification between life, health and non-life business or to apply option 3 in order to ensure the comparability of results. An auditor response suggested further research of the transfer value of insurance portfolios. It was also proposed to consider consistency with international accounting standards when deciding on the approach. A consumer group response recommended option 3.

2. Own funds

Most responses from public authorities favour the Commission Services' suggested approach which sets the minimum amount of Tier 1 own funds required to cover the SCR at 50%, the maximum amount of Tier 3 own funds permitted to cover the SCR at 15% and the minimum amount of Tier 1 own funds required to cover the Minimum Capital Requirement (MCR) at 80%. This option was also supported by some industry respondents who noted that the suggested limits would maximise policy holder protection, while simultaneously giving undertakings the flexibility to have own funds of a "slightly lower quality"[7].

The majority of industry respondents favour the minimum limits set out in the Framework Directive, which set the minimum amount of Tier 1 own funds required to cover the SCR at one third, the maximum amount of Tier 3 own funds permitted to cover the SCR at one third and the minimum amount of Tier 1 own funds required to cover the MCR at 50%. The main

[6] The draft refers to a "portfolio of contracts that are subject to broadly similar risks and managed together as a single pool", see International Accounting Standards Board: Basis for Conclusions - Exposure Draft - Insurance Contracts (ED/2010/8), page 45.
[7] Comment from Investment & Life Assurance Group.

reason given in support of this option is the fact that the higher limits on capital resources for banks being introduced in line with the G20 commitment to improve the quality of capital should not apply to insurers. A number of responses suggest that the Commission Services' suggested approach is not in line with the Framework Directive. However, the Commission Services wish to clarify that the limits set in the Framework Directive are minimum limits for Tier 1 and maximum limits for Tier 3 and the inclusion of the requirement to adopt level 2 implementing measures on quantitative limits (Article 99(a)) allows for these limits to be increased/ decreased respectively at level 2.

A few respondents called for further clarity in the level 2 implementing measures on how the limits should apply. These respondents prefer an approach whereby the limits are applied only to the own funds covering the SCR, rather than to total own funds. This was the approach adopted in QIS5. The effect of this is that eligible Tier 2 and Tier 3 own funds are limited by a percentage of the SCR. It was noted that market consistent valuation will make own funds and particularly Tier 1 more volatile. If limits apply to total own funds, respondents consider that decreases in Tier 1 will result in smaller amounts of Tier 2 and Tier 3 being eligible which could in some respondents' view accelerate a breach of capital requirements. These respondents consider such an approach to be pro-cyclical.

In QIS5, the Commission tested an approach whereby the amount of other paid in capital instruments, defined as preference shares, subordinated liabilities and subordinated mutual member accounts was limited to 20% of total Tier 1 own funds. Several respondents noted the need to consider this limit and the limits on own funds generally in conjunction with the criteria for classification of own-fund items. It was highlighted that the criteria for classification of own-fund items in Tier 1 tested in QIS5 would mean that many existing capital instruments would not meet the requirements. Several responses emphasised the need for transitional provisions to avoid undertakings having to replace existing capital instruments with Solvency II compliant own-fund items within a short space of time.

The treatment of Expected Profits included in Future Premiums (EPIFP) was also highlighted by a number of industry respondents. EPIFP results from the inclusion in technical provisions of premiums on existing business that will be received in the future. Respondents who commented on this issue support the QIS5 approach of including the amount of EPIFP in Tier 1 own funds.

One respondent noted that, provided the limits on own funds are applied in a uniform way, the only driver on the cost of capital will be an undertakings' capital composition and its credit spread. This would be likely to create a level playing field within the EU insurance industry when raising own funds and is consistent with the Solvency II objective of deepening the integration of the single market. Another respondent noted that any requirement for the insurance sector to hold more capital as a result of Solvency II could coincide with the large capital raisings that have been mandated in the banking sector. This simultaneous increase in demand for capital may have upward pressure on the cost of capital.

The risk/ return trade-off was highlighted with several respondents noting that investors in higher quality own funds would demand a higher yield because they assume more risk. This is because high-quality own-fund items need to absorb losses on a going concern basis. As a general comment several respondents noted that increases in the cost of capital would to a greater or lesser extent be ultimately borne by policy holders.

Respondents representing the mutual sector highlighted that, as compared to publicly listed companies, mutuals have more restricted access to external Tier 1 finance and suggested that the level 2 implementing measures should take this into account.

3. SCR standard formula

Equity risk – Pillar I dampener

Respondents welcomed the use of dampener mechanisms in Solvency II. While a couple of public authorities prefer a 12 month dampener in line with CEIOPS advice, most respondents supported the Commission Services' suggested time period for the dampener of 36 months. Some representatives of the insurance industry would be in favour of a potentially longer period (more than 36 months).

Some respondents suggested that the index underlying the symmetric adjustment should reflect the actual equity holdings of the insurance or reinsurance companies. Some respondents also questioned the design of the symmetric adjustment as not taking into account the fact that equity indices are on average higher than the historic moving average or as being too volatile when the index is close to its historic average.

Risk absorbing capacity of technical provisions

The vast majority of responses recommend the use of the modular approach. It is considered simple and in line with the insurers' best practice. Some responses pointed out that the double-counting of loss-absorbing capacity under the modular approach is sufficiently prevented by capping the results with the value of future discretionary benefits.

The equivalent scenario was rejected by the majority of respondents for being too burdensome, complex and difficult to understand and producing arbitrary results, in particular in the calculations at group level. The risk margin calculation and the treatment of ring-fenced funds were also mentioned as areas where the equivalent scenario was difficult to apply. There was a small minority of support for the equivalent scenario. A financial analyst response preferred the equivalent scenario because it takes into account side effects such as the increase in lapses after a rise of interest rates. An auditor response considered the equivalent scenario to be superior from a technical perspective. One industry stakeholder noted the advantage of the equivalent scenario in capturing the non-linearity of risks, but preferred the modular approach for practical reasons.

The option of a fixed percentage of technical provisions adjustment was not considered to be sufficiently risk sensitive. However, one industry response expressed a preference for this approach due to its simplicity.

One suggestion was to allow insurers to choose between the modular approach and the equivalent scenario.

Diversification effects – correlation parameters

The majority of industry responses favour a decrease, as compared to QIS5, of the correlation parameters between lines of business in the non-life premium and reserve risk sub-module. Reduced parameters are considered to be more in line with the calibration objective of the SCR.

Some responses recommended zero correlation parameters between lines of business which can be considered to be independent. The parameters between direct business and non-proportional reinsurance and the parameters in relation to the line of business miscellaneous insurance are believed to be too high. It was pointed out that lower correlation parameters would better incentivise diversification of business.

A minority of industry responses, a response from actuaries, financial analysts and responses from public authorities support the calibration in QIS5. It was pointed out that this calibration has worked well in both QIS4 and QIS5. One response gave a number of reasons for dependence between lines of business, for example inflation, large claims, or in health insurance the coincidence of the insured persons in different lines.

A captive response welcomed the simplification for the non-life premium and reserve risk sub-module for certain captive insurers and reinsurers, but suggested a lower calibration of the correlation parameters for the simplified approach.

Diversification effects – geographical diversification

A large majority of industry responses supported the allowance for geographical diversification in the premium and reserve risk sub-modules of the SCR standard formula. They pointed out that diversification is a core principle of insurance and ignoring diversification in the standard formula would not be in line with the economic approach of Solvency II. Not allowing for geographical diversification would disadvantage cross-border companies. Reference was also made to Recital 64 of the Framework Directive which states that the SCR should be calculated on the basis of the true risk profile of those undertakings, taking account of the impact of possible risk-mitigation techniques, as well as diversification effects. It was noted that the allowance for diversification is in line with the way the insurance business is managed by the undertakings and that an allowance for diversification would incentivise undertakings to diversify their insurance portfolio. One response reported a significant influence of the adjustment factor for geographical diversification on the SCR of undertakings: ignoring diversification would increase the SCR by up to 20%.

