CEA Insurers of Europe

Annex to ECO 8049

To: the Joint Task Force
On capital for conglomerates
c/o CEIOPS Secretariat

Subject: IWCFC Call for Advice for recommendations

7 March 2008

Dear Sirs,

We are grateful to the Interim Working Committee on Financial Conglomerates (IWCFC) and the Joint Task Force on Capital for Conglomerates (the Joint Task Force) for the opportunity to participate in the meeting on 19 February 2008 on recommendations for action that the IWCFC considers appropriate to address the consequences of the differences in sectoral rules on eligible capital for the supervision of financial conglomerates.

We are now writing to set out our comments with the presentation given at the meeting and with the report on recommendations to enhance a level playing field within financial conglomerates and between financial conglomerates and "pure" banking or insurance groups and the avoidance of undue burdens for conglomerates.

We strongly support the aim of harmonization and the medium to long-term goal for capital being to ensure market consistency applies across Solvency II, Basel II and the FCD, but in general, we believe the review of the Financial Conglomerates Directive should rely on principles aiming at an economic approach.

While the European Insurance Industry supports the work developed by the IWCFC on the analysis of the impact on conglomerates of the differences in the banking and insurance rules with regard to own funds, and broadly share the recommendations on how to address the consequences of the differences identified, it should be highlighted that care should be taken not to introduce new sectoral differences by achieving the harmonization.

The European Insurance Industry would be willing to participate in any future discussions or round tables that you may hold to achieve these objectives.

Convergence with the banking sector is preferable but this must not be at the cost of inappropriate solvency rules

The European Insurance Industry supports the aim of harmonization to ensure a level playing field and fostering a single market for financial services. Convergence between banking and insurance regulation is supported. However we do not support convergence at the cost of inappropriate solvency rules.

Whilst there may be many similarities in the nature of the business between insurance and banking business, there are also significant differences:

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(i) Immediate liquidity is a major issue for banks, much less so for insurers. Even after a large catastrophe (non-life) or a surge in policy surrenders / withdrawals from a Life assurer following reputational damage (e.g. Equitable Life), the insurer has months to manage the issue. For banks it can be a matter of hours or a few days. This means that asset valuation adjustments to reflect liquidity should be more important for banks.

(ii) This also argues for less punitive treatment for insurers' participations in other insurers, banks etc, as the parent insurer has time in an adverse situation to realize value in some way, whereas the bank is more constrained by how much capital can be immediately 'up streamed' from subsidiaries and other participations.

(iii) Insurers' assets tend to be mostly traded and readily valued, whereas banks have a greater proportion of unlisted assets including bespoke instruments and self-originated loans that do not have a readily available market value. Again this means that prudential asset valuation adjustments are more important for banks.

(iv) Arguably bank risks tend to be shorter duration than insurers' or at least shorter than Life assurers' risk profiles, so there could be an argument from the banking side that insurance hybrid should be longer-duration. This is acknowledged in Solvency II where the directive requires the duration of the obligations to be taken into account in determining the appropriate duration of capital.

(v) Diversification even in tail scenarios is robust for insurers, whereas for banks there is more of a tendency for risks to be correlated in the extreme tail. There is for example never a plausible link between Gulf of Mexico hurricanes, Tokyo earthquakes, changes in legislation or increasing life expectancy!

As a result, the CEA only supports the alignment of banking and insurance principles where the principles are economically justified and appropriate for insurance.

Hybrids

In general, the European Insurance Industry agrees with the IWCFC recommendation on principles and requirements for eligibility of hybrid instruments being the same for banks and insurance companies, where differences should reflect specificities of both sectors and harmonization among sectors should occur at the latest with the implementation of Solvency II.

It is essential that the European Insurance Industry has ready access to the capital markets and has sufficient flexibility to allow it to issue instruments that are attractive to potential investors. This is needed to ensure that companies and their policyholders are able to issue capital instruments in the most cost effective form, which will enable policyholders to benefit from reduced costs and companies to maintain / improve their international competitiveness.

We note that the treatment of hybrid capital in the banking and insurance regulations are a moving target and are not yet explicitly addressed by EU legislation.

In the banking sector the treatment of hybrids is currently being reviewed and member states have based their assessment on the international agreement embodied in the Sydney Press Release.

In the insurance sector, discussion is taking place in the context of Solvency II where draft QIS4 technical specifications for the first time sets out specific characteristics that capital instruments need to have in order to be eligible to cover the MCR and SCR capital requirements.

The CEA has major concerns over the QIS4 treatment of hybrid debt instruments, which are currently an important source of financing for the European Insurance Industry, and has provided written comments to the European Commission on these concerns on the CEA response to the draft QIS4 package of 15 February 2008.

In the CEA's working paper on Marketability (also sent to the European Commission and attached for your convenience) we have provided the requirements the European Insurance Industry believes are critical to ensure marketability of instruments. We have identified those requirements we consider are sufficiently addressed in the proposals of QIS 4, but also those we believe have not been addressed.

To illustrate our concerns, we have provided a large number of instruments which have been issued. This illustrates more clearly key requirements for instruments to be marketable. In addition, some constraints which have been prescribed in the draft QIS4 specifications of recognizing hybrid instruments as tier 1 capital are being addressed, as for example:

1) Recognition of moderate step-up coupons after 10 years from the issue date (and not from the reporting date).
2) Write-down features should not be mandatory.
3) Payments through Alternative Coupon Satisfaction Mechanisms (ACSM) must be allowed and should not only include conversion into equity.

To achieve harmonization between sectors a strong dialogue, exchange of ideas and cooperation in specific areas with CEBS, CEIOPS, the IWCFC and the banking and insurance industry is desirable. Particularly, on the evaluation on the outcome both from the CEB's consultation and the QIS4 exercise cooperation is needed to assess the hypothetical impact of harmonization.

Revaluation reserves and unrealized gains

In accordance with paragraph 67 and in our letters of 9 October 2007 and 29 June 2007, assets in the insurance sector are to be more liquid than in the banking sector and that due to the long duration of their liabilities insurance companies are not obliged to realize certain assets immediately.

The European Insurance Industry shares the IWCFC view that the treatment of revaluation reserves and unrealized gains is closely linked to the different valuation methods used in the two sectors and therefore no recommendation is given other than to strive for consistency in the national transposition of the sectoral directives and the national application of prudential filters across the EU.

Participations and deductions

The main difference in the way insurers and banks treat participations to eliminate the double use of eligible own funds is on the threshold used. While insures deduct participations in an insurer, bank or financial institution once a threshold of 20% has been reached, this threshold is limited to a 10% if a bank is held by another bank.

It is possible that the existence of two different thresholds for the deduction of participations causes regulatory arbitrage opportunities within a conglomerate. The European insurance industry shares the IWCFC view to gather further evidence and information on this issue.

Methods of calculation

The accounting consolidation-based method is being proposed by the insurance Framework Directive Proposal as the default calculation method of the solvency at the level of the group. Where the exclusive application of the consolidation method would not be appropriate the alternative deduction and aggregation method or a combination of both methods could be applied.

The European Insurance Industry supports the IWCFC recommendation as it is in line with the Solvency II proposal and shares the need for harmonization and convergence in the practical application of the method by supervisors.

Yours faithfully,

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