CFO FORUM

CRO FORUM

20 MAY 2010

QIS5 Consultation Feedback: High Level Issues

The CRO Forum and CFO Forum are pleased to be able to provide comment on the QIS5 draft specification, as prescribed in the QIS5 consultation. We welcome the openness to cooperation between us and trust that this is merely a point in our continuous dialogue.

We note the marked improvements evidenced in the European Commission's draft QIS5 specifications, compared to the final advice for Level 2. We are most welcoming of:

(I) The recognition of 'in-force cash flows', or what CEIOPS terms as "expected future profits", as Tier 1 capital. A departure from the economic total balance sheet approach to define eligible own funds could have an impact in excess of €100 bn for the European Industry. Therefore, we welcome the classification of the excess of assets over liabilities in Tier 1.

(II) A wider application of the illiquidity premium to insurers' liabilities than a binary approach. The Commission is moving in the right direction. The Industry has provided a practical framework for the application of Liquidity Premium to the liabilities to be tested in QIS5.

(III) The allowance for diversification within the Risk Margin, where we welcome the definition of reference entity as set out in the QIS5 specifications, which allows diversification between lines of business within one entity and between entities at group level.

(IV) The calibration of the "global" equity shock of 39% and the symmetric adjustment mechanism calibrated over a 3 year period.

Nevertheless, the CRO Forum and CFO Forum still believe that the draft specifications are too conservative and need improvement in a number of areas. This document sets all our **high level issues** in relation to the QIS 5 draft specification and we provide separately a list of more detailed observations on the clarity of drafting.

We have also prepared separate short memos to cover technical issues raised during the QIS5 stakeholder's meeting on 30th April. We reiterate that the CRO Forum is currently conducting a pre-QIS5 exercise (11 major members agreed to participate in this survey). Results will be presented by early June to the Commission.

We would like to thank you for the opportunity to comment on the QIS5 draft specification, and we would like to offer resources to work together with CEIOPS and the European Commission in the coming weeks to help fine-tune the specifications in advance of QIS5.

N°	Separate contributions – short memos	Timeline
1.	Practicability Issues on QIS5 draft specifications	Sent on the 20th May
2.	CRO Forum final feedback on the CAT paper	Sent on the 20th May
3.	Joint Industry paper on the application of Liquidity Premium to products (allocation to the defined categories)	Sent on the 20th May
4.	Joint CRO Forum & CFO Forum paper on the calibration of the RFR for 13 additional currencies	Sent on the 14th May
5.	CRO Forum memo on Risk Free curve (LP extrap., Ultimate forward rate, floor for the basic RFR)	Sent on the 17th May to EC (14th to CEIOPS)
6.	CRO Forum memo on the Spread risk module to cover bonds, structured products, credit derivatives and covered bonds (calibration of the shock, design of the module).	
7.	CRO Forum memo on the volatility risk. This paper intends to remain neutral and addresses all the issues raised in recent discussions (relevance, practicability, horizon of the shock, scope)	
8.	CRO Forum memo on the Financial Risk mitigation to cover the treatment of hedging instruments and a simple approach to partially reflect Dynamic Hedging within the standard formula	
9.	Joint CRO Forum & CEA amended paper on the non-life module highlighting our concerns and present publicly the results from the CRO Forum benchmarking study on calibrations within Internal model.	

