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## **Solvency II - Groupe Consultatif response to MARKT/2502/04**

### **Asset Management**

#### **Issue 1: Do you have comments on the draft wording of the directive? Would the requirement to cover the capital requirements involve implementing measures or supervisory guidance?**

In principle, the Groupe Consultatif agrees with the proposal that the required capital to cover risks should be of appropriate quality.

It may be worthwhile to introduce a differentiation between companies using the standard formula for assessing their capital requirements and companies running internal models since any standard formula will have to be calibrated to some kind of "average" classes of assets. This means that actually held assets should not be too far away from these standard assets which give rise to more or less detailed asset restrictions. On the other hand, for companies running internal models, their held assets and their respective risk structures should be incorporated into the model (reviewing this is an issue for Pillar II). Thus, for this case, asset rules may be unnecessary, or at least less restrictive, and regulation may rely more heavily on the prudent person approach. Moreover this would be an additional incentive for companies to introduce internal models.

The Groupe also agrees with strengthening investment management of insurance companies by introducing a requirement for an investment plan. This should embrace both assets covering technical provisions and assets covering the required capital. It is important that the investment plan and its implementation are subject to regular review and that, first of all, there is a definition and detailed rules in respect of what such a plan would be required to contain. This is critical for maximum harmonisation.

#### **Issue 2: Do you agree with the proposals? Do you have any comments or further suggestions?**

We agree that the development of rules concerning the investment plan should correspond to the criteria of IAIS ICP21. These criteria also embrace asset liability management (ALM). We believe it is important that the rules are sufficiently flexible to allow insurers to formulate plans appropriate to their own mix of risks and to their individual economic and capital situation.

It is important that guidance is given on the harmonisation and alignment of the three key elements: investment plan, target capital requirement and available capital. In particular in the case of companies using internal models this will be a Pillar II issue.

## **Asset Liability Management**

### **Issue 3: Do you have comments on the draft wording of the directive?**

The Groupe agrees with the proposed directive wording. Asset liability (A/L) analysis is characterised by integrating the capital management with the core business activities such as business planning, risk management and regular management reporting. We believe that the asset-liability risk should be accounted for in the quantitative and qualitative measures or the target capital requirement, both for life and non-life business. A simplified stochastic version of the calculation of the A/L risk should be included in the standard approach of calculating the target capital level. More advanced methods can be introduced when moving to internal models. An intermediate step would be the use of stress tests, which could be a part of a Pillar II supervisory review process.

It is important that guidance is given on what kind of A/L analysis is appropriate for different kinds of business or, rather, the risks a company has to carry, and how effectiveness of procedures for A/L management will be assessed. There should be flexibility in the issue of what is appropriate to the business of a particular company (and therefore to the risks it carries, too). Further to section 112 of MARKT/2543/03, CEIOPS should detail proposed requirements on companies, and the performance of an A/L analysis could be one of these requirements. It would be preferable to draft the Directive articles relating to these requirements in the light of CEIOPS proposals, and to have a global approach to the legal implementation of these requirements for determining which are addressed in the Directive, which are regulatory measures and which are guidance.

### **Issue 4: Do you agree with the proposed approach? Do you have any further comments?**

We agree that the standard formula for the target capital for life and general insurance should capture A/L risk in a sound way. The role and use of A/L models will be dependent on the approach and structure of the target capital formula under Pillar I, as well as the interaction between the Pillar I and Pillar II levels of capital. For any company, the A/L risk will presumably be more appropriately reflected by assessing the risk using an internal model than that which would be captured in a standard approach. ALM is likely to be a principal focus of the Pillar II supervisory review process.

It is important that there is some general guidance as to what level of sophistication of A/L techniques should be used for Pillar I (both for the standard formula and for internal models) because A/L analysis and assessment can take many forms. It is important, when calculating target capital in the standard formula, that those calculations do not put too much strain on small insurers, and in particular that they do not result in the obligation to perform a fully-fledged ALM model. It should be possible to feed the target capital formula with the results of a simple projection over a period of not more than 3 to 5 years. The suggestion to request preparatory work from CEIOPS on the role of ALM is helpful, and the Groupe Consultatif would be very keen to co-operate with CEIOPS during the course of this work rather than being consulted on the outcome.

One should be aware that it may not be possible to capture the asset-liability mismatch very accurately using simple formulas as envisaged for the standard formula, because it is closely intertwined with the re-investment risk and the different level of guarantees in the liabilities. It may therefore be advisable to stay on the conservative side in order to keep the calculation simple. Insurance companies should, however, have the option to invest in an internal model in order to calculate the required capital more accurately.

