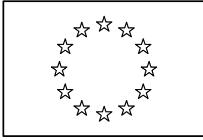

EUROPEAN COMMISSION
Internal Market and Services DG
FINANCIAL INSTITUTIONS
**Insurance and pensions**

# PUBLIC HEARING SOLVENCY II

## 21 JUNE 2006

### 1. Summary of Panel 1, "CEIOPS Update"

*Panellists:* *Paul Sharma (Pillar 1), Petra Faber-Graw (Pillar 2), Fausto Parente (Pillar 3), Noel Guibert (Groups/Cross-sectoral issues), Vesa Ronkainen (Financial Stability Committee)*

*Chair:* *Elemér Terták*

During the Panel the chairs of CEIOPS' Solvency II Working Groups gave an up-date of the work being carried out in their working groups.

**Paul Sharma** took as his starting point the question how to measure the balance sheet. The decision between the percentile approach and the cost of capital approach would be fundamental for Solvency II. Regarding the standard formula he asked for stakeholders' input on whether it should be allowed to have several solutions (factor-based/scenario based) for each component within the formula? Another important issue will be how to bring the components of the standard formula together (simple add up or diversification)? With regard to the calibration of the standard formula he stressed that the calibration is not "final" yet as the results of QIS will be taken into account. Regarding internal models the following issues need to be discussed: how to ensure the quality of an internal model, the consistency between internal models and how to inform the public about internal models?

**Petra Faber-Graw** stressed that the focus at the moment is mainly on Pillar 1 issues. However, there is a broad range of tasks and powers for the supervisor under Pillar 2. Issues being discussed at the moment are: control of investment/risk management, harmonisation of supervisory powers, the supervisory review process and a company's internal capital and risk assessment. Starting point is the regulatory capital requirements (SCR/MCR) but there needs to be an internal capital and risk assessment in each company. That does not mean that there is a further capital control level or that each insurance undertaking would be forced to have an internal model. In this context the principle of proportionality needs to be applied.

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**Fausto Parente** stressed the relationship between accounting rules and supervisory reporting. The borderline between public and internal reporting needs to be defined. Further harmonisation of supervisory reporting is envisaged. The likely outcome of the IASB work will be taken into account as well as IFRS developments.

**Noël Guibert** stressed that the starting point is solo supervision and that group supervision is only supplementary. The powers of the group supervisor need to be enhanced to fit with the internal organisation of a group. Regarding internal models he pointed out that all involved supervisors have to act in concert. If the internal model is developed and used at group level it should be validated at group level but the other supervisors should be consulted. Supervisors should exchange experience and information. If no common decision is possible the group supervisor should decide about the calculation of the SCR. However, the solo supervisor would remain responsible for the decision about the solo SCR. The solo supervisor would have the competence to ask for additional capital or he could ask for the application of the standard formula if the application of the internal model of the group does not make sense at the solo level. Regarding diversification benefits, **Noël Guibert** stressed that these effects can be negative or positive, hence they should be called diversification effects. Discussions on under which circumstances capital support by the parent undertaking will be taken into account at the solo level need to continue.

**Vesa Ronkainen** gave an up-date of the work of the Financial Stability Committee. Up to now 3 studies have been carried out: The preparatory field study, QIS 1 which focused on technical provisions and QIS 2, which focuses on quantitative elements of Pillar 1. Answers by industry to QIS 2 are expected by end July, country reports should be prepared by end August. The summary of the country reports is expected for October 2006. Further quantitative impact studies are to be expected. There should be a third QIS in 2007 dealing with the calibration of the standard formula.

**Questions and answers:**

It was clarified that an "entry price calibration" for the calculation of technical provisions has not been discussed in any depth in the pillar 1 working group as yet.

The question was raised what will be permitted as capital and what the supervisor will be allowed to do. It was stressed that CEIOPS follows an evolutionary approach by ensuring consistency between the pillar 1 and pillar 2 working group.

It was argued that if solo undertakings need to be sufficiently capitalized at all times that might lead to too restrictive rules at group level. It was stressed that the issue of diversification needs to be further discussed within CEIOPS. If there were to be an internal model at group level, diversification effects (risks and benefits) could be taken into consideration. If a standard formula were to be applied, such effects would be taken into account in the formula as well as by using consolidated data. The issue needs to be discussed how such effects will be taken into account if there is a simple addition of the solo-SCRs. Furthermore, it has to be discussed on how to take capital support by the parent undertaking as capital element at the solo level into consideration and how to calibrate it.

The question of whether the pros and cons of allowing different calculation methods within the standard formula should be explored further will be discussed in the CEIOPS Members' Meeting in Frankfurt in June.

