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Mr Henrik Bjerre Nielsen
Chairman
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Dear Mr Nielsen

Comments on CEIOPS Consultation Paper No. 7 Draft Answers to Second Wave of Calls for Advice (Solvency II)

We are pleased to see that progress is being made and have pleasure in attaching the comments of the Groupe Consultatif on CEIOPS' draft answers to the European Commission's Second Wave of Calls for Advice.

In general, the Groupe Consultatif supports the majority of CEIOPS' response. However, there is one issue which recurs throughout CP7 and which gives us, as the professional actuarial body for Europe, considerable cause for concern. On the one hand a huge amount of actuarial knowledge input is needed for Solvency II; on the other hand CEIOPS does not seem to recognise that this input necessarily has to be given by actuaries, who throughout the European Union are organised within professional organisations – yet, paradoxically, CEIOPS seeks to define the role of the actuarial function. As this is a major issue for the actuarial profession, the Groupe Consultatif will address this matter and offer a separate discussion to CEIOPS in the near future.

Before dealing with each of the draft answers in detail, the Groupe would like to point out that many terms used in the context of Solvency II deserve exact definition, or at least further clarification. Although the latest version of CP7 has taken particular steps towards this, we note that a clear and uniformly accepted terminology does not exist. So further work is required to provide a clear definition of concepts underlying the Solvency II system in general.

To this end, the Groupe Consultatif, in collaboration with CEA, is currently working on a glossary of terms. In addition, the Groupe would like to offer comments on the general outset of Solvency II from an actuarial point of view. These comments specifically concern topics such as:

- Purposes and interdependencies of technical provisions, risk margin and MCR/SCR
- Definition and calculation of risk margin and MCR/SCR
- Use of probability distributions and approximations for calculating these figures
- Relationship of these terms to current balance sheet positions (e.g. nominal provisions in non-life insurance)

We understand that many of the terms have already been introduced by the EU Commission in various MARKT publications. The recent Solvency II Framework for Consultation¹ – at least provisionally – tried to fix them in order to provide a common working basis.

The Groupe also observes, however, that the various actuarial bodies within European countries have different opinions on these terms and use them differently. As a consequence, the Groupe Consultatif has initiated an extensive discussion on the general architecture of Solvency II, especially the topics listed above. The discussion will be finalised during the forthcoming meeting of the Groupe's Insurance Committee (20 Oct 2005). We hope to achieve broad consensus on a draft version of the above-mentioned general remarks, but it is not our intention here to anticipate any decision in the Groupe's

¹ *Amended Framework for Consultation on Solvency II*, European Commission, July 2005.

Insurance Committee. Any further proposals or comments will be made available to CEIOPS as soon as possible.

CfA n° 7: Technical provisions in life assurance

Quantitative standard for technical provisions (7.10 – 11)

In the valuation of lapse options, any interest rate sensitive behaviour of policyholders should be valued using risk-neutral valuation.

Portfolio segmentation (7.16)

Portfolio segmentation presented itself as an issue in the recent preliminary field survey, and guidance will have to be given to those addressing the imminent QIS.

The actuarial management of most life business is based primarily on statistics which are generic to a population rather than specific to the portfolio of a particular insurer. Such being the case, the need for segmentation of a portfolio for purposes of calculating technical provisions should be kept to a minimum.

We consider that, once specific segments are implemented, diversification effects between these segments must be allowed and handled reasonably. The following segments may nevertheless be appropriate:

- Disability
- Critical illness
- Life protection
- Life investment
- Annuities in payment
- Unit-linked investment
- Group insurance
- Participating business

Firms and groups should be encouraged to envisage segmentation consistent with their approach to management i.e. distinct profit centres would be deemed also to be distinct risk groups.

Discounting (7.18 – 20)

The Groupe Consultatif would like to support CEIOPS in using a set of principles to establish risk-free rate term structures for currencies with deep bond markets (at least euro and sterling).

The relative merits of supervisory adoption of principles and of prescription of the rates themselves are debatable. The former seems likely to be more flexible in taking into account capital market developments but could have the effect that different companies interpret the principles such that rates differ by a few basis points. The latter could correspondingly be less flexible.

There are minor differences in yields on bonds issued by different sovereign euro members. The risk-free rate should exclude premiums for credit risk.

Long-term liabilities present particular difficulties and an approach may have to be prescribed for these. Where supervisors do prescribe (maximum) rates, the underlying rationale should be required to be published.

Contractual and constructive participation (7.21 – 23)

We agree with the CEIOPS analysis and would like to offer support from the profession in defining the character of liabilities. Possible management actions in adverse circumstances can present particular difficulties.

Risk margins (7.20, 28 – 35)

The Groupe disagrees with the idea of achieving prudence through interest rate margins. The approach tentatively adopted by CEIOPS appears not to recognise the important distinction between risk and uncertainty (as distinguished within the IAA treatment of, for example, mortality risk).

