CEA Response to CEIOPS CP 15 to 19 inclusive

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Introduction

The Industry recognises the importance of the new Solvency II system and welcomes the further guidance it. This document summarises the emerging European Industry consensus on the key issues on the following CEIOPS consultation papers:

- CP15 – supervisory reporting and public disclosure requirements
- CP16 – Pillar II issues relevant for reinsurance
- CP17 – solo and group Pillar II capital add-ons
- CP18 – harmonisation of supervisory powers in a solo context and a group context
- CP19 – safety measures

More detailed comments on the various consultation papers are contained in Appendices B to F.

We would emphasise that the various issues considered in the consultation papers cannot be viewed in isolation and need to be considered in the context of the whole Solvency II framework. It should be noted that the comments in this document should be considered in the context of other publications by the CEA listed in Appendix A. These documents together constitute a coherent package. As such, the rejection of certain elements of our positions is likely to affect the remainder of our comments.

In addition, these are CEA's views at the current stage of the project. As our work develops, these views may evolve depending in particular, on other elements of the framework which are not yet fixed.

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1 Key Messages on CP 15

1.1 In CP15, CEIOPS provides advice on Pillar III supervisory reporting public disclosure requirements. Our key messages on the Pillar III guidance contained in CP15 are described below.

Clear distinction between supervisory reporting and public disclosure needs

1.2 The CEA recognises that supervisory reporting and public disclosure are important and different elements of Pillar III of the Solvency II framework.

1.3 The different objectives for supervisory reporting and public disclosure mean that they are likely to have different information requirements. The CEA believes that there needs to be a clear distinction between the information needed by supervisors to do their job and that which is needed to be publicly disclosed.

Publicly disclosed information should be focused

1.4 The CEA strongly believes that publicly disclosed information should be focused on that needed to achieve the objectives of Pillar III, i.e. high level information that helps stakeholders understand the overall financial condition and the risks associated with it. The information should be disclosed at the appropriate level, e.g. if business written in a particular entity is supported by the Group, then the most relevant financial information may be at the Group level.

1.5 It is important that the information publicly disclosed is at a sufficiently high level so as to protect the interests of the company and its policyholders. Publishing information at too detailed a level could allow other participants such as competitors, hedge funds, potential acquirers, etc to use this information to the disadvantage of the company and / or policyholders.

1.6 The CEA agrees with the comments of the IAIS "A regime would be expected to differentiate between public disclosure and reporting to the supervisor which is subject to confidentiality. Information provided to the supervisor and subject to confidentiality will generally be more detailed and technical in nature. Ensuring appropriate confidentiality not only guards against disclosure of commercially sensitive information but also fosters openness between the supervisor and the insurer."[1]

The role of SCR needs to be clearly communicated and set in the context of the overall framework

1.7 We recognise that Solvency II is fundamentally different from Solvency I with changes in:

- Valuation of Assets and Liabilities
- Changes in definition of eligible elements
- Capital requirements based on a comprehensive analysis of risks
- Greater focus on risk management and internal controls
- Greater focus on supervisory intervention in a transparent, harmonised way with a focus on on-going early dialogue

1.8 The above approach is very different from Solvency I. In particular, the CEA has previously indicated that the SCR should be an important target level of capital and that companies able to meet the SCR are in a relatively strong position.

1.9 We note that the external economic environment is volatile and given the role of insurance company is to absorb risk, it would be normal to expect balance sheet fluctuations. As a result, it should be recognised that

[1] Article 113 IAIS Common Structure for the Assessment of Insurer Solvency Draft 4 December 2006

from time to time companies will dip below the SCR. Failure to do will result in the SCR becoming a hard target

1.10 The consequences of treating the SCR as a "hard" target would be severe:

- It raises the requirements for insurance companies and in so would form a barrier to entry into the Insurance industry and reduce potential competition
- It undermines the Solvency II framework where the MCR is meant to be the hard target. Supervision is meant to be proportionate between the MCR and SCR
- Companies will be forced to hold capital in excess of the SCR. The cost of holding this sterile capital will be passed on to policyholders
- It reduces the ability of the company to accept risk and for the Industry to invest in assets such as equities to the detriment of long term policyholder returns
- It increases the risk of pro-cyclicality

1.11 In light of the above arguments, care is required to ensure that communication of the new Solvency II system does not result in incorrect emphasis being given to certain elements, e.g. that undue attention is given to the SCR, with breaches of the SCR being incorrectly interpreted as a sign of serious financial weakness. Doing so would ignore the greater sophistication of the new framework and the role of other elements such as the MCR. Hence we do not necessarily see the need to focus on disclosure of breaches of the SCR at this point.

1.12 Particular care is also needed during the period after Solvency II is introduced as this will be a learning experience for both companies and supervisors. The level and amount of disclosure (for example breakdown of the SCR) is more likely to be evolutionary and driven by market requirements as opposed to supervisory pressure.

As markets understand the changes brought about by a risk based framework they will request more targeted information. This is already the case with a number of companies already providing results based on their internal models.

1.13 Greater explanation and different disclosure requirements may also be appropriate as the Solvency system becomes embedded in the different jurisdictions and this is an area which would require further work.

1.14 Finally we believe that public disclosure can also act as an incentive for supervisors to act in a transparent and consistent manner. In this regard, we believe that supervisors should disclose, on a no names basis, the extent and prevalence of capital add-ons in the different jurisdictions.

Existing reporting and public disclosure requirements should be used where possible

1.15 Where possible, existing supervisory and public disclosure requirements should be used in order to minimise the cost and disruption incurred by companies and their policyholders. An example of this for proprietary companies is the IFRS public disclosure requirements in respect of risk management principles, market consistent valuations, integrated ALM etc. Also, we believe that lead supervisors should play an active role in streamlining data requests and in ensuring that supervisors in the different States are as consistent as possible with their requests.

1.16 The timing of Pillar III reporting and disclosure should be made explicit, and needs to be take into account other activities such as financial reporting.

