LLOYD'S

CONSULTATION DOCUMENT ON LEVEL 2 IMPLEMENTING MEASURES FOR DIRECTIVE 2009/138/EC

LLOYD'S RESPONSE

Introduction

This response is submitted on behalf of the Society of Lloyd's ("Lloyd's"). Lloyd's is a society of members that operates as an insurance and reinsurance market in London. Its aggregate gross written premium income in 2009 was EUR 25bn, 16% of which originated from Europe other than the UK and 64% from outside Europe. The business written within the Lloyd's market is predominantly non-life insurance and reinsurance.

We have not attempted to answer every question, only those that are relevant to Lloyd's. Many of the questions are framed as "*Do you agree that the Commission Services' approach would be the most efficient and effective in order to achieve the objectives of*:" followed by a list of features. We have simplified questions in this form to "*Do you agree with the Commission Services' suggested approach?*" We have not sought to assess whether Commission Services' approach would promote compatibility with prudential supervision of banking or with the work of the IASB's international accounting standards, as we consider that this requires detailed technical research of the appropriate instruments.

This response does not take into account the impact of the Omnibus II Directive, a proposal for which was issued by the European Commission earlier in January.

Policy issues

Own funds – quantitative limits for SCR and MCR

Question 5: Do you agree with the Commission Services' suggested approach?

Commission Services propose the following limits:

- Tier 1 own funds: minimum of 50% of SCR.
- Tier 3 own funds: maximum of 15% of SCR.
- Tier 1 own funds: minimum of 80% of MCR.

The Directive requirements are as follows:

- Tier 1 own funds: higher than one-third of SCR (article 98.1(a)).
- Tier 3 own funds: less than one-third of SCR (article 98.1(b)).
- Tier 1 own funds: higher than one-half of MCR (article 98.2).

Although we agree that Commission Services should not feel bound by the four options set out in the paper, we do not agree with the approach that it proposes to adopt, following CEIOPS' final advice. The adoption of significantly tighter requirements than those contained in the Directive requires justification. The proposed limits will reduce undertakings' flexibility, with potential consequences for the competitiveness of the EU

insurance sector. We consider that the tiering limits should be closer to those set out in the Framework Directive.

Supervisory reporting – content, form and modalities

Question 9: Do you agree with the Commission Services' suggested approach?

Commission Services proposes to adopt scenario 3, which will mean:

- **Content of the RTS qualitative aspects:** Undertakings to provide a full report for the first year and thereafter on a frequency established by its supervisory authority, depending on each undertaking's risk profile.
- **Frequency:** Core quantitative data to be provided quarterly, while all quantitative reporting templates and all qualitative data are provided annually.
- **Level of assurance:** Specific quantitative data are externally audited annually, with the remainder unaudited.
- **Reporting format:** Quantitative data reported in a standardised reporting format and qualitative data following a predefined order, in free format.

We broadly agree with this approach. The only aspect with which we disagree is "frequency", where we consider option 3 to be preferable: "*all data is provided annually unless more frequent submission is required in the Directive*". This would be a more proportionate approach, reducing undertaking compliance costs, which threaten to be particularly onerous for small undertakings. Option 3 also appears closer to the Directive's intentions. Directive preamble 23 refers to supervisors being able to obtain from undertakings information "*which is necessary for the purposes of supervision*": option 3 would mean that supervisors receive all the information necessary for supervisory purposes, whereas option 2 would mean the disclosure of information more frequently than is required for those purposes.

Solvency II's reporting obligations have the potential to impose significant and costly administrative burdens on undertakings, contrary to the proportionality principle and efforts to reduce the frequency of reporting and the quantity to be reported are desirable.

Question 10: The Commission Services are currently of the view that, in line with the proportionality principle, the level 2 implementing measures should only require material and/or relevant information to be provided. Do you agree with this approach?

We agree with this approach. It is important that all reporting and disclosure requirements are justified. They should be analysed in detail before they come into force to ensure that this is the case. Information provided to supervisors should have a proper supervisory function and information disclosed publicly should be necessary for a proper understanding of the undertaking. We note and welcome the proposal that reporting requirements will be based on the information that is publicly disclosed in the Solvency and Financial Condition Report, supplemented with an additional report to supervisors including confidential and proprietary information.

Public disclosure – content, form and modalities

Question 13: Do you agree with the Commission Services' suggested approach?

Commission Services' suggested approach is:

i) **Content of the SFCR:** the level of detail to be specified in a concrete way and minimum content defined.

