



Solvency II

Making it workable for all

January 2011

I. Introduction

Based on the experience of the fifth quantitative impact study (QIS 5) exercise and indications received from its members, the CEA is concerned that the current proposals for the future Solvency II regulatory regime are too burdensome, too complex and therefore too expensive for companies to comply with.

The CEA has always supported the Solvency II project and favours the introduction of a robust economic risk-based prudential regime that follows the principles set out in the Solvency II Framework Directive. However, due attention should be paid, at this stage, to the objective to make the implementation of the regime workable for all insurers and reinsurers. This is an area of particular concern for small and medium-sized insurers.

It is therefore essential that the Level 2 implementing measures and Level 3 guidelines related to all three pillars of the new regime are drafted appropriately, avoiding undue complexity and administrative burden while maintaining an appropriate reflection of risk. The CEA appreciates that the European Commission, reacting to industry concerns, is taking initiatives, together with the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), to address this. This paper aims to contribute to the debate by setting out proposals under the following headings:

- Reducing the complexity of the default approach
- Applying the proportionality principle more appropriately
- Other practical ways to make Solvency II workable

The issues presented in this paper are wide-ranging but essential to the success of Solvency II. However, they are only a subset of the overall issues that need to be addressed to make the Solvency II regime workable for all. The CEA recognises that discussions are likely to evolve over time, in particular once further feedback from QIS 5 is available, and is ready and willing to contribute further to the ongoing debate.

The comments in this document should be considered as a whole; ie, they constitute a coherent package. As such, the rejection of elements of our positions may affect the remainder of our comments.

II. Reducing the complexity¹ of the default approach

A key concern for undertakings is the unnecessary complexity and the very large volume of calculations required under the default approach of Solvency II.

It is crucial that for some areas of the current draft of the Level 2 implementing measures, complexity is reduced. However, when doing so, care is needed to ensure that the right balance is struck between making the regime workable for all and maintaining the appropriate level of risk sensitiveness and policyholder protection.

The feedback we have received from the industry indicates that the proposals that will place an unduly high burden on undertakings include:

Technical provisions

- **The current proposal for the default approach for the calculation of the risk margin when valuing the technical provisions**

The requirements for a full projection of future solvency capital requirements (SCRs) is so complex that it is beyond the capability of virtually all companies, both large and small. The default approach also has completely spurious accuracy, as the risk margin itself is an approximation. One of the simplifications proposed in QIS 5 should be adopted as the default method.

- **The requirement to produce quarterly reporting of the minimum capital requirement (MCR) and other “core” financial and solvency information**

Based on the current reporting proposals, full quarterly calculations will prove very onerous, particularly for the first year of entry into force of the new regime and especially for small and medium-sized enterprises (SMEs). Undertakings should generally be allowed to use simplified methods to determine the information required quarterly by supervisors. The key criteria in determining whether a simplified estimation approach is sufficiently accurate should be whether or not it might mislead the assessment as to whether an undertaking could cover its MCR; ie, a risk-based approach should be adopted that takes into account the specific circumstances of the undertaking. In the rare circumstances where the use of an estimation approach can reasonably be demonstrated to be materially distorting whether or not an undertaking can cover its MCR, supervisors should have the right to require that a more accurate approach be used.

- **The requirement to capture dependencies between different causes of uncertainty in a best estimate liability calculation**

The current text, if interpreted too strictly, could be overly complicated. While in practice this requirement can be fulfilled for market risk drivers — using a correlated Economic Scenario Generator — it would be overly complex to

¹ The issue of reducing the complexity of the standard approach should not be confused with the issue of appropriately applying the proportionality principle. While both are key to making the regime workable for all, reducing complexity refers to the standard approach while the latter issue refers to simplified approaches that should be made available to undertakings that meet criteria related to the nature, scale and complexity of their business. This is discussed in section 3.

model other dependencies; ie, correlation of mortality and lapse. The key phrase in this text is the use of “where relevant”. If this is not interpreted sensibly, it could add to complexity.

- **The degree of granularity entailed in determining the value of reinsurance recoverables**

The current approach is excessively burdensome and neither feasible nor necessary for most undertakings. It should be kept in mind that it is in the interests of their policyholders that SMEs are encouraged, not discouraged, to make greater use of risk mitigation instruments, such as reinsurance.