A characteristic of uncertainty is that it is not diversifiable and needs to be considered in relation to a run-off horizon.

Portfolio dependence (7.37)

We believe the issue here may be that CEIOPS is leaning towards a 'percentage sufficiency at line of business level' approach which would be entity specific and would vary by portfolio size (effectively requiring higher margins for smaller portfolios relative to best estimate). CEIOPS is aware that a portfolio invariant standard is theoretically more desirable for technical provisions, but may look for support in considering how such a standard should be implemented.

The issue is of greatest significance for non-life business, but is relevant to life also (partly depending on the approach to segmentation).

Surrender value floor (7.51)

Ideally we would express support for the second sentence quoted from the IAIS to the effect that total guaranteed surrender values need not be covered by technical provisions but by total financial resources.

If the surrender value floor is confirmed as a feature of IFRS it will require adjustments to arrive at an economic balance sheet for regulatory purposes.

CfA n° 8: Technical provisions in non-life insurance

In our view further work is required to provide a clear definition of concepts underlying the Solvency II system and the technical provisions. We would recommend that the overall principles for the different components of the solvency framework (including a description of their key features) are communicated to stakeholders and companies participating in the forthcoming QIS in an unambiguous and conceptually consistent way.

Portfolio dependence (8.32 – 41)

A fundamental challenge with the risk margin calculation is the question of what segmentation of the business that should be applied. The calculation must be made on homogenous risk types. If a 75th percentile risk margin is applied on a line of business basis, the consequence would be that the overall risk margin for the entity would be well above the 75th percentile unless the company was allowed to make some reduction for a diversification between segments. We think that diversification within and between lines of business should be allowed.

We note that any segmentation would result in the provisioning standard not being 'portfolio' invariant. This means that the value placed on a particular liability (best estimated discounted plus the risk margin) would vary between companies dependent on the size and mix of their portfolios.

Reinsurance allowance (8.42 – 45)

The calculation of best estimates should be performed gross of reinsurance, with allowance then being made for expected reinsurance recoveries in order to derive the net position. This would also be considered best practice from a business perspective with a transparent approach to how the risk mitigation in place, here the reinsurance programs, have been accounted for.

Any risk associated with this program should be evaluated and an assessment made whether capital is required to capture potential credit risk. It is important to point out that different assessment of varying complexity can be applied to credit risk (based on rating of the reinsurer and potentially some allowance according to the supervisory requirements of the reinsurer).

The risk margin we recommend to be disclosed net of reinsurance only.

Treatment of future cash flow (8.53 – 62)

We agree that the discounting of reserves should be based on a risk-free approach and that a yield curve must be used and not a fix set of rates for future development until full loss settlements.

The actuarial report must include a specific section on discounting including:

- Payment pattern
- Yield curve
- Assets backing liabilities
- Volatility of above assumptions

Provision for claims outstanding (8.66 – 71, 104)

We recommend including in the technical provision an actuarial assessment of future liabilities which should include a statistical adjustment on top of the case by case estimate. This statistical adjustment should be assessed by homogeneous type of risk under common actuarial practices.

Actuarial assessment relies on consistency of claims handling procedures and processes over time. Therefore, the actuarial report mentioned above should also include a specific section on claims processes, and in particular should comment on any change in procedures or strength of underlying case reserves.

The actuarial adjustment to case by case estimates could be positive or negative and will reflect local claims handling procedures and its stability overtime. This adjustment (positive or negative) will contribute to harmonization of best estimates around entities and countries. Case by case reserves should not be seen as a floor for actuarial estimates.

With regard to statistical methods, it is important to define what is meant by different methods, i.e. what qualifies them as being different (8.104).

Any breakdown or default of claims handling processes and procedures in the future should be seen as an operational risk and assessed under the solvency requirement.

Premium provisions (8.79 – 90)

If reserves are estimated by underwriting year approach, a differentiation between loss and premium reserves will not be required. On the other hand, if reserves are assessed by accident year, the difference between loss reserves and premium reserves must be clearly specified. However, the risk margin must be seen on an aggregate basis to avoid penalizing companies according the way they assess reserves (accident year vs. underwriting year).

Premium reserves by definition include uncertainties around the future occurrence of claims.

Using the UPR as a floor would appear sensible. However, it is not consistent with the best estimate approach plus risk margin that is recommended for outstanding claims. If companies have to build up from the UPR this could overstate the capital requirement, hence the prudence should be taken account of as part of the capital requirement.

Equalisation mechanism (8.92 –99)

Currently there are very different practices within Europe relating to the use of equalisation reserves. To a large extent it is also a tax issue.

The equalisation reserves mechanism is an approach from an actuarial / business point of view to set apart, year on year, an amount to cover future large loss. Local tax authorities should specify tax allowance and mechanism allowed.

