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# **Lessons learned from the crisis (Solvency II and beyond)**

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## EXECUTIVE SUMMARY

1. CEIOPS has developed its advice on Solvency II over the past 5 years. Ongoing field testing has shown that the overall architecture of the future system is a sound one. However, and in the light of the unprecedented crisis with spill-over effects for all financial sectors, CEIOPS has launched a lessons to be learned project in autumn 2008. Its working groups have looked at the current crisis, analyzed different aspects relating to the insurance sector, and identified potential areas for improvement to ensure that Solvency 2 can operate both in normal and stressed times. Our main findings and possible conclusions for Levels 2 and 3 are reflected in this report.
2. The crisis originated and developed in the banking sector, subsequently spreading to the insurance sector. Our main lesson of the current events is that Solvency II must be adopted. In crisis situations supervisors have an even stronger need of harmonized and risk-oriented information on the financial soundness of the insurance entities we supervise. *Harmonized*, because that increases transparency and consumer protection. In the current juncture such transparency is clearly lacking, and comparison of insurers' solvency ratios is a tricky exercise. The economic valuation principles underlying Solvency II will largely resolve such inconsistencies. *Risk-oriented*, because that allows us to make meaningful inferences with respect to insurers' available financial resources relative to what they actually need in order to protect their policyholders.
3. Perfect solvency regimes do not exist, if only for the simple reason that any form of regulation creates new distortions in and of itself. In a rapidly evolving sector like the financial sector, there will be a recurrent demand for refinements both on the levels 2 and 3 of the Lamfalussy structure. The crisis has highlighted needs for a further refinement of the existing Solvency II calibrations, both at module and sub-module levels. For instance, in light of the highly correlated nature of current stress events, we may want to strengthen the dependency structures underlying the standard formula. Also, developments in various asset classes have provided fresh insights on the amount of volatility the system will have to absorb and the resulting calibration of the market risk module. Finally, experience has taught that in real crisis situations, only high-quality capital elements can truly be a first line of defense in the sense of absorbing losses without taking the insurer into full bankruptcy.
4. As in the financial sector at large, governance, risk management, and internal controls in the insurance sector need to be strengthened. These elements are key to Solvency II's underlying philosophy of a risk-sensitive system, where the ultimate responsibility for risk identification, monitoring and steering lies with the firm's management, thus requiring from them an understanding of the rationale underlying either the standard formula or internal models. Solvency II is not just about risk measurement and quantification, rather it is about effective governance and risk management.
5. Again, within this overall architecture, the crisis has highlighted some elements that may need to be reinforced. Also in the insurance sector we have observed insurers investing in structured products they did not

sufficiently understand. Effective risk management requires a strong emphasis on own risk assessment, for example where the use of external ratings by Credit Rating Agencies is contemplated. Likewise, liquidity risks will need more attention, to be followed by a higher reporting frequency in stressed situations. For the application of internal models, key success factors relate to model governance (checks and balances, proper documentation) and the involvement as well as proper understanding and steering by board and senior management, much more than to fine-tuning the ultimate risk metrics.

6. We need to rethink the scope of regulation and supervision focusing more on consolidated entities rather than on solo entities only. Solvency II puts more emphasis on group-wide supervision already. Within this context, better functioning of supervision at the level of the group, and better cooperation among supervisors (including timely exchange of relevant information) is urgently needed. When taxpayers' money is at risk, successful cross-border rescue operations by national authorities need to be built upon a joint assessment of the risk situation as carried out by an existing supervisory college.
7. We should take a similarly holistic approach to insurers' exposures to special purpose vehicles such as off-balance value-in-force securitizations, in order to provide supervisors with a consolidated perspective on the risk to which policyholders may become exposed. Where insurers apply complex holding structures possibly involving non-regulated entities, supervisory powers should include monitoring, data collection, and intervention at the holding level also. Mirroring the CRD amendment with respect to own retentions of banking risk securitizations, we may also want to contemplate a minimum risk retention requirement for insurance companies that originate insurance risk securitizations.
8. The aforementioned idea of consistency in the regulatory treatment should be extended as well to the treatment of Credit Default Swaps (CDS), as it would have a positive impact in avoiding regulatory arbitrage between Banking and Insurance. The principle of substance over form should apply to CDS as compared to alternative mechanisms such as credit insurance, and a similar regulatory treatment, in particular regarding capital charges, should be introduced.
9. The crisis has also raised the issue of procyclicality of regulatory regimes. The potential for excessive procyclicality of solvency requirements is clearly less pronounced in insurance than in banking. One main driver of cyclicity is credit risk, which is more prominent in the risk profile of a typical bank than in that for a typical insurance company. Another important driver is market risk. Any point-in-time assessment of an insurer's actual solvency position will therefore also entail some element of cyclicity, and it is important that the pillar 1 (SCR) assessment is complemented by a rigorous stress testing requirement under pillar 2 (Supervisory Review Process). For an inherently cyclical line of business such as credit insurance, we may want to think about a form of through-the-cycle ("dynamic") reserving, while at the same time respecting the need for transparency of any such equalization mechanism.
10. Several high level work streams outside the Solvency II project are currently dealing with lessons to be learned from the crisis, like the FSF and G20 recommendations, various EFC Working Groups, or the expected

follow-up to the recent De Larosiere report. CEIOPS together with its sister Committees is actively contributing to these work streams. To ensure consistency between financial sectors (e.g. with the revision of the CRD), additional conclusions - for example on procyclicality or on remuneration as a long-term rather than short-term incentive for senior management - may be drawn at a later stage.

