CEA Guidance on Quantitative Impact Study 4 ("QIS4")

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Introduction

CEIOPS has released its final specification for its fourth Quantitative Impact Study ("QIS4") along with qualitative questionnaires on the solo calculations, the group calculations, internal models and operational risk.

As with previous QIS exercises participants are invited to take part on a best efforts basis. It is important that as many companies / groups as possible participate, especially smaller companies and /or those with unusual characteristics in order to identify issues in advance of Solvency II being implemented.

Past QIS exercises have shown that industry feedback can elicit positive changes with this most likely to happen where the industry:

- Gives consistent messages
- Provides hard (empirical) evidence, e.g. figures on alternative bases
- Suggests alternative and improved approaches

With this in mind, this document highlights potential issues and possible feedback that companies might consider providing. It also describes the assistance that the CEA will be providing to companies – the helper spreadsheet tools and QIS4 website forum.

As well as helping to improve Solvency II, another strong reason for participating in QIS4 is that groups and companies will get a good idea of what their solvency position will look like post Solvency II and therefore what, if anything, they need to do prior to its implementation.

The views expressed in this document represent the CEA's views at this stage of the project. As our work develops, these views may evolve. Also, these views need to be considered in the context of the CEA's other publications, which can be found on the CEA's website www.cea.eu.

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1. Key areas requiring industry input

Further work is required on improving simplifications and the criteria for their use

1.1 The Framework Directive Proposal requires that the approaches and requirements of Solvency II are proportionate having regard to the nature, scale and complexity of companies' risks. QIS4 therefore introduces, for the first time, a number of simplifications and proxies to assist companies when calculating technical provisions and SCR capital amounts. It is important that companies provide feedback on the:

- Overall thresholds for when companies can generally use simplifications (TS.II.A.38 and TS.VI.G.3)
- Practicality and appropriateness of the specific simplifications, including the criteria needing to be met for their use
- Extent of any conservatism inherent in the simplifications, which is best assessed by companies performing calculations on both the full and simplified approaches
- Additional simplified methods that companies should be able to use

1.2 The CEA's view that the criteria for determining whether simplified approaches can be used should be risk based and not unduly influenced by size or legal form. For example, larger companies should not be prevented from using simplifications purely because they are large.

A pragmatic approach is required to calculate risk margins

1.3 The default cost-of-capital method specified in QIS4 requires companies to project future SCR amounts for each business segment and for each future year. For many companies, especially life companies using Monte Carlo simulation approaches, such a calculation will not be possible. Even where it is possible, it is debatable whether the improvement in accuracy is in proportion to the effort and cost involved.

1.4 The approach described in TS.II.C.28, where future SCRs are based on the initial SCR and the run-off of the best estimate, is likely in the large majority of cases to strike the right balance between accuracy and cost / effort. Provided companies agree, the CEA recommends that companies advocate this in their feedback with the proviso that companies should be able to use more sophisticated approaches, e.g. directly projecting future SCR amounts, should they so wish.

Risk margins must allow for diversification effects

1.5 The purpose of risk margins should be that when added to the best estimate the combined value represents a good proxy for the economic value of the insurer's obligations. This is needed where the technical provisions cannot be based on market prices and a "mark to model" approach is therefore needed instead. In order for this to be an appropriate proxy for market prices it needs to fully allow for diversification effects between different business segments. However, the cost of capital approach specified in QIS4 does not do this.

1.6 The CEA therefore recommends that the industry provides feedback on the need to allow for such diversification effects in an economic approach and shows their commitment to this by additionally supplying risk margin figures with allowance for diversification effects. As described later in section 2.1, the CEA has developed a spreadsheet to assist companies doing this which is available on our website www.cea.eu.

Impact of eligibility restrictions on capital available to cover the MCR and SCR

1.7 Companies / groups are asked under QIS4 to split their available capital between Basic and Ancillary Own Funds and also into tiers. The significance of this is that under Solvency II there will be restrictions on what types of capital can be used to cover the MCR and SCR.

1.8 The tiering criteria being tested in QIS4 will be used in conjunction with the eligibility limits specified in the Framework Directive. The current proposals include the following eligibility limits:

- Only tier 1 and tier 2 Basic Own Funds can cover the MCR, with at least 50% needing to be tier 1 capital. Thus, none of the MCR can be covered by Ancillary Own funds or tier 3 Basic Own Funds.
- At least 1/3rd of the SCR needs to be covered by tier 1 capital and no more that 1/3rd can be covered by tier 3.

1.9 It is important that companies / groups understand the impact of the classifications and limits. It is important to assess this at both group and solo levels. For example, capital is often raised at a group level using hybrid debt instruments and then transferred to subsidiaries as an equity injection. At the solo level these funds are therefore treated as equity and qualify as tier 1 capital. However, at the group level they are treated as hybrid capital and may not have the characteristics needed for a tier 1 classification.

