

Solvency II Pillar I Non Life Working Group



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Dear Annette,

Solvency II: Second Wave

I am pleased to attach a series of questions relating to the European Commission's 'second wave' of Calls for Advice on Solvency II.

CEIOPS will formally respond to the 'second wave' by end October 2005. However, its working groups are currently preparing draft answers in advance of a three-month public consultation period, which is scheduled to begin in late June 2005.

The attached questions cover various technical aspects of the Calls for Advice on:

- safety measures;
- the SCR standard formula; and
- SCR internal models.

We would welcome your written comments in response to any of the points raised.

Please note that I am sending similar letters to the Comité Européen des Assurances (CEA) and the Fédération des Experts-Comptables Européens (FEE). As a result, you may wish to focus your attention on those issues which are of most direct interest to the Groupe Consultatif, or to co-ordinate your response with these other groups.

Both Pillar I working groups are meeting on 18 & 19 May to review draft answers to the Calls for Advice. Shortly afterwards, the drafts will be passed on to the Secretariat for consideration by CEIOPS members. **Written comments received before the 18 & 19 May meeting therefore have greater potential to inform our technical recommendations.**

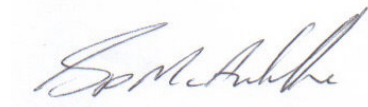
This exercise is an informal initiative of the Pillar I Non Life Working Group (rather than CEIOPS itself), so any comments received will not be made public. In addition, the contents of this letter or the questions themselves should not be taken as an indication of the likely form or content of CEIOPS' draft answers to the Commission.

I appreciate that the timeframes envisaged are very challenging and would stress that, given the forthcoming public consultation, this is not the only opportunity to feed into CEIOPS' work on the 'second wave.' My group accepts that it may not be possible to respond to all of these questions or to give anything more than very general comments. But, in any case, we hope that this letter will lead to an open and constructive exchange of views.

Please do not hesitate to contact me if I can provide any further context

Many thanks for your ongoing contribution to our work.

Best regards,

A handwritten signature in black ink, appearing to read 'Sam McAuliffe', written in a cursive style.

Sam McAuliffe
on behalf of Paul Sharma (Chairman)

Enclosed

TECHNICAL QUESTIONS FOR STAKEHOLDERS ON THE 'SECOND WAVE'

Asset admissibility & investment rules (CFA9)

The current Directives contain a list of admissible assets.

1. Do the current EU requirements constrain the use of some instruments which could otherwise be useful in covering the risks to which insurers are exposed? If so, which instruments would be useful? What are the main benefits and risks associated with their use?

The current Directives contain investment rules which apply only to assets covering technical provisions.

2. In current asset management practice, are there significant differences between the management of assets covering technical provisions, assets covering the solvency margin and 'free assets'?

Insurers should avoid an over-concentrated investment policy. This might be characterised by an excessive exposure to a single counterparty, investment type, industry or region.

3. How do insurance undertakings manage risk concentrations internally?

Minimum capital requirement (CFA9)

In some circumstances, it might be necessary to require recalculation of the MCR during the course of a year to reflect an increased threat to an insurance undertaking's ongoing financial position.

4. Are the present EU solvency requirements conducive to interim calculations?

The MCR should reflect a level of capital below which "ultimate supervisory action" should be triggered.¹

5. Given the MCR's objective under Solvency II, to what extent should its calculation follow a common methodology for life and non-life business?

¹ European Commission (2004) – *Framework for Consultation on Solvency II*

Operational risk (CFA10/11)

As the IAA report² notes, insurers may lack sufficient data for an experience-based operational risk requirement. However, operational risk can play an important rôle in the 'causal chain' of events leading to the failure of a firm.

A simple, standardised Pillar I requirement, together with the option of graduating to internal approaches might encourage better identification, management and control of operational risk.

6. What volume measure (e.g. premium income) could give an adequate proxy for operational risk in calculating a simple pillar I requirement?

Operational failures may manifest themselves as, for example, underwriting or credit losses.

7. How could we minimise potential 'double-counting' of operational risk losses?

Underwriting risk (CFA10/11)

The coefficients of the standard formula could be adapted to reflect the experience of individual firms (for example, on the size and frequency of claims). This might lead to a formula which is more closely aligned to the risk profile of an individual insurer. However, 'personalised' factors could result in an uneven playing field.

8. To what extent could the standard formula be 'personalised' for reserve risk and premium risk?

A capital requirement for underwriting risk should be based on an appropriate division of an insurer's business into various segments. Segments should be credible (a group of claims should be large enough to be statistically reliable), relatively homogenous and distinct from the rest of the business.

