

Consultation Paper No. 13

**Draft Advice to the European Commission in the
framework of the Solvency II project
on
insurance undertakings' Internal Risk and Capital
Assessment requirements, supervisors'
evaluation procedures and harmonised
supervisors' powers and tools**

CEIOPS welcomes comments from interested parties on "Draft Advice to the European Commission in the framework of the Solvency II project on insurance undertakings' Internal risk and capital requirements, supervisors' evaluation procedures and harmonised supervisors' powers and tools".

Due to the increase in Consultation Papers in 2006 because of the need to give further detailed advice to the European Commission in addition to the answers to the three waves of Calls for Advice CEIOPS considers it necessary to shorten the consultation period under its consultation policy to two and a half months.

Please send your comments to CEIOPS by email (Secretariat@ceiops.org) by 12 September 2006, indicating the reference "CEIOPS-CP-01/06".

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

Style convention

The following has been adopted for this document:

Advice appears in shaded (blue) boxes, headed **CEI OPS' Advice**

Extracts from the Calls for Advice appear in unshaded (white) boxes, with text in italics

Descriptive headings are used (such as 'Background', 'Explanatory text' etc.) in an attempt to improve the navigability of the answers.

Explanatory Text

Introduction

1. The European Commission has requested CEIOPS to advise on the development of a new solvency regime for insurance and reinsurance undertakings in the EU.
2. CEIOPS has submitted its Advice in the form of answers to three waves of Calls for Advice from the European Commission and following public consultation¹.
3. Certain areas relevant to CEIOPS' previous Advice on the Supervisory Review Process (SRP) are under development by CEIOPS. As part of that process CEIOPS has formulated principles which it considers material to the proposed Level 1 Directive.
4. These principles cover:
 - insurance undertakings' internal risk and capital assessment requirements;
 - supervisors' evaluation procedures; and
 - harmonised supervisors' powers and tools, including Pillar II capital add-ons
5. CEIOPS has set out its explanations and Advice according to those headings. It anticipates that further detail will be evolved at the level of future supervisory measures. The draft Advice is to be taken together with CEIOPS' answers to the first, second and third waves of Calls for Advice.

Insurance undertakings' Internal Risk and Capital Assessment (IRCA) requirements

6. As an integral part of the overall business strategy, insurance undertakings are required to have in place their own strategies for solvency capital and all material risks to which they are exposed (such as underwriting, credit, market, liquidity and operational risks), as well as an appropriate policy for the use of risk mitigation and transfer arrangements (e.g. reinsurance, derivatives) that together manage and address overall solvency. Insurance undertakings are required to have in place internal control mechanisms and processes that allow quantitative and qualitative measurement of each risk identified, including probability² and impact on the risk profile of the insurance

¹ Answers to the European Commission on the first wave of Calls for Advice (CEIOPS-DOC-03/05), Answers to the European Commission on the second wave of Calls for Advice (CEIOPS-DOC-07/05) and Answers to the European Commission on the third wave of Calls for Advice (CEIOPS-DOC-03/06), available at www.ceiops.org.

undertaking and the amount and quality of eligible capital which is relevant to the achievement of the undertakings' own goals. The IRCA shall be taken into account in the undertakings' strategic decisions.

7. Additionally the IRCA will be one starting point for the discussion about the way and circumstances of setting a Pillar II capital add-on.
8. There are two main reasons why differences between regulatory solvency capital and the result of the undertaking's own internal risk and capital assessment might exist:
 - The undertaking may wish to hold additional capital for business purposes compared to the regulatory capital. For instance, it may choose to hold capital for rating purposes which represents a higher confidence level than that used to calibrate the SCR.
 - The undertaking's risk profile may differ from the one implicit in the SCR. For instance, the insurer's assessment of the capital needed to back a particular risk might be different from the SCR's assessment. Or the insurer's risk profile might include risks which are not covered by the SCR.
9. For the purposes of assessing the need for Pillar II capital add-on's CEIOPS is not concerned with the first type of difference. However, the second type of difference provides useful information for supervisors when considering whether the SCR might be deficient. Supervisors would expect to exercise considerable judgement when using this information and not merely add on to the SCR the differences which the insurer identifies.
10. Therefore, the aim of this advice is to develop some high level principles that clarify the interlinkages between the Pillar II capital add-on, the IRCA, and the SRP. These high level principles also serve as a preliminary CEIOPS' answer to the consultation initiated by the European Commission on the draft Level 1 Directive at EIOPC level. CEIOPS will elaborate further in more detail on these principles in future.

