VIA ELECTRONIC MAIL

Mr. Bukhard Balz
Ms. Sharon Bowles
Mr. Ashley Fox
Mr. Sven Giegold
Ms. Sylvie Goulard
Mr. Peter Skinner
European Parliament
Rue Wiertz, 60
B-1047 BRUSSELS

06 March 2012

Dear Mr Balz, Ms Bowles, Mr Fox, Mr Giegold, Ms Goulard, Mr Skinner,

We are at a crucial phase in the development of Solvency II. The stakes are high given the importance of the role of the insurance industry in the European economy.

Solvency II stakeholders have been working hard for many years to achieve a risk-based prudential framework to ensure robust policyholder protection, strengthen the sector's attractiveness and increase its transparency. Hence, we support the timely entry into force of this regime. In preparation for this, there are significant issues highlighted in this letter that need to be resolved satisfactorily to avoid significant adverse consequences.

We welcome the valuable engagement of the European Parliament to seek solutions. However, the most recent proposed amendments on Omnibus II by Members of the European Parliament would not resolve the key issues.

It is vital that Solvency II enables us to continue to provide important economic and social benefits to Europe's citizens. Solvency II must provide the right incentives for the provision of long-term investment for economic growth and for long-term products for customers to plan their retirement.

Insurers manage diverse pools of liabilities and assets for the benefit of their customers. Our liabilities are generally long-term and have stable cash outflow profiles. Therefore, insurers are substantially able to match these long-term liability profiles with cash inflows of long-term investments. By taking a long-term investment perspective, the insurance industry not only supports the real economy but also contributes to financial stability because it is not a forced seller of assets in volatile markets. As major institutional investors – with nearly €7,500bn of assets under management – the insurance industry contributes significantly to economic growth.

It is clear that the Solvency II regime presents a number of challenges which have been highlighted by the significant market movements during the second half of 2011 and the associated volatility of insurers' solvency ratios under the current Solvency II proposals. This volatility came from the widening of both sovereign debt and corporate debt spreads on the asset side, only partially offset by a discount rate on liabilities based on swap curves, if no Matching Premium (MP) and Counter-Cyclical Premium (CCP) mechanisms are introduced. The essence of insurance management is, to the extent possible, to reduce asset and liability mismatches. The introduction of MP and CCP would reflect in a mark to market environment the fact that cash-flows are matched and that losses resulting from the widening of spreads are unlikely to materialize. This has been magnified for insurers despite the fact that the nature of our business means that our own funds are not exposed to such volatility. Unless appropriate counter-cyclical measures - to help to deal with the cost of market volatility affecting the economic position - are in place, it will be a significant challenge for insurers to provide long-term guarantees to policyholders and to maintain their role as long-term investor in the economy.

Across Europe, it is important that we avoid unforeseen and unintended consequences that we know would damage the environment for vital pension savings and long-term investments for millions of EU citizens and businesses. Urgent action is also needed to remove regulatory barriers to investment in infrastructure.

The Bank of International Settlements, having examined how insurers and pension funds would be affected by forthcoming accounting and regulatory rules, reached a similar conclusion[1]:

> "A related concern is whether life insurers and pension funds can maintain a long-term investor perspective. … A partial retreat of institutional investors from the long-term and/or illiquid segment of the credit market could reduce the private and social benefits the sector generates through long-term investing, and the extent to which it mitigates the pro-cyclicality of the financial system."

In the absence of MP and CCP, any further widening of spreads would lead insurers to pro-cyclical behaviours, i.e. selling good quality sovereign bonds or corporate bonds at high spreads, hence further increasing market disruption.

