CEIOPS-CP-09/06 - Supplement

11 December 2006

Supplement to Consultation Paper 20

Supplementary Draft Advice to the European Commission in the Framework of the Solvency II project on Pillar I issues

CEIOPS welcomes comments from interested parties on its "Supplementary Draft Advice to the European Commission in the Framework of the Solvency II project on Pillar I issues". This should be read in conjunction with Consultation Paper 20 (CEIOPS-CP-09/06). As a consequence, comments to this Supplement should be made in the framework of comments to Consultation Paper 20.

Due to the late publication of this Supplement, CEIOPS extends the consultation period by one week, for both Consultation Paper 20 and the present Supplement.

Please send your comments by email to Secretariat@ceiops.org by 19 January 2007, indicating the reference "CEIOPS-CP-09/06". CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential.

CEIOPS e.V. - Westhafen Tower (14th floor), Westhafenplatz 1 - 60327 Frankfurt – Germany – Tel. + 49 69-951119-20
Fax. + 49 69-951119-19 email: secretariat@ceiops.org; Website: www.ceiops.org

Style convention

The following has been adopted for this document:

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

Introduction

S.1 CEIOPS has issued its Consultation Paper 20 on Pillar I issues – further advice[1]. This Supplement should be taken together with Consultation Paper 20 and its full context.

S.2 The Supplement provides draft advice on certain issues left open in Consultation Paper 20. Those issues are identified by reference to their Consultation Paper paragraph numbers.

Valuation of future profit sharing business

Advice additional to that in Section 3 of CP20 - Advice specific to life insurance

CEIOPS' Advice

S.3 The valuation of technical provisions should generally comprise cash flows arising from future non-guaranteed benefits.

S.4 In line with the current directives, cash flows arising from (realised) profit reserves appearing in the balance sheet where they may be used to cover any losses which may arise and where they have not been made available for distribution to policy holders shall be excluded from the valuation of technical provisions. (Cf. Article 27 (2) d) of the Directive 2002/83/EG on Life Assurance.)

S.5 Such profit reserves shall be included (as tier 1 capital) in the available solvency margin.

1 CEIOPS-CP-09/06, dated 10 November 2006, available at http://www.ceiops.org/content/view/14/18/#CP20.

Approach for harmonised SCR sub-modules

Advice related to paragraph 5.383 of CP 20

CEIOPS' Advice

S.6 The following advice for harmonized SCR sub-modules is based on their needing to be submitted to regular review in the light of market developments; consequently, this should be addressed in the implementing measures.

S.7 For the sub-risks of market risk (equity risk, property risk, currency risk and interest rate risk), as well as for the sub-risks of life underwriting risk except life CAT risk, the standard formula should use a scenario based approach.

S.8 Scenarios are prescribed. Insurers should be responsible for calculating the impact of these scenarios, including the choice of the most appropriate calculation method. This may be supplemented by guidance on possible calculation methods (including simplified, formula-based treatments) in an effort to establish 'good practice'.

S.9 In order to guarantee the harmonisation goal contained in the Framework for Consultation, appropriate principles on the applicability of possible calculation methods should be developed at the necessary level.

S.10 Supervisory acceptance of such calculation methods needs to be governed by the Principle of Proportionality, to avoid subjecting insurers with non-complex risk profiles to unnecessary system costs for compliance with regulatory requirements.

S.11 For non-life CAT risks, a choice between a market loss approach and a scenario based approach should be allowed on a geographical basis.

S.12 For concentration risk, credit spread risk, life CAT risk, non-life underwriting risk (except non-life CAT risk), default risk and operational risk, the standard formula should use a factor based approach.

