CAMINO A SOLVENCIA II (I)

ENERO 2011

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Objetivos

- ⇨ **Based on QIS5 experience and indications received from its members, 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.**

- ⇨ **It is therefore essential that the 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 comments in this document should be considered as a whole, they constitute a pack.**

- ⇨ **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**

Objetivos

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

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Reducing the complexity 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. Items:

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Reducing the complexity of the default approach. Technical Provisions (TP)

I. The current proposal for the default approach for the calculation of the risk margin when valuing the technical provisions

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. <u>One of the simplifications proposed in QIS 5 should be adopted as the default method.</u>

II. 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 <u>will prove very onerous</u>, particularly for the first year of entry into force of the new regime <u>and especially for small and medium-sized enterprises (SMEs).</u>

Undertakings <u>should generally be allowed to use simplified methods</u> to determine the information required quarterly by supervisors. 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 another approach.

Reducing the complexity of the default approach. Technical Provisions (TP)

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

While in practice this requirement can be fulfilled for market risk drivers — using a correlated Economic Scenario Generator — it would be overly complex to 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

IV. The degree of granularity entailed determining the value of reinsurance recoverables

The current approach is excessively burdensome (gravoso) 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 (animadas) to make greater use of risk mitigation instruments, such as reinsurance.

V• 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 (IFRS) calculations is particularly burdensome for smaller undertakings that do not currently carry out these calculations.

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Reducing the complexity of the default approach. Technical Provisions (TP)

VI • The documentation and data quality requirements for the valuation of TP

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 is necessary.

VI • Cash-flow projections for health products

As proposed in TP.2.11, 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 products.

VII • Excessively granular segmentation requirements for TP

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, segmentation by member state or by currency should not be obligatory.

VIII • Valuing TP 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 not necessary to require policy by- policy calculations, as the grouped policies would produce the same result. Results can be achieved through the use of model points with an appropriate level of materiality. Companies using model points will need to have processes and controls to ensure their inherent grouping reflect sufficiently accurately the underlying risk exposure.

Reducing the complexity of the default approach. Own Funds (OF)

- **I - 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.

- **II - Transitional rules for own funds**

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

- **III - Tiering rules for own funds**

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:

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

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Reducing the complexity of the default approach. Solvency Capital Requirement (SCR)

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

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 provide in QIS 5 for counterparty default risk should be set as the default approach.

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

Dual calculations — based on the rating of the instrument/based on a look-through approach — and then take the higher of the two. Calculation should be based on the rating of the instrument only.

III - 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

Reducing the complexity of the default approach. Solvency Capital Requirement (SCR)

IV - Non-life lapse risk

This 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.

V- Cat risk

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. Typical area in which using undertaking-specific parameters (USPs) is likely to be appropriate and effective.

VI - 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.

Objetivos

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

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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.

Applying the proportionality principle more appropriately

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

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

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Applying the proportionality principle more appropriately

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

Typically, SMEs have simple structures and risk profiles. Board application of the 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 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:

I.Public disclosure 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

II Supervisory reporting. 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. - quantitative reporting is incredibly complex -. Investments could be reported by assetclass, standard risk and possibly market sensitivity measures.

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Applying the proportionality principle more appropriately

III. Proportionality in the context of **governance** The small size of SMEs often means that staff 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.

IV. 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. 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. National supervisors should establish a minimum structure and template that insurers could use for the ORSA in the first two years of implementation.

V. 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**. This is especially important for SMEs, given the likely shortage of people with certain qualifications at the start of Solvency II.

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Other practical ways to make Solvency II workable

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:

Undertakings, particularly SMEs, specialise in certain areas. This specialism forms part of their business.

Ability to reflect 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. Another impediment that SMEs face is that the use of USPs will be subject to supervisory approval, 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 "low quality" data, like historical data of a shorter length or a gap in data history would be welcomed.

One way would be to allow a period during which the size requirement placed on the experience data would increase yearly. Another way would be to pool experience with similar SMEs in order to produce larger, more credible, homogenous data groups. This should be on there being reasonable evidence that an SME's experience is likely to deviate from the distributions assumed in the standard formula calibration. Data used 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

Other practical ways to make Solvency II workable

Risk mitigation, such as **reinsurance**, is of particular importance to SMEs, as it enables them to diversify their risks, allowing them to make more efficient use of their capital base and with larger more diverse competitors. Non-proportional reinsurance such as stop loss cover is particularly important to smaller non-life insurers. 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 tightl. Having principles-based risk-mitigation regulation with effective external expost audit compliance checks would be preferable to a strict, detailed rules.

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. 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. 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

Other practical ways to make Solvency II workable

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

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. A range of scenario sets could be provided that best suit different business types. These parameters should be easily applicable by SMEs.

- The development of the cashflow models required under Solvency II could be a very major expenditure for SMEs. 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. 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.