Different views existed among the supporters of the explicit allowance of diversification with regard to the level of granularity of the geographical segmentation that the allowance should be based on. Some responses supported the QIS5 segmentation. Others asked for a finer segmentation, up to segmentation country by country, or asked for specific changes to the QIS5 segmentation. Usually, the responses included no rational for the suggested segmentation. Some industry responses proposed a flexible approach to segmentation whereby the granularity of the segmentation depends on the data available to the undertaking. The option included in QIS5 not to calculate the allowance for diversification was generally welcomed for reasons of practicability. Moreover, some responses noted that for many insurers geographical diversification was not relevant.

Few industry responses suggested no allowance for geographical diversification. They feared that mainly large insurers would benefit from such an allowance and that it could distort competition and change existing market structures.

An accountant response noted that a big impact of geographical diversification existed only in catastrophe risk. Basic insurance risk as captured in the premium and reserve risk sub-modules was rather driven by pricing than by claims.

A majority of responses from public authorities suggest not allowing for geographical diversification. Including the adjustment factor for geographical diversification would make the standard formula unnecessarily complex, could lead to double counting of diversification where it is already included in the calibration of the risk factors for premium and reserve risk. Furthermore it was pointed out that the definition of the geographical segments is arbitrary. It was also mentioned that the impact of the adjustment factor had no impact on the insurers of some national markets.

Underwriting risk (other than catastrophe risk) arising from non-life insurance obligations

Apart from one respondent who suggested ignoring underwriting risk altogether, the Commission Services' suggestion to follow a factor-based approach to assess underwriting risk (other than catastrophe risk) arising from non-life insurance obligations was unanimously supported. The setting up of a Joint Working Group, comprising representatives of the industry, actuaries and supervisors, to refine the calibration of the premium and reserve risk factors in the non-life underwriting risk module of the SCR standard formula was also welcomed. Some respondents considered the adjustment factor for the risk-mitigating effect of non-proportional reinsurance as too complex or inappropriate, whereas others explicitly welcomed its inclusion particularly for small and medium-sized enterprises (SMEs).

Underwriting risk (other than catastrophe risk) arising from life insurance obligations

Respondents unanimously support the Commission Services' suggestion to follow a scenario-based approach to assess underwriting risk (other than catastrophe risk) arising from life insurance obligations. A few respondents think that it would be overly prudent to consider only scenarios that reduce basic own funds when determining the SCR.

Underwriting catastrophe risks arising from insurance obligations

Respondents were generally supportive of the Commission Services' suggestion to follow a scenario-based approach to assess the catastrophe risk arising from insurance obligations. A couple of respondents suggested however that factor-based approaches would be more convenient for SMEs, for captives or for certain lines of business. Many industry respondents called for the possibility to use undertaking-specific parameters for catastrophe risk, in particular for exposures in third countries, a couple of them requesting a requirement to use undertaking-specific approaches.

Many respondents criticized the QIS5 approach as being too complex or poorly designed for certain risks (e.g. flood risk in countries such as Belgium, Poland or the Czech Republic and hail and earthquake risk in the Czech Republic) and for certain lines of business (e.g. liability risk which was considered to be designed in practice as a factor-based approach and over-calibrated within the EU).

4. Treatment of holdings in participations and subsidiaries

Most industry respondents did not support the Commission Services' combination of options. In particular, there was a lack of support for the suggested approach of deducting participations in financial and credit institutions, mainly due to the belief that this may lead to an unlevel playing. Reference was made to the Basel III requirements which require significant investments in insurers (defined as holding of greater than 10%), which are excluded from the scope of group consolidation, to be deducted from own funds. Responses suggest a preference for cross-sectoral consistency to avoid arbitrage opportunities given that the risks inherent in an insurer holding a banking participation are the same as a bank holding an insurance participation all other things being equal.

The deduction of participations in financial and credit institutions was welcomed in some responses from public authorities. These respondents consider that a partial deduction is also needed for participations in (re)insurers to address double gearing at solo level. Several industry respondents highlight that double gearing is eliminated through consolidation in the calculation of group solvency and therefore do not see the elimination of double gearing at solo level as necessary or appropriate.

Most industry respondents support a lower equity stress for all participations on the basis that the Framework Directive requires that the approach for related undertakings takes into account "the likely reduction in the volatility of the value of those related undertakings arising from the strategic nature of those investments and the influence exercised by the participating undertaking on those related undertakings." One respondent suggested that while participating undertakings are exposed to equity risk[8] due to changes in the underlying fundamentals of the related undertaking, these investments are less exposed to equity risk resulting from market events such as the market price of risk or hostile take-overs. A few respondents consider the 22% equity stress for strategic participations to be appropriate due to the analogous treatment of equities held for the long-term under the duration-based approach.

Some responses from industry representatives and public authorities do not consider a fixed charge for all participations to be sufficiently risk-sensitive and prefer an approach that reflects the specific risk inherent in the participation. These respondents support an approach for participations in (re)insurers that links the equity stress applied with the SCR of the participation.

There was little support for the introduction of a concept of "strategic" participations since the definition of strategic is likely to be ambiguous and subjective. Some respondents consider that all participations are by their nature strategic due to the "durable and long term link"[9].

Although not directly linked to the question asked, several industry respondents commented that they would support a wider allowance of mark to model valuation methods so future profits or losses on new business could be included within the valuation of participations.

Respondents unanimously agreed that the choice of options on participations will cause groups to seek to optimise their corporate structure. Some observed that this was a natural

[8] Equity risk is defined as "the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of the prices of equities."
[9] Joint CRO and CFO Forum comment.

consequence of the introduction of Solvency II, which is a significant change in solvency regime for undertakings. It was also noted that a review of undertakings' corporate structure would be caused by the desire to maximum diversification benefits and to benefit from positive third country equivalence determinations.

It was indicated that should the treatment of participations require additional capital to be raised, this may incentivise groups to restructure and transform their related undertakings into branches. This is consistent with the conclusion reached by Deloitte. Equally, if higher capital requirements result from holdings certain participations, then undertakings may be motivated to dispose of these participations and invest in others participations or subsidiaries.

There were mixed responses to the suggestion of alternative approaches for holdings in regulated undertakings. Several respondents would support alternative approaches to the treatment of participations in (re)insurers which are based on that holding's SCR. These respondents agree that the additional information should be used to ascertain the contribution of certain regulated related holdings to the risk profile of the undertaking.

One suggestion was to only allow the own funds in the participation in excess of the participation's SCR. Another suggestion was to vary the equity charge depending on the level of investment (for example 0% for subsidiaries, 20% for participations). Some respondents suggested that undertakings be given the option to apply a "look through" approach, which would involve sub-group consolidation. The Commission Services note that such an approach blurs the distinction between solo and group treatment.

Other respondents did not favour alternative approaches and prefer a fixed equity charge. The reasons being that such an approach may result in undue complexity or that such an approach could lead to a capital requirement higher than the standard equity charge, which some respondents consider to be contrary to the Framework Directive.

Several respondents suggested that additional information about the holdings' contribution to the overall risk profile of the undertaking should be considered as part of the undertakings Own-Risk and Solvency Assessment (ORSA). Although the Commission Services agree that this would be an important part of the ORSA, it is important to note that there is no scope in the Framework Directive to introduce level 2 implementing measures in this area.

5. SCR internal model

Integration of partial internal models

The majority of industry responses prefer to use dependency structures determined by the undertaking provided that they are justified (option 3). In their view, undertakings should not be discouraged from developing an appropriate integration technique that reflects their risk profile. Some responses stress that this option is more aligned to the philosophy of an internal model where the firm proposes and justifies the internal model as part of the approval process. These respondents think that requiring proof that all standardised integration techniques are not adequate would be too burdensome for SMEs.

