Association Suisse des Actuaires
Schweizerische Aktuarvereinigung
Swiss Association of Actuaries

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EUROPEAN COMMISSION
DG Internal Market and Services
Insurance and Pensions Unit
1049 Brussels, Belgium

Comments on Level 2 implementing measures

Dear Sir

We realize that Switzerland is neither an EU member state, nor even situated in the EEA. However, the Swiss Association of Actuaries (SAA) nevertheless would like to comment since Solvency II already has a large impact on the Swiss insurance market, an impact that will grow when Solvency II will be implemented.

The SAA would like to comment in particular on two elements of the valuation proposed by Solvency II: The Counter Cyclical Premium (CCP) and the Matching Premium (MP). We consider both elements to be at variance with a market-consistent valuation standard that is the basis of Solvency II (see for example Art. 76 of the Directive). We are concerned by the incentives both the CCP and the MP are giving for investment into assets. It is likely that investments will be geared to such assets that will increase the insurance undertakings' exposures to risk, in particular in situations of financial stress. Insurance undertakings using an economic valuation standard and risk management based on economic principles will find it difficult to compete with undertakings using the CCP and MP as the latter will be able to outperform them by investing in more risk assets with higher expected returns without incurring the required additional capital costs. More insidious, both the CCP and the MP will lead to lower technical provisions, directly impacting the safety of policyholders.

We structure our comments into five parts:

- Incentives given by the CCP and the MP
- Our understanding of market consistent valuation
- A rational why the use of the CCP and the MP leads to a valuation that is not market consistent and why they will likely lead to increased exposures to risks
- A proposal on how to reduce pro-cyclical effects without having to resort to the CCP
- Suggestions on how to limit the potential damage, if the CCP and the MP have to be introduced
- Answers to the questions

Incentives given by the CCP and the MP

Both the CCP and the Matching Premium contain a hold-to-maturity argument. In the case of the Matching Premium, this is explicit in (Article 42bis.1 (a): *the insurance undertaking has assigned a portfolio of assets, consisting of bonds and other assets with similar cash-flow characteristics, to cover the best estimate of the portfolio of insurance obligations and intends to maintain this assignment over the lifetime of the obligations, except for the purpose of*

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maintaining the replication of cash-flows between assets and liabilities where the expected cash-flows have materially changed such as the default of a bond;

In case of the CCP, this assumption is more implicit but the basis for the arguments for the introduction of the Liquidity Premium in the *Report of the Task Force on the Illiquidity Premium, 10 March 2010.*

The CCP gives the incentive to invest in illiquid assets, since this would be consistent with the arguments brought forward for its introduction. The Matching Premium in addition gives an incentive to invest in risky assets, since the spread depends explicitly on the assets held by the undertaking. We are aware that European regulators are clear of these incentives, and there are rules and regulations trying to minimize this risk. However, we would argue that rather than imposing further investment restrictions that are arbitrary and easily to arbitrage against, it would be more natural to use a valuation standard that does not introduce such incentives.

In case illiquid assets become permanently impaired, a hold-to-maturity view point is particularly dangerous. It leads to undertaking holding badly performing assets and selling those that have kept their value and that are liquid. Asset portfolios then tend to deteriorate quickly.

The MP gives the incentive to invest in an asset portfolio with as high as possible expected return, as this would maximally reduce the technical liabilities. It gives the incentive in particular for undertaking with deteriorating solvency ratio to gamble on resurrection, by investing in high yielding assets with high risk.

Undertakings not wanting to use the CCP and the MP for their own risk management will find it more difficult to compete with those competitors who will make use of the CCP and the MP and will tend to be invested in riskier and higher yielding asset portfolios. Those investing most in illiquid and risky assets will likely be undertakings with a financially strained situation. More prudent insurers might leave entire business lines since competing would be economically irrationally.

Already now, risk managers at undertakings are coming under pressure to allow increased investments into more illiquid assets. At the same time, there is lobbying that insurers are taking on more banking debt to support banks achieving their liquidity requirements under Basel III. We consider this a dangerous tendency as it will expose the insurance industry to increased risk, in particular during times of financial crises.

Our Understanding of Market Consistent Valuation

The Directive states in Art. 76.3: The calculation of technical provisions shall make use of and be consistent with information provided by the financial markets and generally available data on underwriting risks (market consistency).

