



**COVER NOTE TO THE RESPONSE BY THE
ASSOCIATION OF BRITISH INSURERS TO CEIOPS THIRD WAVE OF DRAFT
ADVICE ON LEVEL 2 IMPLEMENTING MEASURES FOR SOLVENCY II
ISSUED ON 3 NOVEMBER 2009**

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. And through the ABI they come together to improve customers' experience of the industry, to raise standards of corporate governance in British business and to protect the public against crime. The ABI prides itself on thinking for tomorrow, providing solutions to policy challenges based on the industry's analysis and understanding of the risks we all face.

The ABI welcomes this opportunity of commenting on CEIOPS' draft advice on the implementation of the Solvency II Directive. Following a highly conservative approach endorsed by CEIOPS in the second wave of CPs, another round of over-prudence has been proposed in the third wave. We are concerned by the cumulative effects of the different measures proposed in particular for the market/spread risk module, non-life underwriting risk and treatment of participations. Combined with the proposals in wave 2, their interaction would lead to excessive margins of prudence resulting in a very serious financial impact for the industry as well as imposing considerable administrative burdens.

We set out below our key concerns and an overview of our more detailed work of the possible financial impact of CEIOPS's proposals for UK insurers. We also include an annex which summarises our most pressing concerns from across the 16 CPs.

ABI Key concerns

1. **Market risk / spread risk module** – The capital charges in CP70 are unreasonably high and represent an overall increase of the capital charge factor of 3.5 for a typical bond portfolio relative to QIS4. Along with the conservative interest rate calibrations, there would be adverse effects on capital requirements of firms backing their long-term liabilities using high-grade corporate bonds.
2. **Non-life underwriting risk** –The proposed calibrations in CP71 are at least 35% higher than under QIS4. This appears to be overly prudent and will most likely lead to higher premiums for policyholders. Furthermore, neither geographical diversification nor effects of the underwriting cycle have been sufficiently taken into account.
3. **Treatment of participations** – CEIOPS' approach on double gearing may effectively result in a double exclusion at subsidiary and parent level and some groups may take advantage of the exercise to relocate outside the EEA. We also believe that some element of goodwill should be recognised.

Financial Impact assessment

In our Wave 2 response we noted that at each stage there has been substantial increases in conservatism, leading to unsustainable of prudence in the regulatory system. Work we have undertaken since that time confirms that the impact of this advice would be to increase capital requirements and reduce eligible own funds in the order of £50bn, as at year-end 2008. The main drivers being:

- A run-off model for technical provisions.
- The use of a lower discount rate for technical provisions, based only on 'AAA' government bonds.
- The possible removal of the liquidity premium in the calibration of the discount rate for illiquid liabilities (in particular annuities)
- The over-calibration of the SCR under the standard formula (which may also be imposed on firms with internal models).
- Additional restrictions placed on the MCR and the interaction of solo MCRs and the Group SCR
- The lack of recognition of diversification
- The over-calibration of the risk margin
- The very significant restrictions on capital eligibility and the corresponding need to replace a wide range of existing hybrid instruments.

Whilst CEIOPS final advice on wave 1 and 2 contemplates some welcome changes, the most significant financial impacts remain largely unaltered. Now, under wave 3, a further substantial increase in prudence is proposed. The key drivers of the increases in capital requirements are:

- Huge increases in the spread risk charges, an increase of around 3.5 times the QIS4 level. (CP70)
- Non life underwriting risk and CAT risk – increases of around 63% in the SCR calculation and bigger increases in the CAT risk charge. (CP71)
- 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 (CP67)

With a combined impact in the order of £70bn (~~€~~30bn) 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.

The annex and associated CP responses explain these concerns in more detail. We would of course welcome the opportunity to explain these concerns in more detail and to work with CEIOPS and other stakeholders to arrive at appropriate solutions to address these concerns and ensure that Solvency II will achieve its original aims as set out in the Level 1 Directive.

Association of British Insurers
January 2010

Annex – Overview of our responses to the main CPs

• CP 67 – Treatment of participations

Providing that transferability is not limited, we urge CEIOPS to remove any restriction in the allocation of capital within groups of companies. The proposal as it stands would inevitably involve some major restructuring and some groups may take advantage of the exercise to relocate outside the EEA. In particular the excess own fund from participations in financial institutions should be allowed to be used in the SCR of the parent company.

We believe that the value embedded in subsidiary companies should be recognised provided that it can be realised and used to absorb losses. For instance, through the sale of an asset management division of a life insurer.

For non financial non regulated participations the method used to determine the equity stress for participations should be based on the economic substance of the participation. It does not seem logical to apply a standard equity charge to a participation in a real estate holding company when the same assets held directly would bear a lesser capital charge for property assets. Similarly we fail to see any justification to apply an equity shock to a participation in a servicing company.

For (re)insurance participations we believe that two approaches are possible:

- Own funds to which a shock is applied; or
- Own funds less SCR and then the entire surplus should be allowed.

We don't understand the need to apply a shock to the SCR since by definition it has already been subject to a stress.