- **The requirement to base the valuation of assets and other liabilities on IFRS**

The valuation of assets and other liabilities based on national accounting rules should be possible provided they meet the economic principles laid out in the Solvency II Framework Directive or under the principle of proportionality. A requirement to carry out International Financial Reporting Standard (IFRS) calculations is particularly burdensome for smaller undertakings that do not currently carry out these calculations.

- **The documentation and data quality requirements for the valuation of technical provisions**

The proposals are unjustifiably demanding and are likely to represent a disproportionate cost and burden for SMEs. A clearer definition of “quality” for the inputs to use in the standard approach is necessary.

- **Cash-flow projections for health products**

As proposed in TP.2.11 of QIS 5, insurers should be able to assume that the effects of claims inflation and premium adjustment clauses cancel each other out in the cash-flow projections for health insurance products.

- **Excessively granular segmentation requirements for technical provisions**

The segmentation requirements are not in line with the way insurers manage their risks. For life insurance, a reduction of the lines of business is necessary so that no split is required by risk driver. Additionally, we request that segmentation by member state or by currency should not be obligatory.

- **The default method for valuing technical provisions based on policy-by-policy valuations rather than suitable model points**

If a particular set of policyholders have the same product and risk characteristics, it is unduly burdensome and not necessary to require policy-by-policy calculations, as the grouped policies would produce the same result. Perfectly acceptable and accurate results can be achieved through the use of model points with an appropriate level of materiality. Clearly companies using model points will need to have processes and controls in place to ensure that the choice of those model points and their inherent grouping reflect sufficiently accurately the underlying risk exposure, but this is normal actuarial practice.

Own funds

- **Approval of ancillary own funds**

The requirement to assess the ability of multiple counterparties to make payments when seeking approval of ancillary own funds is excessively complex and needs to be significantly reduced in order to alleviate the burden on companies. This is particularly important for mutual undertakings.

- **Transitional rules for own funds**

The current proposal creates unnecessary complexity by using a sub-set of Solvency II rules, which results in both (i) retrospective regulation and (ii) an unlevel playing field. For instance, instruments issued in certain jurisdictions may qualify as grandfathered Tier 1, whereas economically equivalent instruments issued in other jurisdictions can only qualify as Tier 2. Transitional rules for own funds should be simplified by basing grandfathering criteria on existing Europe-wide regulations for hybrid capital.

- **Tiering rules for own funds**

The requirement envisaged for write-down or conversion in the case of future hybrid Tier 1 instruments adds significant difficulty but limited additional economic benefits. Other criteria that are also required in addition to write-down and conversion, including:

- i. ability to cancel coupons on a fully discretionary basis;
 - ii. mandatory coupon deferral in certain circumstances;
 - iii. the so-called regulatory lock-in (ie, absence of an effective maturity at times of stress); and,
 - iv. the requirement that the instrument must not cause the insolvency of the issuer;
- lead to comparable consequences for issuers and investors as a write-down or conversion.

Solvency Capital Requirement (SCR)

- **The current approach for the counterparty default risk requires a separate quantification of the risk-mitigating benefits for each risk-mitigation instrument**

As a general principle, this is appropriate because the use of risk-mitigation instruments is a key way in which SMEs in particular can achieve diversification effects (eg, through the use of reinsurance) and remain competitive. However, the proposed approach is a burdensome and overly convoluted calculation that will discourage SMEs from using such instruments, whereas encouragement would be likely to be in their policyholders' interests. Therefore, "per counterparty" calculations should not always be necessary and a factor-based approach would be a good solution when revising the proposals. If not a simpler approach then at least the simplification provided in QIS 5 for counterparty default risk should be set as the default approach.

- **The requirement for the spread risk calculation for structured products to be based on two different capital charges**

A requirement to carry out dual calculations — based on the rating of the instrument/based on a look-through approach — and then take the higher of the two, proves far too burdensome. The calculation should be based on the rating of the instrument only.

- **The treatment of participations at solo level**

The treatment should be simple, as the removal of double-gearing is done at group level. A single stress of 22% for all participations should be required.

