

Comments on CEIOPS Issues Paper CEIOPS-IGSRR-18/08
Supervisory Review Process and Undertakings' Reporting Requirements

Commentator: Groupe Consultatif

Reference	Comment
General comment	<p>The Groupe Consultatif welcomes the opportunity to share CEIOPS' thinking and to comment on the issues which CEIOPS has identified in supervisory review process and undertakings' reporting requirements connected to the proposed Solvency II Directive.</p> <p>Generally we feel that the Issues Paper captures well the essential elements to be taken into account in supervisory review process and also in public disclosure. We restate the central principles here and strongly support them:</p> <p style="padding-left: 20px;">1.4. The SRP should be applied to all undertakings to ensure that all policyholders receive an adequate level of protection as required by the Framework Directive Proposal. All undertakings will therefore be subject to an appropriate level of supervision to ensure that the requirements of the Directive are met.</p> <p style="padding-left: 20px;">1.5. In accordance with the principle of proportionality, the SRP should be adapted to the nature, scale and complexity of the risks of each undertaking. At the same time, it is the aim of supervision to determine the nature, scale and complexity of the risks facing each undertaking, and to prioritise and focus supervisory actions and efforts according to a risk-based approach.</p> <p style="padding-left: 20px;">3.5. The requirement for a risk-based supervisory approach is designed to ensure that supervision takes the risk profile of all undertakings into account, provides a further incentive for undertakings to better measure and manage their individual risks, optimises supervisory resources and ensures an appropriate level of policyholder protection across their market.</p> <p>Also the idea that supervisory resources are targeted based on the analysis of the risk profile is welcome. This is captured in the following paragraphs of the Issues Paper:</p> <p style="padding-left: 20px;">4.22. Supervisors should use the preliminary assessment just described to form a first opinion of an undertaking's risk profile. This should then be used to determine appropriate supervisory actions. The outcome is that supervisory actions and efforts are prioritised according to the risk assessment of undertakings, and this should be carried out by all supervisory authorities. Given this assessment using common criteria, supervisors may decide to categorise undertakings according to their risk profile. CEIOPS will undertake further work on the results of the SRP such as the convergence of categorisation of undertakings and the manner in which dialogue with undertakings occurs to report back on the SRP.</p>

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- 4.25. Supervisors should consider the following high level principles for prioritising supervisory actions:
- every policyholder should be afforded the same level of protection;
 - supervisory actions should be proportionate to the nature, scale and complexity of the risks of each undertaking;
 - the SRP should be preventive and forward looking; and
 - a supervisor must be able to react properly when it is necessary, especially in fast evolving, adverse situations.

The Groupe Consultatif has worked extensively on the so-called ORSA paragraph of the directive and has developed an interpretation of what is required here (the so-called Solvency Report). We feel that discussions between different stakeholders based on our interpretation could benefit the protection of policyholders, the supervisors and undertakings.

As a general comment we would like to add that CEIOPS should make it clearer in future steps what is public disclosure and what is confidential information only to the supervisor. We feel that in future work it should be made clear what is public (included in SFCR) and what is confidential (RTS). In the current financial turmoil it has again become clear that trust is a central element in financial markets. Wisdom is needed in understanding what should be public information giving the correct understanding to the markets. The supervisor needs much more information to perform its tasks but this more in-depth information could in some situations create even more problems as regards the protection of policyholders if it were public information.

Proportionality is currently more discussed in the context of saying that smaller/simpler undertakings would not be required to undertake onerous techniques and also policyholders should be equally protected in all companies. We would like to add here one dimension to the concept of proportionality. We could easily end up in a situation where the supervision of simpler undertakings could take a huge amount of supervisory resources even though the undertakings only insure a fairly limited number of policyholders. More complex undertakings could take an inproportionately small share of supervisory resources compared to the number of insureds. The proportionality principle could be so amended that it would mean also that resources are targeted so that the insurers of the majority of policyholders are supervised adequately.

Although we believe that the Issues Paper captures well the essential elements to be taken into account in supervisory review process and also in public disclosure we think it is important that an assessment is made of the resources that each supervised entity would have to spend to provide and update the information to the supervisor and the public. We would particularly recommend that a top-down approach is used in defining the information requested from the company. This should mean that a part of the total information requested is given a priority. The supervised entity should then be able to submit this restricted

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information within a short time frame .
The risk might alternatively be that the entity's risk management resources are spent on providing and updating information instead of defining and implementing a risk management culture within the entity. We see the creation of a proper risk management culture within each supervised entity as a very important outcome of the implementation of new directive.
A consideration should also be made to the supervisory authorities' ability to review the amount of information received from the supervised entities. Information submitted but never reviewed will be of value to no one.