1.10 Special arrangements are likely to be needed to transition the Solvency II eligibility and tiering criteria, i.e. grandfathering arrangements. In order to stress the importance of having appropriate grandfathering arrangements we recommend that companies provide feedback on this.

Importance of entity specific SCR stresses

1.11 QIS4 allows non-life companies to derive company specific standard deviation factors for premium and / or reserve risk that are used to determine SCR stresses they use. This is an important and welcome development as it will allow companies to better reflect the specific characteristics of their business and risk exposures. For example, companies specialising in a specific form of insurance may write less complex and less volatile business with this option allowing them to reflect this in their SCR stresses and therefore their SCR.

1.12 Companies taking advantage of this are required to use the standardised method described in the specifications, which, in our view, is overly mechanical in nature. This requires companies to have best estimate liability values for previous years split by line of business, which we suspect many will have difficulty providing. We therefore recommend that companies also use and describe more pragmatic approaches.

1.13 An important by-product of companies opting to determine their own SCR stresses is that these stresses and the associated standard deviation figures will provide CEIOPS with a valuable source of data with which to refine the standard calibration of the SCR for non-life, which is generally accepted as having been set too high.

1.14 We believe that the option to use entity specific data to set SCR underwriting risk stresses should also be extended to Life and Health risk and note the Framework Directive Proposal allows this.

Supporting the group proposals

1.15 The Framework Directive Proposal introduces new and innovative approaches to the supervision of groups that recognise their economic reality and in particular group diversification effects. However, a significant number of supervisory authorities are strongly opposed to them. It is therefore vital that the industry demonstrates strong support for them with a high group QIS4 participation rate (the European Commission have set a 60% target) helping achieve this.

1.16 The CEA has recently published the following papers on the group proposals, which are likely to be of interest and help to groups. They can be downloaded from our website:

- Solvency II: How the Group Support Regime works in practice (Case Studies)
- Solvency II: FAQ on Group Supervision & Group Support Regime
- CEA Responses on aspects of the Solvency II Framework Directive related to Insurance Groups

2. Co-ordinating Feedback

CEA Spreadsheet tools

2.1 In order to assist companies, the CEA has developed the following tools, which are available on its website:

- A spreadsheet to calculate the figures needed for the dampener alternative for equity risk (TS.IX.C.21), which, for the avoidance of doubt, should not be interpreted as the CEA being in favour of this approach.
- Another spreadsheet that allows companies to assess the impact of allowing for diversification effects when calculating risk margins under the cost of capital approach.

2.2 It should be noted that the cost of capital spreadsheet provided by the CEA should not be used to calculate the risk margin figures that are used in the QIS4 spreadsheets as these need to exclude diversification effects in order to comply with the technical specifications. The spreadsheet provided by the CEA should be used to calculate additional figures to show the effect of allowing for diversification effects. The spreadsheet allows users to use some of the simplified approaches described in the technical specifications. As described in 1.6 above, the CEA recommends that companies provide feedback on the need to allow for such diversification effects and provide additional figures to show the effect this would have.

Website Forum

2.3 The CEA has launched a website forum, which has been developed to allow companies to share their experiences and discuss issues. The forum will be available for the duration of the exercise and will close at the end of the consultation in July.

2.4 The forum discussions have been split into the major themes of QIS4. Please note that it is important to indicate clear references to both:

- Technical Specification sections and paragraphs
- Worksheet cells in any referenced spreadsheets

2.5 To access the forum please go to http://forum.cea.eu where you will be asked to register. Once your registration has been validated, you will be free to visit the forum as often as you wish using your username and password. The CEA will act as a webmaster and coordinate members' exchanges.

2.6 Please note that the website forum is intended to facilitate discussions between companies and that the CEA will not be providing answers to any questions. Technical queries should be addressed to CEIOPS using the mechanisms that they have put in place, which can be accessed via their website www.ceiops.eu. We request that companies provide a copy of the questions asked and the answers received to their National Association so that they and the CEA can more effectively represent the industry's interests and co-ordinate its response.

2.7 Depending on the discussions, the CEA may come up with an FAQ document and/or send feedback to CEIOPS in order to assist CEIOPS in preparing the QIS4 report that is due in November 2008.

A united response from the industry can be very influential

2.8 Past QIS exercises have shown that well reasoned and consistent messages have the most chance of being accepted. The CEA, in conjunction with the National Associations, will try to achieve this, but the help of companies is vital to understand the issues and to develop possible solutions to these.

About the CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, e.g. pan-European companies, monoliners, mutuals and SMEs. The CEA represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 065bn, employ over one million people and invest more than €6 900bn in the economy.