High Level Issues

High level Issue#	Reference	Description
H1	Ref: OF 7,8 & 9	**Treatment of excess of assets over liabilities** In defining eligible own funds, a departure from the economic total balance sheet approach could have an impact in excess of €100bn for the European Industry. In this respect, we welcome the classification of the excess of assets over liabilities as Tier 1. We understand, however, that the recognition of 'expected future profits' as high quality Tier 1 own funds is still being challenged. We believe this is at least in part due to a misunderstanding on the nature of these own funds under an economic balance sheet. We note that the term of 'expected future profits' may be misleading and we prefer to refer to them as 'in-force cash flows'. The inclusion of in-force cash flows in the definition of own funds is consistent with the economic basis of Solvency II, and not including them as tier 1 capital would introduce an inconsistent treatment between assets and liabilities resulting in an unduly conservative approach to the solvency assessment (own funds vs. capital requirements) arising from double counting of the associated risk. Possible variation of in-force cash flows is allowed for explicitly in setting required capital. Not including them in tier 1 capital would lead to double counting of risk. The potential quantitative impact of an inappropriate treatment of in-force cash flows would be of the order of €100bn for the industry, based on the current proposals for tiering limits that are far more conservative than what has been voted for in the Directive (min 50% of Tier1 and max 15% Tier3 to back the SCR). *Please refer to the joint Industry paper: 'Why expected future profit must be treated as Tier1 capital' published on April, 19th 2010* *http://www.croforum.org/publication/why_expected_future_profits__must_be_treated_as_tier_1_capital/* Similarly, there should not be a re-examination of the following items under the tiering restrictions,. These should be classed in full as Tier 1 capital: • Any differences between Solvency I balance sheets and Solvency II (e.g. Equalisation provisions) • Deferred tax assets: - We deem it inappropriate to only consider DTA without consideration of DTL. DTA has a clear economic value and a loss absorbing capacity when it is available - at least equal in amount of DTL. Only the excess of DTA over DTL could have a reduced loss absorbing capacity, unless there is convincing evidence that sufficient taxable profit will be available in the future against which the deductible temporary differences, the unused tax losses and unused tax credit can be utilised - We strongly believe that the application of the tiering concept in order to mitigate the risk of limited loss-absorbing capacity will lead to double counting of capital requirements. As a matter of fact, the tiering approach is appropriately applied to sources of capital which are exposed to risks that are not reflected in the calculation of Solvency Capital Requirement ("SCR"). Since the risk of limited loss-absorbing capacity of DTA is already reflected in the calculation of SCR, it would be inappropriate to reduce available capital by classifying a great part of DTA in Tier 3, rather than in Tier 1, and to put the insurer in the position to raise capital twice to cover the same risk
H2	Ref: OF.36	**Grandfathering Hybrid Debt Arrangements** We welcome the introduction of grandfathering for hybrid debt in QIS5, and more generally under Solvency II to avoid any market obscurities. In order to make sure that there will be an EU-wide level playing field grandfathering rules should be based on currently existing EU-wide Solvency I rules, where available. If none available, then we suggest the following rules to be tested under QIS5: • Tier 1: perpetual Solvency I compliant instruments; and • Tier 2: dated Solvency I compliant instruments.

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H3	Ref: TP.1.91.-TP.1.104.	**Boundaries of contract** We welcome the inclusion of future premiums related to in-force contracts in the computation of technical provisions. However: 1) As you are aware, we are working with European Commission staff to help clarify the intention around the contract boundary wording. 2) In addition, interactions between the cash flows to be projected out in the Solvency II balance sheet and the Solvency II requirements also require clarifications. While recognising the need for such risks to be included in the SCR, risks to be included in the new nl lapse risk module should be limited to premiums actually projected out in the technical provisions recognised in the Solvency II balance sheet.
H4	Ref:	**One year of new business** The draft specification does not include any detailed guidance on the treatment of future new business in the SCR and Available Capital. We would welcome additional guidance in the specification to explain how Article 101(3) should be applied and how the same business should be included as available capital so that SCR and Available Capital are consistent in terms of scope of new business considered. In addition, we would like to ensure that the amended QIS5 technical specifications would explicitly state that this one year of new business is related to new business written in normal conditions and not in stressed conditions.
H5	Ref: OF.2.4	**Treatment of Participations at Solo Level** Treatment of all strategic participations should be consistent. The value of all non-insurance financial sector participations being excluded from the own funds of the solo entity could lead to regulatory arbitrage and an understatement of the risk in respect of solo entities that have participations in other financial sector entities. Instead we recommend that they should be treated either as any other (strategic) equity investments subject to an equity shock in SCR of 22% provided that the double gearing is eliminated at group level or with a "look-through" approach (ie. consistent with the treatment of participations for groups as outlined in section G.2.2); when relevant information is available and in the context of the application of an Internal Model. In the absence of quoted prices, undertakings should have the possibility to measure participations using a mark to model approach. Moreover we disagree with the full deduction from own funds of intermediate holding companies. Such treatment does not have any economic background and is more penalising than proposals under the CEIOPS Final Advice (former CP67). The QIS 5 draft specification requires the deduction of own funds for all holding companies, insurance and financial, while the CEIOPS proposal only required the deduction for non insurance holding entities. We are not convinced that it is correct to apply implied volatility shocks to participations, considering that there is often no market implied volatility for a participation (because the participation itself is not traded).
H6	Ref: TP.1.326 TP.1.326 – 1.328	**Liquidity Premium** We welcome the proposals on liquidity premium, which represent a significant step forward and positive evidence of the European Commission, CEIOPS and industry working together. Liquidity premium is a powerful contra-cyclical mechanism and should be applied consistently across Europe. In this regard, we would like to ensure that Liquidity Premium will effectively be applicable to all liability cash flows (buckets: 0%/50%/75%/100%), The approach used by CEIOPS to extrapolate the liquidity premium is inconsistent with the illiquidity taskforce paper. The liquidity premium should be applied to the forward curve. *Please refer to the separate contribution from the Industry with a concrete and simple proposal to apply LQP to all lines of business.*
H7	Ref:	**Ring-fenced funds**