## BACKGROUND

11. CEIOPS, the Committee of European Insurance and Occupational Pensions Supervisors, has been actively involved, during the current financial turmoil, in putting together its members and develop an ongoing monitoring, at an EEA level, of the developments of the Insurance and Pensions industries during the crisis. Such activities include both qualitative and quantitative approaches to the situation, data collection and analysis, meetings with relevant stakeholders and exchange of relevant information among supervisors, to name some of these initiatives.
12. The Committee has also been periodically reporting to the relevant EU institutions, both on request and on own initiative basis. Links with European Council (including Ecofin, EFC and FSC), EU Parliament and Commission (not only Internal Market, but also DG Competition) have clearly been reinforced these months, as well as the relevance of the Level 3 Committees and their role with regards to cross sectoral coordination and convergence.
13. This work has been carried out in addition to the regular contributions from CEIOPS to Financial Stability, namely through its Spring and Fall Reports for the Insurance and Occupational Pensions sectors. CEIOPS has been doing this work since its creation, and welcomes the fact that, in the Commission Decision of 23-01-2009 re-establishing CEIOPS, an explicit role regarding Financial Stability is given to the Committee for the first time.
14. In parallel to the activities that the Committee has carried out regarding the crisis, CEIOPS has been actively involved in the so called Solvency II project, that will imply the application to the Insurance Sector of a risk oriented supervisory system, under which undertakings will have to hold capital in line with the risks they face and the management of such risks. Solvency II is aimed to enter into force in 2013, but will be the cornerstone of prudential regulation in Europe for the upcoming years, even decades. This requires that the design of the system has to be as effective in normal times as in crisis ones, and the current (and unprecedented) crisis is providing the Committee with important lessons to take on board for Solvency II.
15. Members of CEIOPS consider that all the initiatives taken are useful ones in times of crisis, but they have also made a clear statement in the sense that the Committee should also aim to take lessons out of the crisis and make sure that the future Solvency II regulation deals appropriately with the issues raised, both in normal and stressed times. On that basis, CEIOPS Members endorsed a document with a non exhaustive list of issues that should be looked at by the relevant experts, then analysed and integrated by CEIOPS Secretariat.
16. This paper reflects the aforementioned issues and their potential implications, and should serve as a basis for the discussion and work on the levels 2 and 3, not intending to reopen issues already discussed at the level 1 (Framework Directive) of the Solvency II Project, but aiming to improve it. In addition, the paper looks to further lessons from the crisis, outside Solvency II.

## 1. THE SOLVENCY II PROJECT

### 1.1 TREATMENT OF RISKS

17. Solvency II is a project that aims at introducing and developing a risk oriented supervisory framework for the Insurance Sector, in the sense that undertakings will have to hold capital on the basis of the risks they are facing and the way such risks are managed by the undertaking. In such a framework, the appropriate treatment of risks becomes a core issue for the soundness and effectiveness of the whole system.
18. The risk profile of a given undertaking should take into account both the internal and external risks that it faces, quantifiable and non quantifiable ones. In order to do so, there needs to be in place an appropriate interaction between the Pillar 1 (which would be dealing with quantifiable risks) and the Pillar 2, to incorporate those that, in principle, are deemed as non quantifiable (e.g. risks arising from strategic decisions or reputational risk).
19. In addition, the interaction between the risks has to be carefully looked at. The crisis has shown that diversification benefits may have been overstated in QIS4. For example, diversification benefits between credit risk and insurance risk should be limited when risk is transferred to a reinsurer, and that the cedent simultaneously holds securities from this reinsurer.
20. Different risks should be reviewed at the light of the existing turmoil, as lessons can be drawn to help improving the final outcome of Solvency II. Among these risks to be reviewed, credit risk, liquidity risk, market risk, concentration risks, custodian risks or operational risks are to be included.

#### 1.1.1 Credit Risk

21. Definition: Credit risk can be defined as the risk of a change in the value due to actual credit losses deviating from expected credit losses due to the failure to meet contractual debt obligations.
22. Credit risk can affect both the asset and liability side of the undertaking's balance sheet.
23. Treatment in Solvency II: focused on the asset side, in Pillar 1 the module of Counterparty default risk looks at the risk of default of a counterparty to risk mitigating contracts, intermediaries and other credit exposures.
24. The basis for the treatment is linked to the probability of default (PD) and the loss given default (LGD), but also includes some adjustments (e.g. a 50% factor applied to the LGD ) in the formula.
25. Regarding Pillar 2, it should be embedded in the risk management policy of the undertaking.
26. Impact for the Insurance sector: the current crisis, although originated in the financial sector, has extended its effects to the global economy. This increases significantly the PD of counterparts, thus the risk to insurers in

the asset side, as well as the risk of particular classes of insurance business such as Credit and Suretyship insurance.

27. On the liability side, credit insurers will have to adjust their pricing policy to the existing scenario, where more claims are to be expected, and this may affect the access of potential customers as pricing policies will have to be adjusted accordingly. This situation may also, under certain circumstances, bring political pressure due to systemic implications towards the real Economy.
28. Directly linked to credit risk, the role of credit rating agencies (CRA) has been severely criticised, in particular regarding the rating of complex structured products. However, it has also raised the fact that insurers were overrelying on the ratings and models of CRAs, without an internal assessment of the underlying risks and forgetting, when adapting for their risk management processes the model run by the CRAs, that such models deal with credit risk, not with the whole risk profile of the undertaking. More generally, insurers should not invest in products they do not master.
29. Another clear lesson from the crisis is linked to what is to be understood as an effective risk transfer, and this impacts the treatment of alternative risk transfers (ART) such as the use of derivatives or securitisation of insurance risk portfolios. In many cases, due to credit risk, risks thought to be transferred were not. The same may happen in the case of reinsurance agreements where the reinsurer would default.
30. Way forward: different measures have to be adopted to deal with the aforementioned issues, not all Insurance specific. On the general ones, CEIOPS welcomes the initiatives taken by the EC regarding the treatment of CRAs and the settlement of derivatives.
31. CEIOPS thinks that ART, including insurance linked securitisations, are valid instruments to complement traditional reinsurance, and play an important role in the risk management of insurance undertakings. However, further consideration is required in order to assess whether the risk has effectively been transferred, and if such transfer implies additional risks. Pricing is an issue as well, and undertakings should have procedures in place to adequately calculate it.
32. As we have witnessed losses above 50% due to the use of financial derivatives, the formula to calculate LGD in Pillar 1 may be reassessed to see if it mirrors the real risk. What may work for reinsurance, doesn't work for financial derivatives.
33. Reinsurance programmes prepared by insurers will have to take into account credit risk and its implications for the undertaking, as well as foresee ways to tackle it. Pillar 2 should look at this area.
34. Insurers will also have to build up basic expertise to understand, monitor and steer credit products and their embedded risks, rather than relying only on external assessments. Supervisors will also have to work on this area, to further increase their expertise on the subject.

