Federation of European Accountants
Fédération des Experts comptables Européens

European Commission
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Cc: Mr. Karel van Hulle
Head of Unit H2 Insurance and Pensions
DG Internal Market and Services
European Commission

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Ref.: INS/PRJ/LFU/IDS

Dear Sir or Madam,

Re: FEE Comments on EC Consultation on the Level 2 implementing measures for Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

(1) FEE (the Federation of European Accountants) is pleased to provide you with its comments on the EC Consultation document on the Level 2 implementing measures for Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (the "consultation document").

(2) In this letter, we comment on those questions in the consultation document that are of primary relevance from an accounting and auditing perspective. These are pertaining to Section 2 of the consultation document dealing with Policy Issues.

Policy Issues (Section 2. of the consultation document)

Technical provisions – best estimate – risk-free interest rate curve

Question 1: Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:

- **harmonising the calculation of technical provisions;**
- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards; and**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB.**

(3) We support taking illiquidity into account when estimating technical provisions. However, we note that double counting of the illiquidity premium should be avoided. We explain these comments further in the paragraphs below.

(4) The measurement of insurance liabilities is from the insurer's perspective rather than the investor's. The insurer's financial position is affected by liquidity since a liquid liability forces the insurer to invest in more liquid assets. Liquid assets have, as noted correctly, lower returns than more illiquid assets. Consequently, the time value of money for more liquid liabilities is lower than the time value of money for less liquid liabilities.

(5) Liquidity of a liability from the insurer's perspective is any event that could cause the insurer to repay the obligation earlier than expected. Reasons for such events include occurrence of claims and execution of surrender options. The fact that a customer might "cash-in" its rights by other means, e.g. on a secondary market for insurance contracts, does not have any economic relevance for the insurer regarding existing business, except that it might even enhance the illiquidity of the business. It is only relevant in negotiating prices before inception, since a customer will be willing to require lower returns for a right which can be "cashed-in" in markets. However, that is not relevant for measuring existing portfolios from the insurer's perspective, regardless of whether it is the current insurer or any other insurer acquiring the portfolio of insurance liabilities later.

(6) The liquidity characteristics described above are to be fully considered in the best estimate of cash flows and in the risk adjustment by applying adequate probabilities for each possible event causing early payments and applying risk adjustments for the inherent risk.

(7) Consequently, from an insurer's perspective liquidity must not be reflected again in the discount rate. The application of time value of money needs to be on a fully illiquid basis to avoid double counting of liquidity effects. A further distinction is, that the liquidity premiums inherent in market interest rates reflect a financial rational behaviour of holders of option rights, while the explicit consideration of liquidity in the best estimate and risk adjustment considers the current expectations based on experience. Therefore, there is a difference on whether to consider liquidity within discount rates or explicitly.

(8) Double counting would inflate the liquidity impact and consequently impair the comparison between more liquid and less liquid liabilities.

Technical provisions – risk margin – Cost-of-Capital rate

<u>Question 2:</u> Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:

- **harmonising the calculation of technical provisions;**
- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards; and**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB.**

<u>Question 3:</u> Do you agree that a 6% Cost-of-Capital rate would closely reflect the cost of providing an amount of eligible own funds equal to the SCR necessary to support the insurance obligations over the life time thereof?

(9) At this point in time, the outcome of the IASB's project regarding the development of an International Financial Reporting Standard for insurance contracts is still on-going. It should be noted that the objectives of Solvency II and financial reporting are different, whereas the International Financial Reporting Standard is based on a going concern, Solvency II is requiring a break up value. Nevertheless, we support the Commission's intention to promote compatibility of valuation and reporting rules with the International Financial Reporting Standards issued by the IASB as far as possible.

(10) Furthermore, we would like to note that since the capital is often based on "quantile" (i.e. when the basis for capital under Solvency II is "sufficient with a probability of 99,5%"), it does not reflect the overall peculiarities of the risk inherent in the relevant obligations. Consequently, the IASB's proposals to apply a risk-specific, i.e. non-global cost rate to achieve that the calculation of technical provisions is appropriate. However, regardless of the resulting difference to IFRS-reporting, it appears a reasonable short-cut for solvency purposes to use a global cost rate for all obligations. Having said this, it can be questioned whether that cost rate is constant on top of the risk-free interest rate. Risk-aversion regarding average insurance risks may change in markets, therefore, in our view it is not considered to be appropriate to fix that amount neither at 6% nor at any other level.

