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Position paper on

CEIOPS Draft Technical Advice for the Level 2 Rules in the Solvency 2 Directive

The Solvency 2 Directive is a principle-based regulatory system based on the valuation of both assets and liabilities at fair value (market value) and a balanced level of capital. Solvency 2 is hereby contributing to prudent insurance company risk control. It also enables insurance companies to provide effective consumer protection at a low cost.

The EU Regulatory Committee of European Insurance and Occupational Pensions, CEIOPS has submitted proposals for technical advice for the Level 2 rules for the new solvency regime. These proposals conflict with the basic concepts of the Solvency 2 Directive which was adopted last spring. Instead of a system based on market values CEIOPS advocates a return to a system built around conservative assumptions and buffers in all parts of the system.

If CEIOPS proposals are implemented, the consequences will be increased costs to consumers in form of increased premiums. The proposals also threaten the European insurance industry's competitiveness and weaken companies' incentives for good risk control. This is an impediment for the development of reasonably priced, good consumer protection.

The Swedish Insurance Federation is opposed to the regulatory approach CEIOPS is proposing.

1 Background

Solvency is a measure of an insurance company's financial position and strength. Solvency rules describe the capital buffer an insurance company must have in order to conduct insurance business.

The European Commission (COM) began its work on renewing the solvency regime for the European insurance industry in the early 2000s. The idea was to create a new solvency system that would provide better consumer protection and also be part of a larger effort to create a single European financial market and strengthening the European insurance industry internationally.

The European Parliament and the European Council reached political agreement on the Framework Directive for Solvency 2 during the spring of 2009. In the directive the guiding principles for the solvency system are specified. In level two of the so called Lamfalussey-process, the Commission determines the details of the calculations and on a third level, the EU's Regulatory Committee of European Insurance and Occupational Pensions, CEIOPS, sets standards and guides.

However, the Commission has instructed CEIOPS to develop proposals for the more detailed rules on level two. CEIOPS draft technical advice, in the form of consultation documents, has been published and submitted for comment during the spring and summer this year. Further draft guidance is expected this autumn. In 2008 CEIOPS also conducted quantitative impact studies, of which the latest is the so-called QIS4 test, estimating the impact of the Solvency 2 regime on the European insurance industry. The test was intended to give a realistic picture of the impact of Solvency 2 of the European insurance industry.

The basis for the Solvency 2 rules is that insurance companies should hold an amount of capital that reflect the risks involved in the insurance company business. This is made possible when both assets and liabilities are valued at market value. When calculating the solvency capital requirement (SCR) the companies should take into account the entire balance sheet and the interaction between assets and liabilities. This is called a *total balance sheet approach.*

On this basis, an insurance company must hold a buffer of capital, own funds, so that the probability of the capital being able to cover unforeseen risks is at least 99.5 percent over the next year. There are also requirements for risk management, internal control and supervision and on disclosure to the market and to the regulator.

The Swedish Insurance Federation has actively supported the fundamental principles of the Solvency 2 Directive. The new framework will contribute to an efficient and stable insurance market, while competition between companies increases and protection for policyholders is strengthened. The new framework of risk-based capital rules constitutes a much needed modernization of current legislation. The new rules also reinforce the importance of sound risk control and corporate governance.

2 In the Wake of Financial Crisis - CEIOPS Proposals

In March 2009 CEIOPS published a paper, *"Lessons learned from the crisis (Solvency II and beyond)".* In the document the Regulatory Committee outlines their belief that the lessons learned from the crisis should be reflected in the new Solvency 2 system. It proposes more rigorous requirements than those in the QIS 4-test. The proposals concerned mainly increased demands for calculating capital requirements and eligibility of own funds.

During spring and summer of 2009, the CEIOPS submitted nearly 40 consultation papers relating to various details of the solvency regime for comments. Another dozen will be submitted at the end of October. These documents reflect CEIOPS' approach following the financial crisis: more rigorous requirements on the capital eligible for own funds and more severe stress tests and parameters for calculating capital requirements.

CEIOPS has not explained the full impact of the proposals, but it can be expected to be significant. The Swedish Insurance Federation would like to point out a number of concrete proposals that CEIOPS has submitted, and which effectively increases the capital requirement over the politically agreed level of 0.5 percent risk of bankruptcy.

CEIOPS introduces a number of restrictions in their proposal for <u>valuation of technical reserves</u>. CEIOPS' proposal that discounting can take place only on the basis of AAA-rated government bonds involves a number of problems, one of them being that the European insurance debt far exceeds the outstanding AAA-rated government bonds, specifically bonds with long maturities.

