CEA Insurers of Europe

Chief Risk Officer Forum

To: Commissioner Charlie McCreevy
Internal Market Directorate General
European Commission

Subject: Solvency II – Methodology to calculate the MCR

25th of January 2008

Dear Commissioner McCreevy,

The European Insurance industry as you know has strongly supported the Solvency II directive proposal. In particular we support the underlying economic risk-based approach, which allows for a system that reflects the true risk profile and risk mitigation schemes of insurance firms.

Since the proposal has been published we have seen a succession of challenges to the economic risk based approach to a greater or lesser extent. The most recent of these challenges and one which we think is fundamental to the success of the project is the method of the calculation of the Minimum Capital Requirement (MCR). The Directive of course proposes two regulatory capital requirements, the Solvency Capital Requirement (the SCR) and the MCR. The MCR is the lower supervisory intervention point and reflects a level of capital below which policyholders and beneficiaries are exposed to an unacceptable level of risk. It is the level of capital at which the supervisor is obliged to contemplate ultimate actions.

The QIS 4 consultation and the recent discussion paper from CEIOPS on the architecture of the MCR[1] challenge this. It is clear that there is a view among regulators that the MCR should be calculated on a separate basis to the SCR so that it acts as a safety net in the eventuality that a modelled SCR number should turn out to be wrong or too low. This to us is a major challenge to the Directive and in effect a reversion to a Solvency I world of non risk sensitive measures.

In the effort to find a compromise solution, CEA suggested[2] that the solo MCR is calculated as a percentage of the appropriate SCR figure annually calculated by the company and reviewed and approved by the supervisor, whether derived from the use of the standard formula or internal model. In conjunction with each calculation of the SCR, as shown in the example below, this percentage would then be re-expressed as a company specific percentage of technical provisions (or premiums as appropriate) in order to face the issue of legal certainty and auditability as well as to avoid ad-hoc interim-calculation of the SCR. For unforeseen exceptional circumstances, in which this proposed interim calculation would not represent sufficiently well the real risk situation (e.g. after a sudden important crash in the financial area or after the acquisition of a big insurance portfolio), the

[1] CEIOPS –DOC-22/07

[2] CEA working Paper on the MCR and Proposed Ladder of Intervention – October 2006

supervisor or the company should have the right to carry out a regular SCR calculation in order to derive the MCR figure[3].

The CRO Forum fully supported this proposal[4].

Calculating the MCR
For a particular life company, assume that at year end the MCR calculated as a percentage of the SCR (MCR=Factor *Approved SCR) is 30 million and technical provisions (for life) equal 1.000 million. The MCR is re-expressed as 3% of technical provisions (i.e. 30/1000=3%). Assuming that at a future date (for example, 31/03), the technical provisions are 1.100 million, the MCR would be 33 million (i.e. 3% of 1.100 million). The 3% rate would apply until the next point when the SCR is re-calculated with supervisory review. At that point, the MCR is re-calculated as a percentage of the approved SCR and then re-expressed as a percentage of the updated value of the technical provisions.

At this stage of the project, we reiterate our support to this calculation method as the best way to meet the principles stated in the Directive Proposal (art.126), striking a balance between risk sensitivity and simplicity.

The link with the SCR means that the MCR is risk sensitive to a degree and this is critical to ensure that ultimate supervisory actions are taken when the amount of capital is actually at the level "below which policyholders and beneficiaries are exposed to an unacceptable level of risk", taking into account of diversification and risk mitigation to the extent allowed for in the SCR. This allows the MCR to act sensibly as the final step in an escalating ladder of intervention. Please bear in mind that other MCR proposals we have seen thus far are either too simple or too complex. The problem with simple approaches (like Solvency I), the minimum is not sufficiently risk based and will either be too onerous or too aggressive. Inventing another method of calculation for the MCR that is risk based will double the work and still does not satisfy regulatory concerns about the calculations being materially in error. By focusing supervisory attention on the SCR with its review and acceptance it aligns interests and attention between the supervisors and companies while maintaining sensitivity testing under Level II reviews.

The CEA calculation is also objective, relatively simple and easy to communicate to stakeholders. Indeed, the level of complexity and objectivity both of the calculation as such and of the input data are similar to those of alternative calculations considered so far. Also, it would not create additional administrative burden as it would not require interim calculation of the SCR.

We understand that CEIOPS members cannot reach a consensus in favour of the CEA approach and proposes to test an alternative, s.c. linear approach, in QIS 4. We hope CEIOPS will be persuaded by our arguments and, we expect, by the results of QIS 4 to reconsider the merits of the CEA approach. However if the political problems remain too great and consensus still cannot be reached in favour of the CEA approach then we certainly do not close the door to any other method which might also be shown to meet the principles of risk sensitivity and simplicity.

The "linear test" which will be put under trial in QIS 4 is based on the application of fixed percentages on technical provisions and other volume elements.