One response highlighted that option 3 will encourage innovation and diversity of techniques, which will reduce the level of systemic risk across the industry. Finally, another response also stressed that keeping the list of techniques up to date is difficult and that they would prefer a non-binding list of techniques to help small undertakings to use partial internal models.

Some industry responses are in favour of using the techniques provided by supervisory authorities or, if this is not possible or there is strong evidence that the techniques are inappropriate, the technique provided by the undertaking (option 2). In their view this option is less burdensome and ensures certainty and comparability between entities.

All responses from public authorities agree with option 2. One response expressed that options 2 and 3 are similar. While option 3 provides more flexibility, option 2 enables harmonization and reduces development costs.

No respondent was in favour of using as an integration technique only the coefficients prescribed by supervisory authorities (option 1).

Use test

Most of industry responses were in favour of requiring a full integration of the internal model into the risk-management system but without imposing a list of mandatory uses for the internal model (the modified version of option 2 recommended by the Commission Services). These responses did not agree with including a mandatory list of uses as it would be against the principle-based approach to risk management. Some undertakings highlighted that using an internal model does not mean taking decisions always in line with the internal model, but rather using the information provided by the internal model together with other sources of information in order to take the final decision. One response commented that the requirement to use the internal model at all levels of the organisation was too strong and suggested applying the use test to all levels involved in the decision making process in line with the proportionality principle.

Some responses from the industry were in favour of requiring the use of the internal model at the top-most organisational level as in their view requiring the use test at all levels of the organisation may introduce greater uncertainty and lead to divergences in supervisory practices. Some responses in favour of the modified version of option 2 highlighted the need for coordination between supervisors in order to have a harmonised approach. One undertaking was in favour of including a list of mandatory uses of the internal model while having a more flexible approach for other areas.

All responses from the national authorities were in favour of the modified version of option 2 proposed by the Commission Services.

Statistical quality standards

The vast majority of responses from industry and national authorities agreed with the Commission Services' suggested approach of option 2. This option requires undertakings to establish their own data quality principles in line with supervisory practices including data sources, use of expert judgement and validation. These respondents consider options 1, 3 and 4 as not practicable and too burdensome for undertakings and supervisors.

Some undertakings highlighted that the concept of expert judgement should not be restricted to cases when data is scarce but should also be applied in the collection and interpretation of data and in the definition of the assumptions.

Some responses stressed that common European principles are needed to ensure a harmonised approach, particularly in relation to data quality.

Only one response favoured requiring a revision of data and expert judgement by an independent third party, including the possibility to use expert judgement in all areas, as they believe that solvency data should be of the same quality as accounting data.

6. Procyclicality – Pillar II dampener

Responses from industry are split between those favouring time periods between 24 and 36 months (option 3) and those favouring time periods between 36 and 60 months (option 4). Responses favouring option 3 believe that 30 months is long enough to restore compliance with the SCR after an exceptional fall in financial markets. Responses favouring option 4 think that it is not necessary to fix a time period at level 2 and would prefer a longer period of time to ensure flexibility. Their view is that fixing a maximum recovery period does not mean that it should always be applied. One response added that option 4 was more closely aligned with the objective of introducing risk-sensitive harmonised solvency standards, as crises last longer than 3 years. Another response favouring option 4 suggested a shorter recovery period could be agreed provided that the European Systemic Risk Board could lengthen the period if necessary. The need for a harmonized approach for the whole financial sector was also noted.

Only one response was in favour of a shorter period (option 2) as in their view when the SCR is breached, the management of the undertaking should focus on restoring own funds. Increasing the recovery period will not encourage managers to focus on a prompt recovery.

All responses from public authorities took the view that 30 months is long enough to ensure flexibility, without undermining the level playing field.

The vast majority of responses are in favour of introducing an open list of external and entity-specific factors that should be taken into account by the supervisory authorities when deciding whether and for what time period to grant an extension of the recovery period. Some responses explain that it is not possible to foresee how future crises will develop and accordingly it is not possible to pre-define all the factors to be considered. Other responses stressed the need to give flexibility to the supervisor to address the particular situation of each undertaking. Other responses expressed a preference for a clear definition of an exceptional fall in financial markets and a principle based approach that gives guidance on conditions under which an exceptional fall in financial crisis exists. In their view a clear definition will enhance transparency and consistency and allow EIOPA, supervisory authorities and industry to have a clear view on whether such event has occurred.

Only one respondent prefers to have strict factors which supervisors should follow when deciding on whether to grant an extension to ensure consistency between supervisors.

7. Capital add-ons

Although responses were mixed in terms of the options supported, respondents generally agreed that there was a need to ensure a harmonised approach to the setting of capital add-ons by supervisory authorities across Member States. Many suggested that EIOPA should monitor the setting of capital add-ons in order to ensure that this is the case.

Some respondents expressed their overall support for the Commission Services' suggested approach in relation to the policy issue as a whole, whereby for risk-profile capital add-ons supervisors use a fixed percentage of the overall SCR as a reference value (i.e. a rebuttable presumption that the deviation is significant), but are able to depart from this subject to harmonised criteria (option 3), for governance capital add-ons the proposed maximum period for resolving system of governance deficiencies is 6 months, with supervisory discretion to shorten this period subject to general criteria (option 2). These respondents observed that this approach achieves the right balance between certainty over when capital add-ons would be set and flexibility for supervisory authorities to determine if capital add-ons are appropriate.

Several industry respondents prefer option 2, whereby risk profile capital add-ons would only be set if a threshold is exceeded. The reason for this preference was the need for greater clarity on when a capital add-on would be imposed. These respondents generally support setting the level of presumption for a significant deviation at 15%. Other industry respondents expressed a preference for option 1 and setting capital add-ons on a case-by-case basis as a fixed percentage requires a precise quantification of the deviation from the SCR which is difficult where internal models are used. It was also suggested that a fixed percentage could lead to "unnecessary anticipation"[10] in the market if an undertaking was close to its limit.

Several respondents stressed that the time for remedying deficiencies in governance systems should be flexible and proportionate. This suggests a preference for including general criteria in level 2, with no absolute maximum time period. Other respondents supported option 2 and considered 6 months as an appropriate period for remedial measures to be applied.

Many responses noted as a general comment that whatever the choice of policy options the approach should create the right incentives for undertakings to remedy the deficiency that has led to the capital add-on within a short timeframe.

The extent to which supervisory authorities should be able to exercise judgment in the determination of a capital add-on received mixed responses. Most public authorities' responses emphasise the need for a certain amount of flexibility. However, industry respondents expressed concern that too much discretion could lead to an unlevel playing field.

8. Actuarial function

In relation to standards to be applied by the actuarial function, the Commission Services' suggested approach was supported. This approach requires EIOPA to adopt, following a period of public consultation, European actuarial guidelines on technical issues, relating to the tasks of the actuarial function, taking into account the standards set in national and international actuarial associations.

[10] Joint CRO and CFO Forum comment.

The majority of the industry responses are against this approach and prefer the option where the function uses the technical standards that are widely accepted in the industry and actuarial profession. In their view worldwide operating undertakings should not be forced to only apply European technical standards, as their business include non-European operations. In extreme cases where such guidance generates distortions, actuarial guidance should be constructed by interaction of different stakeholders, including industry, supervisors and profession.

Some industry responses agree with the Commission Services' suggested approach as it strikes a balance between public consultation and formal decision making. Actuarial associations also support this approach, but recognise that the process for developing actuarial standards should involve consultation with insurance industry and supervisors. Oversight and eventual adoption of standards by EIOPA will ensure efficient and harmonised supervision. This comment was also mentioned by some (re)insurers.