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	SCR.11.2	The definition of ring-fenced funds causes a significant amount of uncertainty. It is not at all clear what the definition under SCR 11.2 (a) refers to and it appears to add funds on top of those referred to under Level 1 (Level 1 refers to restricted Own Funds only). • The effect of barriers to the sharing of "profits and losses" should already be captured under the net asset valuation approach and the recalculation of Technical Provisions allowing for discretionary benefits. • Furthermore, the definition of ring-fenced funds should refer to those funds that are restricted on a going-concern basis only (in line with the definition of the SCR and the technical provisions). Own funds that are restricted on a winding-up basis would be set as Tier 2 rather than being excluded, under the tiering characteristics of Level 1. *Please refer to CEA paper on ring-fenced funds:* http://www.cea.eu/uploads/DocumentsLibrary/documents/1271423792_cea-position-on-ring-fenced-funds.pdf
H8	Ref: G.1.5	**Fungibility/Transferability of Own Funds at Group level** The Industry welcomes the fact that fungibility and transferability of own funds should not be proved within a night but within a 9 month (6+3 months) period of time, which is consistent with what has been voted for in the Directive (article 138 'non-compliance with the SCR'). We have proposed some minor redrafts that makes our interpretation clearer in the QIS5 spec – see our detailed feedback. We request clarification, however, on what we should disclose to our regulators for the QIS5 exercise in evidence of this item. We reiterate our position that ultimately almost all items could be made transferable because one could always sell these items/ entities at their NAV (less a cost to sell). In addition, own funds can be made fungible through active capital management such as restructuring or internal reinsurance. The consideration of fungibility must be separate from consideration of the Group SCR and diversification. The issue of fungibility should apply to the extent that any restriction (eg. caused by a ring fenced fund) is not reflected in the calculation of the Group SCR. We advocate for an unrestrained calculation of the SCR and Own Funds at Group level. This should be followed by an assessment of the impacts of fungibility constraints on the own funds by identifying the fungible and non-fungible shares of the excess capital at group level, by supervisors.
H9	Ref: TP 1.19	**Segmentation of life business** The QIS 5 draft is not in line with how insurers manage their business. Lines of business tend to change over time with product innovation and changing policyholder demands. We would like to see some flexibility around groupings, as the current drafting does not reflect the way we manage our business. The proposal should enforce companies to be aligned at least with the high level segmentation (4 types) but allow some flexibility for the sub-types.
H10	Ref: TP.2.67	**MVM on non-hedgeable financial risk** Based on current work of the CRO Forum workgroup on extrapolation, we suggest that the risk margin for non-hedgeable market risk and the extrapolation of the risk free curve should be considered simultaneously so as to avoid double-charging the same risk. The risk margin takes into account capital required to offset the interest rate risk that cannot be hedged in the market. We believe that observed market data that is the starting point for extrapolation already prices in the risk that for longer tenors there is already a mismatch in supply and demand (forward curve is consistently downward sloping beyond 20yrs for all major currencies). Furthermore, the long-term rate assumes no term premium. A lower term premium results in lower extrapolated rates and therefore also less risk in the un-hedgeable part of the curve. We believe that the current extrapolation and risk margin are therefore not set consistently. We strongly recommend not having a separate risk margin for non-hedgeable financial risk given the current level/ design of the Ultimate Forward Rate (term premium has been arbitrarily set at zero). *Pease refer to our separate memo on Basic Risk Free Rate / Extrapolation of LP*