The European Commission recognised these challenges in early 2011 with the formation of the Working Group on Long-Term Guarantees. This work concluded that the following counter-cyclical mechanisms should be in included in the determination of the risk free interest rate term structure:

- A **Matching Premium** (MP) to remove the impact of artificial volatility from the asset liability management of insurance portfolios. It applies across all European markets and must be based on the characteristics of insurance portfolios under specifically defined criteria.
- A **Counter-Cyclical Premium** (CCP) to only apply in exceptional market circumstances. Contracts to which a MP is applied would not apply the CCP.
- An **Extrapolation Methodology** to provide a way to extrapolate the interest rate curve beyond the point where the market is deep and liquid.

Aspects of these solutions were incorporated into the draft level 2 implementing measures circulated at the end of October 2011. However, in particular the predictability of the application of the CCP and the scope of the MP still need to be addressed.

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[1] BIS (July 2011) "Fixed income strategies of insurance companies and pension funds"; report submitted by a Working Group established by the Committee on the Global Financial System.

As part of this work and to help deliver Solvency II, European insurers joined together to support the set of key measures that the industry believes would address the challenges. These proposals address the provision of long-term guarantee products and other key measures required in the draft implementing measures (please see Annex).

The industry has been recently exploring technical details around the following:

- The refinement of the matching premium for EU wide application taking into account insurer exposure to spread movements.
- To give predictability, identify objective trigger points for CCP application.
- To maintain the right to use the basic risk-free interest rate without any adjustment where consistent with the way the business is managed.

The direction of the most recent discussions in the European Parliament and its proposed amendments on Omnibus II would be a major change of approach. This alternative approach will not resolve the significant issues for long-term products or long-term investments. The long-term issues arise essentially because of artificial volatility within own funds (balance sheet). Any solution should primarily focus on resolving this rather than providing an adjustment of the capital requirements.

Our proposals set out in the Annex include other key aspects relevant to Omnibus II such as equivalence, soft-launch arrangements and group solvency. As you approach the forthcoming vote on Omnibus II by the European Parliament's ECON Committee and the subsequent 'trialogue', the industry would like to reiterate full support for its previous proposals in order to inform your ongoing discussion and ensure that the necessary legal hooks in Omnibus II are provided.

Our proposals also include a number of other key measures (e.g. contract boundaries, treatment of own funds and deferred tax) which are important aspects of the Solvency II implementing measures. A number of these issues have yet to be addressed and more recently in the latest version of the implementing measures an issue on the treatment of tiering has arisen. We would like to make ECON Members aware of these issues in the context of your forthcoming deliberations on the implementing measures.

The European insurance industry continues to engage in a constructive dialogue with all EU institutions. We remain at your disposal to provide further input where required.

Yours sincerely,

Alex Wynaendts

Chairman of the
Pan- European
Insurance Forum

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Sergio Balbinot

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Insurance Europe:

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, 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 100bn, employ nearly one million people and invest almost €7 500bn in the economy.

About the PEIF:

The Pan-European Insurance Forum (PEIF) is a group of CEOs of major insurance companies in Europe, consisting of AEGON, Allianz, AVIVA, AXA, GENERALI, ING, MAPFRE, Munich Re, RSA, Swiss Re, UNIQA and ZURICH Financial Services. PEIF Members strive for a strongly competitive and fully integrated European insurance market. PEIF companies represent 68% of the STOXX® Europe Insurance.

Transparency Register lobby.

Annex – Outstanding concerns to be addressed

To assist the European Commission in their ongoing deliberations of Solvency II the industry jointly submitted a set of key measures in July 2011.

We continue to fully support these key measures which are restated below, taking into account where i) we have been undertaking further work or ii) new issues have been identified.

1 Provide appropriate basis for the provision of Long-term guarantees

The financial crisis has evidenced the extreme potential swings in the market which have a direct impact on valuation of assets in a market consistent solvency regime. At the same time, insurers have liabilities that are very stable in nature which provides stability to the financial system as a whole and which must be preserved. It is therefore crucial to reflect these peaks and troughs in the market directly in the liability valuation in order to dampen the crisis driven by asset volatility. To this end, the following mechanisms should be in place:

<u>Matching Premium (MP)</u>

The Matching Premium (MP) aims at removing artificial volatility arising from spread movements and at maintaining insurance undertaking's ability to meet its liabilities to policyholders. The industry has explored the basis for its application across Europe taking into account insurance portfolios exposure to spread movements.