## 2. Summary of Panel 2: "Policyholders and other stakeholders"

*Panellists:* *Coenraad Vrolijk (McKinsey), Christiaan Gülich (Bund der Versicherten) and Rob Jones (Standard and Poor's)*

*Chair:* *Karel Van Hulle*

**Mr. Vrolijk** made a brief analysis of the impact Solvency II may have on policyholders, shareholders and on insolvencies. He concluded that Solvency II increases policyholder efficiency (paying the right price for risk) and increases shareholder efficiency (improved transparency / better understanding), provided Pillar 2 is well implemented. As to insolvencies, he took the view that as the real causes for insolvency can not be modelled and are not taken into account in Pillar 1, a strong Pillar 2 will be critical for a good Solvency II. In addition, he believed systemic risk / herding behaviour may increase, particularly in relation to assets.

According to **Mr. Gülich**, policyholders have difficulty to understand what Solvency II or solvency requirements are all about. Most important parts of the project are therefore Pillar 2 (fit and proper) in combination with the introduction of solvency control levels and Pillar 3. Solvency II should not result in the disappearance of certain products but policyholders should be able to understand the different products offered and the risks inherent in those products. In this respect, the requirements on the information provided to policyholders need to be updated, as the policyholder needs to receive understandable and concise information.

**Mr. Jones** sees convergence of methodologies, like the S&P model and Solvency II, for assessing companies. He said that in line with allowing the use of internal models uinder Solvency II, firm's own economic capital models could influence S&P's capital adequacy assessment going forward. Solvency II will put more pressure on the industry to consolidate, but it is not the key driver. Besides, a lot of consolidation has already taken place. He expects companies that are neither big, nor niche players, to have more difficulty to survive. Solvency II will not lead to more capital demand by the industry as a whole, but high risk companies may have to raise capital. More diversified companies could benefit from the use of internal models, whereas small companies would find it more difficult to compete, although this may not be the result of Solvency II alone.

**Questions and answers:**

During the Q&A session it was said that Solvency II is causing a problem, but that at the same time Solvency II is shining a light upon it: i.e. the inefficiencies caused by the current cross-subsidisation of some business lines by others. Now that we have seen the light, there is no way back.

. Some believed that financial strength can never be measured by one standard quantitative metric, as Pillar 1 style capital requirements tend to be bad predictors of insolvencies. Management should be the top priority on any supervisory checklist and this means a large role for Pillar 2. It was noted that a number of academic studies of the US RBC requirements had underlined this point. It was also noted that although the US used to be in the lead in the international solvency debate with its RBC system, the Solvency II project has now become the driving force behind international supervisory developments and thinking.

It was remarked that the greater freedom given to companies with regard to the design of internal models the less likely that potentially detrimental herding behaviour will occur. In this regard it was noted that the likelihood of detrimental herding behaviour in periods of stress might be reduced if a firm's capital calculation were allowed to be based on a longer term view – i.e. greater than one year.

### 3. Summary of Panel 3, "Insurance Products and Markets",

*Panellists:* *Antoine Lissowski (CNP Assurance – CEA), Patrick Peugeot (La Mondiale – AISAM/ACME), Rolf Stölting (Munich Re – Groupe Consultative), Thomas Wilson (CRO-Forum)*

*Chair:* *Karel Van Hulle*

**Mr. Lissowski** emphasised industry's strong support for Solvency II, underlining that attracting investments must be a main objective of Solvency II in addition to enhanced policyholder protection. He considered it to be too early in the process to predict the impact of Solvency II on industry but the question had been raised whether Solvency II would increase or decrease competition in the market. Important outstanding issues were the valuation of liabilities, eligible elements of capital, calibration and group issues. He also expressed fear that, given the time constraint, the replies to CEIOPS' QISII would not be subject to an in-depth evaluation.

**Mr. Peugeot** reminded the audience about the social importance of the mutual and co-operative sector and its significance in the European insurance market (29% of the market in 2003). The mutual sector took an active part in the Solvency II work. With regard to QISII, the sector was eager to participate, but feared that time limits to reply were too short. For the mutual sector, the main issue was to find alternative means of raising capital. Subordinated debt should be allowed to a larger extent than today and the Solvency II system should foresee opt-out possibilities for small mutuals.

**Mr. Stölting** emphasised the important role of actuaries in the new system and underlined the need for pre-defined requirements on actuaries' skills and competencies. He also mentioned the important issue of the independence of actuaries. With regard to Solvency II and reinsurance, the point was made that due to the nature of reinsurance business, reinsurance undertakings, in general, already had more advanced risk management processes in place than direct insurers.

**Mr. Wilson** underlined the CRO-Forum's support for the Solvency II project and noted that Solvency II fitted well with work currently being undertaken by the CRO-Forum. Mr Wilson mentioned five priority issues, notably the valuation of insurance liabilities, diversification effects, supervision of groups, risk mitigation techniques and the standard SCR formula.