All public authorities support the Commission Services' proposed approach although one authority commented that technical standards should be developed by experts from the actuarial profession with the involvement of supervisors.

On the scope of the tasks and reporting of the actuarial guidance most industry responses believe that the Framework Directive is sufficient and no further details at level 2 are needed. Some undertakings prefer some definition of the tasks of the actuarial function at level 2 provided that they are principle based. Responses from the actuarial associations agreed that some clarification at level 2 is needed on the tasks of the actuarial function, but that undertakings should be allowed to exercise some discretion. On the content of the reporting, these respondents agree that some definition is needed at level 2 to ensure a reasonable degree of consistency between firms.

Responses from public authorities are in favour of the proposed approach for the sake of a unified approach across the market.

Most of industry responses agree with EIOPA adopting non-binding guidelines. Responses referred to the appropriateness of non-binding guidance to support SMEs. However, some responses prefer to have guidelines only on specific aspects. Other industry responses believe that actuaries should only be subject to guidelines developed by the profession. Responses from the actuarial associations are also in favour of this approach as actuarial guidelines should also be required for those carrying out the actuarial function that are not actuaries and so no subject to professional guidelines.

Responses from public authorities favour the proposed approach. One authority highlighted that EIOPA, as a European body, is best equipped with the legal powers to fulfil this task.

Most respondents would prefer actuarial guidelines to only relate to technical issues and not to be extended to include professional and ethical guidelines. In their view national actuarial bodies are responsible for establishing professional and ethical standards. Instead fit and proper principles should also be applied to persons carrying out the actuarial function.

Some responses, including responses from actuarial associations, favour extending the guidelines to professional and ethical guidelines. In their view, while actuaries are subject to professional and ethical guidelines provided by the national associations, this will only be the case where the actuarial function is carried out by a qualified actuary. One response recommends introducing qualification standards, including requirements for a specified minimum level of education, relevant practical experience and mandatory continuing education. In their view ethical standards should cover matters such as competence, integrity, confidentiality and independency.

9. Supervisory reporting – content, form and modalities

The feedback received to this question focussed on two main issues: first, on the frequency of the reporting and secondly, the need for transitional measures on reporting requirements (which was not directly linked to question).

With regard to the first issue, the majority of industry respondents in principle agree with the approach taken by the Commission (scenario 3) except for the option on frequency which in their view should be annual and not quarterly. This suggests a preference actually for scenario 1 as the only difference between scenarios 1 and 3 is the frequency. More specifically, respondents representing the views of mutuals, captives and health insurers mentioned the need for reporting to be annual in order to have a concrete application of the principle of proportionality and not to create an excessive burden for SMEs.

Respondents from insurance industry associations also indicated that quarterly reporting should be limited to only some information and not entail the whole set of information that would be reported annually. It was also suggested that approximations be permitted for the quarterly reporting and, for that reason, that it should not be disclosed publicly.

A few industry respondents mentioned that reporting of non-EU operations should not be subject to the quarterly reporting requirement as that would be particularly burdensome since the formats that they have to produce might be different to those required by the home supervisor of the parent company. One respondent noted that a clear case on the usefulness of the information required on a quarterly basis by supervisory authorities had not been made. More specifically, doubts arise in relation to the resources that supervisors have to analyse the information that they would receive.

A number of industry respondents and one public authority respondent queried the volume of the quantitative information required. However, this concern is understood to be linked to the quantitative information that EIOPA has been informally consulting on for level 3, which the Commission is looking closely at. Nevertheless, respondents noted that granularity of information seems excessive taking into account the fact that supervisors can ask for any additional information needed on an ad hoc basis.

A number of respondents called for consistency with IFRS and with accounting rules in the valuation and reporting of assets and liabilities as that would lead to fewer burdens.

The majority of responses from public authorities are supportive of the approach taken by the Commission. The need for EIOPA to further develop harmonized reporting and templates at level 3, without any constraints at level 2 which could endanger the effectiveness of supervision and hamper the supervisory review process, was stressed.

A number of respondents, both from national and European interests groups and public associations indicated their support for standardized reporting formats not only for quantitative information but also for qualitative information. Although not raised as an issue in the consultation, these respondents recommended the use of a particular type of format to submit information in order to ease comparability and also make the production of regulatory reports more efficient and less burdensome reporting entities.

With regard to the second issue raised, a number of respondents called for transitional measures in order to give (re)insurers the necessary time to develop appropriate reporting infrastructures. More specifically, respondents are of the view that there is a need to phase-in reporting requirements over 5-6 years. Some respondents would favour an approach based on a waiver from quarterly reporting and on an extension of the deadlines for submitting quarterly reporting during the first year of application.

One industry respondent suggested a phase-in over a period of 6 years in two steps, where the first step would consist of providing sufficient information to the supervisor during the first year, accompanied by a development plan to be validated by the supervisor and to be implemented during the following 3 years. After 3 years, the supervisor should approve the actions taken by the undertaking and approve a new development plan for the following 3 years. This respondent noted that this would allow convergence with the new IFRS rules which are not yet known and would prevent additional implementation costs.

Most respondents are in favour of the approach proposed by the Commission that only material information has to be reported. In relation to the suggestions as to the application of the principle of proportionality, a number of industry respondents mentioned the need to further specify at level 2 the application of the proportionality principle for small and medium size undertakings. Suggestions on how to implement the principle in practice ranged from limiting the content and/or the frequency of the information to be reported (i.e. that no quarterly reporting is envisaged for SMEs) to taking into account different requirements in the ORSA. Small undertakings that are part of a group were also mentioned as undertakings to which the proportionality principle should apply.

Other industry respondents indicated that, irrespective of the size of the undertakings, the proportionality principle should be respected when filling the templates and that no fixed thresholds should be set for that purpose.

One industry respondent indicated that it should be the task of supervisory authorities to decide which information is key in order to develop an early warning system which provides reliable information on the situation of specific risk scenarios. If the reporting requirements are designed in this way, the may not be overly burdensome, and prove helpful to the supervisor to the benefit of regulated companies.

As to the definition of materiality, some respondents would favour an approach whereby the definition for reporting purposes is based on the IFRS definition. Views were mixed as to who should define the materiality. The suggestion was made that the management of the undertaking should do that as, based on IASB guidance, the application of materiality requires judgement. A number of respondents noted that guidelines on materiality, either developed by EIOPA or laid out at level 2, would facilitate harmonisation across Europe.

One public authority respondent noted that while an investment can be immaterial for the undertaking, that may not be the case from a financial stability perspective and considerations of this kind should be embedded in the definition.

There were mixed views on the question of which data should be subject to external audit. Several respondents from the industry are against any kind of audit. Many different arguments were put forward including that it would not be in line with the Framework Directive, many data stem from accounting and this data will be audited, Pillar II requirements are sufficient to ensure the reliability of data submitted to supervisors.

One respondent indicated that there is no need for audit since the supervisory report will contain a reconciliation of the Solvency II balance sheet with the balance sheet in statutory accounts, which is subject to audit. One respondent suggested that a certain level of assurance could be given on the comparability of the audited financial statements with the quantitative reporting templates.

A few respondents noted that it may be difficult to subject the SCR calculation to an audit. This was considered to be particularly problematic in the case of internal models. The same respondent also noted that the supervisory report will contain forecasts and other expectations which it is not practicable to audit.

Many other respondents, representing public authorities and national and European interests groups (including auditors and representatives of the accountancy profession), were in favour of auditing some of the annual data to be reported to supervisor (their intention is not to audit quarterly information), since that would enable them to get additional comfort and would reduce the need for checking data.

According to one respondent, distinction should be made between data that will be disclosed publicly and data that will be submitted only to the supervisor since a different level of assurance could be provided on these reports.