2 Key Messages on Consultation Paper 16

Consistency between reinsurers and direct insurers

2.1 CEA believes that if Solvency II follows a risk based economic approach then it should be applied consistently to both direct insurers and reinsurers, with the risk mitigation provided by reinsurance being fully recognised. *This means that our comments on the other consultation papers (for example CP 13) would also be relevant for reinsurers.*

For example, we previously noted that companies using approved internal models should not be required to also apply the standard approach for the SCR for comparison (see Final Advice on CP13 Par 15 and the reasoning given in our response to CP13). This may be particularly relevant for reinsurers who may be more likely to use internal models.

2.2 One area that we would also highlight is that in the context of a well designed Pillar 1 (Standard Approach or internal models); there should be no need for artificial limits on eligible assets (prudent person plus principle).

2.3 Assets need to be considered in relation to the underlying liabilities and this is described further in our detailed response to CP 19 and CP 20.

In summary, the CEA is strongly in favour of assessing risks using a risk based economic approach as this enables all the factors relevant to asset risk to be taken into account. This includes factors such as the term, nature, currency and certainty of the liabilities (e.g. their ability to absorb risk), any risk mitigation (e.g. hedges) and the extent of available capital (which is able to protect policyholders by meeting losses in the first instance).

Recognition of third country reinsurers

2.4 The CEA strongly supports Article 49 of the Reinsurance Directive ("RID"), i.e. that third party country reinsurers that conduct reinsurance business in the EU or on a cross border basis must not be subject to provisions that result in treatment more favourable than that provided to EU reinsurers.

2.5 The CEA also supports Article 50 of the RID, i.e. that the EU Commission should seek to negotiate bilateral agreements for major third country markets that achieve mutual recognition of supervisory schemes and practices on reinsurance. These bilateral agreements should ensure that EU reinsurers operating in these markets are treated as favourably as local reinsurers (i.e. local to that market) and vice versa.

Having such agreements should reduce the burden on EU reinsurers operating on a world-wide basis, especially as/when third country supervisors modernise their solvency regimes along similar lines to Solvency II.

2.6 Finally, the CEA notes that the international operation of reinsurance activities is one argument in support of the CEA proposal for a lead supervisor for all insurance groups as set out in our response to CP 14.

3 Key Messages on CP 17

3.1 In CP17 CEIOPS give further advice on Pillar II capital add-ons, which builds on their earlier advice given in CP13. In our response to CP13, "Pillar II Principles and Comments on Consultation Paper no. 13" dated 15 September 2006 we developed a number of key principles that we believe should apply for Pillar II, many of which are directly relevant to the issues considered in CP17.

CEA agrees that Pillar II capital add-ons should be neither routinely nor commonly applied

3.2 The CEA supports supervisors having an appropriate range of supervisory powers and tools at their disposal provided that they are applied in a structured and consistent manner.

3.3 The CEA strongly supports CEIOPS' view (2.4) that capital add-ons should be neither routinely nor commonly applied, i.e. they should be exceptional. They should not be used to deter companies from using internal and/or partial models. Capital add-ons should be used as a tool of last resort, i.e. only used when other tools will not remedy the deficiency within an acceptable timeframe. Before a capital add-on is applied an undertaking should be given the opportunity to rectify the deficiency and / or adjust parameters used in the Pillar I calculations to alleviate the deficiency.

3.4 In order to assist undertakings to better understand and rectify deficiencies, the rationale for applying a capital add-on and the basis for determining its extent should be disclosed to them. The undertaking should also have the opportunity to discuss the capital add-on with supervisors, be able to supply additional relevant information and if necessary, be able to seek independent review within the supervisory authority.

A capital add-on should cease to apply as soon as the undertaking has remedied the deficiency that gave rise to it.

The need for capital add-ons should be based on an overall assessment of the company's or group's SCR

3.5 The CEA appreciates that in certain circumstances a Pillar II capital add-on might be needed in respect of deficiencies. In such cases, a holistic approach is necessary, i.e. that the overall adequacy of a company's or group's position will be considered rather than add-ons being applied for perceived weaknesses in particular components with perceived strengths in other components being ignored.

3.6 The CEA would encourage CEIOPS to streamline group supervision to capture the economic reality of groups. Co-operation between supervisors should be a requirement and not a target / aspiration. As per our response to CP14, we would emphasise the benefits and need for a lead supervisor role, with the lead supervisor having ultimate responsibility for the approval of group internal models. The solo supervisors will have an important role with access to group information but it would not be acceptable if decisions approved by the lead supervisor are de facto overridden by local supervisors.

Applicable capital add ons should be assessed over the one year perspective

3.7 We recognise that the companies would naturally look beyond the one year perspective in order to ensure their ongoing position. Any issues identified as part of this work would be discussed under Pillar II.

3.8 However, the CEA agrees with CEIOPS that capital add-ons should normally be assessed over a one year time period. Given the degree of difficulty in anticipating future events and the high level of protection afforded by the SCR, we think a one year time is the appropriate time period to consider.

3.9 It should only be in exceptional circumstances, where the future event is very material and where there is a high level of certainty, that a future event beyond the one year time horizon should be able to give rise to a capital add-on. This is best assessed under Pillar II.

The application of capital add-ons should be harmonised

3.10 The CEA welcomes the 5 step process proposed by CEIOPS (7.7 to 7.14) as this should help harmonise the approach and criteria used for determining capital add-ons. We believe that such harmonisation is essential to create a level EU playing field and avoid regulatory arbitrage.

3.11 We note that more detailed clarification of the 5 step process is required. In particular, understanding the criteria and approach used to determine whether an undertaking's risk profile is, or is not, sufficiently captured by the standard formula or internal model.

In our response to the CP 20 we outline our support for a standard approach with certain flexibility between factors and scenarios and the ability to use company specific data as this will improve the fit of the standard approach. Such a structure would mean that for many companies, the standard approach will be able to capture the risk profile and hence capital add-ons should be exceptional.

