

June | 2010

# Solvency II

## Bulletin

### Editorial



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#### Keeping it consistent.....

Solvency II was designed before the international financial crisis and was first calibrated during it. This was very evident in much of the CEIOPS financial advice, following QIS4, and it has now been addressed by Commission changes in 2010. These changes, welcomed by many in the industry, including the ABI which campaigned long and hard for them, are a real improvement to the Directive, but they bring us back to the issue that Solvency II is, unlike Basel II (or even Basel III) at core a market consistent approach to valuation, on top of which sits a sophisticated approach to supervision.

Sure all along there were compromises driven by legitimate political concerns- the recognition of surplus funds in tier 1 for example, the duration approach to equities, and the treatment of back book assets backing irrevocably fixed liabilities. Further the crisis showed that SII needed a more sophisticated approach to illiquidity on the front book, as well as an acknowledgement that in some smaller EU economies the government debt curve peters out after ten years or so. All this has required innovation and political compromise, but the SII regime relies at heart on a modern market consistent approach, and so the case for further change is limited. It certainly shouldn't extend to watering down the directive so that the basic approach of a 1 year confidence interval with a 99.5% probability.

In this context the best defence for insurers in the next crisis, will be robust capitalisation, not a hope that things can be sorted out with pro-cyclical arguments about smoothing. Solvency II offers us something much better – both for consumers and shareholders.



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### Save the date: ABI Solvency II conference

The next ABI Solvency II conference will be held on **20 October 2010 at the Grange Hotel in St Paul's**. This will include keynote speeches from Karel Van Hulle, Head of the Insurance Unit at the European Commission, and Gabriel Bernardino, CEIOPS' Chairman, but also interactive sessions on key issues for the UK insurance industry. More details will follow in due course.

# QIS 5: draft technical specifications

Released 15 April – key changes introduced by the European Commission



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A number of changes have been introduced by the European Commission

The consultation on the draft QIS 5 technical specifications (TS) was launched by the European Commission on 15 April. The draft QIS 5 TS were produced by CEIOPS based on their final advice to the Commission on the Solvency II level 2 implementing measures. However a number of changes have been introduced by the European Commission to take account of discussions with Member States and the European industry to ensure that Solvency II capital requirements do not materially increase compared to the last impact study (QIS 4 undertaken in 2008).

In particular, a number of significant modifications have been made to the relevant risk free rate for calculating technical provisions (based on swaps with allowance for an illiquidity premium), the eligibility of own funds (winding up gap and future profits treated as tier 1) and the calibration of the standard formula for the Solvency Capital Requirement (SCR). The European insurance industry, including the UK industry, has long argued for these changes and is therefore generally satisfied with the draft specifications although some fine tuning will be necessary.

The ABI has been feeding comments through the CEA as the consultation on the draft TS and associated information targeted at specific stakeholders:

CEA, AMICE, CRO Forum, CFO Forum, ECIROA, FERMA and Groupe Consultatif. The consultation will last 5 weeks and will end on 20 May 2010.

Full draft technical specifications and related documents available [here](#).

## LEVEL 2

### EC Implementing Measures



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In parallel, discussions are still ongoing on the European Commission's draft proposals for level 2 at the Solvency Experts Group level (SEG – discussions with technical experts from Member States with input from key stakeholders, including CEA, AMICE, CRO Forum...). The ABI feeds into two reporting lines HMT in the UK and CEA at European level. Texts emerging from this process suggest that substantial improvements have been made compared to CEIOPS' advice and reflected, in most instances in most instances in the draft TS for QIS 5. In particular, portfolio diversification is allowed for in the calculation of the risk margin; an illiquidity premium recognised for illiquid liabilities.

There is still a long way to go as the changes introduced are not yet secured and still run the risk of being removed or significantly watered down during discussions with other Member States and regulators.