### **Issue 5: Do you have any comments or additions?**

It is a fact that there are many aspects and variants of ALM in life insurance and, because of this, we agree that maximum harmonisation throughout Europe is an ambitious but important goal. As regards general insurance, similar topics will need to be checked, especially in non-life businesses which generate large claims or have significant provisions/long tail development.

In Pillar I, A/L analysis will have significant impact both on the design of the standard formula and on regulatory guidance for internal models. It is important that there is guidance on required processes with respect to A/L models. The regulatory framework should be practical and applied across the whole EU. ALM techniques should be used (and the companies should be encouraged to use the techniques) in their risk management and investment planning. Moreover, in life insurance, ALM has

to be an indispensable part of internal models, and we suggest this requirement should be more clearly emphasised in 3.4.2., fourth bullet.

The A/L risk and its handling in an ALM framework will be an important issue of Pillar II supervisory review processes.

**Issue 6: In the list above we have not distinguished between different technical approaches or levels of sophistication (e.g. deterministic or stochastic, what risk indicators and assumptions to use etc). Neither have we defined the scope of ALM nor how long a time horizon should be used in the analysis. The organisational aspects of ALM modelling (the role of ALM committee, actuaries etc) have not been addressed either. CEIOPS and other stakeholders are asked to give their opinion if a more harmonised framework and higher level of standardization regarding these issues should be given in implementing measures or supervisory guidance.**

The Groupe believes that this topic is likely to be best addressed by supervisory guidance rather than implementing control measures. Some flexibility is desirable in a field in which best practice is continually responding to new developments in financial markets. Because of these on-going development processes, the role of a company's actuarial knowledge should be emphasised; the prudent person approach may prove useful in this respect, too.

We would point out that there is not yet a generally accepted methodology for Life Insurance companies to utilise ALM models: the purposes are not the same in all companies and some companies have never run any ALM model. As a consequence there are no generally accepted standards for ALM models yet. Nevertheless, there should be minimal – preferably qualitative – requirements, especially for using ALM in internal models.

As regards non-life insurance, we share the view expressed in paragraph 3.4.3, that the use and role of ALM is different from life business.

At present it seems premature to fix technical specifications on ALM models acceptable for supervisory purposes. It may be a viable approach, as a first step, to gather qualified persons' experience and base guidance on the conclusions drawn from this experience. In this context, the different character of ALM in life and non-life insurance should be taken into consideration. The Groupe Consultatif is happy to offer its help in supporting these efforts.

Based on this experience it may also be easier to calibrate the standard formula with respect to A/L risk. When this risk is brought into the formula as a separate element it is important to use the same level of confidence and the same method for incorporating it into the standard formula as is used for other risk types.

## Minimum Solvency Margin and Other Safety Measures

**Remark:** We want to avoid misunderstandings with regard to the names used for various prudential levels. In Solvency II, we see three different levels from highest to lowest, i.e. target capital (TC), minimum solvency margin (MSM), and an absolute floor requirement (expressed in Euros) comparable to the current (Solvency I) minimum absolute amount of the guarantee fund. This absolute floor requirement, which we also refer to as the guarantee fund floor, should play the role of a lower bound for MSM. MSM is intended to be the required minimum capital of any insurance undertaking.

### **Issue 7: How should the minimum solvency margin be defined, i.e. what kind of formula would be most appropriate?**

We agree with the proposed first approach of a simple and objective formula based on balance sheet and profit-and-loss items in line with the current solvency system. This should include reviewing the position when progress has been made with developing the approach for calculating the target capital (TC). We suggest that when considering the settlement of the minimum solvency margin (MSM) there are three sub-issues which have to be taken into account; these concern the inconsistencies of the current formula for calculating the solvency capital, dependencies on the accounting system, and the future review and development of the proposed first approach.

1. If the current formula for calculating the solvency capital is used for defining the MSM initially, then its inconsistencies would necessarily be continued. With regard to this, at least the most important problems of the old system should be avoided when taking over the present methodology.
2. On the assumption that MSM calculations should be based on balance sheet and profit-and-loss items, one would inevitably face difficulties similar to those already anticipated and addressed for the calculation of TC in Issue 1 of MARKT/2543/03. So care should be taken to handle those issues in a consistent and comparable way for MSM and TC. There is also the danger of overlooking A/L mismatch risks by this simple approach, and it might be appropriate therefore to complement such an approach for MSM with a mismatch test in Pillar II.
3. There could be an alternative approach for calculating MSM in addition to those mentioned. We consider that the standard formula for TC as well as any internal model for calculating the TC has to be calibrated to some levels of confidence (cf. Issue 7, 13 and 22 of MARKT/2543/03). So instead of calculating MSM directly based on TC (as proposed in alternative 2 of Issue 7), one could simply calibrate MSM with a method similar to the one used for TC but utilising a much lower level of confidence.