- The current European Commission Level 2 draft matching premium proposals applies to specific cash flow matched contracts. Its application needs to be refined to ensure a level playing field across Europe. The original proposals are outlined below and these are being further developed.
    - Application should apply to high quality eligible assets, not exclusively bonds.
    - Application should not be to single premium contracts exclusively, but should also apply to the cash flows related to paid-in premiums on regular premium contracts.
    - Application should be possible for contracts with immaterial surrender risk as well as other immaterial underwriting risks (e.g. mortality).
- The products should not need to be "ring-fenced" – a requirement to separately manage the assets and liabilities should suffice.
- The calculation of the matching premium should be based on an expected default approach not on historic average spread. The expected default should be predominantly based on historic default data with reference to current data, otherwise it would not meet the aim of aligning the premium on the liability side with the move in the market values on the asset side.

<u>Counter-Cyclical Premium (CCP)</u>

The Counter Cyclical Premium (CCP) is designed to enable the industry to cope with "extreme" market conditions. Contracts to which a Matching Premium is applied would not apply the CCP.

- It should include an illiquidity premium, a government spread premium and an additional discretionary component. EIOPA could amend (positively or negatively) the results of the illiquidity or government spread formulae by using the additional discretionary component to reflect temporary distortions in the financial markets. EIOPA would be required to provide justification and notification before applying such an amendment.

- Formulaic approach should be specified under Level 3 while objective criteria to automatically trigger the application should be defined in level 2. This to have certainty and ensure transparency on its amount. A formula-based approach is needed to automatically determine the impact of a counter cyclical premium in different market conditions.
- Calibration of CCP SCR shock and correlations are currently excessively prudent and not justified.

To facilitate a predictable application of the CCP, the industry has conducted further detailed work and suggested objective triggers when the CCP should be activated and deactivated.

<u>Extrapolation</u>

- In normal market conditions, the EURO bond market is considered as deep, liquid and transparent up to the maturity of 20 years, but not beyond. Same principles should apply for other currencies generating different starting point for extrapolation.
- The extrapolation method should be such that the forward interest rate term structure is stable over time for those maturities which are 10 years or more beyond the beginning of extrapolation.
- Interest rate shocks on extrapolated part of the curve needs to be consistent with extrapolation.

<u>Equity risk dampener</u>

- The design of the equity dampener should be reviewed to ensure a symmetric and adequate behaviour.

2 Recognition of Long-term business: an appropriate definition for Contract Boundaries

We reiterate the extreme importance for an appropriate definition of contract boundaries based on an economic approach recognizing cash flows from long-term insurance business and also capital charges for risks attached to these cash flows.

If the definition would deviate from these principles, the implications would be far-reaching with (i) punishing companies to manage their true economic ALM profile as the companies will be forced to manage to an artificially low liability interest duration, (ii) leading to the risk of known obligations remaining off balance sheet, and (iii) misalignment between internal decision-making model and regulatory capital model which will lead to a meaningless Use-Test.

Therefore, we reiterate that all expected future premiums should be allowed including business subject to re-pricing at the portfolio level. This means that:

- future cash flows under unit-linked and other savings contracts should be included;
- future cash flows under all group contracts including pension should be included, with
- a specific treatment for health non-SLT business satisfying certain conditions, given the specificities of these business lines.

3 Fair treatment of the in-force portfolio (so called "EPIFP")

All expected premiums and charges linked to contractual obligations should be measured over the life of the business on an economic basis and not be subject to tiering.