### 1.1.2 Liquidity Risk

35. Definition: Liquidity risk is the risk derived from the lack of sufficient cash or other liquid assets to meet the insurer's liabilities.
36. Treatment in Solvency II: the current regime deals with Liquidity risk in Pillar 2, both through the Own Risk and Solvency capital Assessment (ORSA) and Supervisory Review Process (SRP).
37. Impact for the Insurance sector: the current crisis has proved that there are differences between Insurance and Banking, in particular regarding the speed in which liquidity vanishes, the funding model that insurers have, and the way lack of liquidity affects the soundness of these institutions. However, this cannot be used as an argumentation to defend the lack of significance of this risk to insurers.
38. We have witnessed how surrenders of life policies, including unit linked products, may endanger the solvency situation of insurers, putting into question the effectiveness of ALM policies within undertakings or the profitability of certain products and lines of business.
39. We have also seen how there was a direct link between the need to provide additional collateral in contracts when the guarantor was downgraded and subsequent liquidity constraints.
40. Last but not least, there have been cases where liquidity has flown from the Insurance to the Banking part of Financial Conglomerates during this crisis.
41. For the time being, the impact to insurers has been limited (with few exceptions), but during 2009 we cannot exclude that this risks materializes in many undertakings, depending on the development of the crisis, and the possible loss of confidence of policyholders.
42. Way forward: Regarding future situations, it's clear that Liquidity risk is also an issue to Insurers, and demands an appropriate treatment. Is Pillar 2 sufficient or should it be also dealt within Pillar 1?
43. When it comes to Pillar 2, liquidity contingency plans, both at solo and group level, should be part of the risk management of the undertakings, to be reported to the board of directors with a higher, weekly if not daily, frequency in stressed times, and specific information should be requested by supervisors to undertakings on liquidity risks.

### 1.1.3 Market risk

44. Definition: Market risk is defined as the risk of changes in values caused by market prices or volatilities of market prices differing from their expected values.
45. Treatment in Solvency II: Market risk is dealt with in Pillar 1, being one of the modules that integrate the standard formula. It is composed by submodules for interest rate risk, equity risk, property risk, spread risk, concentrations risk and currency risk. The loss absorbing capacity for the risk mitigating effect of future profit sharing is also added.
46. Impact for the insurance sector: the results of insurers, for the year 2008, have been hit by the impact of the crisis, and the loss of value of most of

the assets that compose their portfolio. Property values have suffered a significant decline in some markets, equities indexes have lost an average 40%, credit spreads have reached unforeseen levels, currencies have been subject to very high volatilities...

47. The different areas that are reflected in the submodules of the formula have been therefore hit, and may need refining. But this has to be extended as well to the existing correlations within the market risk module, as the crisis clearly shows how they tend to increase in stress times (i.e. all risks tend to realise at the same time). Inadequate correlations would lead to a lesser capital charge than the one that would be necessary to meet a 99,5% confidence level.
48. Among the submodules that would require additional refining at Level 2, we should mention Equity risk, and see whether a 32% charge as tested in QIS4 is sufficiently prudent for listed equities (markets have been hit in 2008 by more than 40%), and whether a 45% for alternative investments (such as Asset Backed Securities, ABS) is also appropriate. With regards to the latter, we should aim at cross sectoral consistency, and avoid creating regulatory arbitrage with the banking rules. On the former issue, CEIOPS is fully aware of the existing political negotiations, but still expects a solution that is prudentially sound and appropriate for the treatment of equities, providing the right level of policyholder protection. Last but not least, within the Equity submodule, the treatment of intra-group participations needs to be further considered, including an appropriate approach to contagion and reputational risks failures and weaknesses in the area of internal controls and risk management have risen during the crisis, regardless of the size of the undertakings. As regards participations in the financial sector, cross-sectoral consistency is an important point
49. Way forward: When it comes to the Pillar 1 design of the Market risk module, CEIOPS should review the calibration and correlations of the different submodules, on the light of the lessons drawn from the crisis by CEIOPS Pillar 1 expert group, FinReq, to assess its soundness and accuracy, in particular in crisis times.
50. In Pillar 2, concrete requirements in terms of specific submissions of information from undertakings to supervisors regarding market risk will be necessary.
51. At the group level, colleges of supervisors will have to assess the appropriateness of the investment policies of the group, the extent to which there is an integrated management of the area, and the existing controls within the group.

#### **1.1.4 Concentration risks (including contagion lines within the Financial sector)**

52. Definition: Concentration risk can be defined as the exposure to increased losses associated with inadequately diversified portfolios of assets and/or obligations.
53. Treatment in Solvency II: Concentration risks area dealt with through a submodule of the Market Risk module. However, the relevance of the issue in the crisis, in particular with regards to contagion lines, calls for an

individualized analysis of it, both from the asset and liability side of the undertaking.

54. There is no specific treatment in Pillar 1 to contagion lines within the Financial sector. It may be part of the Pillar 2 approach to risk management systems, as one of the areas to consider.
55. Impact for the Insurance sector: the first thing that should be noted is that concentration risk affects both the asset and liability sides of the undertaking's balance. A fully comprehensive approach to the issue will require that both sides are considered, as exposures in the liability side directly affect the core business of insurers.
56. Concentration is linked to Diversification. The crisis has shown that diversification benefits (among lines of business, asset classes, geographical, etc.) tend to diminish or not be realizable in stressed times. CEIOPS recognizes the existence of diversification effects (both benefits and risks), but notices that they don't operate in the same way in normal and crisis times.
57. For the moment being, the crisis has put more emphasis on the asset side, in particular when it comes to the excess of exposure to certain types of assets or sectors (e.g. high exposure in real estate or to other financial institutions such as banks that have been severely hit by the crisis).
58. The crisis has shown as well how inappropriate exposures to concentration risk can minimize the effects of risk transfer mechanisms where there are problems with counterparts (monoliners, certain reinsurers, corporate bonds as collaterals in structured products...).
59. In particular, we have witnessed how insurers in principle solvent have been hardly hit by the belonging to a Financial Group, and the bad results of other parts of it.
60. We have also seen cases of liquidity transfers within Financial Conglomerates, from the insurance to the banking part of it. This may have significant consequences in case insurers demand additional capital due to liquidity constraints.
61. We have also detected cases where there have been increases in investments of insurers in the Banking sector (both equities and bonds), increasing their exposures.
62. Reputational risk has hit insurers being part of larger financial conglomerates that have been rescued during the crisis, regardless of the fact that the underlying problems didn't emerge from the insurance part.
63. Way forward: contagion lines and reputational risks should be appropriately dealt with at the level of financial conglomerates. CEIOPS should ask the Joint Committee on Financial Conglomerates (JCFC) to make sure that these issues are tackled in the upcoming review of the Financial Conglomerates Directive (FCD).
64. A full approach to concentration, to that both the asset and liability sides are captured is perceived as appropriate. Such comprehensive approach would cover both Pillars 1 and 2, and extend to solo and group level. Internal limits should be in place as part of the risk management of the undertakings, and should be disclosed to supervisors.