Supervisors' evaluation procedures

11. In its answer to Call for Advice 2 CEIOPS already gave advice on supervisory practices³. In developing further technical advice CEIOPS concludes that the level of harmonisation in Pillar I relevant issues should be higher than in Pillar II. The main reason is that some room should be left for national supervisors' discretion on evaluating the undertakings' specific risk profile when applying Pillar II at national level. This approach is in line with Article 123 CRD and serves to

² Probability in this context does not necessarily require a mathematical-statistical probability distribution.

³ Answers to the European Commission on the first wave of Calls for Advice (CEIOPS-DOC-03/05), available at www.cejops.org.

achieve cross-sectoral consistency. Nevertheless, CEIOPS will need to elaborate further on the specificities of the insurance sector.

Harmonised supervisors' powers and tools, including Pillar II capital add-on's

12. Supervisory Authorities are far from being completely harmonised across Europe, both in their structure and in their powers. Some are independent agencies others are part of a ministry or a Central Bank. Some authorities supervise insurance, securities and banking, and even auditors or insurance consultants, others supervise only insurance and banking, or only insurance and reinsurance, including or not insurance intermediaries, with or without pension funds (which are outside the scope of the Solvency II project). Some authorities have some kinds of regulatory and/or judicial powers, others don't. CEIOPS already dealt with supervisory powers in its previous answers to the European Commission's Calls for Advice, especially in its answer to Call for Advice 14 (Powers of Supervisory Authorities), but also in the answers to Calls for Advice 2, 3, 7, 8, 10, 18, 19, 20, 22 and 23 as well as in its *Recommendation on Independence and Accountability*⁴.
13. To initiate European regulation on this aspect, it would be useful to agree to a minimum set of powers that all supervisors shall have in order to avoid supervisory arbitrage, especially in respect of new powers (e.g. Pillar II capital add-on, powers to give or withdraw an approval for internal models, the burden of proof in respect to technical provisions, IRCA and the calibration test).
14. In particular the new power to require a Pillar II capital add-on led to strong reactions by the industry to CEIOPS' Consultation Paper 9 (Call for Advice 19 – Eligible Elements). During the public consultation of the stakeholders frequently raised concerns that the imposition of Pillar II capital add-on would allow an extremely wide scope of application and therefore be arbitrary.
15. In respect of the Pillar II capital add-on measures one CEIOPS' Member proposes to follow exactly the CRD compromise that those add-ons could be set on a regular basis if systems changes or Pillar II capital add-ons would be able to solve the problem alternatively. As previously stated CEIOPS sees the Pillar II capital add-on as an exceptional solution for systems failures rather than the rule with additional risks due to failures primarily to be fixed and not mitigated by additional capital. The reason for the latter solution is the more holistic and sophisticated approach of Solvency II in comparison to the building block approach of Basel II.
16. Concerning the Pillar II capital add-on in the context of the internal model approval process some Member States think that in the model approval process models cannot be approved unless they are without

⁴ Available at www.ceiops.org.

deficiencies. However, the majority of CEIOPS Members thinks that a “non perfect” model could be approved with an add-on in order to smooth an undertaking’s transition to an internal model. Approving a internal model that is on the one hand more accurate and useful for risk management than the standard formula, but is on the other hand not yet fully implemented and thus in some regards below peer group standards with an add-on would be beneficial for both undertaking and supervisor.

17. In light of these developments CEIOPS revised and supplemented its answers to Call for Advice 14 in line with the evolvement of the Pillar I technical criteria and listed in the advice of this consultation paper more details on the expected new powers. In addition, CEIOPS developed a list of the most important powers which need a higher level of harmonisation and which are still partly not available for all supervisory authorities under the current Solvency I system.
18. CEIOPS will elaborate further in more detail on these principles in order to illustrate specific examples where a high degree of supervisory arbitrage may occur in future.

CEIOPS’ Advice

Insurance undertakings’ Internal Risk Capital Assessment (IRCA) requirements

19. As an integral part of the overall business strategy, insurance undertakings are required to have in place their own strategies for solvency capital and all material risks to which they are exposed (such as underwriting, credit, market, liquidity and operational risks), as well as an appropriate policy for the use of risk mitigation and transfer arrangements (e.g. reinsurance, derivatives) that together manage and address overall solvency. Insurance undertakings are required to have in place internal control mechanisms and processes that allow quantitative and qualitative measurement of each risk identified, including probability and impact on the risk profile of the insurance undertaking and the amount and quality of eligible capital which is relevant to the achievement of the undertakings’ own goals. The IRCA shall be taken into account in the undertakings’ strategic decisions.
20. Similar to Article 123 of the CRD but considering the characteristics of the Solvency II approach as opposed to the Basel II approach, CEIOPS expects insurers to provide as part of the Pillar II process the SCR calculation result and two further analyses:
 - a policy on solvency capital – which is an analysis of how the business plans affect the way in which the insurer will ensure that regulatory requirements are met and will

continue to be met over the time horizon determined for the calculation of the regulatory SCR. An insurance undertaking shall immediately inform its supervisory authority if the SCR or MCR is breached or if the undertaking realised that they may be breached; and

