



Public Hearing on Solvency II

4 May 2010

1. SUMMARY OF PANEL 1: SOLVENCY II LEVEL 2 IMPLEMENTING MEASURES

Chaired by David Wright (Deputy Director-General DG Markt)

Panellists:

Gabriel Bernardino (Chair of CEIOPS)
Peter Skinner (European Parliament)
Andrew Power (Partner at Deloitte)
Marcin Kawiński (Warsaw School of Economics/ FIN-USE)
Michaela Koller (CEA)

The panellists highlighted various issues and concerns in relation to the draft level 2 implementing measures.

Gabriel Bernadino endorsed the view that the measures involved a balancing exercise and should be "as simple as possible and complex as necessary". The extent to which cross sectoral consistency should be taken account was not just a "cut and paste" exercise but also involved seeking a balance.

It was important to recognise that Solvency II was not just about capital but also about good risk management. Unintended consequences should be avoided. These included not just that too high a calibration might lead to unaffordable prices of products but the converse i.e. too low a calibration would lead to inappropriately high levels of risk. Calibration should not be a political exercise but should be based on good testing and evidence from QIS5 and adaptable to take account of future changes. If calibrations were too low there would be greater need to address risk through other means such as capital add-ons or the use of internal models.

He noted that the Commission had been taking CEIOPS' advice into account in most areas but highlighted that there were nevertheless concerns e.g. about the own funds

treatment of future premiums and assumptions about their loss absorbency particularly in view of what was learned from the crisis.

Peter Skinner emphasised the fact that the principles embodied in the Solvency II Framework Directive were now law having achieved an overwhelming amount of political support. The conclusions reached in Solvency II around market consistent valuation and the standard of 99.5% VaR over 1 year were correct for the insurance industry. He warned that the European Parliament would be tough in ensuring that the principles that had been agreed were stuck to and that the level 2 implementing measures (which are meant to be technical and not a political negotiation) did not embark on a new direction. Solvency II was about qualitative aspects too and avoiding a "tick box" approach. Capital adequacy was not a substitute for this and developments such as supervisory colleges were important too.

Michaela Koller agreed implementing measures need to strike a balance but did not think that had yet been achieved yet. Industry supports the risk-based approach of Solvency II. It was important to note that when comparisons were made with QIS4 that this study was based on existing capital requirements in place through Member States which were often higher than those required by the Solvency I regime. A lot of the work done by CEIOPS led to even higher requirements (75%) which as analysed by JP Morgan / Standard and Poors would lead to extra capital being required to the order of a triple digit billion EUR figure! This was to be contrasted with the fact that industry had gone through some of the most comprehensive stress testing and the crisis relatively well.

She reflected that the Commission's draft QIS5 technical specifications moved the calibrations in the right direction but they were still too high. Other solutions such as pillar II ought to be considered. She expressed concern that the debate in the insurance sector was being unduly influenced by other sectors give the different business models and levels of systemic risk.

Andrew Power had the following views from the perspective of impact assessment study on Solvency II that Deloitte has carried out.

It was clear there would be a profound market impact but that this would vary depending on the products e.g. greater impact for longer tail lines in both life and general insurance and also health. Knock on implications included risk transfer to reinsurance and capital markets (and potentially consumers), and diversification across lines of business. Where capital requirements increased this would increase prices and this may affect consumers differently e.g. where particular types of insurance were mandatory.

The implementing measures would involve trade-offs between consumer protection and harmonisation objectives and industry competitiveness e.g. the benefits of greater transparency and reporting also gave rise to costs which could be passed onto consumers.

While the long-term benefits of Solvency II were well documented there were concerns there could be market disruption in the short term as insurers realigned their business and investment portfolios.

Marcin Kawiński highlighted that from a consumer protection perspective the key concerns were around accessibility. Increases in capital requirements could result not only in increases in premiums but also lower levels of cross subsidisation. Households may then be forced to manage more of their risks themselves and the higher costs of insurance could lead to financial exclusion and lower levels of social security, since many insurance products are used within occupational pension schemes and private pension plans. There may then need to be a role for the state in intervening to make sure

insurance products were more easily accessible. Given these concerns which undermined the intentions to deliver consumer protection, it was suggested that the implementing measures should provide for the prices of the most common products to be monitored on at least an annual basis.

