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Mr Henrik Bjerre Nielsen
Chairman
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Dear Mr Nielsen

Comments on CEIOPS Consultation Paper CP9
Draft Answers to Third Wave of Calls for Advice (Solvency II)

I have pleasure in attaching below the comments of the Groupe Consultatif on CEIOPS' draft answers to the European Commission's Third Wave of Calls for Advice..

CfA 19: Eligible elements to cover the capital requirements

Overall comments

There is still potential confusion where valuation of assets and liabilities are mixed together. We would recommend splitting the analysis into two parts: (a) the admissibility of assets; and (b) the calculation of available capital (i.e. assets minus liabilities) after adjustments for hidden reserves etc.

It is not clear how CEIOPS expects to handle a DAC asset (i.e. is the DAC asset admissible or not?). We would favour an approach that reflects economic value and thus allows for a DAC or similar asset.

A particular issue in some countries is the bonus system. It is well understood there that, whilst profits are allocated to individual policyholders, the bonus can be recalled and used as risk capital. We interpret the principles laid down by CEIOPS to allow for this, but believe that it is important that this should be clarified.

CEIOPS has not expressed an opinion as to whether the same capital can be used for MCR and SCR. We believe that the capital should be the same, with the differences being reflected in the calculation of MCR/SCR.

19.2: In the light of 19.61 this addresses the MCR only. It means to consider a run-off portfolio i.e. a portfolio with decreasing size and volume and no further new business, thus experiencing growing cost per unit. We are not sure whether the precise understanding of what "run-off" means has been stated elsewhere. If not, it should be described, e.g. as –

- a run-off portfolio on a stand-alone basis; or
- administered by another insurer (block of fixed costs is shouldered by all contracts held by the insurer). This could happen either by using an isolated IT platform at lower initial cost but larger follow-up cost, or after having transferred the portfolio to the insurer's own IT (at higher initial cost but lower subsequent cost).

Similarly, the term “going concern” has to be defined (c.f. 19.62).

19.11, 12: It seems to be a double effort to recommend further investigations on the eligibility of capital elements. All this should be part of the fair valuation of assets and liabilities, otherwise it would be assumed that fair valuation is not able to capture the inherent risks correctly. For example, it is generally understood that credit risks are included in the fair value of the asset considered.

A similar remark holds for risks and conditions attached to specific capital instruments. It is the hope that 19.11 and 19.12 are additional remarks for the long term only.

19.13: This clarification on the main objective of what solvency assessment should reach is greatly appreciated. It gives a basic understanding of how capital requirements have to be defined, e.g. not by applying tools which may be sensible from a shareholder perspective but “to give reasonable assurance to policyholders that payments will be made as they fall due”.

19.27. If fair valuation is applied to assets and liabilities, the market values derived should already include an assessment of what the filters want to achieve. Alternatively, CEIOPS should state clearly that they mistrust fair valuation principles and consequently should develop their own set of valuation principles which would make more apparent to the industry that they must apply another measurement tool.

19.35: "Policyholders' reasonable expectations" is an expression which could be interpreted in different ways in different jurisdictions (e.g. in UK there could be a special understanding of this term). It should therefore be avoided in this European context.

19.35-36, 19.51: It is unclear what is meant by "assigned to individual contracts". Is an asset share in a UK life insurer assigned to an individual contract? It may be more appropriate to concentrate on the legal right to use the amount to cover general losses. However caution is required insofar as the legal position may change.

19.46 and following: It is outside the logic of fair valuation of assets if Solvency II differentiates between different types of ASM. So the complete tier system should be part of fair valuation. Following a total balance sheet approach, ASM should be the difference of the market values of assets and liabilities. Every part of ASM should be backed by some fair valued assets which already include an estimation about the quality to remain permanently available. If some assets are regarded as of minor quality in that understanding, this should be included in the valuation itself.

We note that CEIOPS does not propose a 3-tier-system but actually a 6-tier-system (c.f. 19.51 – 19.57):

- core tier 1 capital
- innovative hybrid tier 1 capital
- non-innovative tier 1 capital
- upper tier 2 capital
- lower tier 2 capital
- tier 3 capital.

We do not believe that this will support general acceptance and that arbitrage can be avoided.

All further prudential filters should be taken into account when fixing the level of SCR and MCR. So SCR should, for example, mirror all diversification effects of assets. In real terms this means that SCR for a company being invested in one asset only would be larger than for another company with the same insurance portfolio but better diversified assets.

