

CEIOPS-CP-01/08

25 February 2008

## Consultation Paper No. 24

# Draft Advice on the Principle of Proportionality in the Solvency II Framework Directive Proposal

*CEIOPS welcomes comments from interested parties on its "Draft Advice to the European Commission on the Principle of Proportionality in the Solvency II Framework Directive Proposal".*

*Please send your comments –by using the comments template- to CEIOPS by email to [Secretariat@ceiops.eu](mailto:Secretariat@ceiops.eu) by 25 April 2008, indicating the reference "CEIOPS-CP-01/08".*

*Please note that the consultation only refers to the main document. The Annex compiling the simplifications and proxies has been developed for the draft QIS4 specifications, and will be updated following the QIS4 consultation.*

*CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential.*

## Table of content

<b>Background</b> .....	<b>3</b>
<b>Consultation with stakeholders</b> .....	<b>4</b>
<b>Proportionality in the Solvency II Framework Directive Proposal</b> .....	<b>5</b>
<b>Structure of this advice</b> .....	<b>8</b>
<b>Pillar I</b> .....	<b>9</b>
Criteria for applying the proportionality principle.....	9
Calculation of technical provisions.....	11
SCR simplifications.....	12
<b>Pillar II</b> .....	<b>13</b>
System of Governance .....	13
Supervisory Powers and Supervisory Review Process.....	20
<b>Pillar III</b> .....	<b>21</b>
Supervisory Reporting .....	21
Public Disclosure .....	22
<b>Internal models</b> .....	<b>22</b>
General considerations as regards the proportionality principle for internal models.....	22
Quantitative requirements .....	23
Qualitative requirements .....	25
Supervisory action .....	26
<b>Group supervision</b> .....	<b>27</b>
<b>Conclusion</b> .....	<b>27</b>

## Background

1. Solvency II represents a new, risk-based regime. Owing to the level of sophistication of the new regime, one of the key questions is how to gear it to the nature, scale and complexity of the risks to which an insurance or reinsurance undertaking is exposed, particularly, but not only, with regard to small and medium-sized undertakings.
2. CEIOPS has already addressed this issue during the third wave of Calls for Advice, in answer to Call for Advice 23. In this Call for Advice, the Commission Services asked CEIOPS to advise on whether a specific treatment of small undertakings was necessary. In its answer published on 3 May 2006, CEIOPS recognised the importance of the proportionality principle in the application of the Solvency II regime but also found that “policyholders should not expect a lower degree of protection simply because their cover is provided by a smaller undertaking. In addition, CEIOPS recognises that size in itself may not be an adequate proxy for the risk to which an undertaking is exposed. Undertakings within the scope of the Directive should not be classified differently on the basis of size.” (§ 23.40)
3. Later, in the Advice to the European Commission on Pillar I issues – further advice released in March 2007, CEIOPS developed some ideas as to how the proportionality principle might be applied. The focus of this paper was on Pillar I issues.
4. In the Framework Directive Proposal published on 10 July 2007, particular care has been taken to ensure that the new solvency regime is not too burdensome for low risk profile undertakings, which are often small and medium-sized undertakings. Appropriate treatment of these undertakings is to be achieved through the application of the principle of proportionality.
5. The Framework Directive Proposal establishes the proportionality principle as a general principle that applies throughout the Directive, highlighting it in several provisions and leaving its concrete implementation to Level 2 measures and Level 3 guidance.
6. Consequently, in its letter of 19 July 2007, the European Commission has asked CEIOPS to deliver an “advice on the application of the proportionality principle” by May 2008 to help discussion of the Framework Directive Proposal. The implementation of the proportionality principle will rest on the future implementing measures to be developed as well as given the case, future Level 3 guidance.

## Consultation with stakeholders

7. Consultation and transparency are essential elements of the Lamfalussy process. CEIOPS is committed to work in an open and transparent way.
8. Before sending its advice to the Commission, CEIOPS publicly consults on its draft advice in line with CEIOPS' Public Statement of Consultation Practices published in February 2005.
9. In addition to publicly consulting on its draft advice, CEIOPS has also throughout the development of this advice to the Commission, consulted:
  - Informally, at working group level with the CEA and AMICE. CEA has set up a specific working group on proportionality in October 2007, and the joint AISAM-ACME Solvency II working group has continued to work after the transformation of AISAM and ACME into one organisation, AMICE. CEA has presented its work to the Internal Governance, Supervisory Review and Reporting Expert Group (IGSRR) on 13 November 2007 and CEA and AMICE have been invited to present in writing their view on proportionality to the Financial Requirements Expert Group (FinReq).
  - The Consultative Panel that has been set up in 2005, made up of experts who either work in the insurance industry or work for organisations representing end-users of insurance products. Namely, the meeting held on 27 September 2007 dealt with the application of the requirements to smaller entities. The consultative panel of 6 February 2008 received a first insight on the advice on proportionality.
10. In addition, the detailed annex with the Pillar I simplifications has been consulted on separately in the frame of the QIS4 consultation held by the Commission from 21 December 2007 to 15 February 2008.