# ABI Summary table of key changes introduced

Issue	CEIOPS final advice	QIS5 draft TS	ABI position
<b>Risk-free rate</b>	Risk-free rate based on 'AAA' government bonds curve	Risk-free rate based on swap rates with an adjustment for credit risk (12bp)	Agree
<b>Geographical diversification</b>	No allowance for diversification benefits	Explicit allowance of geographical diversification	Agree
<b>Future premiums (VIF)</b>	CEIOPS assumes that future risks need to be capitalised, but ignores the associated future premiums	Treatment of profits arising on existing business (future premiums) included in T1	Agree
<b>Risk margin</b>	No allowance for diversification benefits	Allowance for diversification between lines of business in the calculation of the risk margin on a group-wide basis	Agree
<b>Liquidity premium</b>	Majority of CEIOPS members do not believe there should be allowance for a liquidity premium	Allowance of a liquidity premium with a three-bucket approach (100% for contracts similar to UK retirement annuities, 50% for other long-term liabilities and 0% for policies of less than one year)	Generally agree. Further work on details required
<b>Calibration of the SCR-underwriting risk</b>	Significantly increased underwriting risk factors. In particular, diversification for size and geography not included	Non-life and health premium and reserve risk charges lower than in CEIOPS' final advice. No changes for the life underwriting sub-module	Further work required
<b>Calibration of the SCR-market risk</b>	Market risk factors have increased substantially. Substantial increase to spread risk - increased 3.5-fold from QIS4	Charges for corporate bonds lower for high quality bonds ('AAA'-'A'), but significantly increased for lower quality bonds. Equity risk reduced from 45% to 39% for global equities and from 55% to 49% for other equities. Introduction of a three-year dampener. Correlation parameters have been reduced and concentration risk has been removed	Further work required
<b>Calibration of the SCR-CAT correlations</b>	No final advice	Not included in the draft technical spec	Further work required
<b>Own funds</b>	Only limited recognition for hybrid instruments with low 15% limit	Specification of categories for T1, T2 and T3. Allows current hybrid capital to be grandfathered	Generally agree. Further work on details required
<b>Participations</b>	Assumes that fund managers and banks are valueless and place strict limits on the recognition of surpluses arising in individual insurance entities across the group	Own funds are now 'only' reduced by the value of participations held in financial and credit institutions	Further work required

# Third country equivalence

We are in favour of a flexible equivalence assessment process focusing on the outcome of third countries' regulatory regimes rather than being a point for point comparison with Solvency II. At this stage we also believe that the question of how to deal with non equivalent territories is at least as important as trying to guess which countries will be considered equivalent when the directive comes into force

## Reinsurance

Based on the Commission draft level 2 text and QIS5 draft specifications there is an indication that reinsurance contracts with entities not subject to the Directive will be recognised if the entity has a better than BBB rating.

## Group with a head office in a non-equivalent third country

According to the Directive, in the absence of equivalence two options are possible: either application of Solvency II at the level of the ultimate parent located in a third country; or an alternative such as the creation of an EU subgroup. It would help a great deal if the threshold from which Solvency II starts to apply to the entire group was clarified.



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## EU group operating in non equivalent territories

This has not been appropriately addressed yet, EU based groups, including UK ones, could be forced to apply Solvency II requirements on a consolidated basis to operations in non-equivalent territories. As a consequence overseas subsidiaries of these EU groups will be competitively challenged against local insurers and therefore may be priced out of some the markets. Firms should be able to choose between the two following options: either apply Solvency II capital requirements for all the business, including in non equivalent countries, and benefit from diversification effects using the accounting consolidation method or apply local capital requirements with no benefit for diversification using deduction-and aggregation.

In any case we urge the European Commission to produce practical guidelines on equivalence sooner rather than later. In addition we are pressing for some discussion to be engaged about transition arrangements for the business in force on the date of implementation.

# Taxes, Levies, Resolution funds

## Banking crisis

In the aftermath of the recent banking crisis there is much talk at national, European and international level regarding a variety of taxes and levies to be charge against part or all of the financial sector . these will be used to pre fund resolution and even compensation arrangements; or in some cases simple to take funds into the central government's funds on a none hypothecated basis.

Whatever the rights and wrongs of this for the banking sector it is inappropriate for insurance- both because insurance risks where not at the heart of the recent crisis, and because the insurance business model in general allows firms to be run off, over a number of years, without a

call on taxpayer funds.

## New Regulatory Framework

In addition the recent enhancements of regulatory and supervisory systems that are being undertaken in many part of the world- not just Europe- means that the sector is becoming better capitalised, on the basis of stronger valuation metrics, and facing more robust supervision than ever before. While this is broadly good, it carries significant costs for shareholders and policy holders. These should be offset be a regulatory dividend- better more target supervision yes, but also clear exclusion around the globe from levies and taxes that have no justification.

**To find out more on these issues please contact our Solvency II team:**

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