The purpose of the SFCR is to enhance market discipline through disclosure and this entails disclosure requirements that are harmonised across the EU at a reasonable level of detail, so that it is possible to make comparisons. On the other hand the more detailed and prescriptive the disclosure are, the more difficult they are likely to be for undertakings, particularly smaller undertakings, to comply. The Commission's preferred approach is compatible with thorough application of the principle of proportionality, to ensure that the level and amount of information disclosed is reasonable.

ii) **Public disclosure:** SFCR to be disclosed on an undertaking's website. If this is not possible, to be disclosed on a trade association's website and if this is not possible, to be made electronically available to any person.

The proposals on public disclosure appear reasonable, although there should be controls on the ability of undertakings not to disclose the SFCR on either their own or a trade association's website. Most EU undertakings should have no difficulties in arranging compliant disclosure, even if the volume of information they are required to publish presents difficulties.

Question 14: The current approach favoured by the Commission Services would be to list a number of items which would need to be put in the public domain. Some stakeholders argue that the SFCR should contain much less information, so that it is understandable by policyholders, while others support disclosure of information directed at a much wider audience. Do you have views on:

a) What stakeholders should be addressed?
b) What are the areas on which stakeholders need information?
c) How detailed has it to be?

a) Most policyholders are unlikely to consult an insurer's SFCR before deciding to buy an insurance policy. Decisions on the purchase of insurance are usually based on price and coverage provided. Only more sophisticated purchasers – or their professional advisers - are likely to pay much attention to the type of information it is intended to include in an SFCR.

Consequently, it is not necessary for the content of the SFCR to be designed for use by policyholders. On the other hand, the more extensive the disclosure requirements, the more difficult it will be for any but the most informed of stakeholders to make use of it. The SFCR should not be designed to include every piece of information that a stakeholder might conceivably find interesting: the principle of proportionality suggests that it should contain the minimum amount of

information necessary to satisfy the pillar 3 objective of improving market discipline through disclosure.

b) The contents of the SFCR are set out in article 51 of the Framework Directive. There are no further areas on which stakeholders require information.

c) As noted previously, an excessive level of detail will make the SFCR more difficult for all undertakings, especially smaller undertakings, to comply with these requirements.

SCR standard formula – diversification effects – correlation parameters

Question 21 Do you agree with the Commission Services' suggested approach?

Commission Services proposes to adopt option 1: "*use QIS4 correlation parameters across lines of business*". We do not agree with this approach: we support option 2: "*use lower than QIS4 correlation parameters across lines of business*".

CEIOPS suggested that the parameters used in QIS4 could be revised, once sufficient data for detailed analysis is available. So far as we are aware, no such analysis has taken place. Consequently, there is no evidence to justify the use of the QIS4 parameters.

It is noticeable that the minimum correlation that they impose, even between lines of business that have no obvious link, is 25%. As an example, there is a 25% correlation between fire and motor vehicle liability, even though there is no link between the two classes. Where there is no clear link between two classes, the correlation parameter should be set at zero.

In other cases correlations are set at 50% even though available evidence suggests that a lower correlation is appropriate. For example, CEIOPS' published analysis of German non-life companies suggested a correlation of 28% between TPL and motor TPL. The proposed correlation of 50% almost doubles this observed correlation.

Deloitte's conclusion was that changing the correlations would have little effect on financial requirements. The description of their work is not sufficiently detailed for assessment but, even if it is correct, option 1 is not justified by evidence. It cannot therefore be described as "risk-sensitive", as it does not reflect actual risk.

SCR standard formula – diversification effects – geographical diversification

Question 22 Do you agree with the Commission Services' suggested approach?

We agree with the Commission Services view, that an adjustment factor for geographical diversification should be included in the non-life premium and reserve risk sub-module.

Recognition of geographical diversification is a necessary feature of Solvency II because:

- Solvency II is based on an economic approach to the setting of capital, an approach that requires recognition of diversification.

- Geographical diversification is a key form of diversification for insurance undertakings. It recognises that there is little or no correlation between losses in different places – e.g. losses arising from bad weather in the UK have no connection to claims experiences in Greece. The KPMG study of insurance prudential supervision, prepared for the European Commission in May 2002[1], commented:

  "International companies experience risk reduction due to geographical diversification of risks."

- The Solvency II Directive therefore makes explicit provision for diversification. Preamble 64 says:

  "…economic capital should be calculated on the basis of the true risk profile of those undertakings, taking account of the impact of possible risk-mitigation techniques, as well as diversification effects."

