Financial Services User Group's (FSUG)

response on

Level 2 implementing measures for Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

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FSUG opinion on Level 2 implementing measures for Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II)

1. GENERAL REMARKS

Solvency II has been primarily designed to prevent insurance companies' bankruptcies and to bring new quality into the insurance market, that is becoming more linked to financial system. Risk-based approach that is the fundament of Solvency I is challenging for both, industry and supervisors, but is unavoidable due to present shape of the financial market.

The conflict of objectives between the solvency of insurers and the protection of policy holders has recently been identified by the US, UK and Belgium, who are adopting the 'twin peaks' approach.

Solvency II heavily penalizes insurers holding equities and thoroughly raises capital requirements and therefore insurers' equity issues needs, while insurers already derive higher profit margins from unit-linked products where the equity risk is transferred to holders.

We ask for long-term impact studies being launched as soon as possible on European equity markets and on individual investors, especially long-term savings and pension products value & performance.

Level 2 implementing measures for Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) are crucial as they form a part of Lamfalussy process. The operational level gives opportunities to update and develop the regulations. Having in mind the need of predictivity, the European Commission should treat them as mid-term regulations. This is particularly so with regard to smaller insurance undertakings where it is more difficult to predict the outcome of the implementation of Solvency II.

Due to time restrictions, the FSUG was able to answer just a few questions, among them some of the high-level issues and most of consumer-related matters. If any further work is needed, the FSUG is ready to cooperate any time.

Technical provisions – best estimate – risk-free interest rate curve. Question 1: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of: harmonising the calculation of technical provisions; introducing proportionate requirements for small undertakings; introducing risk-sensitive harmonised solvency standards; and promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB. (Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)

It should be noticed that risk-free interest rate has changed its benchmark, and in the last period long-dated swap spread anomalies could have been observed, such as negative value of swap spread[1]. As government bonds do incorporate credit risk, at least from the market perspective, the swaps curve with an adjustment (option 3) seems to be satisfactory regarding consumer protection. Budget constraints and future pension liabilities would probably affect government bond interest rate in the systemic way. Furthermore, swaps providing higher liquidity seem to be more adequate in the long term. However, due to possible inconsistency within financial market, cross-sector differences should be taken into consideration, like the choice of risk-free interest rate curve for pension funds in the future

1 *"Regulation", Are there really any risk-free rates?*, S. Sender, 20.1.2009.

What seems to be extremely important is a method of extrapolation that influence long-term interest rate, especially on less developed and illiquid markets.

> 2B: Technical provisions – risk margin – diversification. Question 4: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of: harmonising the calculation of technical provisions; introducing proportionate requirements for small undertakings; introducing risk-sensitive harmonised solvency standards; and promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB. (Please provide reasons and examples. If you do not agree, which option in Annex 1 meets these objectives in a more efficient and effective way and why?)

Due to consumer protection, the FSUG opts for option 3 of List of policy issues and options for the Level 2 Impact Assessment of Solvency II, as in case of risk margin no diversification effect should be assumed. Within one national market different business models are implemented and furthermore possible effect would be rather little, with tiny outcome for small and medium insurance companies.

> Procyclicality – Pillar II dampener. Questions 7-8: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of: introducing risk-sensitive harmonised solvency standards; harmonising supervisory powers, methods and tools; promoting compatibility of prudential supervision of insurance and banking; and promoting compatibility of the prudential regime for EU insurers with the work of the IAIS and IAA. (Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)
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> Should the list of factors to be taken into account by supervisory authorities when deciding whether to grant such a decision be left open? (Please provide reasons.)

The FSUG supports the Commission Services' current view. Due to some instability on the financial market an open list of the external and entity-specific factors for supervisory authorities is acceptable and to some extent desired.

> Public disclosure – content, form and modalities. Questions 13-15: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of: introducing proportionate requirements for small undertakings; harmonizing supervisory reporting; promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB; and ensuring efficient supervision of insurance groups and financial conglomerates. (Please provide reasons and examples. If you do not agree, which option in Annex 1 or alternative suggestion meets these objectives in a more efficient and effective way and why?)
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> The current approach favoured by the Commission Services would be to list a number of items which would need to be put in the public domain. Some stakeholders argue that the SFCR should contain much less information, so that it is understandable by policy holders, while others support disclosure of information directed at a much wider audience. Do you have views on: what stakeholders should be addressed? What are the areas on which stakeholders need information? How detailed has it to be?