### 1.1.5 Custodian risks

65. Definition: The risk of loss of securities held in custody occasioned by the insolvency, negligence or fraudulent action of the custodian or subcustodian.
66. Treatment in Solvency II: This risk doesn't fall under the existing counterparty default risk module. There is only a broad Pillar 2 approach to the issue, as part of the investment policies of undertakings and their risk management and internal control systems.
67. Impact for the Insurance sector: We have seen that certain UCITS have not been able to recover their investments in Madoff, because of gaps regarding the depositary status in certain cases. CEIOPS has coordinated a joint EU supervisors initiative to calculate the exposure of Insurance and Pension funds to Madoff, and the exposures have proved to be limited and handeable.
68. Insurers also use banks as depositors in many cases, in particular in unit linked products, potentially exposing themselves (among others through reputational risk) and their policyholders to risks in case of entities close to bankruptcy.
69. Way forward: CEIOPS welcomes EC initiatives to clarify existing requirements for depositaries, as it will increase the legal and regulatory certainty needed.
70. CEIOPS relevant WGs, in particular FinReq, should consider how to make sure that this risk is accounted for, e.g. through the Counterparty default module.

### 1.1.6 Operational risk

71. Definition: The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes legal risks as well, but this definition (Basel II) excludes business risk, strategic risk or reputational risk.
72. Treatment in Solvency II: Operational risk is looked at both as part of the Solvency Capital Requirement, SCR, through an ad hoc module, and within the risk management systems and requirements of Pillar 2.
73. The way it is currently integrated in the modular approach followed in Solvency II standard formula doesn't allow for correlations with other risk modules, includes a cap based upon the basic SCR, and leaves risk sensitiveness to the Pillar 2.
74. Impact for the Insurance sector: many have said, with regards to this crisis, that the main risk embedded in it has been operational risk. The impact in terms of costs has been enormous, also to insurers.
75. The reason for CEIOPS to include it in a paper that deals with the lessons to be learned from the crisis is precisely to make sure that both supervisors and industry are aware of the relevance of Operational risk, as sometimes the perception is that not enough attention is given to it.
75. We have also noticed, prior to the crisis (and the effects are now visible), that some undertakings would rather take the upcoming capital charge than start working in how to deal with Operational risk (data collection, IT

developments, internal processes...), either due to lack of interest, expertise or funding to do so.

76. Way forward: in order to appropriately measure its potential impact, in particular during stressed times, and incentive active approaches from undertakings to Operational risk, in particular through internal models, CEIOPS may consider the usefulness of the current existing cap to it.

### **1.1.7 Use of stress tests and scenario analysis**

77. As an integral part of an adequate risk oriented system, as the one foreseen in Solvency II, undertakings should carry out stress test and scenario analysis in order to assess the impact on their solvency, both present and future, of different situations, both normal and extreme, that may affect them.
78. Treatment in Solvency II: Supervisors should have the power, as it is currently the case under Art. 34 of the Framework Directive Proposal, to require undertakings to perform such tests, both on ongoing basis and for concrete cases.
79. The existing debate on whether the stress tests should be developed by entities or supervisory authorities should not interfere on the fact that such exercises are of the utmost importance for any forward looking system, and should be embedded in the risk management processes of the undertakings.
80. Impact for the Insurance sector: The crisis has demonstrated the need of performing such exercises, and at the same time has shown that simultaneous (and apparently opposing) shocks may happen at a given moment in time.
81. The current crisis has also underlined the relevance of taking into account extreme events, the fact that certain shocks perceived as unrealistic can occur, and that historical experience can be misleading, by leaving aside relevant risks and scenarios that may lead to insolvency of the firm.
82. Way forward: CEIOPS underlines the relevance of prospective stress test, and expects that the power to ask for such tests remains in the Solvency II Directive.
83. Further use of complex scenario analysis with simultaneous shocks should be encouraged firstly, and prescribed afterwards. Design of such tests should be countercyclical, and include reverse testing (i.e. the point where the undertaking becomes not viable).
84. Information on the results of these tests should be submitted to supervisors by the undertakings involved.

## 1.2 CONSIDERATIONS REGARDING THE USE OF QUANTITATIVE LIMITS

85. In the existing regulatory framework (Solvency I), a series of quantitative limits for investments in particular assets that undertakings have to meet are in place, as well as there are certain asset categories where investments are forbidden in some Member States.
86. In the IORP Directive (Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision), the concept of Prudent Person was introduced, together with some possible limits at national level i.e. Prudent Person Plus, paving the way for more qualitative approaches to investments (five countries have gone for the pure, no limits, Prudent Person principle).
87. Treatment in Solvency II: the framework Directive settles in the recitals that "all investments held by insurance and reinsurance undertakings should be managed in accordance with the "prudent person" principle ". Therefore, it opts for an approach, consistent with the idea of a risk oriented system, which relies on the sound management practices of insurers, including the setting up of internal limits as part of their investment processes, rather than in the existence of fixed limits applicable to all insurers.
88. Impact for the Insurance sector: the current crisis shows how the asset side of the balance sheet can endanger the viability of an insurer. CEIOPS has been closely monitoring different type of exposures (e.g. to equities, banks, Madoff...) as part of its role during this crisis.
89. The existence of limits and the prohibition to invest in certain assets (e.g. hedge funds in some countries), as of today, may have helped reduce the impact of the crisis in some insurers, in particular those with less sophisticated risk management systems in place.
90. But an important lesson from this crisis is that, in many cases, investors didn't know the risks embedded in the assets they were buying. This has been particularly clear in the case of complex structured products. And this cannot be solved by just putting together limits on assets.
91. Way forward: the perception is that, if quantitative limits were to be maintained, there would be a disincentive for certain insurers to carry out an adequate assessment of their risks, and to put together a comprehensive investment policy. On that basis, CEIOPS would rather stick to the Prudent Person principle. Having said so, supervisors would expect to find such investment policies in place, including internal limits settled by the undertakings, both on volume and on types of assets, not investing in complex structured products they do not understand. The Supervisory Review Process (SRP) must pay special attention to this issue, and should require internal limits to be reported to supervisors on a regular basis.

