Swedish Insurance Federation
PO Box 24043, SE-104 50 Stockholm
Karlavägen 108
Tel +46 (0)8 522 785 00
Fax +46 (0)8 522 785 15
www.forsakringsforbundet.com

Försäkrings
Förbundet

2nd June 2008

Position paper
on the Treatment of Surplus Funds in the Proposed Framework Directive on Solvency II

1. The recognition of surplus funds as own funds of the highest quality is essential for the functioning of the business model of Swedish life insurers. This is regulated in the proposed framework directive.
   - Article 77 (3) states that surplus funds are not included in technical provisions.
   - Article 93 set out the characteristics that own funds must possess.
   - Article 90 underlines the fact that surplus funds are own funds.

2. This mechanism is carried forward from earlier regulation and is indispensable for Swedish life insurance industry.

3. Furthermore, Swedish life insurance industry opposes the restriction of surplus funds in article 90 to "realised profits", since it is not in line with an economic approach.

1. Risk Based Solvency based on an Economic Approach

The Swedish insurance industry welcomes the proposed framework directive on a new solvency system. The risk based solvency system when based on an economic total balance sheet approach, will safeguard transparency, comparability, efficient use of capital and an efficient level and system of policyholder protection. The system is foremost created to protect the policyholders, but also to raise the level of awareness among company management about risk management.

Objective and verifiable valuations of assets and liabilities are essential means to reach these ambitious ends. Market consistent valuation methods, i.e. market values where available and valuation using mark-to-model approaches where deep and liquid markets do not exist, are objective and verifiable valuations. They are the cornerstones of the proposal. This is generally acclaimed by industry and regulators.

The liabilities and assets of the insurance company define the own funds and together these three building blocks are the economic features on which a risk based solvency system is built. The interdependence between these elements defines and measures the capital requirement. The company must have available risk capital to meet this capital requirement.

The risk based capital in such a system will focus on the net risk carried by the company when all matching and diversification effects have been accounted for. This capital requirement must be covered by capital that can cover any loss, i.e. a true risk capital.

The main building blocks of an economic approach can thus be summarized as

a. market valuation of the assets
b. market consistent valuation of the liabilities
c. the interdependence between assets, liabilities and capital requirements
d. risk capital available for absorbing risks

In Sweden assets held by insurance companies have been marked to market, i.e. valued at market value, since the implementation of the EU insurance directives in 1995. Market consistent valuation of liabilities was put in place in 2007 through a supervisory tool commonly known as “the traffic light system”. This supervisory tool also introduced a system for the supervision of interaction between assets, liabilities and available capital. Throughout the equity defined in the insurance company act has been available as risk capital available for absorbing risks.

2. Surplus Funds in the Solvency Balance Sheet

An insurance company has own funds equal to the excess of assets over liabilities. Insurance liabilities are defined in the proposed framework. The mark to model-approach utilised in the directive is based on the idea that all future payments due with regards to an insurance contract are discounted with the relevant market interest rate to form the valuation of the contract.

Large parts of the life insurance contracts are indeed “due” to the policyholder. Most Swedish life insurance companies offer contracts where you have guaranteed returns on premiums. The policyholders and beneficiaries have an unconditional right to these elements. They are therefore liabilities for which the company has to set up technical provisions. The technical provisions are estimates of the undertaking’s cost for fulfilling its guaranteed insurance benefits.

For many life insurance products the simple dichotomy between liabilities and own funds does not exist. To the extent that the company has profits that exceed what is needed to fulfil the guarantees these profits are accumulated. In accordance with the insurance company act they are accumulated as equity. These funds are characterized by the fact that they are available for coverage of any loss the company may sustain. Decisions about loss coverage are made by the company’s general meeting – either directly or through delegation to management.