*[To be completed after the consultation]*

## Proportionality in the Solvency II Framework Directive Proposal

11. The proportionality principle is a generally acknowledged principle of the due course of law and is not therefore comprehensively defined in the Framework Directive Proposal. It applies throughout the Directive Proposal. It has two aspects:
- proportionality has to be taken into account when implementing the requirements laid down in the Framework Directive Proposal; and
  - supervision has to be carried out in a proportionate manner.
12. Both aspects are incorporated in the general requirement of Article 28(3) of the Framework Directive Proposal, according to which “Member States shall ensure that the requirements laid down in the Framework Directive Proposal are applied in a manner which is proportionate to the nature, complexity and scale of the risks inherent in the business of an insurance or reinsurance undertaking.
13. Proportionality does not mean the introduction of automatic and systematic simplifications for certain undertakings. The principle will be applied where it would be disproportionate to the nature, scale and complexity of undertakings’ business to apply the general rules (quantitative and qualitative) without relief. The individual risk profile should be the primary guide in assessing the need to apply the proportionality principle.
14. The principle of proportionality applies to all the provisions in the Directive and, as a consequence, to all future implementing measures. The proportionality principle should be applied in a coherent way across the three pillars as well as the group provisions. Where simplifications with respect to quantitative Pillar I requirements are applied, its implications on the supervisory review process, on the insurer’s ORSA and on disclosure requirements under Pillar III need to be considered. Moreover, the proportionality principle is being applied regardless of whether the principle of proportionality is explicitly mentioned in a provision or not. The mention of the principle of proportionality in certain Articles should not lead to the conclusion *a contrario* that it does not apply or applies less where it is not explicitly mentioned.
15. All Solvency II provisions need to be suitable and necessary to achieve their objective as well as appropriate in light of the nature, scale and complexity of an undertaking's risk profile. The two aspects have to be taken into consideration and put into relation to each other: the purpose that is to be achieved and the means employed to serve this purpose. In order to be considered proportionate a measure has to be, at least,

suitable and necessary to achieve its objective as well as appropriate. A measure is necessary if there is no less onerous method available that is equally or even better suited to serve the objective. Appropriateness requires that the drawbacks of a measure are not totally disproportionate to the benefits it reaps.

16. Proportionality works two-ways: it justifies simpler and less burdensome requirements for low risk-profile portfolios, but also raises the expectation that undertakings apply appropriately sophisticated methods and techniques for more complex risk portfolios.

17. In the explanatory memorandum of the Framework Directive Proposal on Article 28, the importance of the principle of proportionality is explicitly linked to the need to avoid excessive strain on small and medium-sized undertakings (Recital 12 also refers to this concern). This does however not mean that size is the only relevant factor when the principle is considered. In Article 28(3), the Framework Directive Proposal links the proportionality requirement to the **nature, scale and complexity** of the risks inherent in the business, which is consistent with the general risk-based approach of Solvency II where the size of an undertaking on its own is not a relevant risk-based criterion.

18. In considering the **nature** of the risks, supervisors will take into account the underlying risk profiles of the classes of business an undertaking is writing, e.g. whether it is long or short-tail business, or whether it is a low frequency and high severity business or consists of high frequency and low severity risks. The specific nature of risks inherent to the reinsurance business and to the captives business should also be taken into account.

19. **Complexity** is somewhat linked to the nature of the business as certain kinds of business may dictate the use of methods or an advanced system of governance, in particular a more sophisticated risk management system in order to deal properly with all risks the undertaking faces. However, it may also be introduced via the investment strategy of the undertaking or because the insurer chooses to employ challenging methods or processes in some areas that require a commensurate degree of complexity in other areas of the undertaking. It is also linked to the complexity in the evaluation of the commitments, for example unlimited motor liability, or investment in a complex option, or annuities (as opposed to a lump sum), or non-proportional reinsurance (as opposed to a straightforward direct insurance business).

20. Via **scale** a size criterion is introduced. Relating to the valuation of assets, liabilities or risks, the criterion resembles a materiality requirement. In order to meet the scale criterion, the valuation approach applied should ensure an appropriate relative or absolute approximation

of the theoretically correct value. Relating to Pillar II, cost-benefit analysis can also be seen as a scale issue, applied for example to governance processes.

21. In assessing what is proportionate, the focus must be on the **combination of all three criteria** to arrive at a solution that is adequate to the risk an undertaking is exposed to. For instance, a business may well be small-scale but could still include complex risk-profiles, or, on the contrary, it may be large-scale with a simple risk-profile (uncomplicated, supporting only limited risk). In the first case, it should not be allowed to use simplified methods, while the possibility may be considered in the second case under very specific circumstances.
22. So, while it will probably tend to be the small and medium-sized undertakings which will apply mostly the proportionality principle through a lowering of the supervisory requirements, it is actually imprecise to talk of proportionality as size-based. Consequently, CEIOPS does not plan to find a definition for small and medium-sized undertakings and develop a whole set of simplified requirements to be applied to these SMEs. However some simplified Pillar I requirements may depend for their applicability on size factors.
23. Undertakings have to provide the means necessary to introduce the appropriate systems, processes and measures or, alternatively, reduce the risks they face. Lack of resources can never be an excuse for not complying with supervisory standards. Since what is required of an undertaking has always to be proportionate to the risk it runs, these requirements should not be viewed as a supervisory burden but rather as a necessary part of good risk management.
24. As with size, legal form and being part of a group are not characteristics that per se are relevant in the application of proportionality. Unless there are relevant differences in the risk profiles that justify a difference in treatment in individual cases, supervisors will deal with mutuals in the same way as with non-mutual undertakings and – on a solo basis – with members of groups the same way as with solo undertakings.
25. Solvency II aims at increasing the convergence of the supervisory practices of Member States. The proportionality principle also applies to this objective. CEIOPS will develop criteria for the circumstances under which simplified measures may be in order. For example, one of the criteria will be quality of management. In applying these criteria supervisory authorities will have some scope for judgmental evaluation, i.e. the criteria will not have the character of a check-list with some easily verifiable conditions to be ticked off. In fact supervisors will have to consider all aspects of the criteria given and assess the circumstances individual undertakings find themselves in as a whole.

- 26.Regarding Pillar I quantitative requirements, the proportionality principle implies that implementing measures will include simplified methods that could be applied for simple, low-risk portfolios. QIS4, which already includes a number of possible simplifications for the valuation of technical provisions and the calculation of the SCR, will have an important role in testing these simplifications. The quantitative and qualitative results of QIS4 will be invaluable in this regard.
- 27.As for the qualitative requirements, the high-level principles of the system of governance are defined in the Framework Directive Proposal and CEIOPS does not foresee significant changes in this area. CEIOPS elaborates in this paper on what is to be considered in the application of the proportionality principle on the qualitative requirements on the system of governance.
- 28.While more detailed guidance on how the principle of proportionality will influence qualitative and information requirements in practice can only be given at a later date, CEIOPS does have some general ideas as to its consequences for Pillar III issues.
- 29.The proportionality principle is mentioned explicitly 8 times in the Framework Directive Proposal. In relation to Pillar I (technical provisions in Article 84(h) and the SCR standard formula in Article 107), Pillar II (supervision in establishment and freedom to provide services in Recital 14, supervisory powers in Article 34(6), the system of governance in Article 41(2) and the supervisory review process - frequency, scope in Article 36(6)) and Pillar III (supervisory reporting in Article 35(3)). In addition, Recital 12 indirectly refers to the proportionality principle.