Long-term liabilities, such as annuities and pension plans, can reach 40 years and more into the future. Market quotes on long bonds are required in order to evaluate these commitments. Since such long bonds are available only rarely, it is essential that CEIOPS prepare an economically viable <u>alternative method to extrapolate the rate curves</u> that may be used for valuation. The Swedish Insurance Federation has already submitted a proposal for such a method.[1]

The CEIOPS proposal does not enable insurance companies to fully benefit from <u>diversification effects</u> (e.g. geographic) in the calculation of the SCR. This is contrary to the basic principles of the directive. The basic idea of insurance is reducing the overall risk by pooling individual risks. Not fully taking into account the diversification effects when calculating the SCR constitutes a discrepancy between the operation of the insurance business and the design of the capital requirement.

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[1] Swedish Insurance Federation and Norwegian Financial Services Association: *Position paper on Level Two rules for the Directive on Solvency II – a Method Based on Macroeconomic Principles for the Valuation of Technical Reserves when no True Market Price Exists*

The possibility of using company-specific data for the assessment of insurance risks has disappeared, compared with QIS 4. The risk profile of an individual insurance company's portfolio may differ significantly from the entire market's risk profile. The risk profile of the individual company is hereby not reflected in the company's solvency capital requirements.

The maximum capital requirement for operational risk has increased. The framework directive defines a ceiling for the capital requirement for operational risk. CEIOPS suggests that the ceiling is increased by one hundred percent.

CEIOPS also introduces tougher requirements on the structure of own funds. The Swedish non-life insurance companies will not be able to use its security reserve (an equalization reserve) as tier one capital. The security reserve can be used to cover deficits in the insurance business and is true risk capital. The proposal has no ground in economic realities and implies an increased need for other capital items.

The increased requirements CEIOPS has presented have caused strong reactions in Europe. A coherent picture of the impact of the European insurance industry is not currently available. In Britain it has been estimated that the increase requires a doubling of own funds, i.e. by almost 50 billion pounds.

Swedish estimates indicate that the increase for operational risks for non-life companies alone is as high as 180-220% compared to the QIS 4 calculations. This would lead to an increase in overall capital requirements by about 10-15%.

The European insurance industry association, *CEA - Insurers of Europe,* has expressed its concern over the new rigorous requirements to CEIOPS[2]:
Overall, the draft advice is characterised by a systematic injection of quantitative and qualitative elements of conservatism that lead to a number of proposed measures which, in our opinion, are not only inconsistent with the principles crystallised in the Framework Directive, but also not in line with the agreed fundamentals of the new regime. The cumulative effects of the proposed solutions would result in a regime which includes a level of prudence that goes far beyond the level which has been politically agreed, fails to encourage sound internal risk management and entails a cost of compliance that would be unreasonable for the whole European industry.

3 Insurance is Not Banking

CEIOPS attribute the increased demands to the experiences from the financial crisis. In this perspective it is important to point out that the insurance industry is handling a variety of risks that are not financial in nature. On the contrary, there are a lot of risks that allow the insurance companies to act as stabilizers in times of turbulence in the financial markets. Against this background, it is important to point out that insurance and banking use completely different business models.

[2] CEA referens

Insurance and banking and are different both in terms of their economic structure and in terms of legal systems design. Insurance business is to pay compensation that may be assessed with some certainty in terms of both time and amount. Insurance companies can therefore manage their assets in order to meet the projected cash flows. Liquidity risk in the insurance business is hereby limited. Insurance has a long-term horizon and commitments and investments often have a 40-50 year perspective. Banks have a short-term horizon, typically weeks or no more than one year, due to the banks traditionally having short-term deposits to meet the (increasingly) short-term lending.

These differences are also reflected in the legal systems - Basel II on the banking side, and the new Solvency 2 regime on the insurance side. In Solvency 2, the entire balance sheet is included with a market consistent valuation of both assets and liabilities. All quantifiable risks should be included in the calculations and other risks are addressed in the supervisory process. The Basel II-rules focus on the asset side and does not capture all risks in banking.

It is important to emphasize that the financial crisis did not stem from deficiencies in the insurance business or the supervision thereof. The crisis was mainly caused by unregulated financial activities. It is also important to point out that the insurance industry has handled the financial crisis and the financial market turmoil well.

4 The Solvency 2 Basic Principles Should Not be Changed

The new rules are well-balanced and provide good protection for policyholders, while making it possible to run an effective insurance business. These good effects are based on the measurement of assets and liabilities at fair value and that the regulations require visible capital buffers.

Due to the financial crisis, CEIOPS has, in its draft proposal, chosen to tighten regulation far beyond the level specified in the Solvency 2 Directive. CEIOPS proposal for the level two rules in several parts go against the basic principles for the whole Solvency 2 project. CEIOPS has chosen to add prudential margins in addition to those listed in the Solvency 2 Directive. This renders the matching of assets and liabilities in the insurance company more difficult, which in turn will complicate the risk control of insurance companies.

The experience of the past year gives CEIOPS no reason to change the perception of risks and capital requirements in the insurance business.