For an economic purpose on a runoff concern, the equalisation reserve should be seen as a capital component. If for example, equalisation reserves are set for the next underwriting year with a probability of occurrence lower than the selected risk measure, then the equalisation reserves must be seen as a part of the available capital to cover SCR.

We believe that the allowance for equalisation/ catastrophe should cover the capital requirement rather than a separate provision.

Solvency II requirement should not be mixed with business approach / tax regulation and accounting purposes. Consistency can be achieved but the purposes are different. But in any case the main requirement is to avoid double counting. Therefore, if there is an equalisation reserves mechanism set, we consider that this must be assessed on deduction of the SCR requirement as it concern future risk (prospective risk) rather than past underwritten risk (technical provision).

Management of technical provisions (8.123 –133, 139 – 141)

Most advices 8.125 to 133 and 8.139 to 141 require the undertakings to comply with obvious principles, but the nature of these requirements is not stated, (merely guidance or regulation which may entail sanctions in case of breach), nor how and by whom adherence to these principles will be assessed.

We presume that the goal of such requirements is to ensure that technical provisions are established and maintained at an adequate level. It is our opinion that, to achieve this goal, it would be more efficient to require undertakings to formalise their provisioning policy in an annual document. The requirement would list the issues to be addressed such as: quality of data, assumptions used, methodologies applied, intervals of confidence, uncertainties, roles and responsibilities of the persons and/or units involved in the establishment of technical provisions, etc.

By comparing the documents of the undertakings operating in its country, a supervisory authority would progressively build its opinion on best practices to be encouraged. The comparison of the provisioning policy assessments in different Member States would be a powerful driver towards harmonisation of the approach of technical provisions across EU.

A side advantage of this suggestion is that it leads to a much leaner regulation than an attempt to state the principles to be applied when establishing technical provisions, and avoids the risks of forgetting an important principle and becoming outdated.

Actuarial function regarding technical provisions (8.135)

This advice includes a requirement for actuarial advice when making decisions on capital adequacy and on business strategy: it would be necessary to state for which purpose, or on which matter actuarial advice is required at any time.

The references to capital adequacy and business strategy are out of place in this section, which deals specifically with the management of technical provisions.

Given the significance, importance and relevance of the issue to the actuarial profession Groupe Consultatif will be responding to CEIOPS on the question of actuarial advice, actuarial functions, actuarial expertise, actuarial competence and actuarial professionalism in a separate document.

CfA n° 9: Safety measures

Transitional arrangements (9.10, 17, 58, 59)

We are not in favour of the idea of a second floor restriction for the SCR internal model (as mentioned in 9.59 4th point). If such a floor was to apply we can currently see no reason why this should only apply to the internal model and not equally to the SCR standard formula.

MCR criteria (9.5, 11, 13, 20, 59, 60)

The Groupe Consultatif is supportive of the general design priorities for the MCR.

We believe that the methodology for calibrating MCR should be clearly and unambiguously defined.

QIS testing criteria (9.20, 39, 59, 61)

A number of comments on QIS have already been raised in our letter to CEIOPS WG2; see also our comments on CfA 13. We would recommend CEIOPS not only to focus on the quantitative aspects, but also to gather information on the quality of the processes or the state of the industry. This would provide some context to the interpretation of the quantitative results.

For the QIS1, one area that definitely needs to be clarified is the extent to which the risk margins are purely envisaged to cover risk associated with the liabilities, or whether they are expected to cover credit risk as well as investment risk associated with the backing assets. We note that for life companies it would be more natural to cover the investment risk as part of the risk margin assessment, whereas general insurance actuaries in most countries would purely consider the risk associated with the liabilities.

MCR options (9.18 – 60)

Without a full understanding of what principles CEIOPS and the Commission wish to underpin the MCR calculation we do not feel in a position to recommend strongly one of the suggested options.

We note a consequence of deciding on the third option in 9.60, where the MCR is a simple calculation based on the standard formula of the SCR – this would imply that the SCR would also have to satisfy some MCR criteria. We believe these criteria may be too restrictive to impose on the SCR standard formula, given the general desire to move to an approach that is more risk sensitive.

Although, for sake of simplicity, MCR may not need to consider investment risk provided balance sheet assets and liabilities are included at fair value, we advocate such an allowance in order to create an incentive to avoid mismatching. We see that there may be special issues outside the euro-zone where the capital markets may be more limited.

The Groupe Consultatif is not supportive of imposing arbitrary floors to ensure there is a certain difference in the level between the MCR and SCR. The SCR should not be allowed to fall below the MCR, so the MCR should function as a lower cap for the level of the SCR.

We note that not only the interplay between the MCR and SCR needs to be considered, but also their interaction with the accounting figures including the calculation of available capital.