3.12 Finally we believe that public disclosure can also be an incentive for supervisors to act in a transparent and consistent manner. In this regard and consistent with our position on CP 15, we believe that supervisors should disclose, on a no names basis, the extent and prevalence of capital add-ons in the different jurisdictions.

4 Key Messages on Consultation Paper 18

Supervisors should have necessary, but not excessive powers

4.1 For many States the advice contained in CP18, if accepted by the EU Commission, would result in supervisors gaining significantly more power than is currently the case.

4.2 The CEA supports supervisors having the powers that they need in order to fulfil their obligations. However, these powers should not be excessive, should not extend beyond insurance related laws and regulations and should be applied reasonably and proportionately.

4.3 It is important that supervisors are consistent in their actions and decisions, including consistent application of the supervisory powers made available. This applies across different countries, different companies and over time. As a consequence, the introduction of any new powers and the harmonisation of existing powers should include detailed guidance as to the extent and circumstances under which the powers would be expected to be exercised.

4.4 In this context, CEA believes that its paper “CEA Working Paper on the MCR and Proposed Ladder of Intervention” (16 October 2006) is a useful reference for structuring supervisory intervention.

Harmonisation is a key objective of Solvency II

4.5 A key objective of Solvency II is to have a sufficient level of harmonisation between different States. ***This is needed to ensure that the requirements are based on the underlying risk and not on the location of the company.***

4.6 CP18 seeks to achieve harmonisation by ensuring that all supervisors have the same powers. CEA supports this provided that the powers are appropriate which could mean a reduction of supervisory powers in States where current powers are in excess of those envisaged under Solvency II.

4.7 We however note that the powers indicated by CEIOPS in the draft advice also include scope for local supervisors to deviate from Solvency II, e.g. making their own assessments of undertaking’s risks, basing actions on their own assessments, developing their own interpretations, standards and guidelines, applying asset limits, etc.

The CEA appreciates that some flexibility in supervisory powers may be needed to cater for the different insurance markets that exist within the EU but in a context of a well designed Solvency II framework this should be limited in order to ensure a level playing field for all EU insurers regardless of where they are located.

4.8 For instance, a well designed risk based and economic approach for the SCR, backed up with Pillar II assessments should eliminate the need for supervisors to make their own assessments of undertaking’s risks, apply assets limits, etc.

4.9 Finally we note that the standardisation of circumstances in which discretion or deviations can be applied will ***<u>not</u>*** necessarily lead to a harmonisation of supervisory practices or a level playing field as supervisors are likely to deviate in different ways, especially over time.

4.10 In this context, further steps may be necessary to achieve a harmonised regulatory environment in each state rather than simply harmonised supervisory rules and powers.

5 Key Messages on CP 19

Risks assessed using an economic approach would not need artificial limits on assets

5.1 CP19 and CP20 both propose safety measures, but suggest quite different approaches.

5.2 CP19 advocates having transitional safety measures (asset limits with a revision clause) only where the risks are not sufficiently captured in the SCR. The CEA supports this as it avoids double counting risks and we note that additional safety measures (even during transitional periods) are therefore not needed where together Pillar I and Pillar II sufficiently capture the underlying risks. In the current Solvency I framework asset limits have lagged behind market innovations, have been open to interpretation and arguably not been that effective in protecting policyholders.

5.3 The CEA is strongly in favour of using a well designed risk based economic approach to assess risk, including asset risk, as this considers the whole picture:

- Assets are not assessed in isolation from the underlying liabilities. For example, long term bonds may be volatile in isolation, but are a match for long term fixed liabilities
- Similarly, applying asset limits in isolation does not take into account the impact of diversification, risk mitigation (e.g. hedging) or any risk absorption from liabilities (e.g. profit sharing)
- More risky investment strategies would be captured within the SCR calculation within a risk based economic approach and this should be acceptable provided that the company has sufficient capital to support such risks

In general Solvency II should not constrain the way companies run their business provided that they have sufficient capital resources. Asset allocations would depend on the agreed investment mandates and any communication to policyholders on the investment strategy.

5.4 In cases where material deficiencies have been identified in the Standard Approach, the Industry's preference would be to improve the design and structure of the Standard Approach to remedy the deficiency. For example the inclusion of concentration risk within the SCR should mitigate the need for asset limitations.

5.5 The CEA also believes that certain other risks such as liquidity risk (which is less important in insurance than in banking) and possible undertaking specific concerns are best assessed under Pillar II where the particular circumstances of the company can be taken into account. As such, the CEA does not see the need for asset limits in Solvency II. The CEA notes that there would seem to be little incentive for supervisors to give up transitional asset limits, which could therefore effectively become permanent arrangements in some States, which would result in double counting and reduced harmonisation.

5.6 In contrast to CP19, CP20 advocates having principles and a list of assets that are eligible to cover technical provisions, the MCR and the SCR. The principles suggested include: assets should be a suitable match for the liabilities and assets that contribute to either a reduction in risk or facilitate efficient portfolio management should be permitted. Whilst such principles may have been needed under the current Solvency I regime we do not believe that they are needed or appropriate for Solvency II.

5.7 The CEA is strongly against the eligible asset list approach suggested in CP20 as the risks they seek to protect against will have already been captured in the SCR and/or Pillar II. The extent to which particular asset types give rise to excessive risks, etc is more appropriately assessed in a well designed risk based economic approach for the reasons given in 5.3 above.

Valuation of the liabilities should be on a market consistent basis

5.8 We strongly support the use of market-consistent valuation techniques. Such techniques use available market information to value the underlying liability cash flows using modern financial economic theory and can be used to value liabilities even if they are not actively traded market instruments.

5.9 We also support the cost of capital approach as a proxy to derive the market value margin for non hedgeable risks including the work done by CEIOPS in QIS 2 and subsequent recognition that the cost of capital approach forms a suitable methodology for the market value margin.

5.10 We however believe that further work is required in order to refine the cost of capital approach (particularly in light of the concerns raised on the calibration of QIS 2) and to ensure that the approach will be interpreted consistently across different jurisdictions.