Q&A

On the subject of whether transitional provisions were desirable, the panellists agreed these would be helpful and sensible in targeted areas. Concerns were expressed though that if they were not defined tightly they would simply delay addressing the necessary changes and undermine the objective of harmonisation. It was remarked that the need to get involved with QIS5 was already prompting some businesses to take the opportunity to review and adapt their investment policies.

The panellists also agreed that as well as harmonising rules, a convergent approach to supervision was key.

A question was raised as to whether, given the importance of life insurance to savings and retirement, and of achieving sufficient returns to protect against inflation, there were enough incentives for insurers to continue to invest in equities as opposed to bonds. Views from the panellists noted variously that the treatment of equity risk had been controversial given the many vested interests and the outcome in the framework directive was a reflection of a political/ economic deal, but also that it was important to target an appropriate level for the capital requirement for this risk.

Concerns were also expressed that uncertainty about the effects and availability of insurance capacity would have effects for the real economy e.g. where multinationals could not afford to do business in certain parts of the world because if captives were not treated appropriately a lot of risks would end up back on the balance sheets of such undertakings.

2. SUMMARY OF PANEL 2: QIS5

Chaired by Ulf Linder (Deputy Head of Unit DG Markt)

Panellists:

Carlos Montalvo Rebueta (Secretary General of CEIOPS)

Yannick Bonnet (Amice)

Jean-Christophe Menioux (Chairman of the CRO Forum)

Rob Jones (Standard & Poor's)

Seamus Creedon (Groupe Consultatif)

The panellists highlighted various issues around the processes underlying QIS5 and the calibrations and emphasised the need for industry to participate.

Carlos Montalvo Rebueta recalled that while the QIS5 exercise was "owned" by the Commission, it was important not to forget that CEIOPS, itself a creature of European law had a special role as a stakeholder in this process. He expressed concerns that due to industry complaints about the calibration being overly prudent this might actually lead to calibrations which were insufficiently prudent and also that if changes to the specification were made without an empirical basis CEIOPS would not be able to properly review and update the calibrations in the future. Particular concerns included the proposal to allow diversification of the risk margin given that in the crisis actual transfers of business had been partial. There were also concerns about extending this

treatment to the group level because there is no diversification benefit where the aggregation and deduction approach is used. On grandfathering of own funds care should be taken not to allow this to be misused. Profits on future premiums should not be treated as highest quality capital as both going concern and gone concern situations needed to be taken account of. On a positive note, the work on discount rate/ liquidity premium was a good example of the stakeholders, CEIOPS and the Commission working together.

Yannick Bonnet noted that the target participation rate for QIS5 of 60%, which amounted to 3000 extra entities was a huge step up. Accessibility was key and an executive summary and templates which include the simplifications would help with this. He noted the increases in calibration compared to previous QISs and highlighted the increases in non life underwriting risks. Some of this was justified because of the impact of the crisis but it was proving difficult to take account of the effect that the size of the company had on these figures. The effects of the financial crisis were still being felt and increased capital meant increased prices for consumers. CEIOPS's line that partial internal models and undertaking specific parameters could be used to correct matters did not provide an answer for smaller firms who may not be able to access these particularly if requirements from supervisors for these options were set too strictly. Higher calibrations would effectively be bringing the role of pillar II into pillar I. He noted that mutuals were particularly sensitive to the proposals to both require greater amounts of Tier 1 and also to restrict what would count towards Tier 1.

Jean-Christophe Menioux reflected that the Commission's draft QIS5 technical specifications were a move in the right direction, in particular on expected future profits being treated as Tier 1, the wider application of the liquidity premium, diversification of the risk margin and the 39% equity shock. There was still a lot of misunderstanding about the issue of expected future profits being included in Tier 1. CFO/CRO forum had, together with AMICE, made available on their website a short note on the matter explaining the need to adopt an economic basis and to avoid double counting. Addressing liquidity premium would provide a powerful counter-cyclical mechanism but the approach had to be available to liability cashflows which were predictable on a pooled basis not just a per policyholder basis. The calibration for non-life underwriting risk was in his view still too high (CFO/CRO forum's survey covering 26% of the market share was showing an increase of 80%) and this could not be explained just on the basis of size. On the other hand, he acknowledged that the calibration for market risk adopted in QIS4 was too low. Other issues mentioned included: the spread risk sub-module was too primitive and inconsistent with the approach on liquidity premium, the inappropriate and penal treatment of credit derivatives, inconsistencies in relation to spread risk for covered bonds, ABS and for non OECD government bonds (Hong Kong and Singapore).