19.62: The general understanding of “going-concern” is continuation of companies’ business activities, especially signing of future new business, beyond the one year time horizon. This inclusion of future new business makes the valuation of assets and liabilities extremely subjective and unreliable because a lot of management expectation has to be included. In particular, weak insurers might tend to guess these assumptions more positively than stronger ones.

As a consequence, a robust definition is required of how and to what extent future business should be included. If there are differences for the valuation of liabilities with regard to the MCR and SCR, it would consequently mean a different basis for the eligible capital under both scenarios.

19.63: We believe that the quality of capital deemed eligible to meet the requirement should be the same for both MCR and SCR. We also agree with the minority of supervisors who prefer to vary the requirements arising out of the supervisory review process rather than vary the deemed quality of eligible capital. (see 19.123 and 19.170).

19.67: We welcome the intention to “recognise the group’s economic interest in subsidiaries and participations” when assessing group capital. It is not clear if the group consolidation rules allow for cases where, for example, a subsidiary is wholly owned but cannot pay a dividend and works in the same manner as a mutual company. In this case it does not make sense to consolidate the entity as its risk capital cannot be accessed for the other entities in the group.

19.64: In addition to the remark to 19.46, it would be over-regulation if a further hierarchy were introduced for capital elements to cover SCR and MCR. If the supervisory ladder is taken seriously, the regulator has freedom to take all measures considered necessary which, of course, could include a rearrangement of assets in order to reduce those elements which are described here as tier 2 or 3.

19.69: We refer to our comments on CfA 18. There should be consistency between the calculation of MCR and SCR. And in both calculations diversification as a fundamental idea of insurance should be recognised.

19.71: What are the arguments within Europe for different rules for MCR and SCR at group level?

19.84-19.87: Transferability is indeed a key issue. However we would prefer a focus on the availability of recourse to meet amounts due to policyholders. We note that the immediate availability of cash is not essential where amounts may not be due to policyholders for many years, and so it should be possible to give credit for non-transferable funds where it can be demonstrated that a value can be made available in time to meet policyholder payments.

If solo SCR is the basis, then diversification actually would be excluded because diversification would make it possible to transfer more than solo SCR. In the extreme, under group solvency considerations it should be possible to transfer assets from one company to cover losses of another company subject only to the condition that group SCR remains large enough. This could work only if solvency power of national supervisors is transferred to a supra-national group supervisor.

An interesting approach is proposed in 19.111 by introducing a receivable in the form of a capital guarantee. As stated there, this would imply accepting a wider range of eligible capital for solo entities and thus ASM would be increased.

19.93 It is not clear why unrealised gains need to be mentioned when the foundation of Solvency II is an economic/market consistent approach. The idea under 19.93 may need more explanation.

19.95: For prudential filters for groups we recommend the same as for solo entities.

19.110 – 19.111: We continue to believe that recognition of diversification benefits are fundamental for insurance. Therefore we favour the mechanism in 19.111.

19.121: There should be clear principles that the standard formula is built in a way that the SCR based on that formula is a definite criterion, i.e., if the insurer's ASM is larger, then the company is regarded as being solvent. CEIOPS seems to mistrust all possible standard formulas when claiming this additional hurdle. On the other hand, CEIOPS feels comfortable enough to regard an SCR calculated by the standard formula as an actually binding figure (19.124).

19.123 These ideas should be clearly rejected as they would open room for potential discrimination of insurers in different countries. There should be clear and strictly limited principles on the extent to which national supervisors are allowed to change the EU-wide principles for ASM and SCR/MCR.

19.138 - 19.142: We agree with CEIOPS on basing "on an accounting perspective" and the need for neutrality (under different accounting regimes) and "prudential filters". We also agree with the emphasis on market values for assets and the corresponding calculation of the present value of liabilities (including a discounting of technical provisions and a risk margin).

19.143: In relation to differences between financial sectors, we concur that the insurance sector has fallen some way behind banking regulation's approach to eligibility of capital. The need for modernisation is ever more acute as more sophisticated hybrid capital instruments are being devised and offered in the financial markets. Solvency II is the opportunity to modernise the insurance approach and, as far as possible, treat banks and insurers and composite groups on a level playing field. The matters highlighted in CEIOPS CP12 on "deeply subordinated debt" emphasise the urgency of "modernisation" (the Groupe Consultatif does not wish to express a view on whether or not, as set out in alternatives in CP12, some tactical changes should be introduced via "comitology" and in advance of the arrival of the more carefully considered Framework Directive).

We have difficulty understanding the implications of paragraph 19.167 regarding "internal capital assessment". Is this not a pillar 2 issue?