Appendix A

It is important to note that the comments in this document should be considered in the context of other publications by the CEA. These can be found under the Solvency II section of the CEA website (www.cea.assur.org) and include:

- Solvency II: Structural Issues (1 March 2005)
- Solvency II - Building Blocks for the Solvency II Project CEA Working Document in Progress (18 May 2005)
- CEA's comments on the CEIOPS' Draft Answers to the 'Second Wave' of Calls for Advice (30 September 2005)
- CEA's comments on the CEIOPS' Draft Answers to the 'Third Wave' of Calls for Advice (9 Feb 2006)
- Solutions to Major Issues for Solvency II – Joint submission by the CRO Forum and the CEA (17 February 2006)
- CEA working document on the standard approach for calculating the solvency capital requirement (22 March 2006)
- CEA document on Cost of Capital (21 April 2006)
- CEA guidance on Quantitative Impact Study 2 (15 May 2006)
- CEA's Pillar II Principles and Comments on Consultation Paper no. 13 (15 September 2006)
- Feedback on CEIOPS Consultation Paper 14 – Joint submission by the CRO Forum and CEA (22 September 2006)
- Assessing the Impact of Solvency II on the Average Level of Capital (16 October 2006)
- CEA Preliminary Feedback from QIS2 (16 October 2006)
- CEA Working Paper on the MCR and Proposed Ladder of Intervention (16 October 2006)
- CEA Working Paper on the risk measures VaR and TailVaR (7 November 2006)

These documents together constitute a coherent package.

Appendix B - Detailed comments on CEIOPS draft advice within CP15

Par 5.1: The new insurance solvency system introduced by Solvency II is based upon three complementary elements or "pillars". Pillar III comprehends both supervisory reporting and public disclosure requirements.

The CEA supports a three pillar approach.

Par 5.2: Supervisory reporting requirements in the framework of Solvency II should support the risk-oriented approach to insurance supervision while public disclosure requirements should reinforce market mechanisms and market discipline.

The CEA supports the high level aims for supervisory reporting requirements and public disclosure. However, there needs to be a clear distinction between the information needed by supervisors to perform their job and that which is needed for public disclosure.

Par 5.3: Supervisory reporting includes different types of information that a supervisor needs, on a harmonised basis, to perform his functions.

The CEA supports and agrees that supervisors should be given the information they need to perform their roles. In doing so supervisors should respect confidentiality, have regard to materiality and proportionality and adopt a harmonised approach.

Supervisory reporting requirements should wherever possible using companies' existing internal analysis and formats for presenting data in order to minimise the impact on companies. Any requests for information that is not currently produced by the company should be subject to materiality and proportionality.

The timing of Pillar III reporting and disclosure should be made explicit, and needs to be aligned with financial reporting.

Par 5.4: Public disclosure requirements under Solvency II shall work as a strong incentive to insurance undertakings to conduct their business in a sound and efficient manner, including an incentive to maintain an adequate capital position that can act as a cushion against potential losses arising from risk exposures.

The CEA recommends that in order to determine the most effective form and content of the information to be publicly disclosed, it is necessary to specify the level of knowledge that the user is assumed to have. We strongly recommend that this is done and suggest that the general user of the information be assumed to be informed and knowledgeable.

Public disclosure should be a sub-set of the supervisory information and focused on that needed to encourage companies to manage their business in a sound and efficient manner.

The quantity of public disclosure should be targeted in order to improve the quality for external users. The standards set should seek to leverage as far as possible from existing reporting requirements, e.g. those of IFRS in relation to risk management principles, market consistent valuation, integrated ALM etc, although we recognise that IFRS only applies to a subset of the market.

Par 5.5: The allowance for not disclosing some information under proprietary or confidentiality principles should be exceptional. In such cases undertakings should clearly state that some items are not disclosed, and explain the reasons. This notion shall be applied to the public disclosure requirements set forth in this document.

The CEA believes that relying on a confidentiality principle; with non-public disclosure being by exception is likely to lead to disputes between companies and supervisors. It could also deter companies from volunteering information to the supervisors and will work against an open relationship between companies and their supervisors.

The concern here is that confidentiality is a subjective notion and could be interpreted differently by different parties. We believe that it would be preferable to have agreed minimum requirements for public disclosure, which typically do not give rise to confidentiality considerations.

If detailed low level information similar to that required for insurance supervision were to be publicly disclosed it might be used by other market participants such as competitors, acquirers, investment banks, hedge funds, etc. to the disadvantage of the company and/or their policyholders. Such information is not needed to form a good understanding of the overall risk exposures and capital adequacy of a company. We strongly suggest that CEIOPS works with the Industry to agree minimum high level requirements for public disclosure.

Par 5.6: CEIOPS is of the opinion that within the formulation of a general public disclosure and supervisory reporting approach for Solvency II the following overarching principles are relevant:

- Information that is necessary to perform an insurance undertaking's solvency and financial condition assessment […]
- Information required under Pillar III shall be provided on a timely and adequate basis and be accessible, meaningful and readily understandable.
- Insurance undertakings shall adopt a formal policy to comply with the established Pillar III requirements and have policies for assessing the appropriateness of their reporting and disclosures, including their internal verification and frequency.
- Where relevant, information required under Pillar III shall be provided on a solo as well as on a group level. Disclosures made by an insurance undertaking under financial reporting, listing or other legal or regulatory requirements may be relied upon to fulfil the equivalent Pillar III public disclosure requirements in order to avoid duplication.
- Public disclosure under Pillar III shall be made on an annual basis at a minimum. However, more frequent disclosures may be deemed necessary in the light of the relevant characteristics of the insurance undertaking's business. For supervisory reporting, a combination of frequencies is most likely to be appropriate, depending on the nature of the information.

In principle, the CEA thinks this is not unreasonable provided that public disclosure is at a suitably high level, excludes commercially sensitive information and the level of knowledge of the target audience is defined. The CEA strongly recommends that the starting position for public disclosures should be the group position unless this is clearly inappropriate.