9. Should the standard formula prescribe how insurance business should be segmented for solvency purposes? Does there need to be flexibility to take account of differences in national markets? How could we ensure that any prescribed segmentation would be practical for different insurers?
10. To what extent does the present EU classification³ represent an adequate segmentation for the purposes of assessing underwriting risk? Would this classification need to be refined to reflect actual firm behaviour more closely?

² IAA (2004) – *A Global Framework for Insurer Solvency Assessment*

³ The insurance classes defined in the First Council Directive (73/239/EEC)



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12 May 2005

Dear Paul,

Solvency II: Second Wave

Thank you for providing Groupe Consultatif with the opportunity to respond to the series of questions relating to the European Commission's second wave of Calls for Advice on Solvency II.

We have decided to respond to the questions relating to:

- the minimum capital requirements;
- the treatment of operational risk within the SCR; and
- the design and potential personalisation of the SCR formula.

We have not answered the questions relating to the asset admissibility and investment rules, as we believe the CEA will be in a better position to express the current practices and the industry's views.

We have added a few comments on areas that we would encourage CEIOPS to consider in the design of the new solvency framework. Some of these comments are in relation to the latest publications from the European Commission specifying the definition of ruin amongst other items.

The views expressed in this letter are solely those of Groupe Consultatif's Solvency II Pillar I working groups and the Solvency II project team. The response is currently being discussed by Groupe Consultatif's Insurance Committee. Should these discussions bring out additional points we will bring these to your attention during our meeting on the 17 May.

We look forward to discussing our response with you in the coming week.

Best regards,

Annette Olesen

Minimum capital requirement (CFA9)

Question 4

Are the present EU solvency requirements conducive to interim calculations?

The current Solvency I requirements are easy to calculate with the basic inputs being the level of premium and reserves on a retrospective basis.

Groupe Consultatif would consider it best practice for companies to perform this calculation on a quarterly basis. The formula is conducive to this; the only hindrance is that groups of companies within some European countries are at present only performing reserving calculations on an annual basis. These companies would either have to

1. move to more regular reserve estimations, or
2. ensure that reserves are monitored and rolled forward quarter to quarter.

The information underlying the solvency calculations should be consistent with the internal quarterly management reporting.

Question 5

Given the MCR's objective under Solvency II, to what extent should its calculation follow a common methodology for life and non-life business?

Groupe Consultatif agrees with the current defined objectives for the MCR as the point at which the supervisors should have sole discretion over the use of "ultimate supervisory actions", which is similar to the actions currently taken when a firm has less capital than the guarantee fund.

We note there are a number of different approaches to how the MCR may be defined so as to implement this principle, that are currently being discussed by CEIOPS, including:

- Adopting the existing Solvency I requirements
- Extending the present Solvency I requirements to capture asset risks
- Using SCR as a reference, either as the basis for a simplified formula or by taking a percentage
- Establishing a risk margin over and above liabilities

Groupe Consultatif believes that the methodology for calibrating MCR should be clearly and unambiguously defined with the following criteria being important for any MCR formula:

- Should be simple and quick to calculate
- Should be an objective calculation
- The company data driving the formula needs to be auditable
- Should be non disputable requirement i.e. stand up in court

In addition, it may be desirable to ensure that the MCR is additive in order to handle groups easily by being able to sum the MCR from the various legal entities (groups/ subsidiaries/ branches). However, this will only work if the MCR level (and the technical provisions) is not too high otherwise the sum of the entity MCRs will be an unreasonable constraint on a group level SCR that reflects diversification.

Groupe Consultatif supports that the same principles underlie the calculation of MCR for life and non-life companies. The percentage and even different variables need not necessarily be the same for life and non-life insurance, due to different one-year risk characteristics of life and non-life business.

However, it is of utter importance that the MCR is based on a consistent methodology for life and non-life insurance. Hence, if the MCR is calibrated according to some (modest) level of prudence over a

one-year time horizon, the same risk measure/ level of prudence has to be applied for life and non-life businesses.

Operational Risk (CFA10/11)

Question 6

What volume measure (e.g. premium income) could give an adequate proxy for operational risk in calculating a simple Pillar I requirement?

Operational risk is currently a difficult risk to quantify for insurers, mainly due to the lack of historic data and an adequate conceptual framework. A number of countries within Europe are pushing some kind of incidence reporting, however there is still a lack of sufficient data to adequately quantify the risk and hence model it.

