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Mr Gabriel BERNARDINO
President of CEIOPS
Westhafenplatz 1
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Subject: Solvency II – QIS5 Call for Advice and Technical Specifications

Dear Gabriel,

Following the consultation on the fifth Quantitative Impact Study (QIS5), please find attached a Call for Advice asking CEIOPS to run QIS5. The Call for Advice requests CEIOPS to run the exercise between August and November 2010 and publish a report on the results of that exercise in April 2011 in order to provide quantitative input to the finalisation of the Commission's proposal on level 2 implementing measures for the Solvency II Framework Directive.

I would like to take this opportunity to thank CEIOPS for developing the draft QIS5 technical specifications and for the valuable technical support it provided during the consultation.

The draft Call for Advice and technical specifications have been discussed with Member States and stakeholders in several fora during the last months. Following these discussions, the Commission services have made a number of changes to the technical specifications. The updated technical specifications were extensively discussed at the meeting of the European Insurance and Occupational Pensions Committee (EIOPC) on 30 June 2010. Furthermore, the general approach to QIS5 was also discussed in your meeting with Commissioner Barnier on 24 June 2010. Before going into a discussion of the changes made to the technical specifications, I think it is important to reiterate some of the more important general points which arose out of the discussion in the EIOPC as well as from the meeting with the Commissioner.

The Commission services have listened carefully to comments made by CEIOPS, Member States and stakeholders. We are aware that not all stakeholders or Member States are totally satisfied with the choices made by the Commission services in the technical specifications, but we have done our best to reconcile the different positions and to test compromise approaches wherever possible. As the Commissioner indicated, it is important to reach a balanced approach in QIS5 that takes supervisory as well as general concerns into account.

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It is very important to stress that QIS5 is a test. This point should be clearly communicated to the participating undertakings. The technical specifications should not be seen as purporting to represent or pre-judge the final outcome of the discussions on the level 2 implementing measures for Solvency II. The intention of the Commission is to publish the proposal on level 2 implementing measures once the results of QIS5 are known. This ensures that the final policy decisions are made on an informed basis.

It was agreed in your meeting with the Commissioner that QIS5 should be used to collect additional empirical data which might help to improve the final calibration. This point was also stressed by Member States at the EIOPC meeting.

In several cases it was not possible to identify one single method or calibration to be tested. The Commission services have therefore, at certain points, set out multiple calculations in the QIS5 technical specifications. Where double calculations have been introduced, undertakings should carry out both calculations in order to ensure that a comparison of the results can be made. The services are aware that such double calculations may be burdensome for undertakings involved in the exercise. Double calculations must therefore be limited to the most important issues. After discussions with Member States it has been decided not to prioritise one calculation over another in order to ensure that undertakings will carry out both sets of calculations. In some cases, the Commission services believe that multiple calculations cannot be justified in QIS5 because the complexity of the calculations in these cases might adversely affect the willingness of undertakings to carry out the calculation or even to participate in QIS 5. In such cases, we are proposing that a restricted test is carried out for a sample of undertakings in parallel to the QIS5 exercise, with the support of industry and supervisors.

It is crucial for the successful introduction of the Solvency II framework that QIS5 provides a solid basis for the final calibration and for other elements of the level 2 implementing measures. A high participation rate in the QIS5 exercise will ensure that we base our decisions on representative data. The Call for Advice sets out an expected participation of at least 60% of insurance undertakings and 75% of insurance groups. It is particularly important that smaller insurance undertakings as well as reinsurance undertakings and specialised insurance providers are included. We also need a representative geographical coverage throughout the EU and participation of insurance undertakings in all Member States.

In order to ensure a high participation, I very much support CEIOPS' efforts to make the QIS5 spreadsheets, which are already being prepared, as user friendly as possible. They should in particular not overburden small and medium-sized undertakings. I would also like to reiterate my support for your idea to develop a QIS5 user manual in order to help in particular those undertakings which are new to QIS exercises.