## **Structure of this advice**

- 30.The first part of this advice will deal with the application of the proportionality principle to Pillar I requirements, as highlighted explicitly in the Framework Directive Proposal. The second part of this advice will deal with its application to Pillars II and III, also following the Directive text. A final part considers the application of the proportionality principle in the context of internal models and groups.

## Pillar I

31. The principle of proportionality applies to all financial requirements. In particular, the Framework Directive Proposal explicitly specifies the proportionality principle in:

- the calculation of technical provisions (see Article 84 (h)<sup>1</sup>), where it indicates that implementing measures should detail simplified methods and techniques to be made available to low-risk portfolios.
- the calculation of (sub-)risk modules of the SCR standard formula (see Article 107<sup>2</sup>) can be simplified for low-risk portfolios, but indicates that these must be calibrated to the same level as the non-simplified calculation. Article 108, referring to Article 107, also states that the Level 2 measures will indicate the criteria to be met by undertakings in order to be entitled to use each of these simplifications.

32. The calibration of the simplifications should theoretically be the same as that of the standard calculation. However, it is expected that the use of simplifications will lead to a higher degree of measurement uncertainty in the valuation of technical provisions and capital requirements. To mitigate this uncertainty, it is necessary to set precise criteria clarifying when an undertaking may use a simplification.

33. For the valuation of technical provisions, the increased measurement uncertainty inherent in the use of simplified valuation methods will also need to be reflected in the calculation of the overall solvency position of the insurer, particularly through the determination of the SCR.<sup>3</sup>

The solvency regime should be designed so that it provides incentives for insurers to improve the quality of their risk measurement over time.

### *Criteria for applying the proportionality principle*

34. The scope of application of simplified methods is, in line with the proportionality principle, restricted to portfolios with relatively simple risk profiles. This simple risk profile is defined by a combination of nature, scale and complexity of the **risks** inherent in the insurer's business :

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<sup>1</sup> Article 84 point (h): "where necessary, simplified methods and techniques to calculate technical provisions, in order to ensure the actuarial methods and statistical techniques referred to in point (a) are proportionate to the nature, scale and complexity of the risks supported by insurance and reinsurance undertakings".

<sup>2</sup> Article 107: "Insurance and reinsurance undertakings may use a simplified calculation for a specific sub-module or risk module where the nature, scale and complexity of the risks they face justifies it and where it would be disproportionate to require all insurance and reinsurance undertakings to apply the standardised calculation.. Simplified calculations shall be calibrated in accordance with Article 100(3).

<sup>3</sup> This has not been developed for QIS4 purpose but further reflexion will be needed on it.

35. Examples in relation to **nature**:

- insurance and reinsurance captives
- the line of business or homogenous group of risk written is simple by nature of the risk (e.g. insured risks are stable and predictable; for example: term assurance, insurance of damage to land motor vehicles)

36. Examples in relation to **complexity**:

- the types of contracts written for each line of business or homogenous group of risk is not complex (e.g. path dependency does not have a significant effect; for example: life contract that does not include any options or guarantees, non-life insurance that does not include options for renewals);
- a group of insurance contracts does not need to be valued separately because all their relevant characteristics coincide;
- the cash flows of an investment are not interest rate sensitive (compared to an investment that includes options);
- certain homogeneity requirements are met, e.g. in a portfolio of bonds, the duration does not significantly differ between rating buckets.

37. **Scale**:

The approximation error caused by the simplified approach to the valuation of a liability or the sub-module SCR must not be material. In order to give a clear guidance for QIS4 purposes, materiality thresholds in absolute terms or relative to the overall size of the technical provisions or SCR respectively were defined (see Annex). The threshold limiting the use of simplifications is stricter for technical provisions than for the SCR calculation because CEIOPS feels that technical provisions are fundamental (they serve as basis for the calculation of the SCR) and wants to encourage most firms to use the full calculation.

38. In addition to these general criteria, the use of some of the simplified calculations is also conditioned to additional criteria, consistent with the assumptions underpinning this calculation.

39. The QIS4 should not be seen as the final CEIOPS view on this issue and does not pre-empt CEIOPS future proposals. Indeed, some questions for further reflexion are still open such as:

- How should “nature”, “scale” and “complexity” be defined and measured?
  - Should they be measured: quantitatively or qualitatively? If quantitatively - should they be valued on an absolute scale or on a relative scale?

- How do “nature”, “scale” and “complexity” interact?
  - Should the three conditions be treated in isolation or is it possible to use a single measure which takes all three conditions into account?
  - In case the three conditions are considered separately: how are the results of these three assessments aggregated/combined?
- With respect to “scale”, should there be a first quantitative threshold and another higher one where, in between, there should be a degree of discretion where supervisors could allow for companies to use simplifications when appropriate (and avoid any un-level playing field)?

## ***Calculation of technical provisions***

40. Technical provisions are split between a best estimate and a risk margin. With respect to the best estimate, both simplifications and proxies have been suggested in the draft QIS 4 technical specifications. Proxies have been developed in case there is insufficient company-specific data of appropriate quality to apply a reliable statistical actuarial method. Therefore proxies can be regarded as special types of simplified methods which are positioned at the “lower end” of continuum of methods that could be applied. These simplifications and proxies are the joint work of the Financial Requirements Expert Group, and the Coordination group set up between CEIOPS and the Groupe Consultatif<sup>4</sup>.