**Questions and answers:**

During the lively Q&A session, questions were in particular raised regarding the use of derivatives and securitisation methods. The panel agreed that the new system should allow increased flexibility as far as the use of new capital instruments and new risk mitigation techniques was concerned. Several questions related to how Solvency II would affect products particularly given remarks made in Panel 2 regarding cross-subsidisation of business lines: Would certain products disappear from the market? The panellists presented different views. It was suggested that Solvency II could have a positive effect on complex life assurance products and foster transparency. Moreover, the point was made that Solvency II could lead to increased business specialisation, implying that undertakings would focus on what they were best at. In addition, Solvency II may increase the need for new insurance techniques. Finally, it was noted that no banking products had so far disappeared as a result of Basel II.

## 4. Summary of Panel 4 "International Developments"

*Panellists:* *Wayne Upton (IASB), Craig Thorburn (World Bank), Michael Koller (Swiss Re), Rob Esson (IAIS – NAIC)*

*Chair:* *Elemér Terták*

**Wayne Upton (IASB – Research Director)** reported on the current status of the IFRS 4 – Phase II project, stressing that the project can be followed in a transparent way on the IASB website. He confirmed the IASB intention to present a Discussion Paper (the first step in the IASB due process) before the end of 2006. He chose to highlight two key issues on which further reflection is necessary. The first one is measurement of liabilities. The Board did not start with any preconceptions on any particular measurement attribute, and recently adopted the concept of "current exit value" (current unbiased estimate of future cash-flows, discounted, with unbiased risk margin), but it will need to revisit this concept. The second issue is participating features of some insurance contracts: it is not because they can be estimated that they meet the definition of a liability under the IASB Framework.

**Craig Thorburn (World Bank – Insurance Supervision)** stressed that the Solvency II project is critically important for many client countries of the World Bank, either because they adopted Solvency I and now intend to move to Solvency II, or because they have just decided to go for a system accepted internationally (i.e. Solvency II, in the absence of an IAIS system). He expressed the opinion that, in this context, the standard formula should be as simple as possible, to ensure its universal applicability. He underlined the potential difficulty of making internal models applicable to business written in developing countries, where many challenges are observed (existence and reliability of data, actuarial competences, staffing of supervisory authorities). He concluded by suggesting that, in developing countries, Pillar III may well be the most important element.

**Michael Koller (Swiss Re – CRO)** stated that both the recently introduced Swiss Solvency Test and Solvency II are based on economic approaches and require a sound risk management framework. The SST is fully principles-based and companies are required to really think about their own risks. He reported that the SST introduction had generated some fear at the beginning, but that there is now more enthusiasm because the new system had delivered a better understanding of risks and profit drivers and had led markets to become more transparent and efficient. He concluded with some lessons to be drawn from the SST: involve the industry early / define the guiding principles from the beginning / apply as many standard approaches as necessary / model only the most relevant risk drivers / make field tests.

**Rob Esson (Chair of IAIS Insurance Contracts Subcommittee and Member of IAIS Solvency Subcommittee)** made clear that changes in accounting will influence the way business is regulated. He highlighted the importance of the IAIS work on solvency, because it will open markets and free financial flows. He referred to the Structure Paper, currently under consultation, building on eight cornerstones which are close to the main ideas developed in Solvency II. He suggested that Solvency II might well serve as a test case for both the IASB and the IAIS, and would then have to be somewhat adapted (Solvency 2.1). Turning to the Second Liabilities Paper, developed with input from the IAA, he underlined the following ideas: settlement is the fundamental principle, the basic approach is exit value, discretionary participating features should be accounted for as liabilities and the own credit standing should not be recognised. He concluded by insisting on the need for all to work towards consistency between accounting and solvency.

**Questions and answers:**

Main points regarding the IASB work: a) the IASB does not consider the organisation of field tests for IFRS 4 – Phase II as a realistic option, but could instead organise field visits to discuss main issues with companies; b) the IASB sees as the main weakness of a current exit value approach that it may push all measurement errors upfront, but the main difficulty with a current entry value approach is how to recognise profit in the period after day 1; c) the IAIS is strongly pleading for recognition in financial statements of policyholders behaviour, in particular for surrender values and participating features.

Main points regarding the SST: a) consistency can be achieved in a principles-based system, because most part of the risk is in ALM (for which a straightforward approach does exist) and companies covering special risks (e.g. satellites) are obliged to develop an internal model; b) the SST was introduced after discussions with industry where it was decided that the system should be based on market values (rather than book values) and a series of field tests, which facilitated a quick implementation by companies; c) a working group composed of regulator and industry is producing guidance papers for companies, usually about 10 pages with practical examples.

Main points regarding the consistency between accounting and solvency: a) the EU expects the IASB to take account of developments in the Solvency II project; b) what is important is that both systems are consistent, not necessarily fully identical (there might be good reasons why financial reporting should be a bit different); c) if systems are diverging, it is crucial that differences are publicly and fully explained.