- **Non-life lapse risk**

The non-life lapse risk module adds undue complexity for a risk which in the vast majority of cases is completely immaterial for non-life undertakings. We believe that this risk module should therefore be dropped.

- **Cat risk**

The calculation requirements for the catastrophe (cat) risk sub-module are extremely burdensome, with the constraint that all the risk-mitigating instruments existing in each market should be considered. We consider the current proposal for the cat risk module too detailed for a standard formula, added to which some of the exposure data requested for the catastrophe scenarios is not easily available. This is a typical area in which the use of undertaking-specific parameters (USPs) is likely to be appropriate and effective.

- **The Single Equivalent Scenario and the modular approach**

The calculations involved in the Single Equivalent Scenario are very complex and time consuming. Based on the preliminary feedback we have received from QIS 5, the Single Equivalent Scenario does not appear to be a workable solution for the standard formula and should therefore be dropped.

III. Applying the proportionality principle more appropriately

The option to use simplified approaches should be available to all undertakings that pass the proportionality test

It would not be appropriate for simplified approaches to be considered in terms of a “closed list”. It is crucial that proportionality should be applied with flexibility and that the approaches currently outlined in the proposed Level 2 measures should be used by companies and supervisors as a guide to how to apply proportionality rather than as a hard rule.

The simplification approach taken by a company should be the result of discussions between the company and its supervisors. Training and case studies provided by supervisors would be useful here. Based on notional companies, the training would describe which simplifications would and would not be most likely to be appropriate, together with the reasoning behind this and the kind of evidence and analysis supervisors would expect to see.

We recognise, however, that a similar level of policyholder protection between those companies using proportionality and those not doing so needs to be ensured. Therefore, where a simplified approach results in an increased potential for model error, then incorporating some degree of conservatism in its calibration to reach the same level of confidence (as the sophisticated approach) is acceptable.

Further guidance on how proportionality should be articulated in concrete terms and on when undertakings will be able to use simplified approaches is needed under Level 2 and Level 3

As the exact method of applying proportionality will differ depending on specific circumstances, the Level 2 implementing measures should introduce the principle of proportionality into specific articles of the implementing measures, with clear guidance to help with interpretation and application. This would complement an overarching statement of principle on proportionality in Level 2. We acknowledge that this is, to some extent, already the case with the articles relating to technical provisions, SCR and systems of governance. However, the principle of proportionality should be more clearly articulated on all three pillars and for the groups sections.

One of the difficulties undertakings have expressed is knowing when simplified approaches can sensibly be used and will be accepted by supervisors. We believe that further details are needed in this area under Level 2 to provide undertakings with more certainty on when they will be able to use simplified approaches. Undertakings should be able to identify which are the most appropriate methods to be used, based on the specificities of their risk profile, without being restricted by rigid criteria set in Level 2 and with relative thresholds being used as a guide for both supervisors and undertakings as to the likely suitability of a particular simplified approach.²

² The CEA's paper “Initial thoughts on the use of simplifications” provides useful information on this area which should be considered for the Level 2 implementing measures

A key concern for SMEs is the potential burden associated with meeting the Pillar II and III requirements

Typically, SMEs have simple structures and risk profiles. An across the board application of the current Pillar II and III requirements to SMEs is likely to be excessively burdensome and would, in effect, result in their policyholders paying excessive and unnecessary costs. There therefore needs to be sufficient flexibility within the Pillar II and III requirements to allow them to be applied in a risk-based manner. A “lighter touch” (ie, less burdensome and bureaucratic) should be taken, reflecting an undertaking’s structure and risk profile, to provide adequate results. The CEA believes that for many SMEs a “lighter touch” is justified and consistent with the proportionality principle. Below we outline areas in which this is likely to be the case.