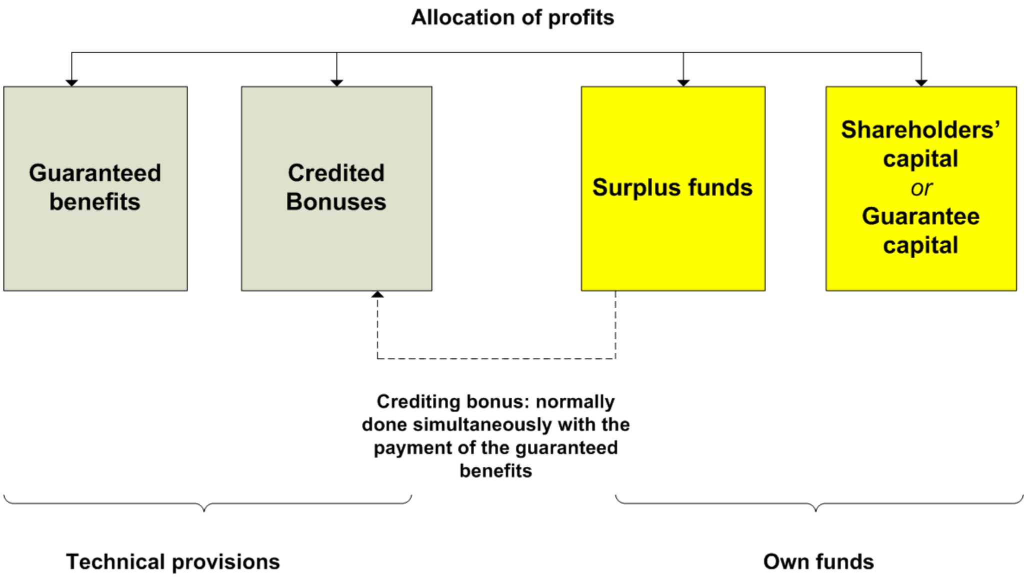

Figure 1. Allocation of profits in life insurance: Profits are allocated to the guaranteed benefits (as technical provisions) and the Surplus funds. When the contract is settled – usually at the beginning of retirement – a relevant bonus is credited the account. Shareholders and guarantors could either receive no part of profits, a predefined interest return or a residual return depending on form of association.

These funds are the company's risk capital until management decides to distribute bonuses to policyholders. Then, and only then, do these funds become liabilities and are as such safeguarded as technical provisions. This capital is called credited bonuses (fig 1). A final allocation of bonuses to individual policyholders, the so-called crediting, will not take place until the contract is settled – usually at retirement. Until then, the assets in the surplus fund may be used to cover the company's deficits. Also, until then, policyholders have no legal claim to the funds. The articles 77(3), 90 and 96(1) of the framework directive ensure that what is risk capital can become technical liabilities if and when the company chooses.

Surplus funds are defined in article 90. Surplus funds are a part of an economic approach since surplus funds are risk capital available for absorbing any risk. Article 90 is the key to the functioning of the business model of Swedish life insurers.

The risk absorbing quality of the undistributed profits – surplus funds in Swedish life insurance companies can be described by comparing them to the criteria laid down in article 93 defining tier 1 capital.

Subordination: As policyholders have no legal claim to these funds payments from these funds are subordinated to any other company commitments.

Loss absorbency: The Swedish Insurance Company Law states surplus funds to be part of equity and as such available for coverage of any loss that may occur.

Permanence: Surplus funds are permanently available. Distribution to policyholders is only done if management is comfortable with the amount of available capital.

Perpetuality: Surplus funds are not limited in time. Distribution to policyholders is only done if management is comfortable with the amount of available capital.

Absence of servicing costs: No interest or dividends are paid towards surplus funds.

Since surplus funds fulfil these criteria, they should be recognised as own funds under Solvency II. Thus, the surplus funds mechanism is necessary to ensure a true economic approach. In fact, in the Swedish life insurance market surplus funds have become the bulk of available capital.

3. Market valuation of Surplus Funds

Market valuation is per definition the amount of money a given asset can be traded for in the market at a given time. Included in the valuation are the discounted future expected earnings due to the asset. These are not realised, indeed the benefit of market valuation is that you do not have to actually realise any profits or losses in order to value an asset fairly.