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H11	Ref: SCR.5.29	**Consistency of Interest Rate shock with Extrapolation** As currently written, a stress of +25%/-30% for Interest Rate is maintained for maturities greater than 30 years. We recommend a reduction in the shock beyond 30 years: - the calibration of the shock to the risk free interest rate term structure should be made compatible with the relative invariance of the ultimate long-term forward rate - we note that the QIS5 assumption of a fixed charge beyond 30 years in fact results in an inconsistency with the MVM for non-hedgeable risk as well as this risk is double counted. Although more work needs to be done in this area beyond QIS5, we advocate a preliminary reduction in the shock beyond 30 years for the purpose of QIS5, and we will offer CEIOPS a suggestion on what such a preliminary reduction could look like.
H12	Ref: TP.2.19	**Diversification and risk mitigating effect of taxes in the risk margin** We welcome the definition of reference entity as set out in the QIS5 specifications, allowing for diversification between lines of business within one entity and between entities at group level. We consider that it is not an option to test diversification under QIS5 – we are pleased to see that Solvency II recognises diversification between risk categories and geographies. The risk mitigating effect of taxes should be reflected in the risk margin. The SCR reflects the risk mitigating effect of taxes. Since the risk margin is intended to be the present value of cost of capital on SCR, then it is inconsistent and unduly punitive to compute it based on something other than SCR (namely, SCR prior to reflecting risk mitigating effect of taxes). In addition, market consistent principles call for valuations at amounts for which liabilities could be transferred between knowledgeable and willing parties. Clearly, knowledgeable parties would reflect the risk mitigating effect of taxes on SCR.
H13	Ref: SCR.12.29	**Hedging instruments in all risk modules** Hedging instruments in all risks modules are only allowed with the average protection level over the next year. We strongly disagree with this treatment since it contradicts to the main aim of Solvency II, namely to have an economic framework. We understand that the idea is to prevent firms from window dressing, i.e. to avoid that derivatives are only installed shortly before the reference date and only for a very short time. As a compromise we suggest that hedging instruments with an average protection level of less than one year shall be fully allowed, under the condition that the firm has a well documented hedge policy in place and that the hedges are part of this hedge policy. *Please refer to our separate memo on Financial Mitigation and a simple approach to partially reflect Dynamic Hedging within the standard formula*
H14	Ref: SCR.5.109	**Spread Risk Calibration** The calibration of the credit spread risk module (bonds, non-OECD sovereign, structured products, credit derivatives, covered bonds) has increased considerably compared with QIS4. The level of credit shocks proposed for corporate bonds and structured credit (also considering the additional qualitative requirements) potentially causing severe dislocation in the capital markets across the EU. *Pease refer to our separate memo on spread risk module which details our counter-proposal of calibration for each rating & type of assets. It reiterates our Market Risk calibration study published last March.*
H15	Ref: SCR.5.115	**Spread Risk Design** We welcome the introduction of the illiquidity premium stress in the spread risk module. However, careful consideration will need to be given to the application of the liquidity premium to the liabilities (eg. allocation to the “predictability buckets”) in order to ensure appropriate results under the spread risk module. The current drafting of this module leaves room for ambiguity; we therefore request clarification on the way the ‘liability adjustment’ should be applied in the formula (SCR.5.115.) and we suggest a formula. *Pease refer to our separate memo on spread risk which details our interpretation of this liability*

