

SOLVENCY II BULLETIN - Issue 14

Summary

Hello and welcome to the latest Solvency II Bulletin, produced by the Association of British Insurers (ABI)

In this bulletin, we discuss:

- Latest analysis from the ABI confirming the scale of impact of CEIOPS advice, around £50bn reduction in own funds for wave 1 and 2 and a further £20bn plus from Wave 3
- The key issues arising from CEIOPS' third wave of consultation
- Some changes conceded by CEIOPS' in its final advice on wave 1&2
- The next steps on the liquidity premium
- The process at Commission and Council level for the negotiation of the Solvency II level 2 implementing measures
- The stress test currently undertaken by CEIOPS to assess the resilience of the European insurance industry

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• Latest ABI analysis (QIS4b) examining the impact of CEIOPS advice on the capital position of insurers

Following our initial quantification of the impact of CEIOPS Wave 1 and 2 advice in the summer, we have undertaken further work with our members to understand the impact of CEIOPS advice, looking at the reduction in capital (own funds) that would result were CEIOPS advice to be adopted unaltered. Key headlines are:

- The impact of wave 1 and 2 advice, across technical provisions, standard formula SCR and reduced eligibility of own funds confirmed in the order of £50bn for the UK industry
- Changes to technical provisions with discounting at the government bond rate, no liquidity premium and a large risk margin reflecting no diversification amongst the principal drivers
- Internal model calibrations have a significant effect in reducing the SCR and in turn the risk margin where an internal model SCR can be used, although this would embed a sensible "going-concern diversification benefit" that is currently not envisaged by CEIOPS

For wave 3, a further substantial increase in prudence is proposed. The key drivers of the increase in capital requirements over QIS4 are:

- CP70 – huge increases in the spread risk charges, an increase of around 3.5 times the QIS4 level. The impact could be in the order of £10-15bn on the basis of the standard formula SCR
- CP71 – Non life underwriting risk and CAT risk – increases of around 63% in the SCR calculation and bigger increases in the CAT risk charge. The impact is estimated to be in the order of £8-10bn on the basis of the standard formula SCR
- CP67 – participations: it is proposed there would be a strict deduction of all value in fund managers and banks owned by insurers and strict limitations on the recognition of surpluses in insurance sub-entities and transfers of this capital across the group

With a combined impact in the order of £70bn (€80bn) this represents a wholly unsustainable increase in prudence. Whilst some concessions have been proposed by CEIOPS in the light of their initial advice on wave 1 and 2, we will continue to press hard for a more realistic regime of implementing measures and will highlight the importance of allowing internal models to be used to calculate more realistic SCR and risk margin requirements.

- **CEIOPS' third and final wave of consultation – Another round of over-prudence**

The consultation on CEIOPS' final wave of draft advice (wave 3) on Solvency II has just closed. The ABI has sent all detailed responses to CEIOPS on 11 December, regretting CEIOPS' continued trend of over-prudence:

- CEIOPS have carried out a preliminary high level impact assessment based on the QIS4 exercise in CP 71 on Non Life calibrations. The proposed increases would result on average in an increase of around 35% on the

premium and reserve risk sub module. However, indicative results from a market study carried out by non-life consultancy EMB show an average increase in SCR in the range of 60 to 65% for GI firms and this is combined with considerable increases on catastrophe and market risk factors. At the time of writing, the survey had finalised results for 40 firms; however there were a number of late entrants into the study so further analysis is being carried out and results will be available in the near future on <http://www.emb.com/>.

- Market risk is subject to substantial increases, with the charge for spread risk standing out. The capital charges for high quality bonds (A-AAA) are unreasonably high and represent an overall increase of the capital charge factor of around 3.5 relative to QIS4 for a typical bond portfolio, appearing to be heavily influenced by a short data period since the crisis began.
- The proposals on participations would considerably restrict the freedom of allocation of capital within groups.

Just a few months after the vigorous criticisms triggered by CEIOPS' wave 2 of consultation, the British industry in common with our European partners have again sent forceful comments to CEIOPS and stand ready to engage directly with the Commission to ensure these points are addressed in their proposals for Level 2.

All ABI's detailed responses to CEIOPS' wave 3 of consultation are available [here](#) (you will need to log in).

- **CEIOPS' final advice on wave 1 and 2 – CEIOPS admit some changes**

On Tuesday 10 November, shortly after the publication of CEIOPS' third wave of consultation on its draft advice, CEIOPS released its final advice for the first and second waves following feedback received from all stakeholders.