Even though we are ready to test and discuss a range of calculations to arrive at a better informed decision, we would like to stress that in principle the linear test approach method does not appear to be consistent with the

[3] Under the principles of art. 101 of the Directive proposal
[4] CROF letter of 5 October 2007 – Feedback on the Solvency II Draft Directive

overall system and could potentially jeopardise its smooth functioning. We think that the linear approach does not lead to a sufficiently risk sensitive measure. It very loosely and approximately puts a number on underwriting risk and does not consider other risks categories at all. In particular it does not explicitly quantify asset liability mismatch risk, which is a key risk driver, especially for life business. Risk mitigating schemes are also not reflected appropriately, as well as diversification effects and the loss absorption capability of liabilities.

This means that the level of MCR would not adequately reflect the true risk profile of the company and would not interact sensibly with the SCR. Companies with relatively high risk exposures could have the same MCR requirement as companies with relatively low risk exposures. This could mean that final supervisory action is taken much too early in relation to low risk companies, possibly at the same time as a breach of the SCR, and potentially much too late for the higher risk firms.

Depending on the calibration of this method, we are also concerned that the MCR could dominate the required capital levels and become the main reference of risk management, therefore reducing the incentives to develop a good internal risk management system or to discourage inappropriate risk taking. It is also worth noting that over time the calibration of the method could become increasingly inappropriate. This is because the implicit margins may not be appropriate under different economic conditions or when new risks emerge. In contrast, the SCR will by design allow for these and so an MCR derived as a percentage of the SCR would also by design allow for them.

Finally, it should be highlighted that an inappropriate calculation of the MCR could affect the functioning of other aspects of the new regime. In particular, from a group's perspective, the sum of the solo MCRs will also serve as minimum level of the group SCR. If the calibration of the MCR is inadequate, it will limit without any economic rationale the extent of group diversification effects that can be taken into account.

We understand that one of the reasons for supervisors to support the linear approach would be its capability to work as a safety net "against a very low SCR" or any potential flaws in the design of the SCR standard formula. We fundamentally disagree with this position. As described above, the SCR is designed to reflect appropriately all quantifiable risks and as such it makes no sense to have a potentially arbitrary and distorting underpinning. Furthermore, the Directive Proposal provides room for more effective (Pillar II) measures to tackle additional risks and/or directly address limited cases where the specific risk profile of the company departs from the assumption underlying the standard formula.

We of course have to recognise that many supervisors have genuine concerns. They are nervous that the SCR approach and internal models in particular may not always work to provide the regulatory certainty that the old Solvency 1 world appears to deliver. The MCR debate therefore is at one level a clear indication of a lack of confidence among some member states in the whole philosophy of risk based regulation. This is unfortunate and it is therefore important that industry does what it can to address the issue and build measures which inspire confidence among all parties.

Supervisors from a range of regulatory traditions need to be satisfied that the risk based approach is workable. From our side, industry increasingly expects to see some clarity on what will be expected from us in practice combined with a commitment that the risk based approach will be respected consistently across member states.

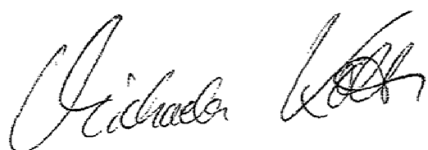
Some of the steps that need to be taken deal with very practical issues. For instance the CRO forum has commissioned a project to develop general principles around the operation scope and approval of internal models. Ultimately we hope this paper will represent an industry standard which can be relied on by firms, regulators and rating agencies. We would be happy to meet with you to discuss what more can be done. There appears to be ample scope to take forward initiatives in such areas as the development of industry benchmarks, in establishing model testing methodology and protocols, or perhaps in providing explanatory material or training to supervisors.

There is of course a simple step that the Commission could take to break the current impasse. At present it is possible for very different MCR methods to be put forward, all claiming to be consistent with the conditions set out in article 126 of the proposal for a directive. The CEA method is we believe faithful to the purpose set out in the preamble to the directive, that the MCR should represent "a level of capital below which policyholders' interests would be seriously endangered if the undertaking were allowed to continue to operate". Measures which are not risk sensitive just cannot meet this objective and some are apparently intended to have a wholly different effect, such as to provide a floor for the SCR. This suggests that article 126 as it stands is insufficiently precise in character to guide level 2 measures in a direction consistent with the philosophy of the directive proposal.

One simple option therefore would be to amend article 126 to be more directional and thereby constrain level 2 measures more closely to an outcome consistent with the wider thrust of the Directive. If you were to require assistance with this we would be very pleased to participate in drafting an amendment.

In conclusion, while reaffirming that the industry broadly supports the Directive Proposal, we draw your attention to the need of not using Solvency I-like principles in the new Solvency II framework. This means that we would have all the costs of the new regime while perpetuating all the disadvantages of the current system.

Best regards,



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