Director General

To: Mr. Klaus Wiedner
Head of Unit, Insurance & Pensions
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1049 Brussels

Your reference: -

Our reference: ECO-14-042

Subject: Final Insurance Europe letter on SII Delegated Acts

Brussels, 06 March 2014

Dear Mr Wiedner,

On 13 November 2013 the trialogue parties agreed on a solution to the outstanding issues on Solvency II. A number of measures were decided that will safeguard the capacity of the insurance industry to provide long-term products and guarantees and to compete internationally. These measures will thus help maintain the insurance industry's role in providing long-term investment and generally acting as a stabiliser in the economy.

The European insurance industry is very concerned about the current version of the draft Delegated Acts (DAs), as they contain deviations from the trialogue agreement made at Level 1, as well as wordings and calibrations that will not work as the trialogue parties intended.

The industry has identified a list of over 100 concerns but, in light of the extremely tight timeline for the implementation of Solvency II, we here highlight the eight highest priority issues that require improvement in order to align the draft DAs with the trialogue agreement and to avoid unnecessary negative effects on policyholders and the economy.

The eight are:

- The credit risk adjustment
- The volatility adjustment
- The matching adjustment
- Extrapolation
- Long-term investments
- Equivalence
- Currency risk
- Own funds

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If not addressed appropriately, these issues would not just dilute, but undermine the trialogue results. They could limit insurers' ability to contribute to long-term investment and stability, could have an impact on the availability, price or performance of insurance products for policyholders, or could harm the European industry's ability to compete internationally. They would entail inappropriate costs (capital costs or operational costs) and unnecessary restrictions.

Insurance Europe remains committed to maintaining the current timetable, as, we know, does the European Commission. We therefore restrict our comments and proposed solutions in the attachment to these eight issues.

We remain at your disposal should you require any additional information or explanations.

Yours sincerely,

Michaela Koller
Director General

__The 8 Highest Priority Issues to address__

We describe below the 8 highest priority issues for finalising the DAs and also provide (in bold) high level descriptions of the solutions to address many of them.

1. Credit risk adjustment

Section 4.1 of the draft DAs determines the "basic risk-free interest rate term structure", specifying for each currency that it shall be derived from interest swap rates. This term structure is one of the most important variables for insurance undertakings as it is the basis to derive the rates at which all future liabilities are discounted. Article 38(1) of that section stipulates that the swap rate should be "adjusted for credit risk" with a Credit Risk Adjustment (CRA).

However, there is no single way to define the risk-free rate and different methods are used across markets by academics, investors and regulators. The CRA itself, therefore, is a questionable concept and any method chosen for Solvency II will be a somewhat arbitrary decision. However, it is a decision which can have a very large impact on the pricing and availability of products and also on investment behaviour:

- A high CRA will be very costly, tying up billions of euros unnecessarily. We estimate that setting the CRA at 35bps would reduce available capital by over 20%, relative to a CRA of 10bps, and therefore increase costs for policyholders.
- Credit risk adjustment in the swap curve would penalise, in particular, long-term liabilities for which the discounting is particularly relevant. The adjustment is therefore not neutral over liability and asset duration, and would move insurers to favour shorter-term business, which is not in the broader policy interest.
- A volatile CRA cannot be hedged and so will cause volatility even for a company with very high quality assets perfectly matched with liabilities – again, this will cause far greater volatility for long-term business than short term business (see above).

In addition the current method proposed in the draft DAs for setting the CRA is flawed because it:

- Uses data for calibrating the CRA which reflects much more than the default risk – this results in unnecessarily high calibrations.
- Is based only on very short term (6 month) data which is then applied to the entire 20 year[1] swap curve.

Therefore, if there is to be any CRA, there should be a cap set at 10bp and the methodology for setting the CRA should use data of appropriate durations, exclude non-default related elements, and use long-term averages.

2. Volatility adjustment

The volatility adjustment (VA) – derived from EIOPA's work on the long-term guarantee treatment – was a key component of the Omnibus II agreement and it is fundamental to shelter insurance undertakings against undue short-term market volatility and to avoid pro-cyclicality.

However, it should be recalled that the shelter provided through the proposed VA is incomplete. It was fixed at 65% in the Omnibus agreement, which means that over one third of financial market volatility is passed through to insurers' balance sheets, causing fluctuations in capital and raising the size of the necessary capital buffer. Any differences between companies' actual assets and the standard reference portfolio used to generate the VA will cause additional volatility.

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[1] 20 years is the last liquid point in the case of the Euro – other currencies will differ.

In order to be a reliable element of the regulation, the volatility adjustment, laid down rudimentarily in Article 41 of the draft DAs, needs further specification to ensure that the impact of the adjustment does not fall below that envisaged when the 65% calibration was agreed at Level 1.