With regard to the specific data that should be subject to audit, one respondent noted that qualitative information can be subject to a certain form of audit as well, while most of those who are in favour of audit requirements referred to the quantitative data e.g. the SCR, the MCR, own funds and technical provisions.

Some industry respondents reported evidence that some groups actually approach reporting requirements from a top-down perspective, as this appears to be efficient for them. However, there seems to be general agreement that this should not be encouraged since groups need flexibility as to how to approach reporting requirements based on their structure and the way their business is managed. Industry respondents noted that the “centralized approach” has been implemented by some groups for a variety of functions and that for these groups it would make sense for reporting requirements to be approached from a centralised perspective.

Although not directly linked to the question asked, one respondent from the accountancy profession mentioned that reporting requirements which are applicable to individual undertakings should be applicable to groups only if appropriate and should not be regularly asked for. This is based on the argument that costs for groups might be disproportionate to the benefits received by supervisors. In particular, that respondent noted that a bigger challenge could be faced by EEA groups with third country subsidiaries. One industry respondent also mentioned the need to have different requirements for national groups and cross-border groups, with less complex requirements being set for the former.

10. Public disclosure – content, form and modalities

The majority of respondents from industry and public authorities generally favour the Commission Services' suggested approach in relation to the content of public disclosure and how it is achieved. Concerns were raised in four areas: 1) the content of the disclosure, 2) the format, 3) where disclosure has to be made and 4) the consistency of information publicly disclosed with IFRS.

In relation to the content of the SFCR, the majority of respondents agree that the level of detail of the SFCR should be specified in a concrete way though some industry respondents raised concerns on the excessive level of detail asked to be publicly disclosed. In their view, the granularity of the information disclosed should be less than that adopted for the reporting to supervisors and the SFCR could be part of an annex to the annual report. One respondent noted that since investors and shareholders can obtain their information from other public sources there is no need for the SFCR to include such detailed information.

Respondents representing the captive industry noted that there should not be any public disclosure requirements for captives, since policy holders are the shareholders and because disclosure of competitive information may be risky for their solvency position.

On the format of disclosures, a number of industry respondents called for flexibility in order to best reflect the way the business is managed and suggest that no standard format should be introduced. Contrary to this view, respondents from the public authorities and national and European interests groups call for harmonization in order to enhance comparability. One respondent indicated that standardised formats may be an issue for non-EEA groups as it will not be uniform across all the subsidiaries.

With regard to how public disclosure is achieved, views were mixed. Most industry respondents and public authorities are in favour of the Commission Services' suggested approach that the SFCR should be disclosed on the company's website or, where that is not possible on a trade associations' website. Some industry respondents questioned the requirement that where undertakings do not disclose their SFCR by these means, they have to make an electronic copy available on request free of charge.

A number of respondents mentioned that having disclosure on the supervisors' website would have some advantages and that having one national central repository of all the disclosed information will facilitate users' ability to find information.

On the point about the consistency of publicly disclosed information with IFRS a number of comments were made. One national and European interests group welcomed the ability for undertakings to make use of information already disclosed under IFRS, as well as under other legal requirements. However, it was noted that many undertakings and groups do not make use of IFRS to prepare their financial statements and therefore consistency with IFRS may be an issue. Other respondents, mainly representing the industry, consider that convergence with IFRS is important to ensure lower implementation cost in relation to reporting requirements.

Respondents are mainly divided into those who include policy holders among stakeholders of the SFCR and those who do not. Almost all of the respondents mentioned that stakeholders are regulators, investors, intermediaries, analysts, advisers, rating agencies, professional associations and other market participants.

Some industry respondents together with one national and European interests group and several public authorities mentioned that policy holders are not interested in a report like the SFCR and suggested that policy holders are more interested in information which is already covered under different legislations like the Insurance Mediation Directive and Packaged Retail Investment Products. This is based on the fact that the information disclosed in the SFCR is quite detailed and sophisticated and therefore may not be useful or readable for policy holders. Against this background, information to be disclosed should include enough information to be useful to all users. Moreover, national and European interests group made the point that useful and complete information for market participants would positively affect policy holders indirectly due to market discipline. A few respondents provided an answer in relation to areas on which information is needed. Areas that were indicated as needed are the Solvency II balance sheet, own funds and their tiering, the solvency position in terms of surplus and the main risks faced by the undertaking and how they are managed.

Other respondents mentioned that policy holders are amongst the stakeholders of the SFCR and therefore the information disclosed there should be suitable also for them. In particular, one respondent noted that the limitation of information provided to the public, if any, should not be based on the level of complexity but on the criteria of usefulness.

One respondent noted that a distinction should be made between listed and non listed undertakings in terms of stakeholders of the SFCR. While for the first all market participants would be interested and therefore information should be tailored to them, for the second the main stakeholders are the policy holders who only need a summary of the SFCR.

Most of the respondents are supportive of the Commission Services' approach which envisages public disclosure of a number of aggregated key figures arising from solvency valuation together with an explanation of the material differences with accounting valuation.

A comment was made that supervisors and stakeholders are familiar with financial statements and that insurance undertakings should provide a suitable reference for comparison. Another reason why this disclosure may prove helpful is to guarantee comparability and to enable an analysis where both sets of data are needed (e.g. where the same product is classified as an insurance contract under Solvency II and as an investment contract under IFRS).

As to the extent of the reconciliation, most respondents agree with having reconciliation at a reasonable level. Some industry respondents do not favour a full reconciliation but would support a qualitative high level explanation of the main differences between the accounting and solvency figures since the objectives of the two frameworks are different. A high level explanation is deemed appropriate also to support transparency and would help readers who may be confused by detailed explanations of every difference. The suggestion was made to only provide a more detailed explanation for material items. One respondent suggested that areas where reconciliation is needed are assets, liabilities, own funds, premiums, claims and expenses. Another suggestion was made that high level analysis should focus on the major changes, the factors that caused the major changes, the assumptions and methodologies and that the level of the reconciliation could be the segment as referred to under IFRS.

It was noted that reconciliation may be an issue for non-EEA groups, as accounting bases would be different. Problems may also arise for third country insurers that operate through branches for the same reason.

Some respondents mentioned that the likely increasing convergence over time of local reporting to IFRS should help to minimise the adjustments needed. A number of respondents explicitly mentioned that convergence with IFRS would still be desirable for enhanced clarity, in particular for investors. However, the approach of inappropriately aligning one legislation to another only to ease reconciliation should be avoided.

11. Supervisory co-operation and co-ordination

Several industry respondents as well as a number of public authorities expressed their support for the Commission Services' suggested approach to set binding quantitative thresholds on the participation of branch supervisors in the college of supervisors (option 1) based on the need to identify the attendees in the College and to avoid ambiguities.

The opposite view was expressed by a minority of industry respondents and some public authorities. The argument put forward by these respondents mainly related to the need for flexibility when it comes to the principles governing the functioning of the college in order to ensure they function effectively. For the same reason, it was suggested that an appropriate mechanism should be put in place to limit the number of attendees in the College. One respondent favoured a case-by-case assessment in relation to the participation of branch supervisors in the College and opposed binding threshold being set at level 2.

As to the frequency of college meetings, most respondents agree with the Commission Services' proposed approach, namely to keep flexibility in relation to the number of meetings to be held. The minimum frequency being that set out in the Framework Directive.

A point was also made that the two areas proposed are relatively minor changes to the College process, while other areas would be important to ensure a proper functioning of colleges.

Respondents unanimously agree that only a minimum set of provisions on colleges should be set in level 2 implementing measures since that would ensure the necessary flexibility in the operation of colleges. Respondents deem it necessary for the operational functioning of the College to be decided based on actual needs rather than being set in the law. Level 3 guidance seems more appropriate to reach this aim. Very few respondents noted that for the sake of consistency and comparability extensive provisions on colleges should be set at level 2.