41. The development of proxy methods for the valuation of technical provisions acknowledges the fact that, even after the introduction of the Solvency II regime, sufficient statistical data will not always be available, e.g. in the case where an insurer sells products within a new line of business, or where the portfolio is too small to allow the build-up of credible historic claims data. Article 80 in the draft Framework Directive Proposal recognises this issue, and explicitly allows the use of case-by-case methods for the valuation of technical provisions (which we regard as a special case of proxy techniques) where insurers have insufficient data of appropriate quality to apply an appropriate actuarial technique.

42. However, considering that the principle of proportionality applies throughout the Framework Directive Proposal, the specific design of a case-by-case method, as of any other method used to calculate technical provisions under the Solvency II regime, would still need to be proportionate to the nature, scale and complexity of the underlying risks. With regards to a lack of data in the context of the valuation of technical provisions, we note that in some situations this could be seen as a

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<sup>4</sup> This latter group has brought together the work done by national groups set up in twelve Member States, composed of the supervisor, the actuaries and other industry representatives.

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characteristic of the underlying risk, for example when the claims experience for this type of risk would generally be very sparse. In these cases, the use of a proxy method could be seen as proportionate to the nature of the underlying risk. Under other circumstances, however, the extent to which historic claims data is available would not be immediately related to the scale or complexity of the underlying risks. In this case, a lack of data in itself will usually not be sufficient to ensure that the use of the proxy is proportionate to the risks. For this to hold, additional conditions would have to be met, e.g. regarding the scale of the exposure.

43. The use of proxy methods should also be subject to clear admissibility criteria in order to encourage insurers to use – whenever this is possible – appropriate actuarial methods for the valuation of liabilities as foreseen in the Framework Directive Proposal, including the establishment of internal processes and procedures to ensure the appropriateness, completeness and accuracy of the underlying data. These admissibility criteria, guiding the use of proxies, should take into account the special situation for which proxies can be used.<sup>5</sup> Some of them could be provided generally within Solvency II (e.g. because of a new line of business being built up by a company), others could be restricted to a certain period after introduction of Solvency II (e.g. in order to build up a necessary data base for an existing line of business).

44. As regards the risk margin, simplifications, in particular as regards the calculation of future SCRs, have been suggested. A proxy is also presented but an adequate calibration can only be done based on QIS4 results.

## ***SCR simplifications***

45. Simplifications have been elaborated in almost all aspects of the calculation of the SCR standard formula.

1. A simplification for the calculation of the reduction for profit-sharing (KC factor) has been suggested for Italian-type with-profits contracts.
2. For the market module, simplifications concern the following sub-modules: interest rate risk, equity risk, and spread risk. The property, currency and concentration sub-modules have not been considered as requiring simplifications.

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<sup>5</sup> Cf. draft interim report on proxies, executive summary

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3. For the life underwriting module, simplifications concern all the sub-modules (mortality, longevity, disability, lapse, expense, revision) except catastrophe risk
4. In the health module, the long term health (that is practised on a similar technical basis to that of life insurance, existing only in Germany and Austria) underwriting risk sub-module has simplifications for expense risk, for small and recent companies.
5. For the non life underwriting module, the calculation of the premium provisions has a simplified option for captives (reinsurance and direct insurance captives).

## **Pillar II**

### ***System of Governance***

46. Pursuant to Article 41(2) of the Framework Directive Proposal the system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking. As part of the system of governance the principle applies to the
- a) Organisational structure (Article 41(2))
  - b) Qualification of holders of key functions (Article 42)
  - c) Risk management, including capital management (Article 43)
  - d) Asset-Liability Management and Investment Policy (Article 43(2))
  - e) Own Risk and Solvency Assessment (ORSA) (Article 44)
  - f) Internal control (Article 45)
  - g) Internal audit (Article 46)
  - h) Actuarial function (Article 47)
  - i) Outsourcing (Article 48)

Accordingly, these qualitative requirements are strongly linked to the individual risk profile of the undertakings.

## A. Organisational Structure

47. The Framework Directive Proposal names some key functions but does not give any specifications as to how insurance undertakings should be organised. It uses the term “function” to denote that an undertaking requires a person or persons who perform a certain task. The term does not imply that the particular person/s may not perform any additional tasks, i.e. that insurers need a separate organisational unit. To what extent staff may perform in dual or multiple roles is a question of appropriate segregation of duties. The performance of some tasks is incompatible with certain other responsibilities, e.g. operational tasks and the controlling concerning these same activities. In such cases, good practice dictates that these tasks be performed by different persons.
48. In some undertakings full segregation of duties may however be considered unreasonable and disproportionate. Therefore undertakings in these cases may make other arrangements to ensure that conflicts of interest are avoided, e.g. make sure that a person with operational and controlling duties does not assess his/her own operational work or introduce compensating actions such as additional checks/reviews for potential cases of conflicts of interest. This must however not lead to a lower level of protection. Additional procedures should be implemented in order to ensure a level of control equivalent to that achieved through a full segregation of duties.
49. An adequate organisational structure is important in supporting the implementation of an efficient risk management and internal control system. It follows that undertakings with complex risk profiles will likely be required to expend more resources – financially and personally – in order to ensure that appropriate information systems and communication channels are in place and duties properly segregated. High risk undertakings may also be expected to introduce a code of conduct that facilitates the development of a corporate culture and enhances sound and prudent management of the undertaking’s business.
50. CEIOPS expects differences in the scope and frequency of the internal reporting of undertakings owing to proportionality considerations. Undertakings with more complex and sensitive risk profiles will be expected to produce reports which are more comprehensive, richer in detailed information and provided in shorter intervals in order to enable the management to act in a timely manner on developments with a potentially negative impact on the undertaking.