Par 5.7: CEIOPS believes that an insurance undertaking shall provide material information based on the following main subjects:

A. Business Overview and Performance
B. Governance
C. Valuation Basis for Solvency Purposes
D. Risk and Capital Management

CEIOPS is of the view that disclosure of the overall capital requirement without any specific breakdown should be recommended. CEIOPS members are of the view that a disclosure at year's end of the occurrence of any breach in the SCR or MCR even if since resolved, with an explanation of its consequences, should be recommended.

Publicly disclosed information should be high level and focused on that needed to assess the overall solvency and financial position of the Group/company and the adequacy of its risk management processes. We do not think it is appropriate or desirable to publicly disclose detailed information on product profitability, expected product line claims experience (which could be used to assess profitability), underwriting practice, hedging strategies, granular risk exposures (which might allow anticipate future trades), etc. Doing so could hurt the interests of both shareholders and policyholders.

As stated in the Key Messages section, care is required to ensure that communication of the new Solvency II system does not focus on a single element such as the SCR, capital add-ons or breaches of the SCR as this ignores the greater sophistication of the new framework.

Appendix C - Detailed comments on CEIOPS draft advice within CP16

General Remarks

Par 40 CEIOPS believes […] that the high level principles for governance, fit and proper testing, […], solvency control levels and capital add-ons for reinsurance undertakings should be the same as […] for direct insurers. Referring to the SRP a demand for closer cooperation and information systems among supervisors should be emphasized as a core objective due to the often international nature of reinsurance activities and its supervision.

CEA agrees that if Solvency II follows a risk based economic approach then it should be applied consistently to both direct insurers and reinsurers.

This means that our comments made on the other consultation papers would also be relevant for reinsurers. For example, reinsurers using approved internal models should not be required to also apply the standard approach for the SCR for comparison (see Final Advice on CP13 Par 15 and the reasoning given in our response to CP13).

Finally, the international operation of reinsurance activities is one argument in support of the CEA proposal for a lead supervisor for all insurance groups (See Response to CP 14).

Prudent person plus principle – Limits on eligible assets for reinsurers

Par 41 It is recognised that with respect to the desirability or otherwise of any limits on assets there are some differences between the Reinsurance Directive and the current Life and Non-Life Directives. CEIOPS intends to discuss this issue in more detail in another Consultation Paper.

A detailed response on the prudent person plus principle is provided in CP 19 and CP 20.

In summary, CEA is strongly in favour of assessing risks using a risk based economic approach under Pillar I as this enables all the factors relevant to asset risk to be taken into account, i.e. the term, nature, currency and certainty of the liabilities (e.g. their ability to absorb risk), any risk mitigation (e.g. hedges) and the extent of available capital (which is able to protect policyholders by meeting losses in the first instance).

Hence in the context of a well designed Pillar 1 (Standard Approach allowing for certain flexibility and company specific information or internal models), there should be no need for limits on assets.

Advice on third country reinsurer

Par 42 The EU Commission, supported by Member States, clearly leads on the overall issues that impact on market access and relations to stakeholders outside the legal framework of the EU. From that perspective, it seems likely that the European Commission will wish to incorporate provisions in Solvency II that reflect those in the Reinsurance Directive and the CRD regarding the negotiation of international agreements.

We agree that the EU Commission should provide leadership on these issues. The CEA believes that the EU Commission should seek to negotiate bilateral agreements for major third country markets that achieve mutual recognition of supervisory schemes and practices on reinsurance and effective market access for the reinsurers in the respective territories. Having such agreements should reduce the burden on EU reinsurers operating on a world-wide basis, especially as/when third country supervisors modernise their solvency regimes along similar lines to Solvency II.

Par 43 In parallel, it seems sensible for CEIOPS to adopt at Level 3 a formal procedure to enable any of its Members to request that CEIOPS initiates a supervisory assessment procedure under which the equivalence of third country regimes as operated in practice and the reliance which can therefore be placed on them would be assessed (liaising with CEBS, the IWCFC and IAIS where necessary). If, on a qualified majority decision, CEIOPS decided to initiate such an assessment it would advise the European Commission at that time, and subsequently inform the European Commission of the results. The European Commission should agree a mechanism for taking such advice into account.

We agree that there should be a formal supervisory assessment procedure. However, we believe that whilst it might be acceptable for the formal procedure to be developed via level 3 guidance, the principle of recognition and the criteria under which a third country would be recognised as an equivalent regime should be specified within either the Level 1 Directive or in Level 2 implementation measures in order to achieve the necessary harmonisation.

The supervisory assessment procedure would include consultation and input from the third country regulator.

Par 44 As this issue needs further discussion with the European Commission, CEIOPS will only give a preliminary advice on the treatment of third country reinsurers. The following procedure has been identified as a possible beneficial solution for both undertakings and supervisors:
A rating approach - in accordance with the SCR credit matrix approach - should at first be taken into account for calculating the credit counterparty risk when assessing non-EU reinsurers. Both the results of a rating approach and the results of a supervisory assessment procedure mentioned in paragraph 37 can lead to the following four alternatives: […]

We generally agree with the above preliminary requirements. Supervisors would need sufficient knowledge of other jurisdictions in order to perform such an assessment.

We believe that reinsurers should be informed of any information request about them made by a regulator to a rating agency and should be given the opportunity to submit additional information relevant to the assessment of them.

Par 45 Notwithstanding this procedure, if at any time there are reliable indications that a particular reinsurer is in financial difficulty or CEIOPS has formally determined that the regime is not equivalently regulated, supervisory authorities may take other supervisory measures in respect of any direct insurer with exposure to the reinsurer in question, including the imposition of a capital add-on.

It is not clear what is meant by "reliable indications that a particular reinsurer is in financial difficult". For example, if this is signalled by changes in the rating of the reinsurer then this should automatically be captured in the counterparty credit requirements for the direct insurer (regardless of geographic location of the reinsurer).