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		adjustment and how the formula should be detailed, or our 'Detailed feedback' paper to draft QIS5 specifications.
H16	Ref: SCR.5.94	**Treatment of Sovereign credit risk** We believe that it is not appropriate to apply these overly prudent market risk charges to holdings of all non-OECD sovereign debt (China, Singapore, HK, South Africa vs Malawi or Yemen). - We oppose the application of the excessive credit spread risk charges to non-OECD government debt on the following grounds: (i) there is no evidence that the credit risk on these governments is anywhere near as high as the spread charges shown in SCR.5.109, (ii) for insurance undertakings in many territories it is often part of the core business model to invest heavily in domestic government debt (due to the absence of other suitable investments). We recommend that home govies (ie. invested in the same countries where insurance contracts are underwritten) are not stressed for the fundamental reason that home govies are what local insurers have to invest in to back their liabilities. The stress is zero for OECD home govies and should also be zero for non-OECD home govies. *Pease refer to our separate memo on spread risk module.*
H17	Ref: SCR.9.30 SCR.9.38 SCR.9.42 Annex K	**Non-life Calibration** We recommend further consideration of insurers' internal models experience in the calibration of underwriting risk in the standard formula, which reflects empirical evidence, therefore, adopting lower calibration factors. Despite improvements, recent recalibrations of insurance risk parameters are still overly conservative (~+20% on average for non-life compared to QIS4 and up to +50% for some lines of business). The industry does not find evidence that such increases compared to QIS4 can be justified. The recent financial crisis should not be justification for the massive increase in the shocks inconsistent with historical evidence. The increase is even more exaggerated when considering the calibrations included in the internal models of major European insurers as evidenced in the CRO Forum's non-life calibration benchmark survey (accounting for 26% of Europe's Gross Earned Premiums). Under such prudent calibrations, allowance of the use of Undertaking Specific Parameters becomes crucial; and should be widely allowed and facilitated by regulators. Fully recognizing risk mitigation and diversification is a crucial element to promote best risk management practices. We welcome the improvements to capture the effects of risk transfer through non-proportional reinsurance as well as the partial recognition of geographical diversification. However, we have issues with the granularity of the geographical segmentation (based on U.N geo schemes and not on a country granularity) and the level of the cap built into the Herfindahl index (that should not become a benchmark applied to Internal Model) that leads in practice to drastically reduce the intended level of diversification benefit. We recommend to use a geographical segmentation closer to QIS4 (EEA country/ region scheme) and to test both a 25% cap and 50% cap in QIS5. Even though the Catastrophe risk module is very likely to result in more sensible risk assessment, we expect further discussions and clarifications from the CAT taskforce, as this module currently appears capital intensive compared to QIS4. *Please refer to our separate memo on non-life risk that reiterates our concerns over the treatment of the non-life underwriting risk module and present publicly the results from the CRO Forum benchmarking study on calibrations within Internal model.*
H18	Ref: SCR.7.37 SCR.7.63 SCR.7.64	**Life Risk Calibration** The Industry has also concerns in the Life risk module: • the design and calibration of the Longevity risk sub-module (not risk sensitive as it is independent of the age of the insured or the duration of the contract), • the calibration of the Life risk Mass lapse stress that has not been supported by evidence, • non-recognition of natural hedges, and non recognition of geographical diversification (eg. within the lapse module) *See our detailed Feedback paper for further detail on these points*

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H19	Ref: SCR.3.2 SCR.3.5	**Operational Risk Calibration** QIS 5 calibration for operational risk increases capital requirements to a level significantly in excess of regulatory expectation. We would welcome further clarity on the rationale for the recalibration. On geographical diversification, it is important to reiterate the need for geographical diversification, which becomes even more relevant in light of the recalibration exercise. Finally, the design of the operational risk module uses the Basic SCR (BSCR). This BSCR does not take account of the risk absorbing effect of future profit sharing and deferred tax. These risk absorbing effects are economically realistic and should be allowed for before calculating the operational risk.
H20	Ref: SCR.13.7. & SCR.13.8.	**Reinsurance risk mitigation** QIS5 includes the requirements that (1) a reinsurance mitigation technique should not include a material basis risk (SCR.13.7) and (2) that no allowance shall be made for finite reinsurance or comparable SPV constructions in calculating the SCR of the non-life premium and reserve risk-module (SCR.13.8 2nd bullet point). We recommend the recognition of the existence of a capital reduction for all reinsurance risk mitigation techniques in calculating the SCR standard formula, as long as a genuine transfer of risk takes place. Furthermore, we suggest not using clauses such as the ratio of transferred premium to gross premium (as is the case in SCR.13.8 1st bullet point) for the recognition of recoverables or premiums for reinsurance risk mitigation technique. If for instance a significant and fairly stable "bulk business" is not reinsured, the ratio of net to gross risk of the overall portfolio may then be smaller than the ratio of net to gross premium.