## **B. Qualification of holders of key functions**

51. CEIOPS does not foresee any scope for proportionality in the propriety requirements. There is only one relevant level of propriety and it applies to all key functions and every undertaking irrespective of its risk profile.
52. Proportionality has however a bearing on the fitness requirements. The level of professional qualification, knowledge and experience expected from holders of key functions certainly depends on the specific set-up of the undertaking as well as on the responsibilities that go with the particular key function.
53. While for low-risk insurers key function holders with somewhat less expertise and experience than normally required may be appropriate, complex risk profile undertakings on the other hand may need persons with specific expertise, such as for example in the area of IT, asset management, the development and maintenance of an internal model or in legal matters.

## **C. Risk management including capital management**

54. The objective of risk management is the identification, evaluation, mitigation, monitoring and control of all material risks to which the undertaking is exposed. The risk management is effective if the end result is an appropriate understanding of the nature and significance of the risks the insurer faces. There are no differences between individual insurers as to what is to be taken into consideration in an adequate risk management system and which outcome, i.e. getting a clear picture of the undertaking's risks, is expected from it.
55. An insurer's risk management function should be closely integrated with its capital management and its risk management policy should describe how this interaction takes place. An insurer should determine the overall financial resources it needs, taking into account its risk tolerance and business plans, based on an assessment of its risks, the relationship between them and the risk mitigation in place. Capital management plans and capital projections are therefore key to its overall risk management strategy. Given the lack of flexibility in requiring an insurer to have an appropriate understanding of its risks, the assessment of its own funds and its capital requirements, there will be very limited scope for proportionality with regard to the quantity and quality of its regulatory capital calculations<sup>6</sup>.

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<sup>6</sup> It is recognised that the Internal Models Expert Group have been considering proportionality and has discussed the various proportionate forms that an internal model could take ranging from a stochastic model for CEIOPS e.V. – Westhafenplatz 1 - 60327 Frankfurt – Germany – Tel. + 49 69-951119-20 – Fax. + 49 69-951119-19 email: [secretariat@ceiops.eu](mailto:secretariat@ceiops.eu) Website: [www.ceiops.eu](http://www.ceiops.eu)

56. Proportionality is applied however when it comes to how the risk management function is to be organised and what methods and approaches are to be used. For example, having fewer and/or simpler risks certainly does not excuse poor quality risk management results. However, insurers with low risk profiles will generally be able to produce the same adequate quality of results as competitors with much more risk-entailing business, applying fewer resources, a more basic risk management system, less sophisticated risk management techniques and a limited amount of risk management procedures. Fewer and/or simpler risks are likely to mean that an undertaking's capital position is less prone to significant fluctuations and therefore would require less frequent capital monitoring than for an undertaking with larger or more complex risks.

57. Undertakings will be expected to document the main risk management and internal control policies, strategies and procedures<sup>7</sup>. Documentation is not an end in itself. One aim of documentation is helping communication within the undertaking and between the Board of directors, management and personnel. The description should be intelligible and comprehensible also to a knowledgeable third party. With this as a measure the requirement to the quantity and quality of the documentation is linked to the complexity and sophistication of the policies, strategies and procedures described. For small, low risk insurers the requirements to the documentation is expected to be lighter in practice and to create only a limited amount of paperwork.

#### **D. Asset-Liability management (ALM) and Investment Policy**

58. Undertakings should develop strategies, policies and proceedings that enable them to prudently manage all market risks they face, including asset-liability management. The general standards applicable to the investment activities are the same for all undertakings. These include requirements on investment policy, asset mix, valuation diversification, asset-liability matching and risk management. However, the assessment whether an insurer's strategies, policies and proceedings are adequate hinges on the undertaking's risk profile.

59. Insurers should be able to demonstrate that the ALM techniques employed are proportionate to the nature, scale and complexity of the business written. This approach should reflect the insurance products on

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larger or more complex firms to a deterministic approach for smaller or simpler undertakings. The Financial Requirements Expert Group are also considering proportionality by developing simplifications for the SCR standard formula to be used by smaller or simpler undertakings. There is no flexibility in that the insurer is required to derive an SCR at a 99.5% confidence level irrespective of the approach.

<sup>7</sup> See Issues Paper "Risk Management and Other Corporate Issues" para. 66

offer, the nature of the expected claims, and any discretionary element of the insurer's liabilities and the sensitivity of the liabilities to any changes in the external environment. For example, life insurers whose liabilities are long-term in nature and where liabilities may be determined by embedded policyholder options and guarantees or changes in the value of assets (that can both often be extremely sensitive to interest rates changes), would be expected to have in place relatively sophisticated ALM and investment management processes.

60. Insurers writing less complicated business, for example a non-life insurer with a relatively short-tailed book of business, may only be concerned with asset price movements and liquidity risk and the sophistication of their ALM function should reflect this. Within a large insurer, it is feasible that different ALM and investment policies could be applied for different lines of business as appropriate.

## **E. ORSA**

61. The ORSA should consider all material risks that may have an impact on the undertaking's ability to meet its obligations and should comprise a process for assessing the capital adequacy relative to the risk profile of the undertaking. It should be based on adequate measurement and assessment processes, be risk-based and forward-looking and be based on the insurance undertaking's business plans and projections. Also the ORSA should form an integral part of the management process and decision making framework of the insurance undertaking. These principles are applicable to the ORSA of all undertakings.

62. As part of its risk management system every insurance undertaking shall conduct its own risk and solvency assessment. The level of complexity and sophistication required of undertakings for the ORSA depends to a large extent on the specific risk profile of the undertaking. The ORSA does not subject undertakings to qualitative measures that are disproportionate to their risk profiles and the methods and approaches they use. In particular it does not oblige insurers to introduce an internal model or modelling very similar in quality to an internal model in order to be able to adequately perform the ORSA requirements. Neither does it oblige insurers to calculate economic capital. However, all undertakings, including small ones, have to be able to understand their own financial condition and solvency position. That is to determine their overall solvency needs irrespective of the supervisory solvency capital requirements.