There are three key areas where the DAs require changes to ensure the politically agreed outcome is maintained[2]:

- In the draft DAs the volatility adjustment is based on a formula relying solely on the weights of bonds in a representative portfolio where equity and property are also introduced. The impact of this will be to dilute the 65% calibration. A **simple adjustment to the formula can rectify this.**
- There is no wording on the specific method for calculating the risk-corrected spread – this element can completely change the overall calibration and override the agreed 65%. Therefore, the approach for determining the risk-corrected spread should be specified. **For government bonds, no allowance for default should be included, consistent with the assumption that no solvency capital is required in this respect. For corporate bonds, the allowance for default should be determined in a way consistent with that used for the matching adjustment.**
- National components of VA are potentially very important but appear to be ignored by DAs – **adjustments are needed to ensure this feature of the VA works as intended by Omnibus II.**

3. Matching adjustment

In order to maintain the political agreement reached in Omnibus II for the Matching adjustment (MA), a number of changes are needed:

- The calculation of the downgrade allowance in the fundamental spread has not been updated to reflect the removal of "cliff-edge" credit quality restrictions in Omnibus II: it is no longer appropriate to assume that all assets need to be immediately replaced following downgrade. Furthermore, it does not reflect economic reality to assume insurers replace assets on any downgrade. It is actually even contradictory to the underlying principle of the MA which requires insurers to maintain the assignment of assets over the lifetime of the obligation. **In order to ensure an appropriate calculation in line with Omnibus II, the text should be amended to state that insurers replace the assets only when they are downgraded to below sub-investment grade** (this is still a very prudent assumption). This approach will also reflect how insurance portfolios are managed in practice.
- Recitals are needed to ensure the MA works as intended by Omnibus II. **These recitals should clarify that companies are allowed to hold cash in their portfolios and ensure the fundamental spread calculation is done in line with Omnibus II** (for exposures to sovereign debt, the 'asset class' should capture the differences between individual Member States; for Eurozone Member States the long-term average shall be based on data starting in the year in which the Euro was introduced). It would also be useful to clarify that the calculation method does not require double counting of the fundamental spread.

4. *Extrapolation*

Extrapolation methods and calibrations will have an enormous impact on the valuation of liabilities and therefore the entire Solvency II system, particularly for long-term guaranteed products. Extrapolation methods which result in unnecessarily low or volatile discount curves will add significant unnecessary costs, especially for long-term products, and can make risk management very difficult. They could also result in market distortions if they force unnecessary market behaviour on the significant portions of the European insurance industry. These were subject to significant discussion as part of Omnibus II and it is vital that the DAs do not contradict trialogue results.

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[2] In order to ensure that the political agreement on Omnibus II has been followed through, the Delegated Acts should be written in such a way as to ensure that in applying the methodology to determine the Volatility Adjuster, the result for 2011 would be at least equal to 82.5 bps (this is the figure that results from applying the agreed 65% calibration to EIOPA LTGA results instead of the initial 20% calibration).

There are two areas related where the DAs need adjustment:

- *Extrapolation and interpolation of the risk-free interest rate*: There is a real risk that implementing methodologies and calibrations will result in the extrapolated part of the curve being overly sensitive to changes of the last liquid point. This can create unnecessary volatility and problems for risk management. **Therefore, the DAs need additional text making it clear that the extrapolation method needs to be designed and calibrated in such a way as to avoid creating over-dependency on the last liquid point.**
- Interest shock for interest rate SCR: The current text implies that the interest rate shock for the SCR should be applied to the extrapolated part of the curve. This undermines the rationale for the extrapolation approach chosen by Omnibus II, which is designed around the concept of a stable long-term rate (the ultimate forward rate). The current methodology also introduces a minimum absolute shock of one percentage point. This does not have any economic basis and could create scenarios with permanently negative interest rates. Such scenarios are unrealistic and were avoided until now; hence we do not understand why they have been introduced. The current methodology would create very large additional costs for long-term business. **Therefore, the DAs should clarify that the interest rate shock applies only to the curve up to the last liquid point, the minimum absolute shock should be removed, and that the interest rates cannot be negative.**

5. ***Long-term investments***

The Level 2 DAs must support the political efforts to foster long-term investment and investment in the real economy – this includes infrastructure, SMEs and securitisation.

Reviving long-term financing for infrastructure and the real economy remains one of the most pressing policy issues in Europe. Its importance is underscored by frequent discussions of this issue at the level of Heads of State and Government. The June 2013 European Council strongly supported the Commission's Green Paper on the subject, increased the EIB's capital for this purpose and encouraged private sector investments in infrastructure and SMEs. An additional element of this strategy is the intention to revive the securitisation market. This is urgently needed in view of the drawn-out process of bank deleveraging. So far, the DAs are not in line with this objective.

Insurers are well positioned to provide long-term financing to the real economy. They maintain long-term liabilities and can therefore hold long-term assets. As they are not exposed to liquidity risk, they can act as a stabilising force in times of financial stress. Changes are justified because the current approaches do not correctly reflect the real risks that insurers are exposed to when holding these long-term assets.