Some respondents (both from the industry and from public authorities) indicated that in relation to specific areas, a minimum set of provisions should nevertheless be set in level 2 implementing measures. The area most frequently mentioned was the minimum set of information to be exchanged by supervisors in the College, based on the arguments that this would avoid duplication of requests and enhance collaboration among supervisors. This was also suggested based on the current functioning of Coordination Committees where practices vary and there is no harmonization.

Other respondents from both the industry and the public authorities indicated that information to be shared in the college should be based on the supervisory reporting package and include the outcome of the supervisory reviews carried out and the results of any stress test performed. Another area mentioned was the sharing of information relating to the internal model approval process outside the approval of the group internal model.

Although not directly linked to the question posed, a number of industry respondents noted that EIOPA will have a major role in ensuring consistency of procedures in colleges. EIOPA and the group supervisor should work closely together to enhance coordination in colleges.

Views on the need for supervisors in the college to systemically exchange information were quite unanimous in indicating that an appropriate exchange of information in the college lies at the heart of efficient and harmonised group supervision, though some discretion should be allowed on the specific information to be shared.

Some industry respondents note that the exchange of information in the college and the coordination of supervisors in the college in general should minimise the supervisory burdens on undertakings and avoid unnecessary duplication of requests. According to these respondents, only information that is necessary for the College to obtain an overall oversight of the group and key regulatory issues should be shared, while domestic issues should be left to the home supervisor.

Other respondents from both the industry and the public authorities indicated that information to be shared in the college should based on the supervisory reporting package and include the outcome of the supervisory reviews carried out and the results of any stress test performed. Other area mentioned were the sharing of information relating to the internal model approval process outside the approval of the group internal model.

One respondent noted that group specific information should be shared in the college, like intra-group transactions, the source of diversification and material group specific risks.

One respondent made the point that setting provisions on the sharing of information at level 2 is not efficient since each college should decide what information needs to be exchanged depending on the specific group. The suggestion is to draft level 2 which empower the college to share information but not require it to do so.

4. Impact on Insurance markets and products

Impact on products

Many respondents suggested that Solvency II would result in the cost of capital and risks becoming a much greater consideration in product development than is currently the case under Solvency I. As a result, insurance prices are predicted to decrease for those products which will incur lower capital costs (for example simple term assurance) and to increase for those products which may incur higher capital costs (for example annuities). In the area of life insurance it was suggested that policy decisions at level 2 on technical provisions, namely the choice of the risk free rate, the definition of contract boundaries and the cost of capital for the risk margin calculation, would likely be the main driver for changes in insurance prices.

On the other hand, for non-life lines of business responses suggested that price changes would be more likely to be impacted by the final calibration of the SCR standard formula. One example noted by several respondents was the reserve risk requirement for Motor Third Party

Liability insurance, which is compulsory in a number of Member States. It was also suggested that prices of property insurance may be affected by the final calibration for catastrophe risk or products would be amended to exclude protection from these risks in the products offered.

A few respondents indicated that increased operating costs would also be a key driver for price increases. However, other respondents suggested that this was only likely to be the case for the first few years post Solvency II implementation.

Respondents suggested that the extent to which increased capital costs or increased operating costs result in increased insurance prices would depend on market competition. In competitive markets, price increases would be less likely to be passed on to policy holders. One respondent also noted that insurance is a cyclical business with many different factors influencing prices and that therefore it would be difficult to isolate the reason for price increases to Solvency II.

Some respondents acknowledged the importance of Solvency II in leading to greater risk awareness, improved risk management and greater confidence in insurance products. It was suggested that this may stimulate the insurance market regardless of price increases. Respondents also suggested that some degree of price increase for certain products may be justified where policy holders gained from enhanced protection.

Several respondents made the comment that insurance products that incurred high capital requirements may be withdrawn from the market if such products were no longer profitable. Other respondents suggested that rather than being withdrawn, there would be increased market innovation in terms of product design in order to reduce the capital requirements associated with certain products. However, respondents recognised that such innovation could be detrimental to policy holders as it could result in them assuming greater risk.

The vast majority of responses noted the potential impact of the level 2 implementing measures on long-term products with guarantees. These respondents suggested that requirements leading to higher technical provisions or higher capital requirements, as a result of high market risk or high underwriting risk requirements, could increase the cost of offering this type of business. In some cases, respondents expect that these costs will be passed directly to policy holders and that the price of these products will increase. In other cases, respondents suggested that these products may be withdrawn from the market altogether. Some respondents acknowledged that the cost of offering this type of business was also impacted by the current economic climate, particularly a protracted period of low interest rates and suggested that the impacts could not be isolated to Solvency II. It was also noted that in some instances insurers are already moving away from offering products with guarantees or were starting to link the guaranteed rate of interest offered more closely to the risk-free rate in order to reduce the cost of hedging their risk.

There were mixed reactions from respondents on the potential impact of the level 2 implementing measures on unit-linked products. Some responses suggested that the price and design of unit-linked products will be largely unaffected. Others indicated that a greater variety of unit-linked products may be developed which change the way that risk and reward from capital market investments is shared between insurers and policy holders with a certain minimum performance guarantee. Other respondents suggested that the definition of contract boundaries, together with the counterparty risk exposures could have a negative impact on unit-linked business and result in price increases. One respondent suggested that potentially negative impacts on unit-linked business could be reduced through the provision of counter-guarantees by third parties such as investment banks.

Respondents also predicted increased innovation in the area of reinsurance with reinsurers developing products which encourage direct insurers to adopt risk transfer initiatives with a view to reducing their capital requirements.

Responses emphasised that policy decisions at level 2 on the calibration of market risk requirements could have a significant impact on insurers' investment strategies. For example, high capital charges for corporate bonds and equities, compared to lower capital charges for government bonds could incentivise insurers to invest in lower risk assets. This would likely result in lower investment returns leading insurers to focus on underwriting profitability. This could result in upward pricing pressure particularly where currently premiums do not fully reflect risk. However, several respondents suggested that this investment trend is already occurring in isolation from the introduction of Solvency II with insurers reducing their equity allocation, increasing their demand for short-term credit and spread products and decreasing their demand for long-term corporate bonds.

Generally most respondents anticipate a reduction in cross-subsidisation under Solvency II. This is because Solvency II adopts a more granular risk based approach and will require insurers to be more transparent in the way they do business. Although generally cross-subsidisation is expected to decrease, some respondents anticipate that there may be cross-subsidisation between the back book (business already written) and the front book (business yet to be written). The reason given for this is that products that have already been written may not earn a sufficient return on Solvency II required capital and may need to be subsidised by increased prices on new business. It was also noted that in some cases national law requires uniform policyholder participation rates over a portfolio of contracts.

Impact on markets

The current European insurance market is characterised by its diversity of corporate structure (mutual vs. publicly listed) and size (large vs. small insurers). Many respondents stressed the importance that this diversity is not lost as a result of moving to Solvency II. Many responses noted that small, specialist insurers currently provide essential insurance capacity in niche areas e.g. insurance for medical malpractice and that these insurers are often better placed to understand and manage the risks of their policy holders.

Several respondents noted that specialist insurers and mutuals have more restricted access to capital markets. Consequently, policy decisions at level 2 on the approval of Ancillary Own Funds and the criteria for Tier 1 own-fund items were likely to be critical. It was also suggested that mutuals could be negatively impacted if the default method of consolidation (accounting consolidation) is imposed on horizontal groups.

Many respondents noted that Solvency II favours well-diversified insurers, as compared to insurers specialising in particular lines of business. While some responses welcomed the recognition of diversification on the basis that diversified undertakings operate a lower risk business model from an economic perspective, others expressed concern that the regulatory benefits deriving from diversification could squeeze specialist insurers out of the market. In particular, it was suggested that low levels of diversification could result in small insurers moving to an "agency" business model, where their role would be restricted to distribution and partial underwriting, on behalf of a larger entity.