63. Insurers should employ the means they deem appropriate to effectively manage their risks and capital. Supervisors will expect the level of

sophistication exercised in the ORSA to be on a par with that used in risk management and in internal controls. They will however not be satisfied with less either, i.e. simple, unassuming assessments by larger insurers with high-level techniques are not acceptable.

64. The use of simplifications and/or proxies to calculate the technical provisions, the MCR or the SCR does not exempt undertakings from their own risk and solvency assessment. In this case the ORSA should demonstrate that the use of these simplifications and proxies complies with the requirements of the Framework Directive Proposal and explain why the undertaking uses these simplifications and/or proxies.

## **F. Internal control**

65. In principle functions or processes can be outsourced. Whenever functions are outsourced, the responsibility for the outsourced activities stays with the outsourcing undertaking and necessary management decisions concerning these activities cannot be delegated either. With regard to the internal control system, the system itself and ultimate responsibility, which comprises the totality of "measures" taken to establish an effective internal control, unlike individual internal control functions or processes cannot be outsourced.

66. CEIOPS believes that not only can the compliance function be outsourced but it may also be performed by members of the management or administrative body. The purpose of the compliance function is to advise the management or administrative body in compliance issues. If the necessary expertise in compliance matters is at hand in the body itself and the relevant person can shoulder the compliance function in addition to his/her other responsibilities, CEIOPS considers this sufficient to meet the requirement. It would be disproportionate to demand that extra costs be engendered for a service-provider or an additional qualified staff member.

67. Ensuring appropriate reporting arrangements will be a greater challenge the more complex the organisational structure is and the more levels there are in an undertaking. Where there is only the management or administrative body and other staff who work closely together, reporting arrangements, on the one hand, may be much less formalised than in undertakings where employees do not know all their co-workers. However, depending on the circumstances, it might be the other way round, with less segregation of duties, requiring more formalised documentation. Supervisors will take into account that in smaller undertakings the management body is often involved in the day-to-day-business and thus has a better overview with regard to the performance

and risk situation of the undertakings than a management body that is removed from the operational business.

## **G. Internal audit**

68. The internal audit function should be performed by persons who do not have additional operational tasks in the undertaking<sup>8</sup>. In order for this requirement not to create an unreasonable burden for undertakings with low risk profiles, these undertakings would not have to provide for a permanently operating function but could commission a qualified party to execute these tasks within an appropriate timeframe.

## **H. Actuarial function**

69. According to Article 47 insurance and reinsurance undertakings shall provide for an effective actuarial function. The person or persons performing this function have to possess the necessary actuarial and financial mathematical skills to be able to appropriately perform the tasks set in Article 47(1) (a) to (i). It is however not required that a person performing the actuarial function has a specific vocational training, e.g. has earned the occupational title "actuary". Moreover his/her skills need to be sufficient to adequately perform the tasks assigned to the actuarial function with regard to the particular undertaking. So the requisite level of skills depends to some extent on the complexity and sophistication of the approaches and methods used by the undertaking.

70. The introduction of the mandatory actuarial function through the Framework Directive Proposal is not a measure solely designed to reassure supervisors that the technical provisions are correctly calculated. Having access to actuarial knowledge is indispensable to an adequate system of governance as it provides important insights for the management of an insurance business. Although the obligatory provision of the function will create, at least for some undertakings, considerable additional costs, it should not be viewed as a burden but rather as a tool to improve the quality of management decisions. For undertakings with a low risk profile it may be sufficient to employ a part-time service provider. There is however no room for relieving undertakings of the duty to establish the relevant function on account of financial strain.

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<sup>8</sup> See Issues Paper "Risk Management and Other Corporate Issues" para. 59

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## I. Outsourcing

71. CEIOPS does not foresee any particular relevance of the proportionality principle for outsourcing issues. Outsourcing tends to get mentioned in connection with options smaller and medium-sized undertakings have in order to meet certain requirements<sup>9</sup> It can in principle be effected for all business activities of an insurance undertaking, unless it materially impairs the continuing compliance with the conditions and obligations of its authorization, and not only be permanently operating but also take the form of a temporary mandate, e.g. where the internal audit of a smaller undertaking is not a task that requires the constant presence throughout the year of the internal auditor. So outsourcing is indeed one of the ways in which a proportionate solution can be achieved where regulatory requirements would otherwise overtax an undertaking's resources. That is, however, not to say that it is not also available to larger undertakings as long as the undertakings ensure compliance with Article 48(2)(a) to (d).

### ***Supervisory Powers and Supervisory Review Process***

72. With regard to supervisory powers the Framework Directive Proposal explicitly states in Article 34(6) that these powers are to be applied in a timely and proportionate manner. Proportionality in this respect does not only mean that supervisory authorities are obliged to avoid making excessive demands on undertakings. It also requires them to take the nature, scale and complexity of an undertaking's business into account when taking action against the undertaking, i.e. treat undertakings in a different way where this is appropriate on account of their different risk profiles.

73. Under the Supervisory Review Process the supervisory authorities review and evaluate the strategies, processes and reporting procedures established by undertakings. The review also comprises an assessment of the adequacy of the undertakings' methods and practices to identify possible events or future changes in economic conditions that could have adverse effects on the undertakings' overall financial standing and the ability of the undertakings to withstand these possible changes. In reviewing qualitative requirements such as for the system of governance, supervisors will take into account the "built-in" proportionality through which the level of adequacy or appropriateness for a specific insurer is determined by the risk profile and individual situation of the undertaking. Where the application of the proportionality principle has resulted in simplified methods and approaches being permitted, supervisory

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<sup>9</sup> Such as paragraph 2.9 of the Issues Paper on Risk management and Other Corporate Issues  
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authorities will assess whether undertakings that have applied these simplifications are eligible to use them.

74. Supervisory resources are limited. In order to employ them most effectively supervisors will endeavour to divide their attention between the supervised undertakings in a proportionate manner. Risk profile, quality of the management, soundness of the financial situation and the extent to which policyholders would be affected if an undertaking were to fail are amongst the criteria that will be taken into account when supervisors decide how much attention they pay individual undertakings.