### 1.3 GOVERNANCE SYSTEMS (INCLUDING REMUNERATIONS)

92. Treatment in Solvency II: the framework Directive Proposal includes a direct attribution of responsibilities to the administrative or management body of insurers, which is understood as a precondition for the effective functioning of the Governance system in place.
93. The text settles a series of general provisions regarding systems of Governance, and determines the need to further develop those at Level 2 and 3.
94. Impact for the Insurance Sector: when looking at the different risks and their treatment, we have already underlined the gaps and failures in risk management and internal control systems, deficiencies on the functioning of internal audit functions... indeed, this has stressed the need we have for an effective risk oriented system, both at Pillar 1 and 2, with adequate degrees of transparency.
95. Being Governance issues covered with a significant degree of detail in the draft Framework Directive, remunerations have usually been left aside sectoral regulations, relying more in general recommendations, e.g., for listed companies. However, the crisis shows to what extent a bad remuneration policy can increase the risks and therefore the losses. As an example, we can refer to the functioning of the wrapping process in CDOs, where not all tranches had the same quality, and not all tranches had the same level of demand, so at the end of the day those tranches not sold would remain in the books of the originating entity, as there was no penalty to traders for behaving like that, but otherwise a clear incentive (bonus, variable remuneration) to keep wrapping more and more credits through CDOs. The same incentive for those granting the credits to generate volume and increase the portfolio, regardless of its quality, as the risks would be transferred to third parties. Again it can be extrapolated to all levels within undertakings, to the extent that even those warning on potential risks would be facing pressure or complete lack of attention.
96. Remuneration schemes with the right incentives should not only be applicable within the undertakings, but they should as well rule relationship with other related parties, such as intermediaries, to avoid creating inadequate incentives that may, at the end, endanger the future viability of the entities.
97. Way forward: CEIOPS should further work in Pillar 2 related issues, namely on areas such as remuneration risk, where no ad hoc work had been foreseen. Wrong incentives have to be avoided, and undertakings should explain to supervisory authorities their remuneration policies, in particular regarding the variable part of it (bonuses). The focus should be put on long term objectives, rather than on short term returns that may endanger the future viability of the insurers.
98. The outcome should then be analyzed in the light of what is done by the other L3 Committees, looking at commonalities and putting together a consistent framework.

## 1.4 LOSS ABSORBING CAPACITY OF OWN FUNDS

99. Own funds are to be used to cover capital requirements, i.e. to absorb losses.
100. Treatment in Solvency II: The draft framework Directive requires insurers to hold eligible own funds to cover the SCR, and differentiates between basic and ancillary own funds on the one hand, and 3 Tiers of capital (Basel II like approach) according to quality criteria regarding availability, extent of it, subordination or duration among others.
101. There are as well limits and criteria with regards to the extent to which own funds can be used to cover the SCR and the Minimum Capital Requirement, MCR, as well as regarding the tiers structure. The underlying idea for those is the fact that not all financial elements provide with the same absorption capacity of losses, i.e. not all own funds are of the same quality.
102. Impact for the Insurance sector: the crisis, in particular in the Banking sector, has underlined the relevance of sufficiency of capital, as well as the issue of quality of it. Indeed, Markets have reacted to the turmoil by significantly increasing the expectations regarding the amount of tier 1 capital (and core tier 1) that banks are expected to hold, going beyond regulatory requirements, and requesting a financing effort from banks to meet such expectations in a moment where raising capital was limited and expensive. A driver for this market demand may be linked to the real loss absorbing capacity, during stressed times, of certain elements integrating the different tiers, not being as sound as expected.
103. Due to the specific business insurers run, the level of pressure has been less intense for Insurers, but for those who have needed to raise additional capital during the turmoil, it has been harder and more expensive than even to do so. But this doesn't mean that the same concern on the real absorbing capacity of own funds, and in particular of Ancillary own funds, can be translated to Insurance. At the same time, the existing provisions regarding Insurers' own funds may have helped them maintain relatively stronger capital positions compared to banks.
104. Way forward: Solvency II should ensure a sufficient quality of capital that guarantees its loss absorbing capacity, in particular under stressed conditions.

## 1.5 ROBUSTNESS OF INTERNAL MODELS AND THEIR APPROVAL

105. Although not used for regulatory purposes under the existing Solvency I regime, internal models are gradually being implemented by insurance undertakings, in particular the larger insurers, as a toolkit to better manage their risks.
106. Treatment in Solvency II: internal models have to be one of the cornerstones of a risk oriented system, and Solvency II, aware of this fact, allows for a gradual approach to modelling that should have embedded a clear incentive for undertakings to advance into this direction: entity

specific data and partial models before ending up with a full internal model.

107. Full internal models are a reference of the Solvency II project, as compared to Banking, where such a comprehensive approach is not allowed. This should allow insurance undertakings to get a full view of the risks they are facing, with implications not only in terms of capital, but mainly regarding the running of the entity (here's where the Use test shows its relevance in the process).
108. Impact for the Insurance sector: during the current crisis, the use and appropriateness of internal models in the Banking sector has been put into question by many stakeholders, as losses have gone beyond what these models predicted.
109. Some consider that the same would have happened if models were used by insurers to determine their regulatory capital. In order to check the validity of such comment, CEIOPS has distributed a questionnaire among those insurers already actively involved in modelling their risks. The responses of this questionnaire have been taken into account to better extract the lessons for the Insurance sector in the area of internal models, together with supervisory judgment and assessment of the situation.
110. Historical data and experience, in a crisis as this one, have proved insufficient to appropriately measure the risks and their impact. Risks considered as not relevant have hit the financial sector in a way almost no one had foreseen (liquidity risk, operational risk, inter alia).
111. Correlations in normal times seem to differ significantly from those under stressed conditions, so internal models based on normal circumstances and not challenging those through appropriate stress tests, may end up resulting in excessive diversification benefits, thus less capital than needed in stressed times, where capital itself is both most needed and harder to raise.
112. There has been a lack of appropriate testing and challenging of the results of internal models. In particular, there is a lack of reverse stress testing (i.e. stressing the model to a point where the firm becomes unviable) in Industry practices. Validation and approval of models, both internal and by the supervisor, remain an issue.
113. The issue of the Use test, and the ability and willingness of senior management to use the outputs of internal models, remains open, in the sense that there are questions regarding how these outputs can be used in cases where there is a lack of understanding of the models.
114. When considering the use of internal models at the group level, group models provide with an economic approach that tends to leave aside both fungibility and transferability of assets. The current crisis has underlined the relevance of these issues under stressed situations.
115. There will have to be an important effort, from the supervisory side, to get the experience and expertise needed to understand and validate models. Initiatives, as the pre visits to the main insurers put forward by CEIOPS, will be of the utmost importance.
116. Way forward: the main message on internal models, in the light of the current crisis and the comments made in the Banking sector, is that they

continue to be perceived as valid management tools, and necessary elements of a risk oriented system. CEIOPS, therefore, supports its use by insurers as well as the inclusion in Solvency II.