### **Issue 8: At what level should the requirement be calibrated?**

We believe that the calibration of MSM relies on the function which it is supposed to fulfil in the Solvency II framework, in particular in the scale of proposed Solvency Control Levels (see Issues 15-17). The particular function of TC in this respect is understood to guarantee a certain level of ruin probability for each insurance undertaking; the particular function of MSM is not yet defined. In order to have maximum harmonisation for principles in Europe, we propose a European standard formula for TC with a set of parameters which can be aligned to national legislations and circumstances. As mentioned in our response to MARKT/2543/03, a common risk measure should be chosen for the formula of TC and the risk level should be the same for all countries (and for both standard formulas and internal models).

The same method should be used for MSM (alternative 2), however based on a lower level of confidence. In order to avoid clashes with solvency margins for technical provisions (used for the calculation of TC), this level should not be lower than the level taken for these. A thorough assessment of MSM and its correlation to TC (MSM compared to TC levels induced by standard formula and by internal models) will be crucial. Such benchmarking is necessary to ensure that MSM is indeed below TC for insurers with different portfolio structures.

In order to follow the idea of a smooth transition to the new solvency regime, and assuming that the Solvency Control Levels can be defined suitably, we suggest initially using a level for MSM which in general is not higher than the prudential levels currently in action.

**Issue 9: Do you agree with the proposal and do you have any other comments?**

The Groupe Consultatif believes that a MSM higher than the current minimum guarantee fund level is likely to be appropriate. This need not necessarily be accompanied by a higher absolute 'floor' requirement (expressed in Euros), since the latter should have regard to an objective of sustaining competition and avoiding barriers to entry.

Clarification on the envisaged functions and relations between the minimum guarantee fund floor, future MSM, TC and Solvency Control Levels (regarding Pillar I and Pillar II) would be welcome.

We presume that MSM should be chosen such that, if a company does not meet this threshold, it must have been subject to an extreme event or suffered from extraordinary conditions causing the erosion of most of the company's capital. With regard to Solvency Control Levels, the level for MSM in particular should be sufficiently low that strong intervention by the supervisory authority would be really necessary if a company is not able to meet it.

**Issue 10: Are there reasons to change the authorised categories of assets (codified life Art. 23)? If so, what changes should be made? More specifically, should the asset classes be the same for covering technical provisions, the target capital requirement, the minimum solvency requirement and the guarantee fund?**

We believe that, in principle, the same categories of assets should be available to cover target capital and minimum guarantee fund as are available to cover technical provisions. However, it should be taken into consideration that assets covering capital requirements and those covering technical provisions serve different purposes, so assets covering the required capital may be of shorter maturity than those covering technical provisions, for example. It should be clarified what guarantee fund means in this context; we interpret it as being the guarantee fund floor mentioned in Issue 9 and in the remark preceding Issue 7. A distinction should be made between companies using the standard formula and companies utilising an internal model for assessing their risks. Since investment risks are supposed to be inherent to any internal model, requirements imposed on the latter should be unnecessary, or at least less restrictive than those on the former. In this case, the investment parts of internal models have to be subject to Pillar II supervisory guidance.

**Issue 11: Regarding the ceilings for asset diversification (Art. 24), a) do we need limits in a future prudent person approach? If the answer is yes, b) how should we define them, and c) should these levels be compulsory (i.e. maximum harmonisation rather than minimum as today)?**

The Groupe Consultatif believes that the principle of a 'prudent person' approach (which has more meaning in some jurisdictions than in others), together with requirements for an investment plan and for regular A/L analysis, should supersede limits on particular categories of assets. These requirements should be reinforced by requiring quantitative measurement and specific consideration of the management of concentration risk. Nevertheless we would not have difficulty with retention of compulsory 'outer limits', particularly in relation to property, unsecured loans, and unquoted securities. This would surely promote maximum harmonisation. Again (as in Issue 10) a distinction between companies based on whether or not they run internal models may be useful.