75. Supervisors will use Level 3 guidance to achieve the necessary degree of convergence in the application of the proportionality principle and as a tool to exchange experiences among them. In doing this they will seek to strike the right balance between converging supervisory practices across Member States and maintaining sufficient flexibility so that the aim of fair treatment on a case-by-case basis does not suffer.

## **Pillar III**

### ***Supervisory Reporting***

76. As already stated in another CEIOPS document<sup>10</sup>, CEIOPS places particular importance on the proportionality principle where supervisory reporting is concerned. In this regard CEIOPS proposes to fit the reporting to a level commensurate to the risk profile of the undertakings.

77. Some reporting requirements will by their nature or on account of the materiality principle not be applicable to all undertakings since certain issues will not be relevant for all undertakings.

78. With regard to qualitative information supervisors will expect considerable differences between undertakings depending on the business insurers write and the methods and approaches they apply. Insurers that use different or more sophisticated methods and approaches, as well as insurers that are innovative or face a lot of risks can expect to have correspondingly increased reporting requirements. More complexity, deviation from the norm and bigger risk-taking generally require more explanations for supervisors and may therefore

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<sup>10</sup> Issues Paper on the Policy on harmonisation of contents and formats for public disclosure and supervisory reporting: "Moreover particular care should be taken to ensure the harmonisation of contents and format is not too burdensome for small and medium-sized undertakings, by applying the proportionality principle to the utmost extent possible."

influence the volume of the reporting. The challenge will be in setting the reporting requirements at an appropriate level.

79. Frequency and extent of the supervisory reporting of different aspects of the business is also an area where the principle of proportionality may be applied.

## ***Public Disclosure***

80. In Article 52 the Framework Directive Proposal establishes principles to ensure that the disclosure burden on undertakings is reduced to an appropriate level and the legitimate interests of undertakings are safeguarded. By properly applying these principles, supervisors will release undertakings from unnecessary and inappropriate disclosure obligations, e.g. by sparing them from a duplication of disclosures or allowing non-disclosure where third parties have a legitimate interest in confidentiality.

81. CEIOPS believes that public disclosure as a principle is required in order to enhance market discipline and thus must apply to all undertakings. However, as with reporting requirements, some disclosure duties will not be applicable in all cases by their nature or on account of the materiality principle. Furthermore, market forces may well result in undertakings following "best practice" set by their peers to bring greater consistency to the quality, depth and coverage to the disclosures over time.

## **Internal models**

### ***General considerations as regards the proportionality principle for internal models<sup>11</sup>***

82. According to articles 99 and 109 of the Framework Directive Proposal firms may calculate their Solvency Capital Requirement either in accordance with the standard formula or using a full or partial internal model, as approved by the supervisory authorities. The use of one of these three options for regulatory purposes has to be coherent with the risk profile and the size of the insurance undertaking and its availability constitutes per se a direct application of the proportionality principle.

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<sup>11</sup> For examples on the definition of nature, scale and complexity please also refer to the Pillar I section.

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83. Moreover, by nature, the concept of an internal modelling approach is strictly linked to that of proportionality. Compared to the standard formula, the construction of an internal model should be driven directly by the type of business of the undertaking and by the nature scale and complexity of the risks it faces.

84. Implicitly, one might also see this principle as relating to the level of sophistication of the mathematical approach used to calculate the level of regulatory capital and therefore to the application of internal models to assess this requirement. In its Guidance Paper on the Use of Internal Models for Risk and Capital Management Purposes by Insurers, the IAIS refers to proportionality in the *Key Feature 4*:

*"In constructing its internal model for risk and capital management purposes, an insurer would be expected to adopt risk modelling techniques and approaches which are most appropriate to the **nature, scale and complexity** of the risks incorporated within its risk strategy and business objectives".*

85. Furthermore, the proportionality principle does not only apply to the quantitative aspects of the internal model but also to its qualitative aspects such as, for instance, the use test, the governance and controls around the internal model, the internal model documentation, etc.

## ***Quantitative requirements***

86. The intention of CEIOPS is neither to propose a series of models, statistical method or stochastic processes, nor to categorize firms, businesses or risks and recommend specific approaches according to this categorization.

87. Overall, a balance has to be struck between the avoidance of unnecessary sophistication of the internal model and the objective that firms' obligations will be met as they fall due. Irrespective of the internal modelling approach chosen, the 99.5% VaR confidence level over a 1 year time horizon is the general common requirement to meet. This level of safety represents one of the core components of the new solvency regime and is part of the necessary conditions to guarantee a level playing field among insurers within the EU.

88. CEIOPS agrees that special attention will have to be paid to the manner in which small and medium-sized firms will be able to cope with the new solvency regime. However, size must not be considered in isolation and

the adequacy of a chosen internal modelling approach to compute the regulatory capital requirements has to be evaluated considering simultaneously the *nature, scale* and *complexity* of the risks the company faces. For example, a company writing only short term pure endowment policies would be expected to use a less complex internal model than another one selling long term life insurance contracts with discretionary participating features, embedded options and other complementary guarantees (such as the risk of disability). CEIOPS' view is that choosing the internal model option does not necessarily imply highly sophisticated mathematical approaches. Simple internal models can be eminently suitable for some risk profiles and sometimes be more or, at least, as appropriate at capturing risks as more sophisticated approaches.

This does not mean, however, that CEIOPS advocates a conservative approach to parameter estimation, as this may distort the actual representation of risk, nor that this implies that using a simpler internal model should necessarily lead to a greater amount of required capital. Moreover, a conservatively parameterised internal model would tend to be less easily compatible with the use test requirements, in particular concerning the assessment of economic capital. Nevertheless, it is important to stress that insurers using internal models, including simpler internal models are subject to the requirements of Articles 117-124 of the Framework Directive Proposal as explained in the following paragraphs. In the same vein, an insurer having a more complex, dynamic and/or less stable risk profile should compute its economic and regulatory capital requirement with a higher frequency than that of insurers with simpler and/or more stable risk features.<sup>12</sup>

89. As stated before, *proportionality is a two-way concept*. Therefore, proportionality must not be solely understood as a possible reduction of the required sophistication of the approach but also as a due supervisory requirement for an appropriately elaborated modelling approach, where necessary due to the nature, scale and complexity of risks.