As a result, we currently believe any operational risk charge has to be based on a simplified approach which is clear and transparent. Once companies have sufficient data, that is sound on a statistical basis and is relevant to their specific situation, they should be allowed to deviate from the standard capital charge that may be included as part of Pillar I

GC supports the inclusion of operational risk in the Pillar I capital requirement in order to cover all major risks to any insurance undertaking:

- Key risk as shown in the study of past insolvencies across Europe (Occasional Paper 20)
- Provide incentive for companies to have better risk management, controls and incidence reporting in place by inclusion in standard formula, with ability to reduce the capital charge either by superior risk management or modelling
- Inclusion in Pillar I will increase harmonisation via a common benchmark – alternative would be Pillar II treatment which would tend to be dependent on approach taken by any individual national supervisor

The difficulty arises as operational risk is not easily quantifiable

- Very few companies have operational risk data – will be part of the historic claims or expense experience. The difficulty is to assess the residual risk
- Even when data exists, likely to be the frequent less severe operational risk losses
- Even when historical data exists, it is not evident that this experience reflects the current situation of the company as internal controls etc. might have changed
- Although some operational risk databases are being built, it is questionable the extent to which these will be applicable to any individual organisation

For inclusion in a standard SCR Pillar I formula a proxy measure is required, possibilities include:

- Premium income
- Reserves
- Factor up load on the overall SCR standard formula (excluding operational risk)

As an extra layer of refinement the volume measure could be split by line of business.

GC believes it should be kept in mind that operational risk constitutes a residual risk and the effort expended on operational risk should be commensurate with its importance. In that sense, it will usually not make sense for a company to use more resources for quantifying operational risk than it does for managing its insurance or market risk.

The discussion on what would be the most appropriate volume measure is ongoing within GC, however, we note the following pro/ cons associated with the proxy measures listed above:

	Pro	Cons
Premium income	<ul style="list-style-type: none"> • Proxy for the size of operation, number of distribution channels, .. • React to rapid growth and associated operational risk • Towards prospective measure of risk 	<ul style="list-style-type: none"> • Not applicable for run-off companies • Does not capture risk associated with underpricing • Counter intuitive relative to the underwriting cycle
Reserves	<ul style="list-style-type: none"> • Retrospective measure of risk capturing largest item on the balance-sheet 	<ul style="list-style-type: none"> • Underestimates for new companies or companies with rapid growth • Does not capture risk associated with under-reserving
Factor up load on overall SCR standard formula excl operational risk	<ul style="list-style-type: none"> • Transparent • Links operational risk to all other types of risks captured by the SCR formula • Close to specific risk exposure for individual company 	<ul style="list-style-type: none"> • Treatment as a general upload

Question 7

How could we minimise potential 'double-counting' of operational risk losses?

GC believes a clear definition of operational risk is required, as mentioned by CEIOPS in the Issues paper¹. Further more it may be appropriate to consider whether the risk of a certain event impacts the companies' clients or the company directly. For example an external natural disaster may impact a given company via policyholders' exposures (typically covered under insurance risk) or the company itself (operational risk). For example failure of underwriting or claim management will be reflected in claim history, the operational risk should only reflect the additional cost.

To some extent operational risk will be included in the past data, but until an industry database is compiled and populated, the SCR will have to rely on judgemental addition to the formula.

Underwriting risk (CFA10/11)

Question 8

To what extent could the standard formula be 'personalised' for reserve risk and premium risk?

The basic SCR formula should be calibrated using a common risk measure, time horizon and risk level across Europe. This will necessarily result in different calibration factors in order to reflect the different markets in different member states.

As part of the calibration exercise it needs to be considered how to allow for diversification between lines of business or between risk categories. This can be done by having an explicit correlation allowance within the SCR formula.

We understand that the personalisation of factors within the SCR model, for example on premium factor, reserving risk or correlation factors, will provide individual companies with the ability to substitute the factor in the standard formula with their own individual factors.

¹This definition coincides by the one mentioned by IAA in "A Global Framework for Insurer Solvency Assessment", which originally was adopted by the Basel Committee of Banking Supervision from the British Banker's Association

Rules need to be objective and define exactly how and when personalisation is allowed (and required). It should not be an option that companies can choose to exercise as they see fit. Compared to a Standard Formula calibrated across the market, one would expect that with a personalised Standard Formula being applied, some companies would get a lower capital requirement (likely to be those that have consistently performed well in past with little volatility in results) and others would get a higher capital requirement corresponding to their above-average volatility or risk profile.

The rules have to take into account when there is enough data for personalisation to be credible, say, it may require as a minimum 10-15 years of historic data. There may also be a need to define an explicit limit on the upper and lower range of the personalization.