Expected profit / loss in non-life insurance

Advice related to paragraph 5.388 of CP 20

CEIOPS' Advice

S.13 CEIOPS recommends that an allowance for expected profits or losses on non-life underwriting should be made as follows:

- The allowance is restricted to expected underwriting profits or losses and needs to be implemented in a 'mechanical' and non-discretionary way, to ensure comparability of results.
- For profits, the allowance shall be restricted to existing business. Expected future profits from existing business emerging during the solvency time horizon shall be elements of insurance tier 3 capital subject to a limit consistent with the overall limitation system of eligible capital. The assumption of new business must not lead to a reduction of an SCR. In a prudential system, future profits should only be taken into account as far as they cannot easily be cancelled by a new pricing policy.
- For losses, the allowance shall comprise both existing business and new business written during the solvency time horizon. Technical provisions should include expected future losses linked to existing insurance policies (including tacit renewals where the insurer cannot change the premium or cancel the policy). Expected future losses from new business should be taken into account by means of an adjustment included in the SRC standard formula.

Restrictions on the partial use of internal models

Advice related to paragraph 7.28 of CP 20

CEIOPS' Advice

S.14 The partial use of an internal model by an insurance undertaking shall be subject to supervisory approval.

S.15 Where an undertaking is implementing a full internal model in an incremental or staged manner, it shall draw up a transitional plan for the period until it has implemented the full model and agree it with the supervisor.

S.16 Non-transitional partial use of an internal model should be allowed if the general requirements for internal models are met and if the undertaking provides evidence that use of the partial model:

- is in line with better risk management (use test);
- is not due to cherry picking, namely by explaining the reasons why

other risks are not included in the partial model; and

- better reflects the undertaking's risk profile than the SCR standard formula.

S.17 In addition, the risk contribution of the non-modelled part to the total SCR shall be less than 20%. Though, on presentation of a valid reasoned case by the undertaking a supervisor may void this restriction.

S.18 Where an undertaking uses a partial internal model at the request of the supervisor (for example where the standard formula does not adequately reflect the firm's risk profile) the restriction on the non-modelled proportion of the SCR shall not apply.

MCR formula

Advice is related to paragraph 8.82 of CP 20

CEIOPS' Advice

S.19 The MCR is a safety net. The MCR should be an auditable, robust and simple requirement, calculated by means of a factor-based approach.

S.20 There is a trade-off between simplicity and risk-sensitivity and the MCR is to be optimized for simplicity.

S.21 In this context, the MCR should address the main risks that the insurer is exposed to. It should therefore be calculated in a modular approach, which will reflect the main risk modules of the SCR in a simplified way, so as to ensure auditability and robustness.

S.22 Conceptually, it should follow the same one-year time horizon as the SCR, but with a lower level of confidence, e.g. 90%, to reflect the ultimate supervisory intervention in case of its breach. The calibration should be adjusted through further quantitative impact studies taking into account as a benchmark the current Solvency I capital requirement.

S.23 The modular MCR should reflect in a robust manner the risk absorption properties of future non-guaranteed bonuses included in technical provisions as well as any other significant design differences between the MCR and the standard SCR that come to light in QIS testing.

S.24 The MCR should include an absolute minimum floor.

Special treatments within the standard formula

Advice additional to that in section 10 of CP 20

S.25 CEIOPS has been recently called to deal with a number of requests for special treatments related to special undertakings and/or special types of business put forward by CEIOPS Members as well as stakeholders.

S.26 As the inclusion of special treatments in the standard formula has clear implications for harmonisation and further requests could be expected a general solution needs to be found.

S.27 It is suggested that a distinction needs to be made between:

- cases which could potentially influence more than one market across Europe; and
- cases that are specific to one single market and only impact on that specific market.

CEIOPS' Advice

S.28 CEIOPS proposes that, at this stage, harmonization and simplicity of the standard formula should be given priority. As a consequence, cases that are specific to one single market should be dealt with via a Pillar II add-on or the use of a partial or full internal model rather than in the standard formula.

S.29 If CEIOPS identifies cases which influence more than one market across Europe, it will recommend an appropriate integration into the formula, by using a Level 2 procedure.