**Issue 12: The available solvency margin is outlined, for example, in Art. 27 of the codified life directive. Do you believe that modifications would be needed?**

In our opinion, modifications are necessary. In addition to the point given in the proposal, there does not seem to be the need to restrict the assets covering the solvency margin, provided their quality has been taken into account in the calculation of the target capital. The definition should be amended not only with respect to international accounting developments, but also to include innovative forms of capital albeit on a prudent basis.

## Supervisory Authorities' Powers

**Issue 13: Should additional powers be given to supervisors? If yes, what additional powers should be given to supervisors? For example, should supervisors have additional powers to investigate? Should fit and proper criteria be more explicitly defined? Should supervisors be able to increase the solvency margin for reasons other than the threat to policy holders' rights?**

It is important that the supervision process is harmonised and that supervisory authorities' powers are adjusted to the new approach set forth in Solvency II. The new Pillar II supervisory review process is one of the main objectives for harmonisation. This should be an adjustment of existing powers to a new situation rather than an addition of new powers.

Powers concerning the main objects of supervision should be extended, since risk management, ALM and internal models are new key objects in Solvency II. The supervisory authorities must have the power to certify internal models for the calculation of the target capital. In order to carry out this work properly, supervisory authorities charged with certifying internal models must have access to sufficient information about the internal models which are used for the target capital calculation (as part of the general supervisory process). In particular, they must have access to detailed documentation of the system. Guidance is expected at least on how such documentation has to be made up and what has to be contained in it. Supervisors should also have the possibility to ask for sensitivity calculations as part of the verification process to which internal models are subject.

**Issue 14: Should the supervisors' powers (currently held or increased) be reflected in a new general article of the directive in addition to the current existing ones mentioning supervisory powers? If yes, should this article include the provision on transparency of supervisory action (see point 7.5 of MARKT/2543/03)?**

Since the adjustments referred to under Issue 13 might make it necessary to revise current powers of supervisors and to introduce new provisions, it might be helpful for the sake of clarity to gather all the articles relating to the powers of supervisors in a specific section of the new Directive (and therefore to delete the relevant articles in the current directives). The Groupe agrees that harmonisation would benefit from an explicit formalisation of supervisory authorities' powers; a specific section of the new Directive might be arranged according to the four categories listed in section 5.1 of MARKT/2502/04. This section should also include provisions on the transparency of supervisory action, subject to our comments on paragraphs 122 and 123 of MARKT/2543/03. It is essential that transparency does not violate companies' needs to keep sensitive information confidential.

## Solvency Control Levels

### **Issue 15: Do you agree with the outlined approach?**

The Groupe Consultatif agrees with the approach proposed by the Commission Services. This approach means that all enforceable sanctions taken by a supervisor are based on explicit rules, and that the principles-based control levels can only result in a dialogue between the supervisor and the company, and cannot be the reason for an enforceable sanction.

### **Issue 16: The Commission seeks CEIOPS' advice on the number and the definition of the solvency control levels.**

There are three natural thresholds (minimum guarantee fund, MSM, TC) which should be used as checkpoints. In order to accomplish the constraint from the IAIS Guidance Paper that intervention is allowed early enough in order for intervention actions to be effective, it may be necessary to introduce an additional non-compulsory solvency control level in between TC and MSM. This level could help to anticipate worsening conditions and prevent companies from falling below MSM by supervisory guidance. It is important to make solvency control levels flexible to be applicable for TC both calculated with the standard formula and internal models.

We propose that control levels should not be aligned to individual elements of the available/target capital; this would cause conflicts with diversification effects presumably inherent in capital assessments.

### **Issue 17: The Commission seeks CEIOPS' advice on the consequences (actions and / or sanctions) that should be attached to each level.**

The control level corresponding to MSM should be compulsory for the supervisory authority. Close discussion with the management and a plan for restoration of a sound financial position might be appropriate at this stage. When going down from TC to MSM, supervisory consulting and action should transform from principles-based to rule-based. Actions that might be appropriate when TC is missed or an additional intermediate threshold is crossed (see Issue 16) might include a closer (Pillar II-) review (e.g. regarding ALM, risk management, investment plan) or extended discussions with the management. In this connection we consider it is indispensable that the supervisory authorities regularly exchange their experience in order to maintain a high level of transparency and a level playing field with respect to different jurisdictions (requirement of peer review). We believe that it is too early to give prescriptive advice on this issue, and we agree with the proposal to seek CEIOPS advice on control levels and their consequences; the Groupe Consultatif will be keen to comment on this.