The CEA believes that capital add-ons should neither routinely nor commonly be applied. Using a reinsurer not deemed to be equivalently regulated is in itself not a justification for imposing a capital add-on or other supervisory measures on a direct insurer. The same principles as used for EU reinsurers should be used to assess any additional risks posed by non EU reinsurers.

Appendix D - Detailed comments on CEIOPS draft advice within CP17

In this section we provide detailed comments on CEIOPS' formal advice, i.e. the blue shaded sections. In addition, we also comment on certain other sections of the consultation paper where we think that this will help the ongoing dialogue.

IRCA and SCR inter-linkage

Par. 7.3: CEIOPS expects insurers to provide as part of IRCA (Internal Review and Capital Assessment) a comparison between (1) their business plan and business capital needs and (2) the regulatory requirements including a policy on solvency capital and the SCR calculation results. Supervisors will take this into account where it shows differences in the actual risk profile of the insurer with the standard assumptions made within the SCR.

The objectives and requirements for the various analyses need to be clarified. IRCA requirements should be proportionate and where possible seek to use companies' existing analyses and reports.

This paragraph and 3.3 describe how undertakings using an approved internal model for the computation of its SCR should analyse the difference between the capital amounts produced by its internal model and that using the standard approach. As described in our response to CP13 we do not understand the purpose of this.

We note that an approved internal model is by definition deemed to be superior to the standard approach. Ongoing comparison between the internal model and the standard approach is likely to highlight deficiencies in the Standard Approach (for that company) rather than the internal model.

Such comparisons seem more relevant to the initial approval of internal models than the SRP or IRCA. Requiring companies with approved internal models to also maintain a standard approach model is likely to result in significant extra costs for such companies, with seemingly little benefit.

Multi year perspective

Par 7.4: Insurers should consider as part of their IRCA events or changes in strategy or new business which extends beyond a one-year time horizon. This may result in the insurer identifying a future need for capital above the regulatory SCR.

Par 7.5: […] The Supervisory authority should have the power to demand a long-term business plan that shows how the insurer is managing and will continue to manage its capital base to meet the future identified risk.

The CEA agrees that it is sensible for companies to have some regard as to how their capital requirements might evolve over time. However we emphasises that the primary capital measure is based on an assessment of risks developing over the one year.

Par. 7.6: CEIOPS Members agree that there is a distinction between the one-year time horizon calculation of the SCR and a potential multi-year perspective of the IRCA and the SRP (Supervisory Review Process), which means that a capital add-on based on events which might occur beyond a 1-year time horizon will be neither routinely nor commonly applied

The CEA is encouraged by CEIOPS' view and strongly agrees that any applicable capital add-ons should be assessed over a one year time period. Given the degree of difficulty in anticipating future events and the high level of protection afforded by the SCR, we think that a one year time period is the appropriate time period to consider.

It should only be in exceptional circumstances and where there is a high level of certainty that future events beyond a one year time horizon should be able to give rise to a capital add-on. In doing so full regard should be given to the future ability of the company to mitigate risks and raise capital.

Harmonised steps to establish a capital add-on

Par 7.7: […] CEIOPS proposes to follow a step by step approach, which should be handled within a European legal system. Steps 1 and 2 and steps 3 to 5 would be seen as parallel processes.

CEA welcomes this step towards harmonisation in the application of supervisory powers.

Par 7.8 (Step 1): Is the risk profile adequately captured by the standard formula or internal model? If yes, no adjustment should be performed, supervisors move to step 3. If no, then step 2 should be applied.

Par 7.9 & 10 (Step 2): […] If the risk profile is not adequately captured by the standard formula or by the internal model, the possible solutions are: (1) the use of entity specific adjustments of parameters […]; (2) development of a partial internal model […]; or (3) developing a full internal model […]

In principle this approach seems reasonable. However, the CEA would like more guidance on the circumstances when an undertakings risk profile might be deemed not to be sufficiently captured by the standard approach and in particular what level of difference will be tolerated. Also, where an internal / partial model has been approved we assume that by definition it will be deemed in step 1 to have sufficiently captured the relevant risk profile.

As described in many of our previous papers, a well designed standard approach using companies' own experience for certain parameters and limited flexibility between factors and scenarios would significantly improve the fit of the standard approach to an individual company's risk profile and is something we strongly advocate.

Requiring companies to develop a partial or full internal model should be a last resort, i.e. be neither routine nor common and be subject to proportionality. This is particularly important as the cost of developing such models may be disproportionately high for many small undertakings.

When assessing whether a risk profile is adequately captured we would stress that the whole picture must be considered. It would not be appropriate to "add" for instances were the standard approach was considered not to fully capture a company's risks and to ignore instances where it may have overestimated the company's risks.

Par 7.11: (Step 2) For companies using an internal model the options are: (1) recalibration based on Pillar I criteria or change of actuarial model […]; or (2) entity specific adjustment of parameters […]

Clarification is needed of what is meant by "recalibration based on Pillar I criteria" as this is not clear. The CEA suggests that the aim should be to adjust the parameters and/or model to better capture the company's risk profile. In doing so, the model and its parameters should be considered in its entirety.

It would not be appropriate to "add" for instances were the internal model was considered not to fully capture a company's risks and to ignore instances where it may have overestimated the company's risks as this would result in excessive capital amounts.

Par 7.12 (Step 3): Are there deficiencies in the qualitative requirements on governance, internal control. Risk management, conduct of business?
Par 7.13 (Step 4): Can deficiencies be remedied within an appropriate time frame?

CEA believes that capital add-ons are a supervisory tool of last resort. The undertaking should, in the first instance, be given the opportunity to rectify the deficiency rather than have a capital add-on imposed immediately.

Par 7.14 (Step 5): Capital add-ons can be set in proportion of the deficiencies […] a percentage of SCR […]. This should be the same process for each supervisory authority. […] CEIOPS has commenced developing a framework to support convergence of supervisory approach.

The CEA supports capital add-ons being set in proportion to the severity of the deficiencies, with these deficiencies needing to be considered at the overall level. As described in our response to paragraph 7.11 above, we believe that the capital add-on should take into account areas where a company's risk might be overestimated as well as instances were they might not be fully captured.