19.144 - 19.149: We support the approach set out by CEIOPS – in particular the tiered approach which gives the desired convergence between banking and insurance. We support the graduation through the distinct tiers, all of which should be driven by a few, simply stated, principles – in preference to large amounts of prescription that would be unlikely to keep pace with the development of instruments. It is important to avoid what can presently occur whereby some capital items of poorer quality can be eligible to a greater degree, while some higher quality items do not qualify at all because the rules did not envisage the arrangements that are available.

19.150 - 19.151: We acknowledge that poorer quality capital, in relative terms, could be more acceptable for the quantum of capital needed, in addition to covering MCR, to attain the SCR level. However, higher quality capital should be insisted upon for MCR. The difference is justified since the MCR is intended to absorb losses in a closed state. The additional amount gives an insurer the capacity to continue to trade in an adverse situation. In practice if there are not large differences between MCR and SCR, and given that classification of capital will inevitably be arbitrary to a degree, it may not be worthwhile to carry out this rather theoretical distinction.

19.152 - 19.163: A holistic view of a group (and its capital needs) must be taken and this is best achieved by the proposed principles-based approach which must be carried through consistently by supervisors at the Pillar 2 stage.

CfA 20: Co-operation between supervisory authorities

Overall comments

Whilst we can see that progress is being made, there are clearly a multitude of problems remaining to be solved.

We would like to emphasise the importance of creating a practical, functioning environment with duplication of reporting and efforts eliminated.

Cooperation with third countries' supervisors still needs to be considered. And there should also be coordination with the supervision of occupational pensions business.

We support the principle of a Group Supervisor and wish to emphasise that it is important that all supervisory authorities recognise the power of the Group supervisor so that double reporting and supervising is avoided.

20.63: Although not specified in the CRD, it is possible for bank supervisors to follow this course of action. It appears to create the opportunity for solo supervisors who do not like the internal model approach to make capital demands. Should the system include some control on this?

CfA 21: Supervisory reporting and public disclosure

Overall comments

Generally the Groupe Consultatif is of the opinion that a good analysis of the purpose of disclosure is very important, and also its connections to what is done in other projects. This seems to be missing in this draft. Apparently in Solvency II the logic of disclosure is the same as in Basel II: to enhance market discipline. Therefore, the scope is certainly wider than just providing material for solvency supervision. Also the relationship to disclosures according to IFRS 4 and IFRS 7 as well as with the forthcoming guidelines of IAIS should be analysed.

With this wider scope, certain questions need an answer. A clear analysis based on the questions – what?, to whom?, and where? would be needed. Our working group 4 is addressing this issue and would very much like to aid CEIOPS in formulating answers to these questions.

A second question is the relationship of Solvency II disclosure to other disclosures. In this area it is essential to see that Solvency II disclosure does not duplicate other disclosure (or, even worse, produce separate disclosure on areas disclosed elsewhere on a separate basis which would certainly create confusion). Instead, areas where Solvency II really requires additional disclosure need to be identified and solved so that users would really benefit. It is worth noting that the emphasis should be on reporting/disclosing relevant information and finding the right balance between reporting requirements, and obtaining the right information to supervise the undertaking properly.

It is important that the basis for public disclosure is uniform throughout the EU, as comparisons will most certainly be made between companies in various countries. It is also important that this basis is coordinated with the IFRS requirements in order to avoid duplication of effort.

It should also be noted that the starting position is different in different countries. For example, in Sweden all information provided to the supervisor is public unless it is specifically designated confidential, whereas in other countries the reverse is true.

21.3: A fairly optimistic view is taken. Clearly, if Solvency II succeeds, more efficient markets and a better market discipline could be the result.

21.6: We agree also with the aims in this paragraph. But a potential danger in this area is that we could end up in a situation where companies have an incentive to show good figures in some key areas and neglect true risk management. Avoiding this kind of "beauty contest" means that disclosure must be really well-designed.

21.27 - 21.28. There is discussion on the role of "regular" and "ad hoc" disclosure for the supervisor. If too much emphasis is put on the "regular" reporting this would mean excessive reporting from too many companies and would be counterproductive. The supervisor could firstly have certain triggers based on the solvency of the company where more "regular" disclosure would be required. Secondly, we cannot see a situation where all relevant information can be specified in advance in "regular" requirements. This means that supervisors must have the possibility to get additional "ad hoc" disclosure.

The figure on page 82 is basically acceptable, but we wonder where disclosure for certain stakeholders (such as policy-holders) fits in?

21.39: Where does "discussion in section 4" refer to?