- **Public disclosure** is a good example of an area where requirements are likely to be excessive and ineffective for SMEs. Publicly disclosing information on risk management and governance in order to use market discipline to encourage good practice will fail if nobody reads and/or understands the information. The financial media, analysts and rating agencies are unlikely to be interested in SMEs because of their size, individually insignificant market figures and risk profile. The vast majority of policyholders are unlikely to read or understand thick reports containing detailed, hard to comprehend information. The current proposals for public disclosure for SMEs are therefore likely to be ineffective, costly and burdensome. Public disclosure requirements for SMEs should be greatly reduced; eg, no more than the executive summary currently proposed for the Solvency and Financial Condition Report should be required, which is likely to be more accessible to policyholders and therefore more effective, both in terms of Pillar III aims and cost efficiency.
- A risk-based approach should also be adopted for **supervisory reporting**. The current requirements, if applied to SMEs, would result in excessive costs and require information that, in practice, supervisors would neither need nor use, given the generally much simpler structures and risk profiles of SMEs. In previous responses, the CEA has highlighted that the area of quantitative reporting to the supervisor is incredibly complex. The Commission subsequently clarified that this will be dealt with entirely at Level 3. It is essential when drafting these requirements that proportionality along the lines described above is reflected. For example, the investments could be reported by asset class, standard risk and possibly market sensitivity measures.
- Proportionality in the context of **governance** for SMEs should focus on what is required to achieve the underlying objectives. The small size of SMEs often means that staff have much wider knowledge of (and can therefore challenge) what is going on outside their immediate areas; they are usually all located in the same place and often interact with each other daily. As a result, provided an SME can demonstrate that possible conflicts of interest are appropriately managed, it should be possible to combine certain functions and for an individual to perform multiple roles; eg, a combined actuarial and risk-management role.

A potentially burdensome area is the requirement to have a fully separate internal audit function. This requirement should not rule out using third parties from time to time to provide an external perspective. This may be a more cost-effective route for SMEs than being required to have or outsource a full-time, separate internal audit function.

- There is still very considerable uncertainty as to what will be required under the **Own Risk and Solvency Assessment (ORSA)**, with SMEs being particularly concerned that this could result in significant and unnecessary additional work. In particular, the ORSA should not result in an “internal model through the back door”. It is essential that a pragmatic and flexible approach is adopted that focuses on whether companies have an ORSA process appropriate for their needs as opposed to a one-size-fits-all approach that results in unnecessary costs. However, we do note that, at the outset, it would be helpful if national supervisors establish for their respective markets a minimum structure and template that insurers could use for the ORSA in the first two years of implementation.
- A flexible approach should be taken when **applying the fit and proper requirements to SMEs**. Greater emphasis should be placed on whether individuals have the necessary knowledge and experience to perform a particular role than whether they have a **particular professional qualification**. It should not be the case that Solvency II effectively disbars people who have efficiently and competently performed a particular role prior to Solvency II. This is especially important for SMEs, given the likely shortage of people with certain qualifications at the start of Solvency II.

IV. Other practical ways to make Solvency II workable

The industry as a whole strongly supports the economic approach underpinning Solvency II. It is important that the economic approach is implemented in such a way that undertakings, and in particular SMEs, can fully reflect their specific circumstances and competitive advantages. In particular:

- Many undertakings, particularly SMEs, specialise in certain areas; leveraging their historic ties, their unique understanding of their customer base or their product expertise. This specialism normally forms part of their business plans. The ability to reflect this via **the use of undertaking-specific parameters** (USPs) is therefore very important to many SMEs. As a result, the scope of USPs should not be restricted to certain areas, as is currently set out in the Level 2 proposal, but rather expanded to life and health. Moreover, another impediment that SMEs face is that the use of USPs will be subject to supervisory approval, with the current proposals requiring companies to demonstrate the completeness, accuracy and appropriateness of the data they use to calibrate their USPs. It is essential that such a requirement is interpreted pragmatically. Ways of dealing with “low quality” data, such as historical data of a shorter length or a gap in data history would be welcomed.

As an example, one way forward would be to allow a period during which the size requirement placed on the experience data would increase yearly.

Another way forward would be to pool experience with similar SMEs in order to produce larger, more credible, homogenous data groups. The emphasis should be on there being reasonable evidence that an SME’s experience is likely to deviate from the distributions implicitly assumed in the standard formula calibration, as opposed to requiring complete certainty. The data used to show this should include all relevant sources of information; eg industry data, qualitative information such as expert judgement and, of course, the company’s own experience.

Both examples would make it possible for SMEs to experience the full benefit of USPs from the date of implementation of Solvency II.