- an analysis of the differences between the capital amount which the insurer considers necessary for its business needs and the capital amount which the standard formula generates; an insurance undertaking that uses an internal model for the computation of the SCR may use a risk measure and calibration different from the SCR standard risk measure and calibration. In this case, this comparison shall be performed together with the recalibration that transforms the internal risk numbers into the SCR risk measure and calibration.
21. CEIOPS expects insurers' IRCA to be forward-looking. Insurers should develop stress tests, or business continuity analysis or dynamic financial analysis in order to assess if the regulatory solvency requirements are met on a permanent basis.
22. An insurance undertaking shall provide to the supervisory authorities on demand all relevant information and explanations relating to its IRCA.

Assessment of the risk profile

23. An insurance undertaking must at the request of the supervisory authority demonstrate in connection with its risk profile the adequateness of technical provisions, the calibration test, and the insurance undertakings' internal risk capital assessment.

Supervisors' evaluation procedures

24. In addition to the requirements set out in CEIOPS' answer to Calls for Advice 2 and 3, the supervisor should take into account all information received on the calculation (standard model or internal model) of the regulatory solvency capital requirements and as a new element the result of the undertakings' specific IRCA in order to get as much as possible a comprehensive overview of the undertaking's actual risk profile. This approach is similar to the approach taken in Article 124 CRD but should consider the characteristics of the insurance specific Solvency II approach.
25. Under the SRP the supervisory authority should check the risk assessment made by the undertaking. All major risks should be assessed: market risk, underwriting risk, credit risk, operational risk, liquidity risk, concentration risk, strategic risk, reputation risk, systemic risk or other risk that is considered major for a specific undertaking.

26. The supervisory authority should also check the risk management and internal control systems implemented to identify, measure and manage each risk. Both operational and oversight functions are to be reviewed.
27. The policy and strategies to mitigate the risks should be assessed to each risk or the risk of each process, as well as the effectiveness in mitigating the risk and processes.
28. A final result of the review as to the deficiencies of the undertaking's risk assessment, management processes and capital adequacy should be given to the undertaking by the supervisory authority. This result will be very useful to the supervisory authority in prioritising future work, to ensure an appropriate degree of consistency in supervisory approach between supervisory authorities and to provide feedback to the undertaking. The undertaking must be given the possibility to understand the overall concept of classification they are taking part in.

Harmonised supervisors' powers and tools, including Pillar II capital add-ons

New supervisory powers which have to be introduced by Solvency II

Gathering information

29. Supervisory Authorities should have the power to require any insurance undertaking (or related party) to provide any relevant information about an insurance undertaking's risk position and its corresponding capital needs; even information on behalf of the supervisory authority, which is not readily available in form of a regular report or analysis within the undertaking.

Eligible capital

30. Supervisory authorities should have the power to assess the quality and eligibility of capital as part of the SRP.

Transfer of a portfolio

31. Supervisory authorities should have the power to facilitate a transfer of the portfolio and policy obligations of a failing insurer to another insurer who is willing to accept the transfer. As a new element the power should also include a compulsory transfer from a failing insurer.

Internal models

32. Supervisory authorities should have the option to instruct undertakings to set up and implement partial or full internal models if the actual risk situation deviates substantially from the assumptions underlying the standard formula.
33. For every internal model prior approval of the supervisory authority is required. Therefore, the supervisory authority should have the power not to grant the approval of the internal model proposed by the supervised undertaking or, after the approval, to withdraw approval for the model's use, if the supervisor concludes that the internal model is no longer an appropriate substitute for the standard formula (see CEIOPS' answer to Call for Advice 11, para. 11.46).

Standard Formula

34. Supervisory authorities should have the power to correct the undertaking's use of incorrect entity-specific parameters within the standard formula for the calculation of the SCR.