90. The dynamic nature of internal models also implies that *what is proportionate is likely to change over time*. For instance, the introduction of the new solvency regime, will enable both undertakings and supervisors to collect more information and data relevant to internal models. This may facilitate the use of more sophisticated approaches and also make it easier to demonstrate that simpler models are good approximations for them.

91. CEIOPS agrees that a lack or shortage of resources cannot justify that an internal model is not sufficiently sophisticated. Appropriate resourcing can be achieved by using both in-house and external resources

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<sup>12</sup> The validation process, together with the other aspects in Articles 117 to 124 of the Framework Directive Proposal, are still work in progress within CEIOPS and will be part of CEIOPS' advice on Level 2 implementing measures.

(outsourcing). Undertakings may resort to *vendor models* or to the intervention of a *consultant*, whatever the risk profile or the size of the company. However, companies must understand the model used to compute the capital requirements, even if it has been developed externally. Firms will not be allowed to use a 'black box' tool or to put forward an amount of required regulatory capital without being able to explain in detail how it has been determined. Within the context of supervision, the interlocutor of the supervisor must be the insurer itself, and not a third party that has built the model. Standards must be at least as high for undertakings resorting to third parties for their internal models or components of it as for those using in-house solutions, and the onus is on the undertakings to demonstrate that the requirements are met.

## ***Qualitative requirements***

92. Proportionality should never be put forward to justify a failure of the use test, not meeting the statistical quality standards or not properly validating the internal model and its use. CEIOPS' view on this point allows no room for more flexibility. In all cases, internal models should be embedded in a strong governance framework. Undertakings should be able to demonstrate that the board of directors and the senior management's understanding of the model is appropriate, given its level of sophistication.
93. *Internal model maintenance* - An insurance undertaking must have a robust on-going monitoring framework for its internal model, whereby it learns over time, regularly revisits its assumptions, and if necessary updates the internal model. Internal modelling and meeting the related requirements and standards should be part of a continuous internal process, and not merely an exercise performed for the purpose of supervisory approval. The proportionality principle does certainly not exempt any insurer from complying with this ongoing requirement or from taking appropriate and necessary actions. Nevertheless the amount of work required on an on-going basis will depend on the nature, scale and complexity of the risks to which the undertaking is exposed.
94. One of the main risks that a company using its own internal model faces is that key persons might leave. It would clearly be a serious setback for a firm to lose the persons who designed, implemented, used and updated its internal model. Firms where these functions are performed by a small number of staff are more vulnerable to this risk. Therefore, proper segregation of duties, as appropriate given the nature, complexity and scale of the business, can be viewed as a mitigating factor. Particularly in such situations, the depth and thoroughness of the model documentation is critical.

95. As regards the *validation* function, CEIOPS does not consider that each company must have this task fulfilled by independent staff. CEIOPS is seeking an effective validation, for which an objective challenge is essential. In this spirit, ensuring the structural independence of the validation function can be a means to that end. When deciding who will perform this task, due consideration must be devoted to the nature, scale and complexity of the risks that the insurer faces and also to the internal organisation of the firm and its governance system. CEIOPS is of the view that the right balance must be struck between any potential conflict of interest that might arise in the course of the validation of the internal model on the one hand, and a disproportionate level of segregation of duties on the other hand.
96. Beyond the question of the *independence of the function*, it is also essential that the individuals performing the validation possess the necessary up to date skills, knowledge, expertise and experience. For this purpose as well, CEIOPS does not envisage to limit the use of external resources subject to the criteria mentioned above.
97. *Documentation of the internal model*. Proportionality does not exempt any insurer from adequately documenting its internal model. Documentation of all internal models (both partial and full internal models) must be thorough, detailed and complete enough to allow third parties to replicate the internal model. For simpler internal models this might result in smaller amounts of documentation. However this should be a consequence of the level of complexity of the model, and not of the thoroughness of its documentation. Documentation is a crucial tool for the firm to demonstrate the supervisor that the undertaking really understands and has mastered the internal model it is using. This represents a key assessment element in the supervisory approval process. The frequency at which the documentation must be revisited and, if necessary, updated, as well as the pace at which the supervisory and public disclosure have to be provided should be in line with the complexity and stability of the risk profile of the insurer and the internal model it uses for the regulatory requirements. This also applies to the frequency of *supervisory reporting* and *public disclosure* of the internal model.

## ***Supervisory action***

98. Supervisors need to be consistent in how to assess internal models, not only across different insurance undertakings but also across member states. As already expressed above, supervisors must apply the proportionality principle based on nature, scale and complexity through

their expectations regarding the insurance companies and reasoning the same way when exercising their supervisory action.

## **Group supervision**

99. There is no explicit reference in Title III (Group Supervision) of the Framework Directive Proposal to the proportionality principle (Article 228 refers to the word proportionality in a different context). As set out in the general introduction, the principle of proportionality applies to the requirements on groups as well as group supervision according to the nature, scale and complexity of the risks inherent in the business of the group concerned. Consequently, CEIOPS does not feel that a differentiated approach is required in respect of group supervision and proportionality should be applied based on the nature, scale and complexity of risks inherent in the business, in accordance with the criteria set out in paragraphs 17 to 21.
100. Nevertheless, as the nature, scale and complexity of most insurance groups, particularly cross border groups, would not meet those criteria, it is unlikely in practice that the proportionality principle, as articulated herein, would apply.

## **Conclusion**

101. The proportionality principle is essential for ensuring that the new regime is workable for all EEA firms. However, the system must remain supervisable and the standard requirements should also be proportionate to avoid any un-level playing field. Finally, the application of the proportionality principle should ensure that the same level of protection is guaranteed for all policyholders.