- Insurance undertakings carrying on business in different regions across the world lessen the concentration of risk that occurs if they are restricted to a single country. This has a material impact on the amount of capital they require.

- The European Central Bank published a report entitled "*Potential impact of Solvency II on financial stability*" in July 2007. This assumed that Solvency II would recognise risk diversification across locations and saw this as contributing to a positive expected outcome of improved efficiency and competitiveness of EU insurers[2]. It contrasted this with existing insurance regulatory systems in EU countries which:

  "…do not adequately account for risk diversification in the insurance business, so that the risk of insurance groups being engaged in many different…geographical areas could potentially be overestimated, and capital requirements may appear artificially high."

Deloitte's conclusion that geographical diversification benefits have a small or moderate impact on financial requirements presumably reflects the overall EU insurance industry, which includes many firms who do not carry on international insurance business and are limited to transacting business in their home state only. Recognition of geographical diversification is an essential feature of the calculation of capital requirements for undertakings that do transact insurance business. Its withdrawal would have a significant impact on their competitiveness as their capital requirements will be significantly larger. The non-recognition of geographical diversification would send a signal that Solvency II does not take account of a key form of diversification for insurers and therefore is not truly risk-based.

Some undertakings who underwrite significant volumes of international business will use internal models. This does not reduce the importance of recognising geographical diversification in the standard formula. If it is not included, smaller insurers transacting international business will be put at a particular disadvantage, not just in comparison with their competitors outside the EU, but with larger undertakings, who are most likely to use internal models. The consequences could be to restrict the writing of international business to larger firms, able to justify and fund the development of an internal model, which is a costly process.

[1] Contract no: ETD/2000/BS-3001/C/45. See para 3.4.16

[2] Section 3.1

The standard formula is likely to have some influence on the acceptability of internal models – firms seeking supervisory approval of their internal models are required to submit the results of using the standard formula alongside the results of their internal model for purposes of comparison. Consequently, even firms who use internal models have an interest in ensuring that the standard formula is properly risk-based, so recognises diversification.

SCR standard formula – underwriting risk (other than catastrophe risk) arising from non-life insurance obligations

Question 24: Do you agree with the Commission Services' suggested approach?

Commission Services proposes to adopt option 2: "*closed formula calibrated at VaR at the 99.5% confidence level over a one-year period (factor based approach)*". We agree with this approach.

SCR standard formula – underwriting catastrophe risks arising from insurance obligations

Question 26: Do you agree with the Commission Services' suggested approach?

Commission Services' preference is apparently option 1, the scenario-based approach. However, although the paper does not make this explicit, in certain circumstances, such as in relation to natural catastrophe exposures outside the EU, option 2, the factor-based approach, will apply.

Consequently, undertakings with significant natural catastrophe exposures outside the EU are required to use option 2 to calculate their capital charge of non-life catastrophe. The consequences in QIS5 were that such undertakings incurred very large catastrophe capital charges, bearing little or no relation to the extent of their catastrophe exposures. This approach was neither risk-sensitive nor proportionate.

The approach to non-life natural catastrophe outside the EU therefore requires a re-think. We suggest that, with supervisory approval, undertakings with significant non-EU exposure should be able to apply the results of an appropriate catastrophe model as an Undertaking Specific Parameter, in place of the natural catastrophe elements of this sub-module. This would be a far more risk-sensitive approach than the options set out in the paper, as it would reflect more closely an undertaking's own risk profile.

We also support detailed changes to the legislative language setting out option 2 in the implementing measures. Option 2 entails the application of factors for different natural catastrophe perils to premiums. The description of this method should make clear that the figure for premiums to which the factors are applied should be split between perils before the calculation is carried out, so that the factors are not applied to the same aggregated premium amount, reflecting exposures to all natural perils, several times over.

SCR internal models – use test

Question 27: Do you agree with the Commission Services' suggested approach?

Commission Services proposes that an internal model should be fully integrated into an undertaking's risk management system, but that there should not be a list of mandatory uses for the internal model. We agree with this approach. We particularly agree that a list-based approach is inappropriate, would be difficult to assemble, would probably not cater for all possible circumstances and would not allow for the principle of proportionality.

SCR internal models – statistical quality standards

Question 28: Do you agree with the Commission Services' suggested approach?

Commission Services proposes to adopt option 2, under which undertakings must have data quality policies that determine sources of data used, use of expert judgement and their respective validations. We agree with this approach.

Capital add-ons

Question 29: Do you agree with the Commission Services' suggested approach?