It may be premature to address this issue ahead of definition of technical provisions, QIS, etc. We might usefully make the suggestion that any transitional requirements be kept simple and brief. Given that transition to Solvency II will, for most EU jurisdictions, involve moving to market-consistent valuation of assets, we expect that transitional requirements may be complex in specification.

Investment rules – Interaction with technical provisions, MCR and SCR (9.46-9.48, 9.77, 9.82, 9.97 - 9.108a)

We believe that investment risk, even for non-life companies, should not be dismissed as immaterial for the purpose of the MCR without further testing. Initial indication from findings in a number of countries shows that the investment risk can be substantial.

CEIOPS propose to introduce similar types of eligible asset rules for assets covering MCR/ SCR as well as technical provisions. Introduction of similar rules for the coverage of technical provisions and MCR may seem reasonable, whether the same is the case for the SCR depends on the design and function of SCR.

Assuming that SCR standard formula includes investment risk, then the capital will reflect the riskiness of the portfolio by resulting in a higher capital requirement – and there is potentially not the need to put restriction in the form of eligibility rules. In this way companies would still have investment freedom but they would need the financial strength to exploit the freedom.

Investment rules – Additional asset criteria (9.86 – 109, 136, 138)

We favour a principle-based approach. Failing this, we favour an approach which specifies ineligible assets. We are concerned that paragraph 9.73 could result in double counting. Furthermore we believe that any limitation on eligible assets should not apply to unit-linked assets (on the basis that the investment risk was borne by policyholders).

The Groupe considers that explicit limits are not compatible with an internal model approach to SCR, but we recognise that they may be required in conjunction with a standard formula. It is likely that a standard formula will not address all risks of complex financial instruments. Therefore it is understandable that some restrictions on eligibility of capital will have to be imposed for companies using the standard formula. For internal models, however, these restrictions should not hold *per se*. For internal models which address the relevant features of the financial instruments, these limits would not make sense.

The limits should only exist explicitly for the standard formula and, if they need to be imposed, the limits should be tailored specifically to cover risks which the standard formula does not capture appropriately. If need be, supervisors can address shortcomings of specific internal models by either demanding improvements of the internal model or by imposing specific restrictions on eligible capital.

The criteria for eligibility of capital are very well laid out in 9.103 and serve as an excellent principle which should be considered when reviewing internal models. The following proposed criteria however do not make sense but rather inhibit or make impossible sound risk management.

For example 9.104 - the first bullet (there should be an active market for the assets) would exclude OTC instruments, participations in other companies, private equity and a vast number of financial instruments.

However we have doubts about the wisdom and practicality of the second bullet. This bullet (except for property where it is impossible to avoid, they should only exceptionally have the potential to give rise to a liability except in limited circumstances) would exclude swaps and forward contracts, among others.

The third bullet would exclude many derivative products as, for instance, puts on shares. Having such a list making impossible the use of a vast array of financial instruments could very well increase the risk to insurers and to policyholders, since many hedging possibilities would be closed to insurers.

We propose, therefore, to have a limited list of instruments which are not eligible for companies using the standard formula and which impose restrictions on eligibility of capital for specific internal models based on the principle laid out in 9.103 (first bullet).

Qualitative Investment rules (9.145 – 146)

In principle, we agree with Advices 9.145 and 9.146, but they do not state the purpose of these requirements, nor their nature (regulation or guidance), nor who will assess compliance with the principles according to which criteria. As a general principle, we would suggest that the purpose and nature of any requirement are clearly stated as well as the method of monitoring and the consequences of possible non-compliance.

Definition of the investment policy on all assets / Implementation of the policy (9.147 – 161)

Advices 9.147 to 161 set out a complex system of strategies and policies involving either the Board of Directors or Senior Management, some of which enter into low level details. Regulation should not enter into the details of the operational processes. Therefore we would propose to simplify this set of advices and replace them by a requirement of a periodical statement of investment strategy encompassing all aspects of the investment strategy: assets, derivatives and asset-liability management. The required content of this statement could be a combination of 9.147, 149 and 150.

It should be noted that there is a difference between a mandatory return target on assets backing liabilities which include a guaranteed return or which are discounted, and a target return which reflects a level of profits requested by the Board or by shareholders.

In any event, we propose "ALM policy" be changed to "ALM strategy" in 9.149 and 9.151 in order to keep consistency with CEIOPS previous Wave I answers (the title before point 98 and the text of point 111).

CfA n° 10: Solvency capital requirement: the standard formula (life and non-life)

Time horizon (10.14)

We encourage CEIOPS to stick with a one year horizon and to assume that management action within that horizon is implausible. This is better than the approach set out in 10.14.