Solvency II will be based on an economic valuation of all assets and liabilities. The current approach favoured by the Commission Services would be to require public disclosure of a number of aggregated key figures arising from solvency valuation and their material differences with the accounting valuation. Do you support that approach? (Please provide reasons and suggestions on how precise such information should be and how it should be presented to be understood well by markets.)

Disclosure of solvency and financial information arises as a very important issue, however it should be acknowledged that although this information to some extent is dedicated to consumers it will be processed by financial advisors and consumer organizations. That is why limitation of the information provided to the public cannot be based on the level of complexity but on criteria of usefulness. The scope of the information should consist of basic financial ratios and figure (among others also capital adequacy, coverage of technical provision, loss ratio in certain business lines, profitability of investments etc.).

The FSUG finds the idea of minimum content as adequate concerning solvency and financial information. As proposed solvency valuation will differ from accounting valuation the disclosure of the assumptions should be provided. It should be stressed that especially such information will be analyzed by experts.

Question 37: Do you anticipate that the Commission Services' suggested approach for level 2 implementing measures would result in an increase or decrease in insurance prices? (Please provide details of the types of product or groups of policy holders affected, the magnitude of the increase or decrease expected and whether the change results from change in the value of technical provisions or capital requirements.)

The final impact on prices is difficult to predict. There are several factors upon which price determination will depend, as Solvency II will be implemented in different insurance undertakings, with different risk profiles, in different countries.

A first factor that may affect prices is a potential change in capital requirements. Recent studies[2] have shown that although QIS-5 will likely mean a decline in the QIS standard formula solvency ratios observed across European life markets as compared to QIS4, this conclusion may not necessarily apply across all European markets (e.g. the case of Poland Life). Another factor refers to the endogenous characteristics of each product. Solvency II captures a wide variety of risks leading to higher capital requirements for products with high volatility in their claims and long-term products. Thus the Directive is expected to affect in a different manner products with different risk features and consequently also affect their prices. For example, the Directive is expected to diminish the profitability of many non-life products which may force companies to raise prices.

Under a broader industry view, large insurance firms with well diversified portfolios will face relatively lower capital requirements than smaller companies exposed to one type of risk. Furthermore, larger companies will most probably be able to develop their own internal model than use the standard model, which will most likely again lead to marginally lower capital requirements compared to smaller firms which will apply the standard model. Thus, while in the short-run prices may decrease, as capital requirements will most probably be lower for larger companies, in the long-run a concentrated industry sector may lead to less

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2 *Report on the Possible Impact of the Likely Solvency II QIS5 Standard Formula on the European Life Market*, Milliman Research Report, June 2010.

competitiveness and thus to a steady price increase. This factor should not be underestimated.

Last, special attention must be paid in creating a regime that does not introduce unnecessary regulatory costs, as these costs may lead to price increases as well.

Question 38: Would the Commission Services' suggested approach for level 2 implementing measures result in a reduction of cross-subsidisation between different lines of business or groups of policy holders? (Please provide details of which lines of business or groups of policy holders will be most affected and the reasons for this.)

The risk-based assessment and valuation will lead to clearer rates of return among different lines of business. This may induce undertakings to proceed to cross-subsidisation; however, this leads to higher transparency as well, so that cross-subsidization is limited. Overall, the Commission Services' suggested approach for level 2 implementing measures is expected to lead to higher transparency and thus limit cross-subsidisation.

Question 39: Would the Commission Services' suggested approach for level 2 implementing measures stimulate product innovation? (Please provide examples of the type of product innovation that is expected and details of the lines of business that this product innovation will relate to.)

Solvency II modifies the principles for the risk assessment in the management of assets and liabilities in the EU insurance sector. Insurance companies will therefore be motivated to develop new products that will optimize a new cost-benefit trade-off within these new risk-based principles. New products are expected to emerge especially in the life insurance sector, as such products require higher capital backing. The non-life sector is expected to face some alterations as well. Overall, new products are expected to emerge after Solvency II is implemented.