Rob Jones commented from a rating agency perspective. He noted that Standard & Poor's have operated a capital model since 1991 and have been monitoring Solvency II. He considered that CEIOPS had done some good work particularly given that much of it had been written during the financial crisis. While draft QIS5 technical specifications were still being digested by the industry and others, including S&P, in Mr. Jones's view things were moving in the right direction in a number of areas (own funds, diversification, non-proportional reinsurance and the liquidity premium) from the perspective of ratings impact and market efficiency. He noted, however, that the increase in capital requirements from QIS4 of 70% based on CEIOPS Advice appears to mean that aggregate solvency ratios would reduce from approximately 200% to 120%. This CEIOPS Advice would likely translate into a failure to cover SCR for many BBB rated undertakings, quite a few A rated and even some AA- undertakings, which was not what

S&P would have anticipated given the industry's resilience during the crisis. Furthermore, the EC had stated that, the issue was more about redistribution of capital rather than wholesale increases. Mr. Jones said that hybrid capital was an important source of funds for the industry and it was not clear yet what the limits around grandfathering would be. Hypothetically, Mr. Jones said, most existing hybrids should be able to qualify as Tier 2 capital assuming their triggers were modified to take account of the SCR. In Mr. Jones' opinion, the timing of the process would be tight but it was important to get things right, given that Solvency II and QIS 5 were emerging not just as the EU standard but as potential global standards.

Seamus Creedon, speaking from the viewpoint of the actuarial profession, thought the draft QIS5 technical specifications were a positive development. Credit was due for the decision to initiate a taskforce on the liquidity premium. In terms of areas for further work, it was important to acknowledge the need for professional expert judgement and that not every detailed situation could be legislated for. The capital requirements for health, non-life and catastrophe risk needed to be looked at again and there were loose ends on the liquidity premium in relation to how it was dealt with in the standard formula. Seamus agreed with AMICE that there was also a need for proportionate simplifications for small firms. Consistency in standard setting and transparency was important. While the treatment of the excess of assets over liabilities as Tier 1 was to be supported, this did raise pillar II issues over how adverse policyholder behaviour was dealt with. The work on QIS5 and implementing measures was hugely ambitious and a dynamic approach to convergence through good stakeholder exchanges and cooperation was vital.

Q&A

Questions were raised on whether there ought to be more differentiation, given the risk-based objectives of Solvency II, to acknowledge lower risk products within the "other equities" category and also whether the treatment that had been afforded to annuity contracts ought to be extended to other types of business. The panellists discussed the tension between on the one hand the complexity that might arise from greater differentiation and the need for simplicity on the other hand. It was unlikely that QIS5 could be the absolutely final word and there would no doubt be a need for further fine-tuning. **Rob Jones** mentioned that the S&P model did not have tiering of capital but that the recognition of value in force was capped at 50%. However, S&P model is not a fully market consistent model.

3. SUMMARY OF PANEL 3: VALUATION, PILLARS II AND III

Chaired by Karel Van Hulle (Head of Unit DG Markt)

Panellists:

Jarl Kure (CEIOPS representative IGSR Expert Group)

Gregor Pozniak (Secretary General of Amice)

Dieter Wemmer (Chairman of the CFO Forum)

Amerigo Borrini (Generali)

Alberto Corinti (CEA)

The panellists outlined some of their key points in this subject area.

Jarl Kure drew attention to the fact that in CEIOPS's advice to the Commission CEIOPS had set out a number of important tasks that the key functions would be expected to carry out and these would be used to develop the subsequent level 3 advice on the system of governance. On transparency and disclosure he stressed that this was not simply a matter of setting out each Member State's regulation on a single website. Effective disclosure was all the more important given that the use of models and undertaking specific parameters would mean the calculation of the Solvency Capital Requirement could get increasingly complex. Jarl noted that despite the criticisms that CP58 demanded too much disclosure, the proposals were still a long way behind disclosure in the US. On reporting, in order to have a single system (used for the systemic risk board as well) it was important to have timely information. By starting the regular reporting to supervisors too late the risk was either that supervisors would have insufficient information or that they would have to compensate by making more ad hoc requests for information.