We believe that the excess own funds of participation in a financial institution should be fully recognised. The standard capital should be sufficient to operate a financial institution otherwise this would be:

- A disincentive to hold excess capital at solo entity level and insurance group would keep the lowest level of equity in their subsidiary.
- An acknowledgement that the supervisory framework of financial institution cannot be relied on.

Whilst we understand the need for some restrictions to diversification when there are limits in the transferability of assets, for example in ring fenced funds, elsewhere diversification should be fully recognised.

We also acknowledge the need to address double gearing, however we are concerned that the approach taken by CEIOPS may effectively result in a double exclusion (at subsidiary and parent level). We suggest to stick to a principle based approach by stating that equity can only be recognised once either by the parent or the subsidiary.

• CP 70 – Market risk module

We note that the proposed market risk stress factors are significantly higher than the calibrations in QIS4. **We are particularly concerned with the proposed stresses for the spread risk module.** The calibrations are sending wrong incentives to good risk management. CEIOPS is providing incentives for insurers to invest in short term investments, which could result in a potential mismatch of assets and liabilities.

Furthermore, the capital charges for high quality bonds (A-AAA) are unreasonably high and represent an overall increase of the capital charge factor of 3.5 relative to QIS4 for a typical bond portfolio. We suggest reverting to something much closer to the QIS4 methodology and stresses.

The inclusion of interest rate volatility in the interest rate risk sub-module should be considered alongside the up and down-ward shocks and should not result in a capital requirement for this risk which is in excess of the 99.5% VaR

From the feedback received in QIS4 it appeared that the capital requirements for interest rate risk were considered to be in line with the required 1 in 200 yr event. Thus, as the shock levels of the QIS4-approach were considered appropriate we would be concerned if the explicit consideration of interest rate volatility would result in higher capital requirements. We request that CEIOPS presents a detailed method for the calibration of the interest rate upward and downward shocks to ensure that when combined with a volatility shock, the capital requirements remain in line with the 1 in 200 yr requirement.

The approach of taking the most onerous of the up or down stress for each currency, with no correlation assumption, is likely to be more onerous than the 99.5th percentile. This approach is conservative as it implies no diversification between currency risks. We suggest that the QIS4 approach under which shocks were performed altogether (using a combined stress) is retained.

We note that the proposed market risk stress factors are significantly higher compared to the calibrations in QIS4. The effects of the increased capital requirements for the insurance industry appear not to be taken into account sufficiently.

- **CP 71 – Calibration of the non-life underwriting risk**

We appreciate CEIOPS' effort to provide more background on the method used to set the calibration for non-life underwriting risk. However, we are disappointed that overall the rates chosen appear significantly higher than in QIS4: 35% increases in SCR across both life and non-life industries as per CEIOPS own estimate.

For UK non-life companies, the indicative results from a market study carried out by non-life consultancy EMB shows an average increase of around 65% in the overall SCR for non-life companies. 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 www.emb.com.

As per CEIOPS own admission in paragraph 3.29 the restricted sample of seven countries implies some acute limitations. We have some doubt over the appropriateness of the given sample which may not be representative of the overall European market.

CAT data has not been split out for premium / reserving risk. This is a serious flaw that has resulted in excessively high calibrations for the standard formula. Whilst this may be avoided using an approved internal model, we are concerned that approval of the model calibration will be benchmarked against the standard formula so it is disappointing to see the calibration increase from already high values (per our QIS 4 analysis).

Regarding the methodology itself we anticipate the following difficulties:

(a) Historic loss ratio variability for many classes is, in part, driven by rating levels. These are reasonably well known for the next year, so we suggest reducing volatility for that year.

(b) At a class level published data will often have significant distortions due to the inconsistencies of methods used and the booking policies of management both within years and over time. These distortions have not been material historically. The actuarial function requirements will reduce those distortions, at line of business level, in the future. We would expect "reported" volatility to reduce accordingly. The assumption that historic provisions are at best estimate is unlikely to be valid.

(c) There is no allowance for the expected profitability of the business.

(d) Treatment of non-proportionate reinsurance is too approximate. In our view this combination of factors will tend to cause the proposed model to systematically over-estimate the parameters.

In addition we are concerned that the proposed method results in a double counting between "cat risk" and "premium risk" arising from the fact that:

(a) Premium risk factors are applied to the whole premium, which will incorporate a cat load.

(b) The calibration of the volatilities for premium risk has incorporated data with catastrophes in it, and thus exhibits excessive volatility.

However, catastrophes are separately and explicitly allowed for elsewhere. **This constitutes a double/triple count of catastrophes, which is extremely penal to companies writing catastrophe-exposed business and particularly catastrophe reinsurance, for which the only exposures are in respect of catastrophes.**

Neither the geographical diversification nor the effect of underwriting cycle has been sufficiently taken into account.

We defend the view that different rates should be set based on the portfolio (not necessarily company) size since it is clearly demonstrated in the CP that most lines of business benefit from a significant degree of diversification by volume. We suggest the creation of three categories: Small, medium and large with a different set of rate for each category.