However innovation should be treated with a certain level of caution. We should not forget that one of the (many) main reasons that led to the global financial crisis was financial innovation which led to products that were not assessed accurately in terms of risk.

Question 40: Would the Commission Services' suggested approach for level 2 implementing measures result in a withdrawal of certain products from the market? (Please provide reasons and examples of products that may be withdrawn.)

As described in Question 37, Solvency II captures a wide variety of risks leading to higher capital requirements for products with high volatility in their claims and long-term products. Thus, the SCR for non-life insurance products is likely to be significantly higher than the current level, while the SCR for life insurance products is expected to be closer to the current level.

Thus, ceteris paribus, undertakings may be motivated to shift their capital to low-frequency, high severity lines of business. Guaranteed products are expected to be reduced or imposed higher fees and in extreme cases, non-life insurance products may disappear, as consumers may consider them as being too expensive to buy.

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Question 41: Would the Commission Services' suggested approach for level 2 implementing measures promote particular types of insurance business model (e.g. specialisation vs. diversification, joint-stock companies vs. mutuals, branches vs. subsidiaries, groups vs. single legal entities)? (Please provide reasons and examples.)

Solvency II directive and level 2 implementing measures promote well designed and implemented process of risk management that can be authorized by supervisory authority. It promotes institutions that are well equipped with human and capital resources. That is why a special attention should be paid to the small and mutual insurer that could be in a detrimental situation, especially in the initial phase of implementation process. It requires very careful execution of the principle of proportionality that would not weaken consumer protection in the same time. It is therefore appropriate that in the implementation phase the effect on small and mutual insurers should be carefully monitored in the initial phase of implementation.

Question 42: Would the Commission Services' suggested approach for level 2 implementing measures affect competition across undertakings in the EU and/or the functioning of the internal market? (Please provide reasons and examples.)

Insurance markets are still national one and Solvency II regulation would not probably change a lot in this respect, if not even lessens the competition (see answer on question 37). From consumer perspective the mechanisms that would encourage to buy insurance products cross-border are fast and accessible Alternative Dispute Resolution and minimum security provided by Insurance Guarantee Schemes. Solvency II is a very wide and complex directive, however it is not panacea for all problems. Without effective and efficient ADR and IGS hardly any regulation would affect competition.

Question 43: What would the impact be of the Commission Services' suggested approach for level 2 implementing measures on small or medium-size enterprises as buyers of insurance? (Please provide examples.)

The impact on small or medium-size enterprises depends largely on business model that would be incorporated by insurance companies within certain market conditions (like competitiveness) and regulations, and level 2 implementing measures are not the only factor. However as more emphasis will be put on proper risk management within insurance company, then one could assume more tightness on risk management process within policyholders, especially in business lines long lasting guarantees. Low level of risk culture in small or medium-size enterprises may increase prices.

SMEs are often opaque and the smaller the company the higher the level of opaqueness. Opaqueness means risk and within a risk-based assessment framework SMEs will most probably face higher insurance prices.

Question 46: What social, environmental or economic knock-on effects could occur as a result of changes to the design, pricing and availability of insurance products? (Please provide examples.)

The most dangerous effects could be: financial exclusion (due to higher premium) or lack of insurance products providing long-term guarantees (like: long-term care or annuities). Low income consumers, and thus riskier for the insurance firms, and in general the most vulnerable parts of the society, are expected to be more severely affected due to the new risk-based assessment orientation. The final social effects will depend on the social security coverage assured by the state. However the last trends emphasize the role of individual awareness of citizens.

Question 47: Would the Commission Services' suggested approach for level 2 implementing measures make it easier or more difficult to obtain insurance for certain risks or groups of policy holders, and will there be a transfer of risk from insurers to consumers? (Please provide examples and where relevant, details of the risks and/ or groups of policyholders affected.)