Question 9

Should the standard formula prescribe how insurance business should be segmented for solvency purposes? Does there need to be flexibility to take account of differences in national markets? How could we ensure that any prescribed segmentation would be practical for different insurers?

Should the standard formula prescribe how insurance business should be segmented for solvency purposes?

For the risk assessment, it is helpful to segment the insurance business into a number of distinct Lines of Business (LoBs). Ideally, the segmentation should distinguish the different risk characteristics of the different LoBs, be compatible with the differentiation done by insurance companies themselves and be compatible with the statutory definition of LoBs. The segmentation should also take into account the availability of data within the different countries and under various local GAAP balance sheet practices. It is impossible to satisfy all conditions perfectly, but the following is a good compromise. It is a segmentation into a reasonable number of different LoBs which corresponds to the usage of actuaries in many territories:

- Accident
- Motor
- Property
- Liability
- Marine
- Credit
- Workers Compensation
- Other

Comment: It might also be useful to add as a special LoB 'multiyear guarantee business' to capture the specific characteristic of policies with longer guarantees. This additional LoB would be advisable if the 'other' category would become 'overloaded' with policies.

Does there need to be flexibility to take account of differences in national markets?

The segmentation can be the same for each country. However, the risk characteristics of a given LoB can differ from country to country, e.g. the volatility of the premium risk of Italian motor business might differ from the volatility of Danish motor business. If a solvency model is defined based on the above LoBs, it is important that the calibration of the model takes into account the country specific parameterization.

How could we ensure that any prescribed segmentation would be practical for different insurers?

There needs to be a clearly defined mapping from the statutory LoBs to the above defined LoBs. In the case of products which span different LoBs, there needs to be clearly defined procedure to split the relevant measures (e.g. premium level, amount of provision,...) of the product to the associated LoBs.

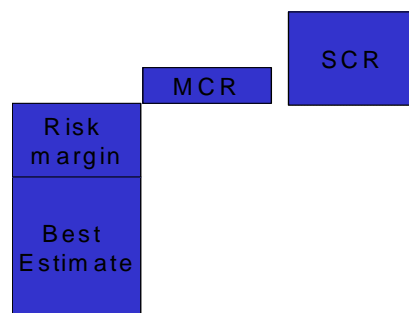
Question 10

To what extent does the present EU classification² represent an adequate segmentation for the purposes of assessing underwriting risk? Would this classification need to be refined to reflect actual firm behaviour more closely?

From a solvency perspective, it would be preferable to have a classification according to risk classes rather than insurance classes. But, as a standard proxy for such risk classes, the EU's insurance classes could be used. The 18 non-life lines of business should, in a standard formula for the SCR, be limited to a lower number, cf. the answer to Question 9.

Additional comments by GC

The GC supports the following building block structure for the solvency capital requirement



We believe the following is essential for CEIOPS to consider:

- How to achieve a consistent best estimate consistent across Europe. A key issue here is how “best estimate” is defined.
- Conceptually define what the risk margin is meant to cover e.g. is it to provide sufficient cover for the solvent run-off of a given portfolio
- Clarity on whether the risk margin is only relating to the risk of the ultimate of the liabilities, i.e. if it excludes consideration of asset and credit risks
- Given it may be inappropriate to define the MCR as a percentage of the SCR, CEIOPS should consider whether the MCR may be defined on a longer time horizon than one year
- Under the condition that the MCR would take into account a longer time horizon (not only the period of one year) several options could be taken into account. One option could be to define it as the minimal capital to cover the market and credit risk of the assets backing the best estimate and the risk margin at the time of run-off. This would take into account that the investment strategy would be changed to an optimally matched portfolio, given liquidity constraints. If the MCR is a formula set by EC a suitable proxy needs to be derived.
- The latter option for MCR may avoid a potential double counting of risk between the MCR and the risk margin.
- Allowance for reinsurance in the MCR or risk margin
- Allowance for the branch structure within a given legal entity
- Allowance for group-level diversification for the legal-entity level SCR
- Whether to allow for profits within a one year time horizon in the SCR model – or alternatively whether it should be accounted for in the definition of available capital

²

The insurance classes defined in the First Council Directive (73/239/EEC)

We notice the new definition of the VaR 99.5% risk now proposed by the EC to be measured as ruin when falling below the best estimate plus the risk margin. This is a more demanding requirement than the VaR 99.5% measure previously described with assets falling below the best estimate.

Further we would also encourage that it is made clear to what extent the same definition of VaR and SCR formula will be applicable to reinsurers. This would require some definition of how the worldwide exposures would be assessed.