Risk measures (10.8, 10, 25, 12.18, 29)

We would suggest that the decision on the appropriate risk measure should not only be based on theoretical considerations, but also on practical issues. The SCR should take into account all quantifiable risks. The Groupe broadly agrees with the discussion in paragraph 10.25. In our opinion, the SCR formula, at least for an initial implementation of Solvency II, should be based on VaR, with an aspiration of moving to TailVaR at a later date. The lack of data on which to base an assessment of TailVaR means that it would be very difficult, if not impossible, to calibrate such a system.

The key should be to encourage a consistent use of risk measure, and encourage the modelling to be embedded into the business. In the case of internal models, where companies are given the choice of measure, they may just have to prove that the capital identified is adequate under the risk measure chosen by CEIOPS/European Commission.

Risk classification (10.34)

We agree with the IAA risk classification. We would note that insurance risk may be a better term than underwriting risk, as many people may associate this term with prospective risks and not the important risk associated with reserving in particular.

One risk category that has been implemented in the UK that could be considered in addition to the IAA risk classification is Group Risk to encourage companies to more structured considered risks and benefits of being part of a large group.

Operational risk treatment (10.37, 38)

The solvency framework should provide incentives to understand, report and measure operational risk. Despite the difficulty in measurement, we understand and are supportive of bringing an operational risk capital requirement into Pillar I in order to create an incentive for firms to consider this risk. However, clear definition and guidance should be provided to firms and supervisors to ensure a consistent treatment between countries and companies.

Methodology for developing the standard formula (10.53 – 58)

We believe that the bottom-up approach may be more appropriate for calibrating a standard formula, whereas its design may also be developed top-down. For internal models, however, it might be most appropriate to use a mixture of these methods.

Risk dependencies (10.66, 67)

We agree that further analysis is required on how to incorporate dependency structures in the SCR standard formula. When a decision is made and the calibration of the formula has taken place this should be done to a level where CEIOPS is comfortable with the implied level of capital. Hence, there should be no need for an additional cushion for model error.

From an internal modelling perspective we note that evidence to support dependency structures will often be based on expert opinion. Sensitivity testing and assessment of any parameterisation and modelling error is more relevant in this context.

Life underwriting risk (10.86 – 92)

We would encourage CEIOPS to subdivide mortality and similar risks as between model and parameter uncertainty, volatility and catastrophes as risk types which need to be handled differently. The different elements of technical risks should be kept in view as set out in the IAA papers.

Approach to modelling of Non-life underwriting risk, market, credit and operational risk (10.93 - 118, 126 – 128, 139 – 141, 148)

Company specific factors (10.113) are seen as a valuable tool for adjusting a standard formula to the individual characteristics of an insurance company which is at first not willing / capable to establish a fully-fledged internal model.

Rules for company specific factors need to be objective and define exactly how and when they are 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 company specific factors to be credible. 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.

Operational risk is implicitly allowed for to some extent within insurance risk, because some of its consequences have usually not been stripped out of claims data used to determine parameters for insurance risk. This is unlike the usual situation within the banking industry. For this reason, it is probably going to be most practical to include it within the Pillar 1 formula by including a simple loading in addition to the implicit allowance in insurance risk. The Supervisor can pick up any wider concerns about operational risk as part of Pillar 2.

Adjusted SCR – incentives/ Pillar II (10.153 – 161, 10.166 – 169, 11.61)

A manual adjustment of SCR following the particular calculation seems quite arbitrary, contrary to maximum harmonisation, and tends to make solvency assessment non-transparent. However we understand that the supervisors need to have a tool to adjust capital if required as a result of the Pillar II assessment.

It would be desirable that CEIOPS confirms whether, in its opinion, the requirement of additional capital should be very rare. There would be several reasons for recourse to additional capital requirements being rarely used:

- there should be none on companies applying an approved internal model, because the verification that all risks have been adequately captured should have been performed when the model was scrutinised before approval;
- for the same reason, the failures in risk management, internal control, etc. should be very major failures entailing such an additional risk that the risk profile of the undertaking deviates extremely from the profile underlying the standard formula.

It would also be desirable that CEIOPS confirms that the requirement of additional capital is subject to the identification and quantification of a risk not captured by the SCR, and that the amount of additional capital will be commensurate with the magnitude and probability (or plausibility) of the risk identified.

It should be remembered that the supervisors also have other effective sanctions to impose in the event of non-compliance with laws and regulations (e.g. conditional imposition of fine, cancellation of licence, etc). In case of deficiencies and failures in the systems and controls as described in 10.168, temporarily raising capital requirements seems to fit poorly with the overall system.

Risk dependencies (10.162, 163)

The proposal to require undertakings to have a policy on solvency capital goes far beyond the advice 48 in the answer to CFA 1. This advice was part of risk management and it is obviously important from a solvency point of view that risk management ensures that the risks covered are within the limits allowed by available solvency capital. It is our opinion that advice 48 was sufficient for prudential purposes and that some of the requirements in 10.163 have only a remote relationship with solvency concerns, such as the requirement to define capital goals and all the subsequent requirements, or the requirement to define the composition of solvency capital.