Commission Services intends to follow option 3. A harmonised reference value of [5% - 15%] of overall SCR would serve as a rebuttable presumption that the deviation is significant. Supervisors could decide to depart from it (in either direction) on the basis of harmonised level 2 criteria.

We agree with this approach, which would give supervisors the flexibility to adapt their response to the particular circumstances of an undertaking. The reference value should be set at level 2, but a range of 5% to 15% is too large to act as a clear reference value.

Impact on insurance markets and products

Question 37: Do you anticipate that the Commission Services' suggested approach for level 2 implementing measures would result in an increase or decrease in insurance prices?

Forecasting the future of insurance prices is a daunting task. There are aspects of the Solvency II regime in its current form that could lead to price reductions and aspects that will work the other way. As there are many other significant influences on the prices of insurance products in what is a highly cyclical business, it would be brave – or foolhardy - to predict whether insurance prices will be higher or lower post Solvency II implementation.

Solvency II aims to produce a single market for insurance services across Europe, subject to harmonised regulatory requirements with greater competitiveness and improved capital allocation. If it can achieve these aims, one would expect it to lead to lower insurance prices.

However, there are aspects of level 2 implementing measures in their current form that will lead to price increases. QIS5 suggested that implementing measures in their current form will mean increased capital requirements for many undertakings, not balanced by reductions in technical provisions. If implementing measures push up EU undertakings' overall financial requirements, these additional costs will be passed on to policyholders in the form of higher premiums. This effect will be exacerbated if implementing measures do not take proper account of some basic insurance concepts, such as diversification. Full details of the likely impacts of current implementation measures are set out in the CEA publication Why excessive capital requirements harm consumers, insurers and the economy dated March 2010.

Proposed implementing measures for market risk are likely to have a significant impact on insurers' investment strategies, leading to reductions in their holdings of equities and corporate bonds and increases in holdings of government paper. The new investment strategies will be less "risky" but are also likely to be less profitable. There may well be an increased emphasis on the importance of underwriting at a profit and a consequent need to charge premiums that fully reflect the costs of the contract.

Solvency II is also likely to increase undertakings' administrative costs. Its requirements in areas such as governance, risk management, reporting and disclosure are in many respects laudable but go further than the requirements currently in place in most EU member states, so are likely to lead to increased running costs for many undertakings. These increases may be balanced for some undertakings by the introduction of more effective and efficient management systems, but the overall impact is likely to mean pressure for increased premiums. Solvency II implementation is, in any case, an expensive business for many undertakings. Implementation costs may not be sufficient to lead to price increases themselves but constitute additional pressure on undertakings' margins and therefore on pricing levels.

Solvency II will encourage insurers to look closely at product lines with higher capital requirements. This may well lead to some deciding to withdraw from such lines, reducing competition and increasing prices. Liability and catastrophe-exposed classes will be capital-intensive and could see reduced competition and higher prices. In the future it may be difficult for legislators at either EU or national level to introduce mandatory liability insurance for particular professions or activities, as the insurance capacity required (particularly for new exposures without historic data) won't exist and may not be forthcoming.

Question 45: What impacts would the Commission Services' suggested approach for level 2 implementing measures have on third country insurers and reinsurers?

The Solvency II programme is likely to have a range of impacts on third country insurers and reinsurers:

- Equivalence will encourage other jurisdictions to move in the same direction as Solvency II, so many third country undertakings could find themselves subject to similar requirements in due course. Nevertheless, equivalence will leave third countries the flexibility to adopt approaches along the lines of Solvency II, but which avoid some of its more difficult or onerous requirements. It will be open to third countries to obtain the benefits of equivalence and at the same time to position themselves very competitively in comparison with the EU.

- Group supervision should facilitate the development of integrated international insurance supervision. Third country undertakings in international groups, like their EU counterparts, are likely to benefit from coordinated approaches to cross-border supervision and more informed supervisory understanding of the group.
- Once the implementing measures are finalised and in force, they will have a significant impact on the decisions of large insurance groups and other capital providers about where to invest in the international insurance sector.

  If the implementing measures impose excessive capital requirements and unnecessarily onerous administrative obligations, third country insurers and reinsurers are likely to benefit from the redeployment of capital away from the EU and into alternative jurisdictions. However, if the Commission takes opportunities to adjust current proposals, in the light of QIS5 results, to ensure that the implementing measures are proportionate, risk-based and take account of international competitiveness, the EU insurance sector will continue to attract international capital.