Mixed views were expressed about the likelihood of market concentration. A few respondents suggested that concentration was less likely to occur in the life sector because diversification benefits were less significant and because the back book of life business could be loss making and therefore unattractive to potential acquirers. On the other hand more market consolidation is expected in the non-life sector as diversification benefits under Solvency II are better.

Several industry responses suggested that level 2 policy decisions could cause undertakings to alter their group structure to maximise the use of branches. The reasons given for this were that this would reduce the reporting burden on undertakings (undertakings would only have to report to one supervisor), lead to greater recognition of diversification benefits and less onerous treatment of intra-group reinsurance and less restrictions on capital transferability/ fungibility. Some responses stressed that the Commission Services' suggested approach for level 2 appeared to reveal a preference for legal entity rather than group structures. Industry respondents are generally not supportive of this and stressed the benefits, such as clearer management accountability and governance, of having separate legal entities. The cost and complexity of combining legal entities was also highlighted.

Responses from public authorities noted the anticipated benefits of Solvency II in improving consumer confidence in insurance products and in the stability of the undertakings offering those products. Several industry respondents welcomed the benefits that the harmonisation of rules would bring, namely firms and products would become more comparable thereby increasing competition throughout the EU. One industry respondent noted that Solvency II would increase consumers' confidence in the quality and reliability of insurance products and increase the amount of cross-border business written. Consequently, responses expect a level playing field between EU insurance undertakings.

Some responses suggested that while in the long run increased competition would result in price decreases, this was unlikely to materialise in the short-term due to the high implementation costs associated with Solvency II. However, other respondents suggested that competition would only increase for lines of business with "low capital consumption" with competition decreasing in lines of business with comparatively higher capital costs.

Industry responses also suggested that if Solvency II had a material impact on insurers' investment strategy, this could reduce their profitability and their competitiveness. It was suggested that Solvency II may lead to competitive distortions, for example between insurers and pension fund providers if the two were not subject to similar regulatory requirements. With this in mind, the need to preserve a level playing field was emphasised.

Some respondents suggested that higher capital requirements could force consolidation in the insurance market which would have several negative consequences, including redundancies and loss of talent in the insurance sector and higher prices for consumers.

A large number of respondents stressed the need to ensure the proportionality principle is properly applied to allow SMEs to continue to operate. Responses emphasised that proportionality was important across all three of the Solvency II pillars and was not just relevant to the quantitative Pillar I requirements. It was suggested that SMEs may be disproportionately impacted by Pillar II and III requirements as these often entailed high fixed costs which mean that larger undertakings can benefit from economies of scale.

Some respondents suggested that Solvency II favours larger undertakings as SMEs do not receive the same diversification benefits and are less likely to be able to benefit from the use of internal models. However, other industry respondents noted that provided level 2 implementing measures allowed for the effective use of risk mitigation techniques and undertaking specific parameters, SMEs and specialist insurers would be able to continue to operate in the market. Specifically, it was suggested that SMEs may need to rely on reinsurance as a capital substitute and that the calibration of the counterparty risk charge should therefore be carefully considered.

Most respondents opposed any preferential treatment of captives and stressed that the focus should be on the risk not on the company structure. One reason given for this was that a more favourable treatment for captive insurers may reduce the role of insurers and reinsurers as fronting insurers or in retrocessions. The potential for captives to be subject to higher capital requirements under Solvency II due to limited amount of diversification in their business and the approach taken to concentration risk was noted by several respondents. It was suggested that captives may be negatively impacted by the extensive qualitative Pillar II requirements under Solvency II. However, respondents acknowledge that this would depend on the extent to which those captives currently have a risk management infrastructure in place. Captives with a focus on risk management would be better placed to comply with Solvency II, than captives with less well developed risk management.

Responses were received from representatives of third country undertakings. These responses stressed the need for an outcome focused approach to equivalence looking at whether the same policy holder protection is achieved. Useful data, obtained from the National Association of Insurance Commissioners (NAIC), on the importance of the US to the EU insurance market and vice versa was provided by one respondent. The need for transitional measures was noted, as it was suggested that there may an additional burden on third country insurers if there is no equivalence finding or transitional measure in relation to a third country. Specifically, the cost of third country groups having to establish EU holding companies or post collateral in the absence of an equivalence decision or transitional measures was highlighted.

Responses from EU industry representatives highlighted the importance of internationally active EU insurance groups continuing to be able to operate competitively. Respondents noted the importance of an equivalence finding in relation group solvency to allow the use of local requirements where the use of deduction and aggregation has been determined as appropriate. The benefits arising from Solvency II of a coordinated approach to cross border supervision were also welcomed. Industry respondents stress the need for transitional measures to give third countries sufficient time to adapt their solvency regimes. It was also noted any transitional measures for equivalence should be designed in such a way as to promote convergence towards an equivalent regime through the use of realistic milestones so that equivalence is ensured at the end of the transitional period. Some responses favoured a long transitional period for equivalence, while others suggested it should be short to avoid there being any competitive advantage during the transitional period.

Finally, responses suggested that level 2 policy decisions, including those relating to equivalence, could influence how groups are structured and could lead to undertakings redeploying capital to other jurisdictions. Specifically, one respondent suggested that having a parent company outside the EU could provide significant flexibility and allow for reduction in capital requirements since the parent would not be subject to Solvency II restrictions.

5. Social and Economic impacts

Social impacts - general

Responses indicated that the social impacts of Solvency II would depend on the extent to which changes to capital requirements result in price increases for certain products. It was suggested that higher prices caused by higher capital requirements could result in consumers reducing the amount of insurance which they purchase, which could have a negative impact on society. The social impact of a decline in insurance coverage where insurance is compulsory was specifically highlighted. Another example of the negative social effects of decreased insurance coverage is the case of creditor insurance contracts, where it was suggested that increased prices would lead to fewer consumers being insured for disability risks when contracting revolving credits. This is expected to have a material social impact as life incidents are currently the major causes of insolvency.

One respondent suggested that the effect of increased capital requirements on prices would be magnified where increased prices led to reduced demand for certain insurance amongst consumers. It was suggested that the impact would be greatest on consumers in Member States that currently have comparatively low capital requirements.

Many industry respondents again pointed to the potential impacts on Solvency II on the ability of insurers to continue to offer long term insurance with guarantees at prices that are not prohibitively expensive for consumers. It was highlighted that this would primarily affect consumers saving for retirement and pensioners. Respondents stressed the important role of insurers as providers of private pensions, particularly given the demographic challenge currently faced by many Member States. It was stressed that if Solvency II results in insurers ceasing to offer long-term products, there would be increased pressure on social security systems to fill the pensions gap. A further consequence would be increased investment by consumers in unit-linked products or variable annuities as a cheaper alternative to long-term insurance with guarantees. It was suggested that such products expose consumers to greater investment risk making it difficult for them to save reliably for old age. Another likely effect anticipated by respondents was an increase in investment in cheaper unregulated products. This could have long-term implications and result in consumers being less well protected meaning that governments would be forced to protect consumers in a crisis.

One respondent noted that although Solvency II has the potential to reduce insurance prices due to increased competition between undertakings, the extent to which consumers would benefit from this in reality would depend on whether they "shop around" for their insurance. It was suggested that so far consumers have not have shown much interest in buying products from other EU product providers.

A few respondents noted that consumers that are not diversified would be disproportionately affected by Solvency II. However, it was suggested that extending collective cover could be a solution for consumers who might be excluded on an individual basis and this would possibly be more attractive for insurers.