117. Regardless of the aforementioned, relevant lessons are to be taken out of this crisis. In particular, at least the following areas should be addressed by the system, mainly in Level 2:
- Quality of data used to feed the model should be an issue both internally and for approval of a model.
  - Coverage of risks, in particular for full internal models, may not be as comprehensive as needed, and risk mitigation techniques may not operate as expected in certain circumstances.
  - Models outcomes and correlations should be internally challenged, in particular by the use of stress testing, before being validated and approved.
  - Model error needs to be accounted for.
  - Appropriate monitoring of the models should be in place, to make sure they adapt to changing environments.
  - There should be internal procedures in place to deal with contingencies derived from excessive reliance on a few experts with regards to the model, so appropriate planning is in place to foresee and deal with staff departures or similar situations.
118. If internal models are to be considered mainly as management toolkits, the Use test should, in practice, play the role foreseen to it in the Solvency II draft framework Directive. Undertakings should prove that models are embedded in their decision making processes and that senior management understands the models and their outputs. If this is not the case, supervisors should not approve the models.
119. CEIOPS needs to play an active role in improving the expertise and convergence of supervisory practices in the area of internal models. Pre visits, training initiatives, ad hoc secondments... are among the measures perceived as necessary to do so.

## **1.6 SUPERVISION OF ALL PARTS OF A GROUP**

120. Insurance undertakings that belong to an insurance group or are part of a financial conglomerate tend to follow an economic approach to their businesses. As a direct consequence, the picture of the solo undertaking is insufficient to understand its solvency position. Rather it is necessary to understand the global picture in order to know what the real situation is.
121. Groups can be national, European or International, and they can be composed by insurers, non insurance undertakings and unregulated entities such as holdings. A holistic approach to risks demands that all risks that may potentially affect the group, regardless on where they are originated, are taken into account.
122. Different countries also imply different supervisory authorities and regulatory frameworks, which are subject to an equivalence assessment.

To check equivalence, CEIOPS has put together a task force of experts, already focusing on issues such as professional secrecy.

123. Treatment in Solvency II: There is, in the Level 1 of the Directive Proposal, lack of clarity regarding the possible supervision of unregulated entities, including holding companies that are part of a group. CEIOPS has been very clear in the need to give supervisors the power to extend their monitoring to holding companies, and to the persons that effectively run the insurance group or entity.
124. There should also be greater clarity regarding the extent to which diversification effects (both benefits and risks) extend beyond the EU, and its interlink with the effective recognition of equivalence.
125. Impact for the Insurance sector: when looking at the current crisis, and its effect to insurers, we have observed the importance of intra-group relations and how parts of a group that are not supervised can have a devastating effect even in the most solvent undertakings.
126. Four immediate lessons are to be drawn from cases analysed: a full picture of the risks is necessary, particularly for complex operating structures: secondly, overly complex operating or legal structures should be avoided, thirdly, a lack of supervision can result in insolvency even for the largest groups of insurers and fourthly at the latest stage of a big crisis, where taxpayers money is involved, there is always governmental involvement.
127. Other lessons would refer to the need by supervisors to access all relevant information, be it within the insurer or within a holding, both in normal and stressed times, including once governments have stepped in. Also the fact that there was no real cooperation or exchange of information among involved supervisors, both EU and third country based.
128. At the EU level, the Coordination Committee for the EU part of some groups did not function as it may have been expected, in particular in the very short term, and relevant decisions such as ring fencing of assets were taken on a national rather than EU basis. And this is not the only case we have seen during the crisis where effective supervisory cooperation didn't happen within the Financial sector.
129. Coming back to holding supervision and the need for it, holdings have been used in some cases to locate some investment of high risk profile, including structured products. Should holdings be outside the scope of supervision, no measure could then be taken.
130. The crisis has also highlighted issues concerning the non EU part of European insurance groups e.g. the US branches or subsidiaries of EU groups. This clearly highlights that risks arising from other parts of the groups need to be adequately taken into account, as well as the fact that not getting information on the existing risks outside the EU level has impeded supervisors to take pre-emptive measures, being forward looking. In helping promote Financial Stability, all impediments to a forward looking approach to risks should be eliminated.
131. Another lesson to be taken of the crisis is the impact that reputational risk may have for insurance groups, both linked to internal events within the group or to the external situation of the financial sector. Reputational risk,

in particular in Life, may have significant effects in terms of lapse rates, thus leading to liquidity constraints for insurers.

132. Last but not least, ring fencing of assets in crisis times has been a broadly extended practice, so both transferability of assets within the group and fungibility need to be taken into account at the group level as part of the risk management plans within undertakings.
133. Way forward: Solvency II needs to clarify the treatment of holdings, in particular regarding their supervision, as well as the treatment of non EU parts of an insurance group. The existing uncertainty may endanger appropriate supervision. Clarification will demand a clear Level 2 Implementing measures package on these two areas.
134. Insurers should aim to integrate their internal control procedures within the group, including internal audit and risk management functions.
135. Solvency II has to treat in a consistent manner (i.e. in line with the risks embedded) the potential risks derived from being part of a group, that had been underestimated, in particular by the Industry, when looking at diversification effects and the economic approach to groups. Further work is needed at Level 2 to deal with reputational risk, strategic risk, concentration risk and all risks derived from belonging to a group.
136. Colleges of Supervisors should be better prepared for crisis periods, and protocols or even MoUs regarding the flow of relevant information in crisis times, as well as setting the right level of authority regarding decision making processes, should be in force. The work on this area, on the basis of the jointly agreed 10 principles for the functioning of Colleges, should not wait until Solvency II is in force, but rather continue its development today, under the existing regulatory framework.
137. A legal obligation regarding the creation and operation of Colleges of Supervisors, together with an European mandate to supervisors, will help improve the current framework in which Colleges operate, increasing effectiveness and cooperation among supervisory authorities.

## **1.7 CONTINGENT LIABILITIES, INCLUDING OFF-BALANCE SHEET SPVs**

138. The treatment of contingent liabilities and off-balance sheet vehicles has become an issue of the highest relevance after the G20 asked, in one of their recommendations, that *Accounting standard-setters should significantly advance their work to address weaknesses in accounting and disclosure standards for of- balance sheet vehicles.*

IASB response includes enhanced disclosure about off-balance sheet risk.

