Solvency II: QIS4 – Results and messages

The results of Quantitative Impact Study (QIS4) released by CEIOPS on 19 November 2008 show that there will be some winners and losers in the Solvency II capital game but almost 90% of participants will be able to meet the new Solvency Capital Requirement (SCR). A majority of insurers see implementing a new internal model as a chance for better risk and capital management – essentially sounder business decision-making - rather than specifically targeting a lower capital requirement. Participation far exceeded the Commission's targets, a market share of just over 60% across most countries, giving sufficient data to draw meaningful conclusions, however there are still a large number of organisations that did not participate which may hide a greater impact on levels of capital required.

Levelling an uneven playing field?

As a whole, like QIS3, the European insurance industry does not need more regulatory capital. QIS4 results indicate a redistribution of capital will need to take place in order to better align capital to the risks and rewards. A small minority of participants (1.2%) failed to reach the Minimum Capital Requirement (MCR), and 11% of participants did not meet the SCR.

Life insurers across Europe reported better solvency ratios compared to Solvency I, there are a number of reasons including market risk, non-life insurers noted the opposite. Composites, reinsurers and captives also experienced decreasing solvency ratios, but figures were inconclusive for health insurance.

There was considerable national variation in the level of capital required suggesting Solvency II may level the playing field. The most significant variations were observed in territories where local accounting rules are currently not based on a market consistent approach.

Proportionality in practice

QIS4 demonstrated that the proportionality principle will work in practice as smaller firms benefited greatly from the introduction of simplifications and proxies. That said, simplifications were used – by small and large firms alike – for example in the risk margin calculation and counterparty default risk, indicating respectively the complexity of the calculation and the paucity in quality data.

No Internal model was Solvency II compliant

Although there was a limited response to the internal models part of the questionnaire, nearly half believe that the use of an internal model may reduce capital requirements by more than 20%. Results showed that non-life firms gained a greater benefit than life firms when using an internal model relative to the standard formula. Although, Internal models produce lower capital requirements than the standard formula across many risk modules, the capital charge for operational risk, equity risk, property risk and mortality risk was higher. CEIOPS reported that no internal models used in QIS 4 would meet the standards set in Solvency II.

The aggregation of business lines leads to imprecision and a loss of diversification benefits which is at odds with the requirement for granular data which many companies struggled to gather.

Market value still the most appropriate measure

A new market consistent valuation basis for assets and liabilities received general support, even with the current turmoil in financial markets. Differing methodologies were used in the calculation of best estimates insurance liabilities, and the approach for the risk margin add-on was unduly complex. Life entities found the valuation of options and guarantees, together with future discretionary benefits a challenge; the appropriateness of the 6% cost-of-capital factor for the risk margin was also questioned.

Participants expressed a strong desire for consistency between Solvency II valuation principles and international accounting standards (IFRS). Across the EU supervisors are concerned about the auditability of Solvency II balance sheets, particularly where these are produced by member states that do not use international accounting standards.

PricewaterhouseCoopers

Standard formula risks: more work needed

Industry and supervisors both liked the modular approach used for the standard formula.

For life businesses market risk drives the majority of the capital charge, of which equity risk tends to be a significant proportion. All parties voiced concerns over the way equity stress was tested and that the equity risk charge of 32% should be closer to 40% in order to achieve a 99.5% confidence level. Although the life underwriting risk component for lapse risk was considered too high, the resulting charge was lower than QIS3.

In terms of non-life underwriting risk, participants welcomed the introduction of geographical diversification, the use of undertaking-specific parameters and the new approach for catastrophe risk. All parties encouraged CEIOPS to further develop and improve these innovations.

Participants felt the operational risk formula lacks risk sensitivity as it does not recognise the wide range of operational risks many of which are qualitative: some noted that the operational risk charge would be best left to internal models and Pillar 2.

The degree of national variation in QIS 4 results, particularly around the approach to best estimate valuation, stresses how critical it is to ensure that regulators across the EU apply the rules consistently. A lack of consistency would significantly undermine the level playing field for insurers.

Groups: key questions remain

While the standard formula for solo entities is largely agreed, the formula for the calculation of the group solvency requirement needs is still very much under discussion. The industry said that it needs further clarity on the application of Solvency II to groups, particularly with reference to third country equivalence, group support, group internal model approval and the use test. Groups saw an increase in the total diversification benefit in QIS4 which averaged over 20% at an overall level compared to the sum of solo entities. All of the issues concerning groups are currently the subject of considerable uncertainty.

The need for greater engagement - QIS5?

Far exceeding the European Commission's 25% target, the 34% participation on a solo basis revealed considerable industry commitment to Solvency II. The 1412 solo participants came from all 30 EEA countries (representing over 60% of market share in most countries), group data was collected from 111 groups from 16 member states giving sufficient data to draw meaningful conclusions for the first time. Importantly, many more small and medium-sized firms participated compared with QIS3, and distribution across insurance lines was even enough not to distort the results overall.

QIS4 revealed a number of detailed areas where further testing will be required. The Commission has indicated that there will be a QIS5: 66% of (re)insurers did not respond to QIS4 and there must be a concern that those organisations do not have a sufficient understanding of the implications of Solvency II.

Level II: going beyond the numbers

QIS4 aimed to test the various aspects of the current proposals, mainly quantitative but also qualitative, to enhance the foundations for CEIOPS' work on the Level 2 implementing measures. Although the exercise has proved difficult, it has provided a steer for further development in this regard. QIS4 primarily focuses on Pillar 1 of the new regime but the work going forwards will focus also on Pillar 2 and Pillar 3 and how the pillars inter-relate. Firms will need to look beyond the quantitative issues to understand the wider practical implications of Pillars 2 and 3. It is also imperative that they stay close to Level II developments and contribute to CEIOPS work as much as possible, or lobby on their own account.

Own funds show substantial increase

Across all countries, own funds increased by 27% due mainly to valuation adjustments related to the move to market consistent valuation, reclassification of equalisation provisions, allowance in full of hybrid capital, subordinated liabilities and ancillary own funds.

QIS 4 has undoubtedly been a useful, if painstaking exercise, and has produced some good data and insights. It has highlighted the extensive work that will be needed for the Level 2 implementing measures in order to ensure consistency in approach and to remove ambiguities in the interpretation of the directive.

Next steps

QIS4 is a significant milestone in the Solvency II process both for those developing the framework and for the industry. The implementing measures will call for a greater meeting of the minds across borders specifically to ensure the consistent application of the proportionality principle in the three pillars not just in terms of the supervisory review process, and as a result, a level playing field for insurers across the EU.

QIS4 has surfaced many challenges in preparing for Pillar 1 requirements not least, building an appropriate internal model, sourcing relevant data of sufficient quality, changing the basis of valuation and the resultant impact on future potential capital requirements. It does not, provide companies with a feel for the extensive governance and control structures required under pillar 2, or the effort and cultural change needed to deliver this change. We urge those who did not participate in QIS4 to go through the exercise as they need to understand now how these issues will impact their organisations.

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