Gregor Pozniak recalled that in representing AMICE's members this entailed not just the mutual/co-operative insurers but also the close to 100 million EU citizens who were members of those insurers. Proportionality was important for this sector given much of it comprises SMEs. In relation to governance, while it was helpful the functions could be outsourced, outsourcing requirements had to be proportionate so as to be of genuine benefit. The principles based approach to governance was welcome, in particular in relation to the compliance function but this approach should be extended to the other functions. On reporting this did indeed impose unduly heavy burdens (as already clearly visible now in the field test of 100 or so reporting templates). Excel spreadsheets with identical granular cells may help statisticians and supervisors to make comparisons but end up being unnecessarily and painstakingly complex for SMEs. Gregor cautioned against any assumption that it would be straightforward to alter level 2 if it was pitched incorrectly. Level 2 changes could take time and in the meantime the risks were that SMEs and consumers could suffer through withdrawal of products or even closure of undertakings and the resulting lack of access to the important alternative business model that mutuals/co-operatives offered.

Dieter Wemmer, commenting from a CFO perspective, noted the importance of capital being aligned to risks rather than being necessarily higher especially given the insurance sector was competing for capital not just with third countries but also with other sectors. Solvency II was not supposed to create a zero failure regime. In relation to interactions with IFRS, Solvency II had to be consistent with these but also the differences between their scope and purpose should be addressed meaningfully and transparently so as to avoid confusion particularly given expectations that the Solvency II balance sheet will be more volatile. The proposals on reporting were too far reaching e.g. was quarterly reporting for practically all quantitative information really necessary? Would supervisors really be in a position to assess the suggested granularity of listing all lines of investments? A lot of the solo reporting was inappropriate and not meaningful given the greater importance of group level information. The focus should be on quality of disclosure not quantity. Similarly the review processes in pillar II relied too heavily on reviewing solo entities. In assessing group capital it was important not to confuse fungibility with liquidity.

Amerigo Borrini emphasised the need to make sure that Solvency II did not penalise complex group structures or lead to changes in business models. In particular on participations the Framework Directive text recognised that the reduced volatility in respect of these holding due the strategic influence held over them. The proposed lower charge of 22% was therefore justified. He was concerned about the proposed treatments for participations in financial and credit institutions and for intermediate holding companies. The economic approach was to look through. A standard equity charge for financial and credit institution participations should be advocated.

Alberto Corinti noted the importance of market consistent valuation of assets and liabilities in Solvency II. These valuations should not include prudential buffers. If there was uncertainty e.g. expected future profits this should be captured in the SCR and not through non-transparent means such as capital tiering. Pillar II provided the "added value" to Solvency II with measures such as the Supervisory Review Process. CEIOPS should continue its work in converging supervisory practice in this area and there would need to be appropriate disclosure and transparency around these processes. Pillar II should not be a short cut to designing pillar I and there should be appropriate flexibility through the use of undertaking specific parameters, simplifications and full and partial internal models. Because capital add-ons could be seen as punitive care should be taken not to mix up add-ons relating to an undertaking's risk profile and those arising from governance deficiencies. On disclosure, a coherent framework was needed and there were concerns about the volume of information in the context of the multitude of reporting requirements (accounting, corporate, macro and micro prudential, statistical) and the different recipients (national, European, systemic risk board).

Q & A

The panellists discussed various questions on the use of a fair value, volatility, the complexity of models and, whether Solvency II would mean a flight by insurers to writing less capital intensive products. One view was that volatility was inherent in pillar I but should be addressed through anti-cyclical mechanisms in pillar II. There should not be excessive differences between model and standard formula approaches especially when it came to risk management. On the question of whether information that was provided should be audited, concerns were expressed by some panellists as to the additional costs and burdens this might create. Thought should be given also to the level of assurance provided.

SUMMARY OF Panel 4: Equivalence

Chaired by Elemér Tertak (Director, DG Markt)

Panellists

Edward Forshaw (Chair of CEIOPS Equivalence Sub-Committee)

Miles Celic (Prudential)

George Brady (NAIC)

Monica Mächler (FINMA)

Jeremy Cox (Bermuda Monetary Authority)