As pointed out in our previous Bulletin ([Issue 13 – October 2009](#)), the industry across Europe reacted robustly to CEIOPS' initial proposals which were found overly prudent and conservative.

In CEIOPS' final advice, most of the original advice remains unchanged.

Whilst some important concessions have been made on:

- CP46 – Hybrid instruments. CEIOPS now accept the case for some recognition of hybrids in T1 with a 20% cap. We welcome this change of position, but believe the limit is still too low and the definition of hybrids far too narrow – it is unlikely that any current instruments would meet the new definition.
- CP53 – Operational risk. The 0.5% capital charge on the largest counterparty has been dropped, the cap on operational risk has been reduced back to 30% of the SCR from 60% proposed in the initial advice. These are two very important changes and we will continue to look at the revised calibrations for the standard formula.
- CP40 – Liquidity premium. Although there is still a lot of work to do in that area, CEIOPS have now been obliged to accept that their original proposals must be re-visited. See below for further details on this issue.

In other areas, such as the risk margin and diversification, CEIOPS has maintained its original stance and there has been no movement. We will continue to press the Commission to make these changes when they formulate the draft Level 2 measures.

- **The Liquidity Premium - Next steps**

Further to the strong calls from the European industry arguing in favour of the inclusion of a liquidity premium in the risk free rate structure, CEIOPS have made a small concession on this issue and recognised that a liquidity premium could be allowed as a solution where the application of Solvency II may have a significant impact in some types of business and certain segments of some concrete national insurance markets. As an Annex to their final advice, CEIOPS have suggested a possible grandfathering for the back book of annuities (single premium retirement annuities in force at the time of entry into force of Solvency II). To view CEIOPS' final advice on the risk free rate, click [here](#).

CEIOPS has also been asked by the Commission to set up a task force to consider how liquidity could be applied to new business after the Directive is legally in force. Industry representatives (CEA, CRO Forum, AMICE, Groupe Consultatif) have been invited to take part in the work undertaken by this task force and the Commission will also be represented. The first meeting has occurred and was broadly productive. Innovative CRO led work promises a practical way forward to recognise a liquidity premium when market conditions produce such a premium, as has happened in the extreme market conditions witnessed over the last two years. This working group will need to release its initial findings no later than 31 January 2010 to inform the Solvency Expert Group discussions (composed of Member State representatives and the European Commission) as they will examine technical provisions in early 2010. The task force will also, quite correctly, look at the use of a swap curve rather than a Government bond curve as a basis for discounting liabilities, and at the broader question of extrapolation.

- **The process now for the negotiation of the Solvency II level 2 implementing measures**

Although some of CEIOPS' advice is now final, confusingly yet luckily for the industry, this does not mean the level 2 implementing measures for Solvency II are now set in stone.

A new process has now begun where the Commission takes responsibility and ownership of the implementing measures. To this effect, the Commission will be informally consulting Member States on all areas subject to level 2

measures, with a particular attention to controversial areas such as the equity risk module or the liquidity premium. This process is undertaken through the EIOPC and Solvency Expert Group which involves representatives of the Council of Ministers. This working group has already met twice to discuss governance, disclosure and internal models and will be tackling the more difficult issues early next year. In the meantime, the Commission will also be having informal discussions with stakeholders (including industry).

As the Commission intends to have any necessary level 2 implementing measures twelve months before the regime becomes operational, it will need to formally adopt proposals for the level 2 implementing measures by the end of 2010.

- **EU Stress tests**

In order to test the resilience of the European insurance sector, CEIOPS is currently conducting a stress test exercise for the largest European groups before end of 2009. In preparation to this exercise, CEIOPS invited representatives of the CRO Forum and CEA including the ABI to a meeting to discuss their stress testing options on 23 October. We have also engaged with the FSA to express the industry's key concerns.

In particular, we have insisted upon

- The purpose of this exercise: this test is aimed at providing a view of the resilience of the largest and important insurance groups; it is not intended to assess individual capital needs.
- The importance of data protection and confidentiality.
- Great care will be needed in any public statement or comment by CEIOPS on the results. Since the scenarios are so extreme, it is unlikely that the industry as a whole will be able to pass the tests, which contrast with the much lighter stresses put to the banks in their stress test earlier in the year.
- The need for the FSA to confirm that the stresses are, in their view, highly simplified and far beyond a 1:200 standard, being the S2 requirement.

For feedback and comments on this bulletin, or to be added to the distribution list please email Erfan.Hussain@abi.org.uk or call him on 020 7216 7411.

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