While ideal historical data sets are not available for many of these assets, this is the situation for a range of Solvency II calibrations and elsewhere this was not used as a reason to avoid calibration decisions. The importance of these asset classes and long-term investment in general is great enough to justify making decisions based on the available information:

- *Infrastructure*: There is evidence that infrastructure investments react less (or even not at all) to general financial market movements due to their long-term nature and underlying exposures. There is also evidence that, especially post-construction phase, the risks of default and/or recovery rates of infrastructure investments exhibit better performances than those of corporates. The calibration of capital charges for infrastructure investments have to allow for (i) the recognition of the specificities of infrastructure and implicit lower investment risk, as well as for (ii) the recognition of the low correlation between infrastructure risk and other asset risks. Such an approach would require a definition of infrastructure (for which proposals are being developed) along with simple approaches to improve the SCR calibration methodology. It may also require a different approach for calibrating charges in the construction vs the post-construction (operational) phase of infrastructure projects.

- *Securitisation:* While we welcome recognition that high quality securitisations can and should be identified, the definition of the high quality "Type A" is unnecessarily restrictive. Furthermore, the calibrations proposed are still unnecessarily high and will still not allow this asset class to be viable for insurance companies. For example, an AA 5-year securitisation will still get over 42% capital charge. This should be compared to a total actual accumulative default rate during the crisis (2007 to 2013) of only 0.14%.

- *SME investments* are key to funding economic growth in Europe. Insurers, via their long-term and illiquid liabilities, have the ability to hold such investments in their portfolios. The current calibrations do not appropriately take into account how the long-term nature of such investments and the risk mitigation of collateral and risk mitigation features can reduce the risk.

- *Long-term bonds:* These are actually the main way via which insurance companies invest long-term in the real economy. Omnibus II recognised that insurance companies can reduce and even eliminate exposure to spread risk on corporate bonds leaving instead exposure to default risk, and used this to design the Matching Adjustment and the Volatility Adjustment measures. This is currently completely ignored by the DAs where it is assumed that insurance companies are always, and fully, exposed to corporate spread movements. This is not true and, as a result, the SCR for corporate bonds, especially for long-term bonds, is set unnecessarily high.

- *Transitional measure for equity risk:* the DAs should reflect the Directive and therefore ensure that all eligible equities, including type 2 equities and investment funds, are in the scope of the measure.

6. Equivalence

The current draft DAs remove any real choice by group supervisors as regards the choice of method for calculating group solvency to be applied in relation to third country supervisory regimes deemed equivalent or provisionally equivalent. As such, the current draft DAs negate the Level 1 provisions on provisional equivalence that are intended to address the major level playing field issue for Europe's internationally active insurance groups. This, therefore, needs amending.

In Omnibus II the concept of (provisional) equivalence was a key part of the negotiations. It is clear that this was done so that groups with entities in third countries which were deemed (provisionally) equivalent are allowed to use the local capital requirements in calculating their total group capital. This can only be achieved by using the deduction and aggregation method (method 2). This was confirmed by the chair of ECON who after the trialogue agreement - in referring to the ten-year renewable period of provisional equivalence – said: "This gives a long period within which there is this effective equivalence, which means the insurance companies from Europe are able to operate under the local regime." It is further reinforced by Article 227 of the Directive which, in its opening paragraph, takes as its starting point the application of method 2. Although this does not pre-empt how a group supervisor exercises its choice of method under Article 220, Article 227's exclusive reference to method 2, its location in sub-section 3 on application of the calculation methods, as well as its explicit focus on situations of equivalence and provisional equivalence, indicate a presumption that method 2 would be applicable in such situations.

In order to align with the intention of the Directive, we therefore suggest that, **when the Commission deems the solvency regime in a third country either equivalent or provisionally equivalent, Article 321 of the draft DAs shall not apply to undertakings of that country and method 2 may be applied in relation to them. In addition Recital 149 is no longer required.**

7. Currency risk

The DA text is flawed. It creates incentives for poor currency risk management and penalises entities for meeting local solvency capital requirements, thereby exacerbating currency risk exposure. It will be costly for EU groups and solo entities which operate internationally, as it imposes a 25% currency charge on any surplus assets held in foreign currencies. The consequences for EU undertakings and groups engaged in global business will be the imposition of entirely unnecessary, inappropriate and counter-productive capital charges that could amount to several billions of euros. **Insurance Europe has presented an alternative method to EIOPA and the Commission which would address this issue and encourage correct currency risk management. The DAs should be changed to this method.**

8. Own funds

There are a number of issues with the classification and use of own funds that risk severely restricting the availability of these items and duplicating risk management actions across the business. These can create very significant additional capital costs which are unnecessary and will impact policyholders through pricing or availability of products. They may also impact the competitiveness of the European industry internationally. We have identified three main types of concerns: Tiering limits, unnecessary restrictions on flexibility of capital instruments and, unnecessary restrictions on fungibility of capital for group capital calculations. **Careful review of the own fund criteria is required and unnecessary and costly restrictions removed.**

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