- **Risk mitigation**, such as reinsurance, is of particular importance to SMEs, as it enables them to diversify their risks, thereby allowing them to make more efficient use of their capital base and compete more effectively with larger more diverse competitors. Non-proportional reinsurance such as stop loss cover is particularly important to smaller non-life insurers. The CEA welcomes the improvements included in QIS 5. Nonetheless, the conditions for the recognition and use of mitigation contracts should be flexible enough that the most available instruments and hedging strategies can be deployed without excessively tight, restrictive and expensive *ex-ante* internal control. Having principles-based risk-mitigation regulation with effective external *ex-post* audit compliance checks would be preferable to a strict, detailed rules-based system that tends to get outdated.

- It is commonly understood that some **finite reinsurance** programmes do not contain substantial risk transfer. Nevertheless, for the purpose of being recognised as insurance risk mitigation under the standard formula, it is the effectiveness of risk transfer that should be taken into account. As a result, a general exclusion of finite reinsurance as insurance risk mitigation would not be appropriate, as in some cases substantial risk transfer from the ceding company to the reinsurer can be proved. Uncertainty about practical handling can be avoided by specifying harmonised, reasonable and practicable criteria for qualifying effective risk transfer (eg, a “risk transfer test”).
- As stated previously, one of the main problems for SMEs is the system of governance. They consider that one of the best incentives that regulators can give them to develop a better internal structure is to materialise the level of internal control by including an **adjustment to the operational risk capital requirement**, taking into account the adequacy and the quality of their operational risk management procedures. Though we acknowledge that, in practice, the connection between the management and the measurement of operational risk is difficult to quantify, not including an allowance for the risk controls within an undertaking in the proposed operational risk formulae would not reward or encourage sound risk management.
- The implementation of Solvency II will require **training and support for the staff** of undertakings. SMEs on their own are less well placed to provide this. A way of mitigating this would be to create centres of excellence in the run up to Solvency II that provide training courses and support, for example lectures on reserving and valuation methods, risk management and reporting. These centres could also provide “Question & Answer” services, similar to the support provided by CEIOPS on QIS 5, but in relation to all aspects of Solvency II.

Similarly, another way of helping SMEs would be for supervisors to extend the support currently provided as part of the QIS exercises. For example, supervisors could provide and maintain spreadsheet tools for calculating elements of the SCR, as an extension and continuation of the QIS spreadsheet help tabs.

- Currently, CEIOPS **provides market parameters** for the interest rate yield curves to be applied in the QIS calculations. This could be expanded to include other useful market parameters, such as implied volatility surfaces and correlation parameters that may be needed to calculate the best estimate liabilities. Similarly, supervisors could provide sets of country-specific economic scenarios appropriate to market conditions at each valuation date with an explanation as to the liability characteristics for which they would be suitable. A range of scenario sets could be provided that best suit different business types. Naturally, these parameters should be easily applicable by SMEs. This would help reduce the costs for SMEs and help ensure standardised assumption-setting for market parameters.
- The development of the cashflow models required under Solvency II could be a very major expenditure for SMEs, especially the smallest ones. A way of

mitigating this would be for **cash-flow modelling tools to be provided by, for example, an industry body** for use by small life insurance entities for standard product types. There would need to be sufficient flexibility within the model to adapt to different types of business. For given criteria and caveats, development, management and validation of the model could be performed centrally, thereby minimising and pooling costs. Sufficient documentation on the methodology assumptions and validation tests would need to be provided to users (including supervisors) to allow them to assess the appropriateness of the model to their business as they will retain ultimate responsibility for results derived using these tools for their companies.

V. Conclusion

The CEA believes that, notwithstanding the work already carried out in respect of the proportionality principle and simplified calculation methods, significantly more needs to be done to help make Solvency II implementation workable for all insurers and reinsurers. This must be addressed when drafting the Level 2 and 3 measures. The CEA looks forward to expanding and further elaborating on the points and suggestions made in this paper.



The CEA is the European insurance and reinsurance federation. Through its 33 member bodies — the national insurance associations — the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of over €1 050bn, employ one million people and invest more than €6 800bn in the economy.

CEA aisbl
Square de Meeûs 29
B-1000 Brussels
Belgium
Tel: +32 2 547 58 11
Fax: +32 2 547 58 19
www.cea.eu