CfA n° 11: Solvency capital requirement: internal models (life and non-life) and their validation

We are comfortable with the approach indicated in this chapter and support the direction in which CEIOPS is moving, which appears to be principle-based and not too prescriptive in order not to inhibit new developments in the area of risk models.

Costs and benefits (11.10 – 14)

We do not consider that there should be variation by jurisdiction either in how costs of validation are borne or in the application of the 'in use' test as apparently contemplated by 11.10. For the avoidance of doubt in 11.11, we believe internal model approaches can be used by the types of firms described there, both to their business advantage and to the advantage of supervisors. Footnote 66 to 11.14 needs explanation

Conceptual Framework (11.18 – 20, 25, 32)

Comments to the illustration in 11.18:

- The box named 'internal model' – We support the underlying message of integration and a strong link between the risk management and capital management. Another key feature here will be the link to the business planning process.
- We are surprised about the two boxes "internal estimate of SCR" and "Pillar I SCR", in particular the formulaic recalibration. Our understanding was that the SCR standard formula would be calculated and compared to the outcome of the SCR internal models, as part of the process of agreeing the SCR internal model with the supervisor.

Control level/ procedures (11.51, 11.62- 11.66, 11.84)

We are not supportive of any artificial levels between technical provisions/ MCR and SCR. We believe the introduction of the control loops and testing criteria will move the industry towards what we would believe to be best practice.

CfA n° 12: Reinsurance (and other mitigation techniques)

We note that CP7 in general seems to have been written very much from the perspective of direct writers – there does not seem to have been any consideration of the particular issues that apply to reinsurers. The Groupe suggests that that CEIOPS should address this issue more extensively.

Reflection in technical provisions (12.4 – 7, 23)

We agree with the comment made in 12.6 that effects of reinsurance on the relationship between assets and liabilities are complex. The value of assets in excess of liabilities may be significantly different measured gross and net of the effect of reinsurance.

The broad assumption being made in 12.7 that the numerical value resulting from gross and net of reinsurance valuations are similar may not be correct when it is proportional reinsurance. The Groupe would like to point out that this is certainly not the case where non-proportional reinsurance is concerned.

We would encourage analysis for both the gross and net portfolios, and for companies to understand any differences in results.

Reflection in the SCR (12.13 – 19)

We believe it would be an unjust burden, as well as not being particularly, meaningful to calculate the SCR both gross and net of reinsurance (or risk mitigation more generally). We would be more supportive of results being presented on a net basis only.

However, it would be best practice to model individual risks on a gross basis incorporating the effect of the different levels of risk mitigations in place, including reinsurance. Any given company should therefore be able to justify any modelling assumptions showing the consideration taken and adjustments made for risk mitigating factors.

CEIOPS' Advice (12.47, 59)

The Groupe expected that the SCR would take into account risk mitigation arrangements (reinsurance or ART) irrespective of their contractual formalism and with consideration to the effective risk transfer. In this context it is seen to be important that CEIOPS defines "significant transfer" of risks.

CEIOPS' Advice (12.49 – 60)

We would suggest reducing this set of advices to a requirement to produce annually a reinsurance and ART policy statement. The list of items to be addressed could be the list under 12.56, but extended to ART.

CEIOPS' Advice (12.61, 62)

The use of derivatives should be part of the statement of investment strategy suggested above under CFA 9.

CfA n° 13: Quantitative Impact Study and data related issues

Our view is that the current draft text for the QIS1 is too high-level to ensure a QIS which would be useful in calibrating the approach to technical provisions. Although we are supportive of the QIS, we believe it is essential that companies have confidence in the process – and that the value from QIS will only materialise if there is a common understanding of principles and more detailed guidance available.

For the QIS1, scheduled for the Autumn 2005 and focusing on technical provisions (including the risk margin), we believe the QIS faces a number of difficult issues including:

- Different practices for the best estimate reserving across Europe
 - In order to make the results of different countries comparable the estimation of the 75th percentile should be harmonised as far as possible.
- Lack of current practice (and methodology) to determine the percentile
 - There is no market practice in setting the 75th percentile - and individual companies involved in the QIS are likely to utilise a range of results based on outputs from capital models and other analysis as well as actuarial judgement to determine the figures requested as part of the QIS.
 - Small versus large firms will be facing different challenges regarding data availability, historic experience and how to deal with diversification – and generally we believe that the key driver of the result in an early QIS will be actuarial judgement
 - As a consequence of this and the limited time for companies to conduct the QIS, these initial test results may be far less credible than results that may be generated by companies if the process of setting the 75th percentile was well established in the company with proper controls and procedures in place including senior management sign-off of the numbers

- Guidance for the calculation of risk margins. Clear guidance is required in a number of areas including
 - Discounting (including whether implicit allowance for inflation is allowed); although we understand the QIS may specify which discount rate to use, this may not necessarily be appropriate going forward
 - assessment of probability distributions for different risks/ classes of business (including use of loss distributions vs individual claims distributions; approach to large losses/ catastrophe claims)
 - treatment of reinsurance
 - approach to use to assess loss adjustment expenses and unallocated loss adjustment expenses
 - treatment of explicit non-allocated IBNR over and above actuarial estimate.