Specific powers for group issues

35. CEIOPS will develop separate advice on this issue to be published for consultation in October 2006.

Insurance holding companies

36. CEIOPS will develop separate advice on this issue to be published for consultation in October 2006.

Pillar II capital add-on

37. The Pillar II capital add-on will be neither routinely nor commonly applied. If the supervisory authority concludes that the solvency capital requirement (SCR) for an individual entity is not prudent enough compared to the risk profile of that undertaking, either because there are risks that are not captured by Pillar I calculation or because they are captured insufficiently, the supervisory authority should be empowered to require the undertaking to hold more capital against its existing risks. In case of Pillar II failures such as inadequate arrangements, strategies, processes and mechanisms, a Pillar II capital add-on should be imposed until the deficiencies have been rectified, if the sole application of other measures is unlikely to reduce the risks from these failures within an appropriate timeframe (see Article 136, para. 2 CRD).

Further high level principles for the Pillar II capital add-on

Aim of a Pillar II capital add-on

38. The aim of the Pillar II capital add-on is to increase the level of the SCR given by the standard formula, or the internal model approved by the supervisory authority to calculate the SCR, so as to match more accurately the actual risk profile of a specific insurance undertaking.

Pillar II capital add-on in connection with internal models

39. At this stage of the discussion CEIOPS will only give a preliminary advice on the Pillar II capital add-on in connection with internal models. When an undertaking is using or wants to use an internal model to calculate the SCR, the following possibilities have been identified as beneficial solutions for both undertakings and supervisors in the context of the approval process. Setting a Pillar II capital add-on could help to:

- smooth an undertaking's transition to an internal model. Rather than making the model approval process a binary yes/no decision, this would allow some flexibility by approving it partially, together with an add-on or subject to other conditions;
- correct deficiencies in the internal model itself ("model error"), which although of concern are not so severe as to call into question the reliability of the whole model itself.

40. CEIOPS intends to publish a further consultation paper on quantitative and qualitative requirements on internal models in the end of October 2006.

Definition of a Pillar II capital add-on

41. The Pillar II capital add-on is a statutory capital requirement which can be defined as a supervisory tool that allows supervisors to require undertakings to hold capital in addition to the SCR as calculated by the standard formula or by an internal model, if the SRP leads to the conclusion either that the level of required solvency capital being held by the undertaking is insufficient or that the undertaking needs to remedy qualitative deficiencies.

Transparency issues

42. CEIOPS believes from a prudential perspective that the public disclosure of the amount and purpose of any individual undertaking's Pillar II capital add-on should not be required. At this stage of the discussion CEIOPS proposes that for public disclosure purposes any Pillar II capital add-on becomes part of the final SCR; the derivation of the Pillar II capital add-on

remains private between supervisory authorities and the insurance undertaking concerned. Further discussion is however needed under Pillar III, taking into account company law, national legislation, IASB discussions, etc.

43. CEIOPS believes that there should be no obligation on supervisory authorities to make public their reasons for imposing a Pillar II capital add-on for particular cases.

The following non-exhaustive list of existing supervisory powers should be closely harmonised under Solvency II in addition to the answers already given in Call for Advice 14:

Governing function

44. The future Level 1 Directive should regulate the duty of insurance undertakings to inform the supervisory authority about the appointment/resignation of directors.

Breach of the SCR

45. If the available solvency capital does not meet the required SCR then the supervisory authority should require the undertaking to directly address the problem and to execute any measures deemed necessary by the supervisor. As a first step the undertaking should produce a plan to restore the capital to the level above the SCR. If the undertaking does not produce a plan, produces an inadequate plan or fails to comply with that plan then further supervisory action should follow. CEIOPS already recommended a principle-based set of supervisory powers in its answer to Call for Advice 15. In addition, some Member States see a specific concern to stress that especially the below mentioned supervisory powers, which should be available to all supervisory authorities, should be subject to a higher degree of harmonization:

- limiting dividend payments, depending on the solvency control level that is breached;
- requiring the undertaking to take no additional business or to reduce the level of risk retained.

Breach of the MCR

46. When the available solvency capital does not meet the MCR and is not rapidly restored, the supervisory authorities should have the power to take any measures necessary in order to protect policyholders' interests. In its answer to Call for Advice 15 CEIOPS already recommended a rules-based set of supervisory powers. A special need for a higher degree of harmonisation is seen by supervisory authorities for the measures: prohibiting new business, appointing a special commissioner, withdrawing

the licences, ordering winding up or petitioning for it.

Fit and Proper

47. In addition to its answer in Call for Advice 16 CEIOPS sees a strong need to stress explicitly that supervisory authorities should have the power to check fit and proper requirement not only once but on an ongoing basis. Under a future Level 1 Directive, this new power should aim at a high level of harmonisation.