Therefore we reiterate our messages:

- EPIFP should be retained 100% in Tier 1;

- We do not support public disclosure requirements and if the concept were to be retained for disclosure purposes it should be based on “net cash flows” rather than the current asymmetric “profits” definition;
- We do not support the proposal tabled by the Commission for the last SEG meeting to give supervisors the ability to apply a capital add-on for the lapse risk module in relation to EPIFP. Such an approach seems inconsistent with the calibration requirements for lapse risk and could result in inconsistent applications across markets.

Apart from the requirement for public disclosure, the above raised concerns in relation to the treatment of EPIFP have been addressed by the draft implementing measures as published by the European Commission in October 2011. However, on a potentially related issue, the calibration of the lapse risk module has been inappropriately raised from 30% to 40%, for which we have seen no corresponding calibration analysis and which we strongly oppose.

4 Group Solvency and the treatment of fungibility

Solvency II solo and group calculations shall not be influenced by national statutory regulations, particularly not by national accounting rules. We reiterate the need to consistent interpretation from our various authorities, especially for our non-European surplus, once Solvency II is implemented. Groups should be treated as one unit.

5 Treatment of net DTA

- The proposed treatment of deferred taxes as Tier 3 is not appropriate.
- The calculation of the Risk Margin should include allowance for the loss-absorbing capacity of Deferred Taxes.

6 Own Funds

Treatment of new hybrids

We reiterate the need to amend the treatment of hybrids in Level 2 to reinforce the permanence of hybrid capital while enhancing insurers’ access to capital market:

- Increase the maturity of Tier1 (30 years instead of 10 years in current draft level 2) but 5 year call date allowed for Tier1 to be treated the same way that banks.
- Increase as well the permanence of Tier 2 by increasing the maturity to 10 years to avoid “5 year bullet Tier 2”.
- Simplify the layers of subordination.

The first two points of the above raised concerns in relation to the treatment of new hybrids have been addressed by the draft implementing measures as published by the European Commission in October 2011.

Tiering

In addition, we would like to draw your attention to a new issue which has arised since July 2011:

- The own funds Tiering limits should apply to all eligible own funds, including surplus own funds, and not just to the own funds that cover the SCR.

7 Non-life and Health Non-SLT treatment

- The industry and EIOPA reached a good compromise in the task force working on the Non-life calibration for premium and reserve risk for those lines of business for which the calibration has been finalised.
- The treatment of CAT risk is still very concerning, for which many of the proposals set out by industry were unaddressed by the task force working on this issue. However, we should note that we welcome the task force proposal to recognise geographical diversification for non-EEA entities in the factor-based approach, and we are concerned by the amendments made by the Commission to this proposal for the 22 June SEG meeting.
- Appropriate treatment of non-proportional reinsurance in the standard formula should be supported with a risk sensitive approach and the allowance for different USP methods.

8 Participations

- All participations should be treated as strategic, in line with the Level 1 text, and should have a 22% equity shock.

9 General transitional for a soft launch of Solvency II

- A main priority should be to develop a system that is workable for all undertakings. Postponing inappropriate rules is not the solution.
- The industry is ready to work with a soft launch of Solvency II as long as legal transposition of Solvency II stays as planned (2013) and that the provisions necessary to begin the process of supervisory approvals (e.g. full and partial internal model, approval of USPs) should still apply from the date of transposition of Solvency II into national law.
- Under this soft launch, undertakings will need at least 18 months between finalisation of the reporting templates for Solvency II and the first requirement for undertakings to report, in order to implement the necessary systems.
- Should not circumvent the need for specific transitional provisions e.g.: equivalence (see # 10 below); hybrids for 10 years.
- The use of an internal model should be allowable during the soft-launch phase – “opt-in option”.

10 Equivalence Transitional

- The equivalence transitional for third countries should apply for 5 years with a review clause for an additional 5 years, with agreed milestones set at the outset.
- The transitional should not be weakened by additional level 2 requirements which require the Group supervisor to consider whether the use of the deduction and aggregation method (method 2) would materially affect the results of the Group solvency calculation relative to using method 1 (consolidation).