Definition: according to IAS 37, *A contingent liability is:*

- (a) *a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*
- (b) *a present obligation that arises from past events but is not recognised because:*
  - (i) *it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or*
  - (ii) *the amount of the obligation cannot be measured with sufficient reliability.*

*An entity should not recognize a contingent liability. An entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.*

- 139. In addition to that, IFRS 7 requests certain quantitative information disclosure to be incorporated in the Memory. the IASB will review IFRS 7 Financial Instruments: Disclosures to assess its effectiveness in ensuring that entities disclose information that reflects their exposure to risk and any potential losses arising from financial instruments with the off-balance sheet entities with which they are involved.
- 140. Treatment in Solvency II: the draft framework Directive deals with Special Purpose Vehicles, SPVs, in article 209, listing the different areas to be covered by Level 2 implementing measures.
- 141. Additionally, securitisation is explicitly recognized in Solvency II as a way to transfer risks off the balance (e.g. in Article 106).
- 142. Impact for the Insurance sector: the last years we have witnessed a very significant increase in securitisations, in particular in the Banking sector, as a way either to funding or to transfer risks, taking them off the balance. One of the drivers for this trend was the fact that there was a direct incentive in terms of regulatory capital requirements.
- 143. We have also witnessed a liquidity risk problem linked to the fact that there is no market or price for some of these structured products.
- 144. However, risks that were thought to be transferred were not, and new risks emerged with an unexpected repercussion, including counterparty default risk in the case of SPVs, reputational risk... Risk management weaknesses rose, as there was not sufficient incentive to maintain controls in terms of credit risk quality, etc. because such portfolios would be taken off the balance.
- 145. Strong reliance was put on the ratings provided by CRAs to all these structured products and vehicles, whilst no internal analysis of underlying risks was done by undertakings. Not only there was not sufficient analysis, but in many cases there was an almost complete lack of understanding regarding the (generally complex) products and embedded risks.
- 146. Lack of transparency and inappropriate disclosure didn't help in the process, and meant, at the end, that we still don't know the extent of losses and where they are located.

147. Regardless of the fact that the main problems regarding off balance sheet exposures have been located in the Banking sector, insurers have not been immune to this trend. We have recently seen that for the 4<sup>th</sup> Q results of some groups, the main driver for the losses can be located precisely outside its core business, on the area of structured products, with substantial exposures and losses.
148. Even if the incentive is not as significant as it is in the Banking sector, still it can be an issue concerning Insurance Linked Securitisations (ILS), according to both the current and upcoming regulation, as long as you assimilate it with the treatment of reinsurance (as alternative risk transfers). However, the main issue regarding ILS, lies on how to adequately price it, and on whether we are talking about transfer of risk or financing without increasing debt ratios. Should it be the latest, then we should carefully look at the situation, as it may flag important problems in insurers the fact that they would need liquidity (let's keep in mind the fact that in Insurance, liabilities are usually deferred in time).
149. Other undertakings in the Insurance sector have made certain risky investment decisions through SPVs, including investing in assets that would be considered as not eligible according to their own internal investment rulebooks. And we have witnessed in this crisis that SPVs invested in CDOs backed by subprime (or Alt-A mortgages) were no longer able to meet their commitments (outflows of cash), having then to be liquidated, creating a problem in terms of counterparty default risk that was not foreseen by insurers.
150. Certain insurers (e.g. an example given in Italy) have decided during 2008 to compensate customers of index linked products for the losses incurred, due to reputational risk generated on investments in structured products with collaterals. Counterparty default risk within SPVs has also raised as an issue, due to the situation of some banks that would be part of the structure.
151. Way forward: the main finding that we should translate to the upcoming regulatory framework is linked with the need of a holistic approach to undertakings, which include as well SPVs and risk off the balance. This is directly linked to the issue of transparency and disclosure on the one hand, as well as to capital requirements and risk profile on the other.
152. Risk management needs to be reinforced, to avoid excessive exposures derived from complex products. Level 2 shall deal with the necessary Governance requirements. Internal assessments of risks should be in place, to avoid excessive reliance on external ratings. Risk assessment shall cover risks that can raise from this area, including reputational risk, counterparty default risk, liquidity risk, inter alia.
153. An effective risk transfer should be settled as a precondition before allowing any impact in terms of capital requirements. Otherwise, we risk a misuse by undertakings similar to the one we have witnessed in the Banking sector.
154. A sufficient level of transparency and adequate disclosure is needed. CEIOPS relevant WG will have to look at it, and information shall cover all relevant aspects of these exposures and structures, both from a quantitative and qualitative way.

## 1.8 FAIR VALUATION OF ASSETS AND LIABILITIES IN INACTIVE MARKETS

155. Treatment in Solvency II: Recital 27 of the draft framework Directive states that *The assessment of the financial position of insurance and reinsurance undertakings should rely on sound economic principles and make optimal use of the information provided by financial markets, as well as generally available data on insurance technical risks. In particular, solvency requirements should be based on an economic valuation of assets and liabilities (economic solvency balance-sheet).*
156. Valuation standards for supervisory purposes should not require to have a second set of accounts although prudential filters may need to be applied. They should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden on insurance or reinsurance undertakings
157. Impact for the Insurance sector: one of the main drivers of the current crisis has been directly linked to the combination of lack of disclosure and inappropriate valuation of complex products. The principle of not buying or selling an asset you cannot value or understand was constantly left aside. Reliance on external ratings, inappropriate valuation techniques, wrong remuneration incentives, could be named as drivers of this trend.
158. During October, 2008, IASB urgently amended IAS 39 and IFRS 7, so as to allow for reclassification of certain assets (estimations add up to 3.5 billion in assets reclassified in Banking). Such practice has been more used in the Banking sector than in the Insurance one (CEIOPS is mapping the extent of use within the Insurance sector of reclassifications, and a Questionnaire has been submitted to Members). Additional Guidance on how to measure the fair value of financial instruments where markets are no longer active has been also issued by IASB.
159. However, there is further work that needs to be done, in the areas of embedded derivatives, fair value option and impairment
160. It is a fact that many insurance companies follow local GAAP instead of IAS accounting rules. This has enabled local supervisors to adapt specific measures to avoid procyclical effects, but a lack of coordination when adopting these measures has been noticed. Indeed, many argue that procyclicality is more of an issue of the investment policies and business strategies of undertakings, than a pure accounting one linked to the fair valuation of assets and liabilities.
161. Valuation is of the utmost importance, not just for accounting reasons, but also for risk management purposes or on the calculation of the level of own funds, as it should be embedded to decisions on whether to invest or not in an asset, the ALM policy of an undertaking (e.g. using SPVs to match durations) and its overall investment policy. Inadequate valuation has been linked to overpayments and underestimation of underlying risks.
162. In addition to that, in a fair value environment, undertakings should be expected to calculate the value of their assets and liabilities, and this has not been the case regarding structured products, in particular where trading for these products has vanished. Lack of markets, and thus lack of transparency and reliability in the formation of price.