Edward Forshaw outlined CEIOPS' approach to equivalence for the three separate assessments contemplated by Article 172 (reinsurance), 227 (group solvency where

deduction and aggregation method used) and Article 260 (group supervision). CEIOPS would also be producing level 3 guidance in this area. Consultation revealed broad support for the proposed approach of seeing whether principles/ objectives were met as evidenced by the presence of various indicators. CEIOPS had addressed consultation responses by clarifying the indicators were not hard requirements. The assessment should look for a "similar level of protection" and not every indicator needed to be met. On timing while CEIOPS did not see transitional provisions as necessary for the assessment process, there was reference to the possibility of qualified equivalence finding given not all aspects of the third country regime would always be relevant. The Commission would have to draft implementing measures having considered CEIOPS advice. CEIOPS would also consult on its advice to the Commission on the first wave of countries to be assessed, but again ultimately this was for the Commission to decide. Determining the first wave for Article 227 decisions would be challenging given the number of potential candidates. Assessment was an iterative process and full co-operation of the third country supervisory authorities was essential.

Monica Mächler commented that the Swiss solvency regime which had been proposed back in 2006 would be fully operational next year. This regime was also based on a total balance sheet approach, and incorporated provisions on governance, risk management group supervision provisions and effective cooperation between regulators. The approach of looking for similar rather than identical provisions was to be supported e.g. there may be different risk measures such as tail VaR rather than VaR but what was important was that policyholders received similar protection. Assessment of governance systems should not be overly prescriptive and care should be taken not to go overboard in the field of disclosure as this could risk creating confusion. On timing issues, it should be recognised that regime changes had to go through legislative processes which took time. The capacity to give provisional recognition of equivalence conditional on such legislative change would be useful. The effects of equivalence needed to be clarified including the role of third country regulators in the college and cooperation of the regulator with EIOPA and the Commission.

George Brady highlighted the commonality of the goals of consumer protection and deepening supervisory cooperation. There were more similarities than differences. The US system was also in transition with a Solvency Modernization Initiative and proposals in relation to reinsurance collateral and a Federal Office of Insurance which would have power to conclude binding international agreements on behalf of the US although importantly this would not supplant the state based system of supervision. The IAIS was a good forum to determine ground rules which would work globally. George commended the IAIS's proposals to develop a common framework (COMFRAME) for insurance groups, but noted that group supervision should supplement solo supervision, not replace it. NAIC had seen benefits in centralising information sharing and analysis and in fostering a culture of cooperation and practical exchange of supervisory practices. The US did care about equivalence and recognised that this was an integral part of the solution to the supervision of cross-border groups.

Jeremy Cox emphasised the shared goal of ensuring high quality supervision and the importance of the COMFRAME initiative of the IAIS. He outlined the role of Bermuda in the wider insurance market (e.g 3rd largest reinsurer after US and DE, 124 billion USD of gross premiums) and its role with respect to the EEA (e.g. 40% of P&C windstorm and flooding, 5.4 billion of Lloyd's premiums). Bermuda had strengthened its legislation and now had a risk based framework of supervision, a focus on fair value valuation, group wide supervision, and provision for cooperation including being able to invite

other regulators to participate in supervisory colleges. The Bermuda Solvency Capital Requirement was introduced for class 4 undertakings in 2008 and has since been rolled out to further sectors of the insurance market. A pilot programme on internal model approval processes had been launched as well as a code of conduct highlighting risk management issues. The "CESA" Bermuda's version of pillar II/ORSA was also an important feature of the system. Having addressed earlier issues identified back in 2003, Bermuda had received a clean bill of health on its 2007 IMF assessment and now hopes to be in the first wave of Solvency II assessments.

Miles Celic highlighted the importance of equivalence issues to Prudential given roughly a third of its business was in the US and another third in the Asia. He raised concerns about the effects of requiring capital in excess of a third country's requirements, as this could put European insurers at a competitive disadvantage. Solvency II capital requirements were likely to fluctuate differently to other designs of risk based capital and there was clearly a need to ensure a level playing field. CEIOPS' views, in particular on the need for flexibility by considering factors as indicative rather than pre-requisite as well as its recognition that equivalence was an iterative process, were to be welcomed. Transitional provisions needed to be considered, without a smooth changeover there was a risk of major capital out-flows. In relation to the US system there were a number of similarities aimed at achieving the same regulatory outcomes, the evolution of risk based capital signalled a move towards a closer alignment.

Q&A

A question was raised as to how mediation / resolution of disagreements could be addressed in relation to third country supervisors. The panellists' insights were that there was mutual interest in making arrangements work. As well as considering the nature of contractual or supervisory obligations it would be important in practice to develop good working practices on cooperation, a culture of peer review and a common understanding of risks.