Market consistent valuation relies on using information provided by market prices of financial instruments that are traded in deep, liquid and public markets. Insurance liabilities give rise to future cash flows that are uncertain. These cash flows can be decomposed into two components: One component that can be replicated with financial instruments from deep, liquid and public markets and one component that cannot be replicated.

The market consistent value of the insurance liabilities is then the sum of the market value of the portfolio of financial instruments replicating the first component of the insurance liability cash flows and a risk margin that depends on the second component.

The second component gives rise to the risk margin that covers the expected cost of the insurance undertaking having to hold capital to buffer the risks of the insurance liabilities that cannot be replicated.

The importance of using financial instruments with reliable market prices cannot be overstated. Using financial instruments with less reliable market prices – e.g. less liquid ones or ones not publicly traded – will then require judgment and lead to a less objective valuation.

We formulate our understanding of market consistency using a replication approach as this is also the basis of the Solvency II approach for valuation as described in the Directive (e.g. Art. 78.4).

This formulation also makes transparent the interrelationship between the financial instrument used for replication, the discount rate and the risk margin. It is not possible to change one of these elements without considering the impact on the others for the valuation standard to stay consistent.

If for example replication is done by credit risk free government bonds that are traded in a deep, liquid and public market, this implies a risk-free discount rate. The risk margin is then determined by the risk that is remaining when the insurance liability cash flows are replicated with credit risk-free government bonds. Specifically, this would imply that the risk margin would not contain liquidity or credit risk emanating from the replicating instruments.

If replication were done – to go to another extreme – with illiquid corporate bonds, then the discount rates would be implied by the spread of the replicating instruments, i.e. it would be higher than the risk-free rate. The risk margin, being a function of non-replicable risk, would then contain the liquidity and credit risk of the replicating instruments. The risk margin in this case would then compensate the higher discount-rate by being higher than the risk margin in a situation of replication with credit risk free government bonds.

Why the CCP and the Matching Premium are not Market Consistent

There are two main reasons why the use of the CCP and the Matching Premium lead to a valuation standard that is not market consistent and therefore not in-line with the Directive.

They lead to technical provisions that are not necessarily reliable (Directive, Art. 76.4: 4. Technical provisions shall be calculated in a prudent, reliable and objective manner.).

Market consistent valuation requires the use of financial instruments that are traded in deep, liquid and public markets for replication, since these instruments have reliable market prices. They allow the measurement of the cost of insurance liabilities in a reliable and objective manner. Per definition, less liquid financial instruments are traded less deeply and their market prices are therefore less reliable. Both the CCP and the Matching Premium imply the use of financial instruments for replication that are illiquid and therefore do not have reliable market prices.

They lead to a systematic underestimation of technical provisions. This violates in particular Directive, Art 76.2: *The value of technical provisions shall correspond to the current amount insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking.*

The risk margin depends on the risk that is remaining after replication with financial instruments. In case of replication with financial instruments that are credit risky and contain liquidity risk, the risk margin consequently contains a component for the expected cost of capital that the

undertaking has to hold to buffer these credit and liquidity risks. In the CCP and Matching Premium proposals, this interaction with the risk margin is not considered. While the credit risk is taken implicitly into account by reducing the spread by a component for credit risk, the liquidity risk is not included in the risk margin.

Arguing that insurers are well suited to hold illiquid assets is not convincing. This basically assumes that the illiquidity spread is purely due to the lack of liquidity. In reality it is also a function of the lack of transparency, valuation uncertainty and other factors. The CCP and the Matching Premium both implicitly assume that illiquid instruments eventually recover but the credit crisis has shown that this is not necessarily the case. Illiquid assets can and actually did become permanently impaired.

This risk is not captured in the risk margin, thereby leading to a market wide underestimation of technical provisions.

A proposal on how to reduce pro-cyclical effects

Irrespective of our proposal below do we believe that regulators have sufficient tools to counter pro-cyclical effects during financial crises without resorting to CCP or changing valuation standards.

The credit crunch has shown that in times of freezing markets, spreads observed in financial markets can increase. We would find it most natural that in these exceptional situations, the problem is tackled where it actually emerges, namely on the asset side of the balance sheet. In times of market seizures, EIOPA might limit the movements of spreads that are used for the valuation of assets until such a time that markets are functioning again. This would have several advantages:

- The valuation of insurance liabilities would remain market consistent, in accordance to the requirements of the Directive.
- The valuation of assets would remain market consistent too, except in times of market seizures, where market consistency makes less sense anyway.
- The counter-cyclical measures would be targeted. By limiting the spreads only on these financial instruments for which markets do not function anymore, the counter-measures would be much more effective. There are easily situations imaginable, where only specific markets cease to function. If an insurer were heavily exposed to assets in such a freezing market, then an “averaged” liquidity premium might not be sufficient to compensate the effects of the spread widening. In contrast, a targeted approach on the asset side would be effective also in such a situation.