I believe that a close cooperation between the insurance industry and supervisors is essential for the success of the QIS5 exercise. Supervisors should invite insurance and reinsurance undertakings to participate in QIS5 and provide appropriate support, in particular through an efficient question and answer procedure, seminars and where appropriate, communication through trade associations.

Detailed comments on the QIS5 Technical Specifications

The key changes made to the specifications in response to the issues raised during the consultation are set out below.

Discounting of technical provisions – The definition of the product buckets that determine the application of the illiquidity premium was amended to clarify the allocation of all insurance products among buckets. The scope of the transitional provisions on discounting was also broadened.

SCR standard formula: operational risk – The component for the increase of technical provisions was excluded from the calculation of the capital requirement for operational risk because it was considered not to be risk-sensitive.

SCR standard formula: volatility shocks – The volatility shocks were removed from the interest rate risk and equity risk sub-modules to avoid inconsistency with the treatment of other assets.

SCR standard formula: spread risk – In order to better capture the risks relating to the allowance of an illiquidity premium in the discount rate, the illiquidity premium shock was removed from the spread risk sub-module and a specific sub-module for illiquidity premium risk was introduced in the market risk module. The calibration on corporate bonds was lowered to reflect the removal of the illiquidity premium shock. Furthermore, a specific lower calibration for covered bonds of low default risk was introduced to reflect the particular risk profile of investments in these instruments. The design of the shocks on structured products was amended to avoid regulatory arbitrage between direct holdings of assets and holdings through structured products. A more granular approach to the shocks on credit derivatives was introduced in order to better capture their risk profile. The specific treatment of mortgage loans made to policyholders was removed to avoid inconsistency with the treatment of other assets. It was clarified that mortgage loans made to policyholders fall into the scope of the counterparty default risk sub-module.

SCR standard formula: concentration risk – In the sub-module for market risk concentrations the correlation parameters for the aggregation of different concentrated exposures were set at zero, based on the rationale that the systematic risk of these exposures is already captured in the other sub-modules of the market risk module. Moreover, intra-group exposures are exempted from concentration risk provided that they are already subject to group supervision.

SCR standard formula: life underwriting risk – The structure of the module was aligned with the structure set out in the Framework Directive. Based on additional actuarial analysis the stress for longevity risk was reduced from 25% to 20%. Furthermore, the increase of the stress for disability risk compared to QIS4 (change from 35% to 50% for disability risk of the next year) was reversed.

SCR standard formula: non-life underwriting risk – Based on additional actuarial analysis the calibration of the premium and reserve risk sub-module for some lines of business was reduced. Data from undertakings will be collected as part of the QIS5 exercise to further revise the calibration. The impact of the adjustment factor for non-proportional reinsurance was restricted in order to avoid inconsistencies with the calibration of the standard deviations gross of non-proportional reinsurance. The non-life catastrophe risk sub-module was amended based on the report of the CEIOPS task force on catastrophe risk. The non-life lapse risk sub-module was amended to capture the risk of mass lapse events.

SCR standard formula: health underwriting risk – For reasons of consistency, the scope of the module was extended to entirely include non-proportional health reinsurance. The correlation parameter for the aggregation of the capital requirements for SLT health underwriting risk and Non-SLT health underwriting risk was reduced from 0.75 to 0.50 because the high parameter was not substantiated by sufficient empirical evidence. With regard to health insurance that is technically similar to non-life insurance, the segmentation of health insurance obligations was amended to include a split between medical expense insurance and income protection insurance. The new split is believed to be more risk-sensitive. The calibration of premium and reserve risk for medical expense insurance and income protection insurance was revised, based on additional actuarial analysis. Data from undertakings will be collected as part of the QIS5 exercise to further revise the calibration. Special provisions for the treatment of health risk equalisation systems were introduced in the health premium and reserve risk sub-module. Based on the report of the CEIOPS task force on catastrophe risk, the non-life catastrophe risk sub-module was amended.