One respondent noted the role of mutual insurers in providing products that promote and/or reward environmentally responsible behaviour of their clients. However, no details on the types of products and why these would not be possible under Solvency II were provided.

Social impacts - health

Most respondents acknowledged that the impacts would depend on the health system operated in each Member State. Some respondents suggested that the calibration should reflect the different health systems operated in Member States. One respondent suggested that a one-size fits all approach could lead to Member States rethinking the way that their current health system operates. Others noted that the existence of different health systems reinforced the need for the effective use of undertaking specific parameters (USPs) and stressed that the requirements to be able to use USP should not be too onerous.

It was highlighted that if Solvency II leads to higher capital requirements for health insurers and this leads to higher premiums, there would create increased pressure on social security which would be required to fill the gap left by the reduction in insurance coverage. In some instances, it was suggested that this may have a significant social impact. It was noted that increased reliance on the public system may be particularly problematic in Member States that operate supplementary health insurance, where private health insurance exists to fill the gap left by the social security system.

In Member States that operate a complementary health system (e.g. France) it was suggested that increase requirements could reduce access to ambulatory care, dental and optical health insurance which is largely covered by private health insurance.

Economic impacts

Many respondents emphasised the important role that insurers play in financing the real economy. It was also noted that the continuous inflow of liquidity generated by the insurers' premium income allows insurers to adopt a steady and predictable investment policy. Further, the long-term nature of insurers' commitments allows insurers to take a long-term investment horizon. The effect of this is that insurers play a crucial role in reducing market volatility and stabilising economies during market crises. It was suggested that following the financial crisis insurers would be key in ensuring sustainable economic growth and recovery and were key to achieving the EU 2020 objectives of "a smart, sustainable and inclusive growth". Consequently responses stress the need to avoid policy decisions that impede the ability of insurers to play this role, for example by disincentivising long-term investment. On this point respondents pointed to ECB data which shows that in the second quarter of 2010, €2.5 trillion were allocated by insurers to long-term debt securities and loans.

It was noted in several responses that insurers are significant investors in bank capital and securitisation transactions. Credit institution need to be able to securitise their loans to be able to provide financing to individuals and small businesses. If Solvency II makes insurers investments in repackaged loans or bank capital unattractive, then insurers will reduce their investments, which will in turn restrict the ability of credit institutions to extend financing to households and SMEs.

One respondent commented on cross-sectoral consistency with the banking sector. It was suggested that rules that are cross sectorally consistent should be introduced with caution given the different business models of banks and insurers. Further it was suggested that too much cross-sectoral consistency may lead to a herding behaviour and could increase volatility in financial markets. However, it was acknowledged that the same risk should be subject to the same treatment as banks and insurers operate as investors in the same markets. It was also noted that if the level 2 implementing measures result in insurers transferring more risks to other financial intuitions, e.g. banks and hedge funds, for example by issuing catastrophic bonds or longevity swaps, then the insurance sector will become more systematically important, as it will be more integrated with the rest of the financial sector.

Several respondents noted that insurers' investment strategy would continue to be based on the return on assets given their level of risk, but observed that the return on assets would be effected by the capital requirements for the different asset classes. One respondent noted that the effect of the level 2 implementing measures on insurers' investment policies was a natural consequence of moving to a risk based approach. This respondent went on to highlight that the risk of the impact is only detrimental if there are "arbitrary distinctions affecting the treatment of different asset classes".[11] Calibrations that do not appropriately reflect the riskiness of different assets may create negative distortions in capital markets or reduce insurers' diversification across asset classes. The calibrations most frequently mentioned as potentially causing negative distortions, if unchanged from the approach proposed in QIS5, were the calibrations for equity risk, property risk and for corporate bonds.

Responses were mixed on the specifics impacts that Solvency II may have on insurers' investment policies. Some respondents suggested that insurers may decrease their investments in government bonds and increase their investments in corporate bonds to address the mismatch in value between assets and liabilities. Others suggested that insurers would move towards less risky assets and increase their investments in government bonds and away from corporate bonds and equities. As evidence of this likely move, one respondent provided data showing the decline in equity investments in the UK following the introduction of the ICAS regime, which has some similarities to Solvency II.

It was also suggested that insurers may decrease their investment in assets of a longer duration. One reason given for this is the design of the spread risk sub-module in QIS5 which imposes higher capital requirements on corporate bonds of a longer duration. It was suggested that if requirements result in insurers ceasing to offer long-term insurance products they would also cease to invest in long-term assets. Another reason given for reduced long-term investments by insurers was the volatility of own funds. If reduced long-term investment by the insurance sector proves to be a reality, the role of insurers in providing long-term financing would diminish. This may have wider economic impacts, including hindering the ability to recapitalise the banking sector following the crisis and making long-term funding for all sectors more expensive.

It was also suggested that increased investment in low risk assets versus high risk assets would make the insurance sector less profitable and therefore not attractive to investors. It was observed that insurers already have lower valuation multiples than other sectors and that the increased volatility created as a result of Solvency II would reduce investment in insurers. One effect of this may be that the cost of insurers raising capital increases. One respondent suggested that this may be further worsened if the rules on the type of hybrid capital that can be included in own funds are too onerous. One respondent referenced research which

[11] Just retirement.

illustrates that investing purely in government bonds would reduce annual returns by 121bps for life insurers and 165bps for non life insurers compared to their current investment policies. If the profitability of insurers is reduced by too high capital requirements or the disclosures required for EU insurers are too onerous, this may also put EU insurers at a competitive disadvantage globally.

Another concern highlighted by respondents was the potential for policy decisions on the market risk module to reduce investment in European property markets. One respondent suggested that insurers would move from low risk/ return property investments to property investments with high risk/ return profiles unless there is a more granular calibration.

Respondents suggested that the impact of all European government bonds being treated as risk-free regardless of their rating would be that undertakings would increase their investments in long-term government bonds with higher credit risk and a lower credit rating, as these bonds offer higher yields. Another respondent noted that treating all European government bonds could have additional negative consequences. It was highlighted that the credit ratings of certain countries could be negatively impacted by the large levels of national debt and the gaps in pension adequacy. It was stressed that policy holders should not subsidise the government by accepting a lower rate of interest than would prevail under free markets. Finally it was suggested that while an approach that treats European government bonds as risk-free could help in reducing the public deficit over the long-term, this may be at the expense of crowding out the private sector.

Some responses suggest that the standard formula may create incentives for insurers to invest in more exotic products that are specifically designed to generate a lower capital charge. For example, it was suggested that mechanisms may be found using derivative or synthetic products to circumvent unduly high capital charges on certain assets. Such products could take advantage of arbitrage opportunities but would create frictional costs.

To the extent that the calibration of the market risk module does influence insurers' investment policies, it was suggested that having harmonised rules throughout the EU may result in insurers all changing their investment portfolios in the same way at the same time, which may create additional systemic risk. However, some industry respondents suggested that the effects on insurers' investment behaviour could be mitigated by introducing transitional measures, the effect of which would be to allow insurers to rebalance their portfolios over time in a way that would limit market disruption. One respondent specifically suggested that transitional measure could be introduced in relation to the equity risk module to minimise the impact on insurers' investments in listed equities.

It was highlighted that Solvency II should incentivise insurers to select investments that are suitable, rather simply efficient from a capital perspective. Level 2 should not result in insurers becoming opportunistic, rather than long-term, investors as such effects may undermine financial stability. Responses stressed the need for sound and efficient counter-cyclical mechanisms, such as the illiquidity premium, yield curve extrapolation and dampeners in Pillars I and II, to avoid insurers de-risking in times of stress in order to protect their solvency margin.

One respondent noted that improved transparency of insurers' balance sheets under Solvency II would help to increase financial stability. It would also suggested that Solvency II would result in firms being solvent and well-run, thus making the mismanagement that triggered the financial crisis less likely to occur.