We also believe it important that performance information be compared with plans and budgets wherever practicable as this will provide useful perspective on internal control systems. Performance against plan would appropriately be discussed in the context of on-site visits.

Para. 1.3

The application of the supervisory review process to all undertakings is an opportunity to develop comparative information, which we regard as important. Subject to considerations of proportionality, we believe it important that the process develops a database which supports performance comparisons.

Para. 1.8

In paragraph 1.8 it appears that CEIOPS places significant emphasis on annual reporting. A better approach might be to differentiate between (say) quarterly reporting on key areas, annual reporting on most areas and triennial reporting on in-depth analysis.

Additionally, we feel that it is not sufficient just to make certain that there is public information. The other part of this is that financial education and awareness of the public is essential to make it possible for policyholders and the general public to understand the information given, otherwise the information is useless. The OECD has produces a "Recommendation on Principle and Good Practices for Financial Education and Awareness" (July 2005) referring to the roles of all participants including supervisors. We feel that this paper (together with an OECD paper of March 2008 specifically dedicated to insurance activities) could be very useful to attain the objectives of public disclosure in Solvency II.

Para. 4.22

In paragraph 4.22 we would stress that the categorisation of companies for supervisory purposes should not be public information.

<p>Para. 4.36 and 4.38</p>	<p>In the area of categorisation we however have some doubts whether the categorisation truly reflects our understanding of the actual supervisory operation under Solvency II. Already in paragraph 4.36 the undertaking is required to calculate its own solvency capital needs with the ORSA process and to report them where it is not clear whether this reporting is public or reporting to the supervisor:</p> <p><i>4.36. To safeguard the interests of policyholders, supervisors must be aware when there is a growing threat to an undertaking's solvency. Effective supervision in this regard is enhanced by the establishment of solvency control levels. The current Framework Directive Proposal requires undertakings to calculate a MCR and a SCR. The undertakings are also required to derive their own solvency needs through the ORSA process along with an assessment of their own risk profile and changes from their risk assessment process. This information should be regularly reported by the undertaking, along with its level of own funds, and should be used as an important supervisory tool for monitoring undue risks to policyholders. All of this information should provide the supervisor with an indication if the undertaking has a deteriorating financial position or an increasing risk profile. Supervisors should maintain records over a period of time comparing the submissions from undertakings within its jurisdiction to identify such adverse trends.</i></p> <p>Apparently the "solvency needs" referred to here refer to the concept of economic capital. We have been critical in our earlier submissions of the use of the word "breach" even when capital goes below SCR. Now however we note that this rather strong word is used even as regards the internal requirements derived based on the ORSA. We feel that this tends to create hard limits even higher than SCR (which we still think should not be a hard limit) as undertakings are urged to think also that ORSA capital requirements are more critical than they should be. We do not disagree that supervisors should be aware of the solvency position of the company in all situations but we think that policyholder protection and efficient use of capital does not need to result in higher or critical hard limits above the MCR:</p> <p><i>4.38. Discussions should commence well before any own funds requirement or own solvency needs are breached. It would be beneficial to determine possible early warning indicators, taking into consideration the specifications of the new solvency regime, to act as an early warning system for intensified supervision within Solvency II. This process would prevent the situation where the first time a supervisor became aware of a deteriorating financial position was either after the undertaking had breached the SCR or had identified that it would do so within the next three months. These early warning indicators should not however function as a new solvency control level, and could be both quantitative and qualitative in nature, and do not necessarily indicate that the undertakings is in financial distress.</i></p>
<p>Para 4.45</p>	<p>The allocation of resources is more exactly defined in paragraph 4.45. In connection with what we have commented above, we would have expected a clearer description of how supervisory actions are targeted on level A below. We think it is essential to be much clearer here in order not to create the idea that the "ORSA SCR" is a hard limit (actually, we feel that the text here does not give any guidelines on how the resources are targeted above SCR):</p> <p><i>4.45. If a regulatory solvency level (the MCR or the SCR) is breached, the supervisory actions should vary according to which solvency level is breached. It is important to note that the undertaking's internal capital needs, as derived</i></p>