163. Valuation has become an issue, in particular in illiquid or non active markets, demanding in many cases a turn towards Mark to Model valuation, which should require additional consistency in the treatment and additional disclosures. Work to be delivered by International bodies (e.g. IASB) should be consistent with regards to sectoral and cross-sectoral treatment, not creating unlevel playing field within the Financial sector.
164. Way forward: CEIOPS considers that the economic valuation of assets and liabilities should remain as valid, and necessary, for a project like Solvency II.
165. CEIOPS welcomes additional work to be done on valuation by IASB, and considers that solutions adopted should bring consistency within the Financial sector. CEIOPS should closely follow the works in IASB and EFRAG, to make sure that the characteristics of the Insurance sector are rightly taken into account. In particular, the lack of market for insurance liabilities and the complexities involved in their valuation should be considered.

## **2. LESSONS BEYOND SOLVENCY II**

166. In order to get a regulatory framework that works both in normal and stressed conditions, there are certain areas that, although outside the scope of Solvency II, are important elements of the global picture, and need to be addressed appropriately.
167. Among those elements that need to be considered, we would like to focus on the following:

### **Insurance Guarantee Schemes**

168. Insurance Guarantee Schemes (IGS) are not in place in all 27 EU Member States, as there is no EU provision that settles them on a compulsory basis. However, a significant number of countries have implemented different schemes that provide such guarantee to the system.
169. Lack of harmonisation brings, first of all, a problem linked to unequal treatment among EU policyholders, as some will benefit from existing guarantees, and others won't have access to them. Cases like Independent, show the implications regarding the cross-border functioning of these schemes, where settled, and the difference in treatment of nationals of the different countries.
170. But this is not the only problem worth mentioning, as the current crisis has meant that the existing guarantees in the Banking sector have broadened significantly (in some cases unlimited guarantees for deposits), thus creating a potential problem of competition, whereas for those life insurance products that are designed as investment or long term saving vehicles there is no guarantee for the policyholder as the one for depositors. Industry has raised this issue of competition, and a sound solution needs to be found to address this problem, as it may lead to an increase in surrenders, and a reduction in generation of new business.

171. Together with all the aforementioned, a number of stakeholders perceive the existence of a EU consistent scheme, with clear rules on how it would enter into force and whom it would cover, as a precondition for further developing on delegation of responsibilities among supervisors for Insurance groups.
172. Having said so, a solution is not simple, as issues currently open in the Banking sector, including funding (whether it needs to be harmonized and ex ante vs. ex post financing), access, scope... need to be solved. Different considerations may apply to these issues in the Insurance sector. Answers are also needed to Insurance specific questions such as whether these schemes should operate in Life only, or extend their functioning to Non life as well.
173. Way forward: on the basis of the described situation, it is clear that a problem has been identified, and that a workable solution is needed. Therefore CEIOPS is putting together a group of experts to explore the different alternatives and to try to come to a common and workable proposal for it.

### **Information to policyholders**

174. Confidence in the Financial sector in general, and in particular in the Insurance sector, is of the utmost importance for its development, and confidence demands time and reliance to be built, whilst it can be destroyed very quickly.
175. The reverse of the coin, i.e. lack of confidence, always implies surrenders, cessation of underwriting new business and a general deterioration of the business. Whilst generating confidence mainly depends on the undertaking itself, the loss of it can be originated outside a concrete undertaking, and have many sources. Therefore it is essential to try to provide with a general framework as adequate as possible in order to deal beforehand with potential gaps that can hit the confidence in the Insurance sector.
176. Among the most relevant areas to address, information given to policyholders remains as a basic issue. Indeed, policyholders (as any other consumer of financial products) need to have the relevant information that allows them to make the better decision according to their profile at all times, i.e. before signing the contract, during the life of the contract and once the contract has expired or the claim is due. Appropriate information should reduce misselling, that has been an issue in particular in the Life business lines in many undertakings, and may have implications in terms of reputational risk.
177. We have seen during the crisis how some policyholders with unit linked products have been affected by exposures to specific counterparties they had no clue were there, or how they bought complex products that, in principle, would be sold as having a minimum guaranteed return and further benefits linked to evolution of indexes, that were again guaranteed as collateral with corporate bonds (namely because with the higher credit risk spread, the insurer would be buying options regarding evolution of markets, as part of the product offered).
178. Different practices and requirements are currently in force in the EU, in many cases derived from Contractual law (either general or Insurance

specific). Together with it, the Insurance Mediation Directive regulates selling practices (distribution channels), and include a series of requirements regarding precontractual information that has to be provided by the mediators.

179. For certain lines of business, in particular unit-linked, there are no prescribed requirements for information (as a global approach, because certain Member States have included such request on a national basis) during the running of the contract, in particular on expenses and commissions. Such information is requested in MiFID Directive (Markets in Financial Instruments Directive), but the Directive explicitly excludes from its scope Insurance. Industry has repeatedly said that MiFID should not be extended to Insurance sector, and that such requirements would at the end be a source of additional expenses rather than a source of useful information to unit-linked customers.
180. Way forward: with policyholder protection as the main objective of supervision, all steps given by CEIOPS to increase such protection have to be taken. In this case, CEIOPS needs to look at what information should be relevant to policyholders, not only precontractual, but also during the full life of the contract. Information must be complete, adequate and understandable.
181. A horizontal approach to product information is among the issues that CEIOPS is currently looking at. Best practices need to be collected and shared among supervisory authorities in this area.
182. Another line of work to protect consumers is the prevention of mis-selling, in particular requiring insurers the approval and application of ethic commercial policies and its appropriate disclosure.

### **Common reporting formats**

183. During the current crisis, the reaction of the Markets regarding insurers has shown that there is a lack of transparency, understanding and comparability of the financial situation of these undertakings. The consequence has been a reduction in their share price, not only but also due to the perception that something is hidden or unclear.
184. Lack of common reporting formats has implications as well in terms of information collecting and processing, and during this crisis supervisors have sometimes struggled to collect the information they needed on exposures and risks of undertakings.
185. It has additional negative effects regarding large cross border groups, as they will have to deal with different requests that are neither consistent nor uniform, while at the same time producing internal information. This additional administrative burden should be avoided, but having said this, in many cases the main hurdles come from within the Industry, as many are reluctant to changing either due to cost related issues or to unwillingness to migrate from their own internal formats and IT toolkits.
186. Way forward: CEIOPS has committed to the highest political levels to come with common definitions and formats that would be implemented with the new Solvency II regime requirements. Consistency among sectors

is another aim, so joint work and appropriate coordination with CEBS will be needed.

187. In order for this very ambitious project to be operative, the highest commitment from all relevant stakeholders is needed. Without the compromise of all parties involved, the outcome will be a failure.