Own funds are defined as excess of assets over liabilities. When all assets are marked to market and all liabilities are marked to model, own funds are automatically valued at market prices. Thus it is not compatible with the economic approach that surplus funds are restricted to “realised profits”, and article 90 should be amended accordingly.

4. Capital resources available to Swedish life insurers under Solvency II

Surplus funds constitute the bulk of risk capital available for absorbing risks in the Swedish life insurance industry. The total of risk capital available for absorbing risk in the industry amounts to 68 billion Euros, of which 55 billion Euros (80 percent) are surplus funds (see fig. 2).

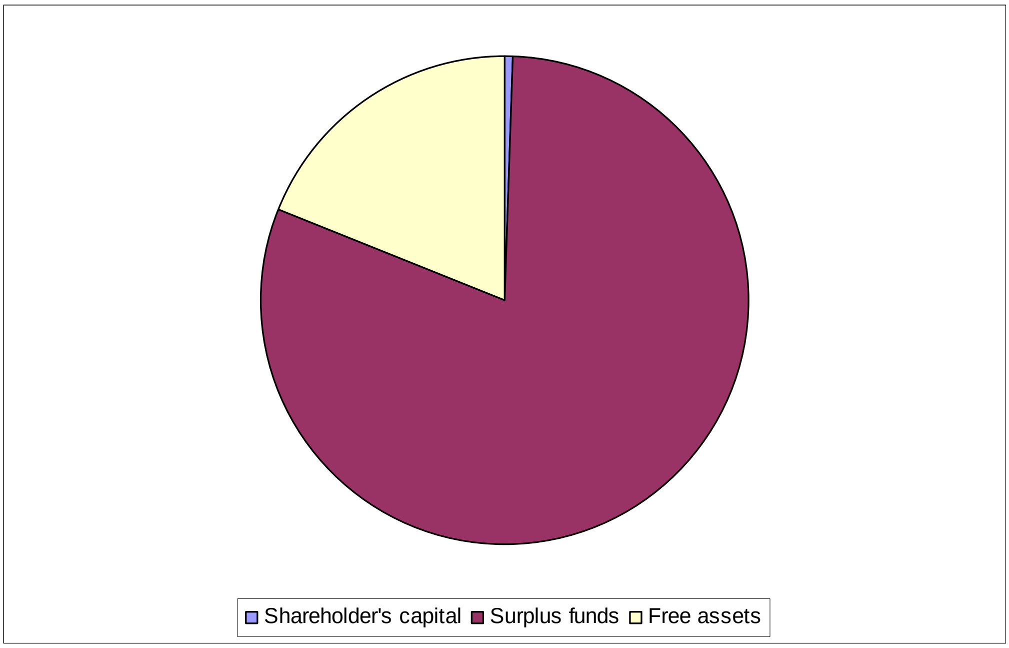

Figure 2: Risk capital available for absorbing risks. *Swedish Supervisory Authority*, Life insurance companies’ balance sheets end year 2006.

Surplus funds are the prevailing source of risk capital available for absorbing risks in companies distributing the traditional “with profits”-product. These companies dominate the Swedish life insurance market. They hold 95 percent of the risk capital available for absorbing risks in the sector. In these companies – where funds cannot be distributed to shareholders – alternative sources of equity – i.e. shareholder capital – are limited to less than 16 percent of available capital.

Surplus funds amount to 55 billion Euros. Of these funds 37 percent are unrealised profits. The current limitation in article 90 to “realised profits” would therefore reduce own funds by 20 billion Euros.

5. Conclusions

Due to the fact that Swedish life insurance companies accumulate profits as equity that can be used to cover any losses the Solvency II regulation must provide the mechanism allowing funds that may become technical provisions to be risk capital today. The regulations laid down in articles 77(3), 90 and 96(1) of the proposal are essential to achieve this. The Swedish insurance industry underlines that article 90 is necessary for the proper functioning of the Solvency II regulation in line with an economic approach. The wording of article 90 does however limit the scope of surplus funds in a manner that is not compatible with an economic approach. The word “realised” should therefore be deleted from the article.