Question 5 to Member States:

How could the criteria set out in Article 41(4) be amended in order to reduce EIOPA's discretion in determining stressed financial markets while keeping the principle-based approach (i.e. without introducing an automatically triggered formula)? Please provide drafting suggestions, for instance additional indicators that could be used to determine that stressed market conditions exist.

We do not believe in the validity of the CCP. If the CCP were to be introduced, then the mechanism should be consistent with the underlying idea of the illiquidity premium or CCP. As is argued by the proponents, the CCP is to be used only in situations of freezing markets. We propose that this should be defining criteria of using the CCP. The use of the CCP could be triggered by exceptionally high bid ask spreads and massively reduced volume transactions. The

threshold should be set so high that the CCP would be expected to be used very rarely in exceptional situation.

Question 6 to Member States:

Do Member States agree to exclude intangibles and reinsurance recoverables from the representative portfolio of assets?

Yes

Question 7 to Member States:

Would Member States favour an approach whereby correlations between the counter-cyclical premium sub-modules and other sub-modules in the market risk module would remain at 0% but the shock on the counter-cyclical premium in the counter-cyclical premium risk sub-module would be lower than 100%?

We do not believe in the validity of the CCP. We also do not believe that there is a theoretical or economic basis for it. In particular, we do not believe that there is any theoretical or empirical basis for setting correlations to other sub-modules in the market risk module.

Question 8 to Member States:

Are Member States of the view that several different portfolios of assets can be used to determine the different situations for which a counter-cyclical premium could be triggered? Should each of these portfolios represent the assets that would be under stress in the respective situations?
Do Member States agree that the aggregation of these portfolios would need to be specified at Level 2 and which aggregation would they see as appropriate?

We do not believe in the validity of the CCP. If the CCP were to be introduced, then it should be invoked only in exceptional situation as for example during the credit crunch where markets cease to function. If many portfolios were to be used – any one of which could potentially invoke the CCP – it is likely that the CCP would be used often, completely contrary to its spirit. In our view, the lack of clarity of when to invoke the CCP is a further sign of its lack of economic basis.

Question 9 to Member States:

Which solutions would Member States recommend in order to avoid the risk of setting wrong investment incentives?

Are Member States of the view that the portfolio of assets used to determine the counter-cyclical premium should represent:
- the assets that each insurance or reinsurance undertaking is actually invested in?
- or the portfolio of assets of an "average" European insurance or reinsurance undertaking?
- or be independent from the assets held by the undertaking and from the assets held by an "average" European undertaking?

We do not believe in the validity of the CCP, one of the main reasons being that it gives wrong investment incentives. The easiest way of avoiding the risk of setting wrong investment incentives would be to not introduce the CCP. Using the actual assets that insurance

undertakings are invested in to set the CCP would give perverse incentives to invest in assets that are risky and have the potential to become illiquid in particular during times of market crises. All the arguments for the CCP and the MP are assuming that the values of illiquid assets will eventually recover and not be permanently impaired. The CCP then is in essence a free put supplied by tax payers. This might go well or it might play out as in Ireland. We would like to advise to follow a prudent course and not introduce the CCP.

Question 10 to Member States:

Would Member States favour the introduction of an 'opt-out' clause to the counter-cyclical premium?

We consider this highly hypothetical. If the illiquidity premium were introduced, it is difficult to imagine any undertaking giving up the substantial advantages it thereby gains.

Question 11 to Member States:

Are Member States of the view that the draft implementing measures should further specify the calculation of the amount of premium to be applied?
If yes, what approach would Member States suggest in order to ensure flexibility to react swiftly to market developments?

We do not believe in the validity of the CCP. We suggest to not specify since regulators already have sufficient tools to react to market developments. Any mechanical specification will limit the flexibility of regulators. The ability to have a CCP defined in such a way that it reacts automatically counter-cyclical implies to us the ability to predict the form and shape of future financial crises. We do not believe that this assumption is realistic.

In case of any questions, please feel free to contact us.

Best Regards

Swiss Association of Actuaries

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