The Groupe Consultatif would be pleased to assist in this definition of terms. We are also, as you are aware, providing a supporting role in developing a glossary of terms with the CEA.

If time is considered limited to enable the above definition of terms and principles, one option for the forthcoming exercise could be to make the initial investigative QIS more qualitative, with the aim to gather information on current practices applied by the industry and challenges foreseen. This could be done whilst finalising the definition of terms and principles as requested above.

The questionnaire (potentially multiple choice) could cover areas relating to

1. Reporting of reserve uncertainty to management

- No report exists/ Report on best estimate only/ Report on best estimate with some indication of sensitivities/ Sensitivity report on key drivers of best estimate reserves/ Reporting on reserve distributions and percentiles
- Reporting of result at company level/ line of business level
- Types of risk margins used none/ quantile/ market value margin/ actuarial judgement/ other (and reason for choice)

2. Segmentation used with the company

- What drives chosen segmentation: regulation/ business needs
- Number of lines of business (broad categorisation) used for assessing the reserves/ solvency reporting/ capital assessment
- Split by regions? By sub-class of business?
e.g. motor counts as one line of business – but may be analysed splitting claims between bodily injury and the rest

3. Treatment of diversification for reserving purpose

- Implicit/ explicit
- Level of diversification taken into account: at group level, between lines of business, between risk categories

4. Approach management would envisage to setting the 75th percentile

- Challenges envisaged for setting a 75th percentile (free format)

QIS1 - Communication of findings

With the QIS being the main vehicle for policy development going forward, we would encourage CEIOPS to communicate their intentions for the upcoming quantitative impact studies. This would include including what details CEIOPS are envisaging to share with stakeholders, and what output will be published.

CfA n° 14: Powers of the supervisory authorities

The Groupe Consultatif considers that no action should be taken by the supervisory authority unless the undertaking has been given the opportunity to present its own analysis.

This right to discuss the supervisory authority's assessment before action is taken is especially necessary since it is not possible to put guidelines on the assessment methodology applied by the supervisory authority.

We suggest that the details of any direct contact between the supervisor and the 'company' actuary (who could be internal or external) should be captured in the Annex A details on the actuarial function. As already mentioned, the Groupe proposes a separate discussion with CEIOPS on this point.

For the sake of clarity, the measures listed in 14.33, 52, 53 and 55 should be cross-referenced with the control levels in CFA 15.

CfA n° 15: Solvency control levels

Supervisory Ladder (15.16, 15.29)

We support the principle of a supervisory ladder, but propose to merge level 2 with level 3 since, according to CEIOPS' CP7 (15.16), adjusted SCR should be considered as SCR.

As already mentioned in our comments on CfA 10, the Groupe Consultatif believes that neither the circumstances in which the adjustment may be made nor the mechanism for determining the amount of any such adjustment is sufficiently clear.

We would specify the wording of the box detailing the supervisory toolkit at level 3. Level 3 encompasses a wide range of situations, from very close to SCR to very close to MCR, which do not merit the same measures. We acknowledge that it would not make sense to introduce an additional control level because the supervisory authority will encounter a continuity of situations, but the indication of a hierarchy of the measures would help to harmonise the application by supervisors.

It is not clear what is intended by CEIOPS when using the word "punitive" in paragraph 6 of the level 3 box because it should not be an issue of punishment, but only an issue of reducing risks.

The wording of paragraph 1 of the box relating to level 4 could be understood that the delay of 7 days is the delay for restoring capital at the level of MCR.

CfA n° 16: Fit and proper

We acknowledge that the list of the regulated functions is yet to be proposed, but 16.6 includes functions which have not yet been defined in the course of Solvency II (Senior management, Apportionment and oversight, Compliance oversight, Money laundering reporting, Risk assessment, Internal audit, Significant management). Furthermore it does not include Risk management and Internal control which have been extensively defined in the answer to CfA 1.

There is overlap between 'fit and proper' requirements and qualifications for holding an actuarial role and responsibility. The Groupe Consultatif will return to this in its separate document on the position of the actuary.

CfA n°18: Group and cross sectorial issues

Regulatory arbitrage

It is not clear what is meant by "consistent" cross sectors in 18.11 and 18.12? We would suggest more directly can be something like "equivalence".