SCR standard formula: financial and insurance risk mitigation – In recognition of the features of commonly used financial risk mitigation techniques, allowance is made for rolling hedge programmes provided that certain conditions are met. It was clarified that no allowance is to be made for dynamic hedging as a risk mitigation technique.

SCR standard formula: treatment of participations in (re)insurance undertakings – QIS5 tests an equity shock for participations in (re)insurance undertakings that is based on the value of the participation. Additionally information will be collected to allow a better calibration of this approach and a better understanding of other different approaches.

Ring-fenced funds – In order to be in line with the economic approach of Solvency II, restrictions on reserves or provisions existing in financial statements, for example technical provisions set up in national accounts and equalisation provisions or reserves set up in national accounts, should not be considered to be ring-fenced funds in QIS5. Future transfers attributable to shareholders in respect of profit participation arrangements that are ring-fenced funds (shareholder value) should in most cases not be treated as restricted within a ring-fenced fund as these amounts are fully available to absorb losses. Diversification within ring-fenced funds is permitted for calculation of the notional Solvency Capital Requirement, but there is no allowance for diversification between ring-fenced funds and between the ring-fenced funds and the rest of the undertaking. This is in line with the Framework Directive requirement for the SCR to be adjusted to reflect the reduced scope for risk diversification in the case of ring-fenced funds.

Own Funds – A definition of expected profits included in future premiums (EPIFP) and a methodology for determining this amount according to a CEIOPS proposal was included in QIS5. Net deferred tax assets are included in Tier 3 in recognition of their reduced capacity to absorb losses. The criteria for grandfathering were revised so that undated paid in capital instruments, which meet certain criteria, are grandfathered as Tier 1 and dated capital instrument, which meet certain criteria, are grandfathered as Tier 2.

Groups – Calculation of the group risk margin was amended not to take into account diversification between entities. This approach reflects the expectation that the transfer of insurance and reinsurance obligations is not always made at group level or to a well-diversified group. For reasons of consistency, the group floor SCR was amended not to include the minimum capital requirement of other financial sector entities.

Double calculations in QIS5 are foreseen in the following areas:

Transitional provisions for the discount rate – In relation to insurance and reinsurance obligations subject to the transitional provisions for discounting, participants should calculate technical provisions both with and without the transitional provisions.

Internal models – Participants that already use a full or partial internal model should calculate the SCR both with the internal model and with the standard formula.

SCR standard formula: loss-absorbing capacity of technical provisions and deferred taxes – Participants should calculate the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes according to both the equivalent scenario and the modular approach.

Groups – Group participants should assess their group solvency based on both an accounting consolidation and on the aggregation and deduction method.

QIS5 will collect information to assess the impact of alternative approaches in the following areas:

Illiquidity premium – The discount rates for the calculation of technical provisions include an illiquidity premium. Data will be collected to assess the impact of the introduction of the illiquidity premium.

Risk margin – The risk margin should be calculated allowing for diversification between lines of business. However, the risk margin at group level should not take account of diversification between entities. We are proposing that industry and supervisors assess the impact of two alternative approaches for a restricted sample of undertakings and groups in parallel to the QIS5 exercise: Firstly, the calculation of the risk margin without allowing for diversification between lines of business. Secondly, the calculation of the risk margin at group level taking into account diversification between entities.

Participations – The equity shock for participations in insurance and reinsurance undertakings is based on the value of the participation. Additional information will be collected to analyse approaches where the shock is based on the SCR of the undertaking in which the participation is held.

Transitional provisions for own funds – The classification of own fund items should be carried out both with and without the application of transitional provisions for paid-in capital instruments.

Expected profits included in future premiums – EPIFP will be considered as a Tier 1 item in QIS5, but the collection of the number will allow for an assessment of the impact of different approaches.

Thank you once again for all CEIOPS' hard work and support on this important European project.

Yours sincerely

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