21.41, 21.52, 21.53: The starting point here seems to be that there are differences between accounting and prudential treatment. We think that the starting point should be that there are no differences and then, as an exception, allow differences where solvency supervision absolutely requires.

21.47: In some places, like in this paragraph, it is not clear whether public or supervisory disclosure is meant.

21.48: Basically one could also think that Solvency II could require IFRS accounting. The question here may be more relevant with smaller or larger companies. Could we think that, from a certain size, IFRS would be required, and below that some method with adjustments could be allowed?

21.80: This refers to the appendix. What is said above with respect to the questions to be answered, and as regards relation to other disclosure requirements, is relevant to this area. In the appendix it seems that these questions are forgotten.

CfA 22: Procyclicality

Overall comments

In general we agree on the answers of CEIOPS concerning the treatment of procyclicality within the Solvency II framework. In particular, Non-Life insurance has relatively strong cyclical movements (i.e. the underwriting cycle). The underwriting cycle can strongly influence the profitability of a non-life insurer and could also have its impact on both claims and reserve risk.

Although it might be possible to measure the underwriting cycle for historical years, we agree that the underwriting cycle might be very difficult to predict, specifically several years in the future. This makes it relatively hard for the supervisors to anticipate the future development within the SCR framework.

The SCR should be a stable measure and therefore the methodology to derive the factors for the SCR calculations should ideally not be changed by the supervisor due to temporary changes in market conditions. However, we believe the supervisor should take flexible supervisory actions in case of negative movements of the SCR due to cyclic (and therefore periodical) effects, without changing the SCR over the cycle.

As procyclicality is an important but difficult topic, the supervisors should (jointly) have analysed possible problem scenarios and have contingency plans that can be called on if required. This in turn means that the framework needs to be flexible enough to allow for the implementation of such contingency plans and also to allow for special actions that might be needed in case of a major incident or change in economical environment which was not foreseen in the problem scenarios.

Procyclicality in the SCR

The Groupe Consultatif specifically agrees with CEIOPS on the following points made in CfA 22:

22.24 - 22.25: Within Pillar I, the standard SCR should be considered as a measure for which the parameterisation is based on a fixed (e.g. 1 year) timeframe. Within this, the SCR should require consideration of potential changes in the long term outlook, which implicitly means that the SCR contains so-called "through-the-cycle" elements.

22.34: A multiple year perspective should generally not be part of the standard SCR calculation. Analysis from a multiple year perspective could be carried out as part of Pillar II. Under Pillar II the effects of procyclicality could potentially be tested through specific stress & scenario tests or within the internal models.

22.40, 22.46: The SCR should be a robust measure and should be seen as a requirement that insurers are expected to meet on an ongoing basis. Therefore supervisory action should aim to prevent recurrent breaches of the SCR every time a particular phase of a cycle occurs. Supervisors should, however, be aware of any potentially severe effects and take flexible supervisory actions in order to avoid systematic effects on the economy at large.

Internal models are tailored to the individual characteristics of the insurer. Assumptions on internal and external conditions (e.g. cyclicity) should be made by the insurer to anticipate their risk profile as accurately as possible. This could also mean the use of a multiple time horizon. However, assumptions on both internal and external conditions should be appropriately substantiated and in line with general market expectations

CfA 23: Small undertakings

Overall comments

We agree with CEIOPS that there should be some recognition of the existence of small undertakings and that, from the point of view of the policyholders, there should not be a lower degree of protection simply because of their smaller size or cover provided.

Therefore - although some recognition may be necessary - it should not result in specific adjustments to the SCR or MCR requirements for small undertakings. Any differentiation should be made with regard to qualitative aspects in Pillar II.

For a certain number of countries this is of particular concern, as there are a lot of extremely small companies. A practical balance needs to be found that provides protection to policyholders whilst being practical to implement for the companies.

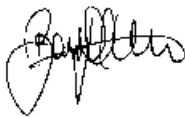
We suggest that it could be appropriate to consider a number of layers (for example medium, small, extremely small), rather than finding a black and white definition of a company being designated as small or not. The embedding of a small undertaking as part of a bigger group should be considered.

We also note that the absolute floor for MCR can be a problem. We would advocate a more flexible approach to minimum MCR, where account is taken of the scope of the entity in question.

Finally we want to emphasise the special importance of reinsurance as risk mitigation method for small companies and the importance that full solvency relief is allowed for reinsurance.

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

A handwritten signature in black ink, appearing to read 'Bart De Smet', with a stylized flourish at the end.

Bart De Smet
Chairman, Insurance Committee