Technical provisions – risk margin – diversification

<u>Question 4:</u> Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:

- **harmonising the calculation of technical provisions;**
- **introducing proportionate requirements for small undertakings;**
- **introducing risk-sensitive harmonised solvency standards; and**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB.**

(11) Whilst the IASB proposals restrict the recognition of diversification effects to the "portfolio of insurance contracts", that may not be necessary for solvency purposes. First, regarding consistency with IFRS, the "portfolios of insurance contracts" might be a smaller disaggregation of the business of an insurer than the line of business or might even consist of business across several legal entities. Consequently, consistency may actually not be achievable at all by reference to lines of business of an entity (i.e. policy option 3: diversification within, but not across, the lines of business).

(12) Considering the purposes of solvency, not bound by general accounting principles, it would be appropriate to consider policy option 2 (i.e. the same diversification of the undertaking for which the calculation is made), since if the entity is in distress, a transfer of the entire business with all its diversification potentials could be considered. Although that would cause some limited harmonisation of the measurement of individual technical provisions, uniform measurement of provisions is not the purpose of solvency. Such consideration of diversification effects would also motivate and reward efforts of smaller insurers to improve diversification.

Supervisory reporting and Public disclosure – content, form and modalities

<u>Question 11</u>: Do you have any suggestions on which specific quantitative data should be subject to external audit?

<u>Question 13:</u> Do you agree that the Commission Services' suggested approach would be the most efficient and effective in order to achieve the objectives of:

- **introducing proportionate requirements for small undertakings;**
- **harmonizing supervisory reporting;**
- **promoting compatibility of valuation and reporting rules with the international accounting standards elaborated by the IASB; and**
- **ensuring efficient supervision of insurance groups and financial conglomerates.**

(13) As far as FEE understands the proposals in the consultation document, the reporting by the insurance undertaking on specific quantitative data would be outside the financial statements of the insurance undertaking. Therefore, it would not be audited as part of the statutory audit of the financial statements of the insurance undertaking. In such case the specific quantitative data could be subject to other assurance work carried out by the same auditor as the statutory auditor or by another auditor. This would be in line with the public interest for such work as expressed in the CEIOPS final advice and based on the impact assessment analysis carried out by Deloitte. With this in mind, FEE would like to mention a few more detailed points, which are set out below.

Public information versus private reports to regulators

(14) An important consideration when deciding which specific quantitative data should be subject to assurance work from an auditor is whether the results of the work done by the auditor are to be reported to the supervisor privately or whether (part of) the publically disclosed information in the Solvency and Financial Condition Report (SFCR) should be accompanied by an assurance report from an auditor.

(15) When such quantitative data are made publicly available, the assurance report attached to it would need to be based on a framework for such a report, both as far as the data to be reported and the assurance to be given by the auditor are concerned. In the consultation document, the Commission limits the options for auditor's involvement to either audit (reasonable assurance) or no assurance. FEE would like to highlight that auditors can provide other work than reasonable assurance that might be relevant in this context, such as limited assurance that has a lower level of assurance than audit or a factual findings report based on agreed-upon-procedures where specific procedures are agreed between the involved parties and reported on by the auditor.

(16) Where the auditors' work is on a private basis to regulators there would be more scope for the tailoring of specific requirements for the reporting by an auditor.

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Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986

Information subject to audit should consist of quantitative and certain qualitative information

(17) However, we would like to point out that the framework for the information that is subject to formal assurance requirements – whether in the form of reasonable or limited assurance - should always consist of quantitative information and certain qualitative information (principles of valuation, critical accounting principles, major assumptions, models and parameters used, link to risk management and control for "through the eyes of management" information, etc.). This will allow the user of that information to have a comprehensive and unambiguous understanding of the data. Concentrating this information in one clearly identifiable subsection of the report would be more convenient to the reader.

(18) The decision on whether to require the published quantitative data to be accompanied by some level of assurance may also affect the quantity of information that must be reported privately to the supervisor: Certain information that the supervisor may need to perform its supervisory role may not necessarily need to be reported, if that verification is covered by the assurance report provided by an external auditor. This interdependency should be taken into account in the further process of defining data to be reported and which is to be accompanied by an assurance report.

Level playing field

(19) We welcome the decision to open the debate around the need for independent assurance of certain information of the SFCR and the Report to the Supervisor (RTS), as it is important to create a level playing field which will likely improve the inconsistent current state of supervisory reporting and auditor involvement within the European Union.

For further information on this letter, please contact Leyre Fuertes, Project Manager, at the FEE Secretariat on +32 2 285 40 76 or via email at leyre.fuertes@fee.be.

Yours sincerely,

Philip Johnson
President