CEA welcomes CEIOPS' development of a framework to facilitate supervisory convergence for the application of capital add-ons. The outcomes of CEIOPS future work should be published and national supervisors should explain any deviation from CEIOPS guidance.

As part of a constructive dialogue between supervisors and companies, the rationale and basis for determining any capital add-ons should be clearly communicated.

In general we would expect capital add-ons to be regularly reviewed and if a company satisfactorily rectifies a deficiency that caused a capital add-on, the capital add-on should immediately cease to apply.

Capital Add-on in a group context

Par 7.15: Definition and calculation of the capital add-on should in general be the same for solo and group undertakings. The solo supervisor will inform the group supervisor of the setting of a capital add-on. The group supervisor will decide if it is relevant to apply also this capital add-on at group level. Nonetheless, this principle does not address the case when a capital add-on is required by a solo supervisor who does not agree with the approval of an internal model at group level.

In our response to CP 14 we indicated that for insurance groups, the focus should be on group supervision with a lead supervisor appointed for each group with responsibility for monitoring group solvency.

In such a case, the focus would be on capital add ons at the group level, which requires co-operation between supervisors with it being expected that the lead supervisor would make the ultimate decisions about the application of capital add-ons for the insurance group.

Separately, we would emphasise the benefits and need for a lead supervisor role, with the lead supervisor having ultimate responsibility for the approval of group internal models. The CEA expects that local supervisors will be involved in the approval process for such models but disagrees with local supervisors having the power to de facto override decisions by the lead supervisors.

Par: 7.16 […] CEIOPS notes that further work will be needed on group SRP and group diversification […]

The CEA looks forward to collaborating with CEIOPS on these group issues.

Appendix E - Detailed comments on CEIOPS draft advice within CP18

Supervisory Powers under Solvency II in a solo context

Par 4.1: Member States should ensure that their supervisory authorities have the powers which are necessary to allow them to fulfil their responsibilities […]

The CEA supports the supervisory authorities having the powers necessary to fulfil their responsibilities, although these powers should not be excessive and should be applied proportionately to the problems encountered.

In addition, the introduction of any new powers and the harmonization of existing powers should include detailed guidance as to the extent and circumstances under which the powers would be expected to be exercised.

Par 4.2: Supervisory authorities need to be independent in order to be able to wield their powers effectively, as well as adequately equipped with regard to funds and human resources with the appropriate level of skills and legal protection

The CEA agrees with the objective of having independent, well equipped supervisory authorities.

In particular, the supervisory authorities should start working with the Industry to ensure that they have the new skills sets needed under Solvency II framework, such as internal models and risk management processes, ahead of the implementation of the framework.

Par 4.3: In general, all supervisory authorities should have the power to enforce compliance with laws and regulations, at least insofar as these are insurance related.

In general the CEA agrees with regard to insurance related laws, but not other laws as this is likely to go beyond their area of expertise. The powers granted to supervisors should not be excessive and should be applied proportionately.

Par 4.4: Supervisory authorities should have the power to lay down standards, recommendations and guidelines and to adopt interpretations.

The CEA emphasises the need for the harmonisation of supervisory rules and supervisory practices. If supervisory authorities are not given sufficient guidance regarding standards and interpretations then there is a danger that there will be significant differences in how Solvency II is implemented and "gold-plating" (i.e. additional levels of regulation introduced by local supervisors), which would result in disruption and additional costs for insurers. This would undermine the objectives of Solvency II resulting in an uneven playing field and scope for regulatory arbitrage.

Par 4.5: The Supervisory authorities should have the power to define and implement the principle of proportionality for undertakings and to grant waivers to rules where the implementing measures prescribe that the supervisory authorities may grant such waivers.

The CEA supports the principle of proportionality, but believes it is important that it is should be harmonised, i.e. principles defined centrally with guidance surrounding its application to ensure it is applied consistently across different countries and companies and over time.

Par 4.6, […] Supervisory authorities should have unrestricted access to all existing information […] be able to request any additional information that is reasonably required for supervisory purposes […] supervisors should not ask any undertaking for information that is readily available from another supervisor […] There should be no limiting list of the information available for the supervisory authorities. […] Any obstacle made to this key power as well as any distortion of the information given to the supervisor should be subject to serious sanction.

Par 4.7: Supervisory authorities should […] have free access to any staff of the undertaking and to any item of information on paper or in electronic form, with the right to demand that documents and information are prepared or produced in readiness for the supervisor's visit. The supervisory authorities should also have the power to investigate in any connected entities/persons […] but only on matters concerning the supervised undertaking (e.g. for outsourced functions) […]

We recognise that supervisory authorities require access to information and to staff and we appreciate efforts made to reduce the burden on companies. It is important that supervisors seek to use existing processes and information as far as possible, e.g. those performed during independent audits. All requests for information that is not readily available should be proportionate having regard to the materiality of the risks and provide firms with a reasonable timeframe during which to meet such requests. We would expect that these requests would be exceptional for companies with good governance and risk management structures.

In order to avoid disturbing companies' day to day operations, we recommend that a standard request list is developed under central guidance, which although not exhaustive, would provide guidance on the appropriate level of information required to be developed by companies and allow them to develop efficient and streamlined processes. Supervisors should where possible seek to fit in with companies' existing processes and timetables in order to minimise the burden on companies, i.e. if a particular report is already produced on a particular date supervisors should seek to use that rather than request information at a different date.

Par 4.8: All supervisory authorities should be empowered to impose limits on assets or categories of assets if the prudent person principle is breached, and to require a divesting of a proportion of certain assets or categories of assets if the technical provisions are not covered or not sufficiently covered by admissible assets, or the matching rules for assets or the SCR are breached.