Capital requirements (SCR and MCR) at group level (18.13-18.30)

Only when the standard approach is known can it be assessed whether it automatically gives recognition to diversification effects at group level. In our view the diversification effect exists; the point in debate is how it should be reported (18.19, footnote 92).

We agree that more detailed analysis is needed. We would note at this stage that it is important to build group level SCR from the risk components at the solo level and not from aggregations at the solo entity level.

The value of proposal 18.25 can only be assessed when the level of MCR and technical provisions are known. In our opinion 18.29 is too much concerned over group legal operational or reputation risk without any recognition of the positives which a group can bring.

Qualitative requirements at group level (18.32 – 33)

We believe that by using risk transfer and by commitments of capital from the group a combination of allowing for group diversification and solo capital at stand alone level is possible. The only problem is that the commitments should be “real”, taking into account that the capital is really available (within the bounds of the confidence level for the group).

Capital requirements (18.43)

Our conclusion is that for sufficient capital requirements there is a need for further work on how that group diversification can be used. Our key arguments are:

- Diversification is the fundamental idea of insurance.
- It is recognised (in the Solvency II work) that diversification exists and should be allowed for within business lines and between business lines. Ignoring diversification between entities and across markets within a group is not logical.
- In a number of large financial groups today diversification effects are measured and used in risk management. Clearly there are methods available to allow use of diversification in solvency assessment.
- The diversification effect at group level can be recognised by the “solo” entity using a commitment of capital from the group. That such a commitment exists is clear: the key question is how best to measure and regulate the strength of that commitment.

Groups exist because of reduction of costs. An important part of this reduction is based on diversification. An example is the fact that concentration risk will be reduced by forming a group out of several solo entities. A result of the reduction of cost following diversification effects is that the cost for the policyholder can be reduced.

Miscellaneous comments regarding CP7

Annex B

Lapse risk (B7 – B10)

It is not clear if there are really two distinct types of lapse risk? Different products tend to have different exposures to lapse risk, depending on the interaction of technical provision and surrender value.

Catastrophe, segmentation etc. (B37 – B46)

We would suggest that some of these points be expected to move from Pillar II to Pillar I over time.

Credit risk (B105 – 109)

This is perhaps relatively straightforward for liquid traded assets – many of the difficult issues may relate to unquoted securities and instruments.

Miscellaneous

There is a question as to whether the life / non-life distinction is relevant, or whether the distinction should be between short-term and long-term business.

We are concerned by the number of occurrences where CEIOPS proposes that supervisors may require additional capital:

- CFA 10: in relation to policy on solvency capital, risks not captured by Pillar I, failures in internal control, risk management, governance and/or market conduct;
- CFA 11: through the application of a recalibration factor and through the discretionary adjustment of the SCR derived from an internal model;
- CFA 14: in relation to risks not captured by Pillar I, requirement to set up partial or full internal models, application of a recalibration factor, market conduct.

This could give rise to the apprehension that the system might be distorted because a supervisory authority would consider the standard SCR as a minimum assessment of the necessary capital, on top of which it requires additional capital whenever it has a worry about an undertaking.

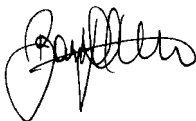
Several advices propose that supervisory authorities have power to require additional capital, to adjust SCR, to take preventive, remedial or corrective measures and to impose sanctions (see 10.166 to 169, 11.66 and 67 and CFA 14). These advices do not state the procedure that the supervisory authority should follow before taking such actions. Whenever an intended action relies on an assessment of risks, technical provisions or financial situation, it seems to be important for us that the undertaking is, prior to any decision, given the opportunity to present the reasons supporting its own assessment and its comments on the supervisory authority's assessment. Indeed the assessment of risks (or of technical provisions, or of a financial situation) is a complex exercise involving data and facts, assumptions, methodologies, and actuarial judgements. It could be dangerous to take actions with heavy consequences on the basis of an assessment which has not been subject to discussion.

Several advices put requirements on the Board of Directors and other requirements on Senior Management (see 8.123 and 124, 9.147 to 150 and 12.49 to 54). The Board of Directors is solely accountable for the undertaking and is the only body entitled to put requirements on Senior Management. Therefore there should be no requirement put by regulation on Senior Management.

CP7 appears to be written mainly in terms of direct business, and different considerations may arise in relation to assumed reinsurance business (life and non-life). CEIOPS is encouraged to recognise the distinction explicitly.

I hope the foregoing comments are of assistance to CEIOPS. In conclusion, let me add once again that the Groupe Consultatif welcomes the opportunity to contribute to the Solvency II project through direct dialogue and interaction with CEIOPS and its working groups. As always, we are available for further discussion and input as you consider appropriate.

Yours sincerely



Bart De Smet
Chairman, Insurance Committee