	<p><i>from the ORSA, are not a regulatory solvency level. The supervisor should however be notified of such a breach in order to discuss the reasons for such differences with the undertaking concerned. Regarding regulatory solvency levels being breached, a "Supervisory Ladder" could look as follows:</i></p> <ul style="list-style-type: none"> • <i>Level A Own funds = SCR (SCR including any capital add-on14)</i> • <i>Level B MCR < Own funds < SCR, or if the undertaking observes a risk of noncompliance in the coming three months (Article 136 of the Framework Directive Proposal)</i> • <i>Level C ('ultimate actions') MCR > Own funds (including an absolute floor) or if the undertaking observes a risk of non-compliance in the coming three months</i> <p>In this area we feel that the Issues Paper wants to build its attitude reliant somewhat too much on off-site inspection. We feel that the ORSA process could create fruitful discussions between an undertaking and its supervisor. If however too strong emphasis is given to off-site inspection and the word "breach" is used even in the context an ORSA solvency requirement, this is not beneficial to the discussions between an undertaking and its supervisor.</p> <p>Also the Issues Paper might be rather over-reliant on consideration of developments in solvency over time. We think that the development of solvency over time can be influenced by extraneous noise (catastrophe experience, asset market movements, etc.). It might be that relative movements in solvency might be more telling, i.e. outliers of general developments. Therefore comparative analysis is needed. Also a more telling indicator might be how well the company succeeds compared to what the company has planned.</p> <p>While it is important that resources should be allocated efficiently we feel that there should be sufficient resources so that every policyholder will be afforded the same level of protection. Prioritisation and proportionality are needed for the efficient management of the SRP but lack of resources as regards policyholder protection should never be a normal situation.</p>
Para. 5.3	<p>The Issues Paper places heavy emphasis on the supervisor understanding the undertaking's business to be able to probe its performance. We of course do not disagree with this but we believe that there should be much more emphasis on the requirement that the undertaking understands and analyses its own business.</p> <ul style="list-style-type: none"> • 5.3. The supervisor should understand the business the undertaking writes. With this information, the supervisor has the possibility to analyse trends on the main business lines to be aware of the undertaking's main profit areas and the potential risks to them. Adverse changes to the trend could be noted and if appropriate, discussed with the undertaking's senior management.

Para. 5.7	<p>In contrast to paragraph 5.3 we feel that paragraph 5.7 is fairly modest in its attitude. Especially in the current financial market crisis it has become evident that supervisors (and of course undertakings) need more expertise than before in understanding investment risk.</p> <ul style="list-style-type: none"> • 5.7. Supervisors should have knowledge of the undertaking's financial performance from investments. The supervisor should be satisfied with how senior management make investment decisions as well as the key assumptions made with respect to interest rates, exchange rates and market indices. It is important that the supervisor has an idea of profitability and how well the undertaking is managed in this area.
Para 5.11	<p>In paragraph 5.11 d we feel that this could prove difficult for certain asset classes, particularly property. We think that the Issues paper should be clearer in concepts: our understanding is that Solvency II tries to achieve market consistent valuations. This paragraph seems to apply the concept of fair value to valuations that can lead to the interpretation of this as the so-called full fair value (observed directly from the market). We think that it should be clear that cash-flow modelling is possible also here.</p>
Para 5.17	<p>Paragraph 5.17 also takes the fair value approach to valuations, possibly leading to the full fair value interpretation. We would favour the use of market consistent valuations that make it clearer that cash-flow modelling is at least an option.</p>
Para 5.38	<p>Paragraph 5.38 discusses the role of the actuarial function. We feel that generally the discussion here is in the right direction. However, it seems that the definitions and roles expected from the actuarial function are not clear enough and we expect CEIOPS to return to this issue in the forthcoming Issues Paper on governance.</p> <p>We believe that an actuary who is also an employee can never be completely independent of executive management. The supervisory review process should consider the degree of independence afforded to the person discharging the actuarial function.</p> <p>We also note that the involvement of actuaries in various other organisation and governance capacities additional to discharge of the specified actuarial function can be of value to the supervisory review process. Actuaries may be involved in a range of executive management functions or may be non-executive members of the administrative or managing body.</p>