If the underwriting process strengthens relation between risk and premium and cross-subsidization within certain business lines and among business lines is to be lowered then one could expect problems for groups with substandard risks. The FSUG is especially aware of low-income households and SMEs. Solvency II shall not be a welcome carte blanche for every kind of increase of prices (premiums). The supervisory authorities' approach to new regulations should avoid unreasonable, not comprehensive or even sharp price increases for policy holders with small income. If price increases occur they should not be a matter of self-fulfilling prophecy but should be explainable on very concrete accounting principles.

Question 48: Would the Commission Services' suggested approach for level 2 implementing measures have significant consequences for the financial situation of individuals/ households, both immediately and in the long run? (Please provide examples.)

The access and price for long-term investment products, long-term health products and professional liability products could have significant influence on future financial situation of households and microenterprises, but the final effect will depend on the impact on prices, which is rather difficult to estimate (see answer on Question 37)

Question 49: What is the impact on the social inclusion and protection of particular groups? (Please provide examples of the specific groups of individuals affected (e.g. firms, localities, the most vulnerable, the most at risk of poverty, the elderly.)

Please see an answer on question 46 and 47. There is also a threat that it would cease any existing and prevent any new micro-insurance initiatives.

Question 50: Would the Commission Services' suggested approach for level 2 implementing measures affect some categories of consumers more than others (e.g. elderly people vs. younger people; low income consumers vs. high income; people collectively insured vs. people individually insured)? (Please provide details of the expected affects and examples.)

Please see an answer on question 46.

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Question 51: What is the impact on the access to, and effects on, social protection and health systems?

There is a real danger that the access to long-term care products and annuities would be heavily affected.

Question 52: Would the Commission Services' suggested approach for level 2 implementing measures impact more heavily specific types of health insurance products (e.g. disability insurance, long term care insurance)? (Please provide examples of the expected impact.)

Due to the fact that the costs of long-term care and most of health care services grow faster than inflation it is essential to assure adequate financing. That is why long-term products will be affected by the implementing measures.

Question 53: Would the Commission Services' suggested approach for level 2 implementing measures have significant effects in certain Member State and/or regions due to the specific role played by the private insurance in those Member States/regions (e.g. primary and complementary health insurance)? (Please provide details of those effects and examples.)

As implementation of Solvency II is based on maximum harmonization principle the countries with present low capital adequacy will suffer deeper and negative consequences are much more dangerous for the market and consumers. That is why a identification of such regions, followed by close monitoring, is required to make the implementation process as smooth as possible.

Question 55: Would the Commission Services' suggested approach for level 2 implementing measures impact the investment policy of insurers? (Please provide reasons and examples.)

The precise effect of the implementation of Solvency II on investment into SMEs hinges on the treatment of equity for capital adequacy purposes. Equity is generally riskier than many other assets (such as bonds, for example), and many believe that small business or private equity may be significantly riskier than those traded on recognized capital markets. It is important to recognize for Solvency II purposes that equity stakes in smaller, private businesses may not be traded in liquid markets, which means that regulated parties assume the additional risk of having to dispose of them in a fire sale. SMEs whose shares are traded in illiquid markets most likely include even the majority of publicly listed SMEs – as per the findings in the Demarigny Report that top 7 % of companies by market capitalization benefit from more than 93 % of the available liquidity.[3]

3 *An EU-Listing Small Business Act - Establishing a proportionate regulatory and financial environment for Small and Medium-sized Issuers Listed in Europe (SMILEs)*, F. Demarigny, March 2010.

2. CONCLUSION

Not questioning the principles of Solvency II the FSUG would like to emphasize that not only insurance companies are to be aware of risk management. Retail user of insurance products should be also taken into consideration during and after implementation of Solvency II. Households and SMEs should be prepared for more effective and efficient risk management, just like insurance companies.

Within implementation process of Solvency II the balance between security and accessibility is to be reached by regulators and supervisory authorities. That is why EIOPA should implement monitoring system and building conceptual model that would help reaching the balance and avoid shifting all risks and costs on consumers. It is very important also due to forthcoming regulations on Insurance Guarantee Schemes that will results in price increase, at least in some of the countries.

Due to time constraints the FSUG was not able to answer fully on the question. However we would like to encourage the Commission Services' to contact us if any further explanation is needed.