The CEA advocates that powers are sufficiently harmonised. As discussed in our submissions for CP19 and CP20, the CEA does not see the need for a prudent person principle and asset limits. A properly designed standard approach is the best way of assessing risk as this uses a risk based economic approach that takes into account the interaction of assets and liabilities (e.g. profit sharing), risk mitigation and the extent of the capital available to protect policyholders. Liquidity and entity specific risks are best addressed under Pillar II.

The CEA does not understand the references to admissible assets and matching rules for the assets or the SCR. To date these rules have not been mentioned in any of the consultation papers and seem to refer to the current Solvency I regime. As described above, the CEA supports a risk based economic approach, which automatically allows for risk thereby removing the need for such rules.

Par 4.9: The powers given to supervisory authorities […] should see a considerable degree of harmonisation in order to promote a level playing field. All supervisory authorities should have the same powers […] every supervisory authority should further be empowered to do its own assessment of undertakings' risks and to base its actions on its appraisal. Supervisory authorities should have the power to set limits on assets on a case by case basis, as one possible tool, either where the company has not satisfied qualitative standards established with the aim of ensuring harmonisation between supervisory authorities, or instead of using another tool.

The CEA strongly supports the aim of harmonising supervisory powers, which ideally should be achieved using level 1 and 2 measures.

Allowing supervisory authorities to carry out their own assessments of undertakings' risks and to base their actions on their own appraisals would seem to be contrary to the aim of harmonisation, which is a key objective for Solvency II. Potentially allowing different supervisors to adopt different risk assessment processes and actions could result in significant disruption for companies and scope for regulatory arbitrage.

Par 4.10: Insofar as supervisory authorities are given the power to waive Solvency II requirements or accept procedures that deviate from general rules, the conditions for granting such relief should be fully harmonised so that an adequate common standard of Solvency II requirements is being observed.

The CEA is concerned about the scope for local supervisory authorities to depart from the Solvency II requirements. Harmonising the conditions for granting such waivers to deviate from Solvency II will not result in harmonised supervisory powers as different supervisory authorities might choose to waive different rules. If supervisory powers are not fully harmonised then there is a danger there the regulatory environment in different States will be sufficiently different to be burdensome to companies and to encourage regulatory arbitrage.

Supervisory Powers under Solvency II in a group context

Par 4.11: The group supervisor, as defined in previous CEIOPS documents, should have all the powers necessary to assess the relevant group issues and take action to ensure compliance with the requirements set at group level.

We welcome the continued consideration of group issues in all relevant areas. The CEA has in previous documents indicated its support for a lead supervisor for insurance groups. The lead supervisor would be responsible for monitoring the solvency of the group as well as other clearly allocated responsibilities for example approving group internal models.

Co-operation between supervisors should be a requirement and not a target / aspiration. The solo supervisors will have an important role with access to group information but it would not be acceptable if decisions approved by the lead supervisor together with the coordination committee, are de facto overridden by local supervisors.

The concept of a lead supervisor will provide a clear framework for supervisory convergence and a level playing field at the European level.

We believe that there is a certain commonality between the high level objectives set out in the joint submission by the CEA and CRO Forum on Consultation Paper 14 (further details are contained in the Appendix) and a paper recently issued on "Supervising insurance under Solvency II" by the HM Treasury and FSA. In light of this, we believe that the ideas and proposals within this paper merit further consideration.

Par 4.12: When the parent company is a holding company (or any non regulated entity) the group supervisor should have the relevant powers to perform his duties. In particular he should have the power to check the fitness and propriety of managers and the board, as well as be entitled to get information from this entity and make any investigation at this level.

See answer to 4.11. We would expect the powers of the lead supervisor to be applied reasonably and proportionately in consultation with local supervisors.

Par 4.13: The group supervisor should have the duty and the powers to enforce the delivery of "capital support" in cash and in a timely manner when needed at solo level.

We would expect that the delivery of capital support would be governed by the terms of the agreement between the group and solo entities.

It is unclear why capital support should necessarily be given in the form of cash. Unless the local entity has a specific liquidity problem, we believe that other forms of capital support are equally valid.

Such powers should be viewed in the context our comment that for insurance groups the focus should be on group supervision (CP 14) and the concept of a "lead supervisor" who would be responsible for monitoring the solvency of the entire group.

Annex

The relatively short consultation period has meant that the CEA has not been able to fully consider the Annex to CP18. The CEA has interpreted the table in this Annex as being a summary of the extent of existing (i.e. Solvency I) powers in different States, which is intended to demonstrate the variation in different States. It has been assumed that any new powers being proposed are described in the main body of CP18, i.e. the table does not contain any new powers **not** discussed in the main text.

In general, the CEA is in favour of harmonisation both in the powers available to supervisors and the application of the powers.

Appendix F - Detailed comments on CEIOPS draft advice within CP19

Prudent Person "Plus" Approach

Par 4.36: The "plus" should cover risks which will not be sufficiently captured in the SCR formula. It comprises qualitative requirements and quantitative limits which function as a safety net.

We understand that the "prudent person rule" described in paragraph 1.2 is in practice not a rule and is instead a principle that was part of the Reinsurance Directive, which we understand was an interim measure preceding Solvency II. Consequently, we do not believe that it is appropriate to directly transpose this from the Reinsurance Directive and that the need for such a principle needs be assessed in the context of the whole Solvency II framework.

The "prudent person rule" advocated by CEIOPS involves looking purely at the characteristics of an asset and not taking into consideration any risk mitigation, the ability of liabilities to absorb risk or the level of available capital. However, we believe that if a risk is adequately allowed for in the SCR then we see no need for further "safety measures". Furthermore, we generally believe that the SCR is usually the appropriate place to assess risks as this can capture potential offsets between assets and liabilities as well as diversification and risk absorption effects.

The CEA strongly advocates using a risk based economic approach (for Pillar I and II) and in such a system the need for artificial restrictions on assets such as the "prudent person rule" is reduced. This should avoid the possibility of double counting of risks.

Par 4.37: If risks are only partially covered by Pillar I any Pillar II measure should take into account the Pillar I results in order to prevent double counting.

There should be no double counting of risks. An SCR appropriately designed and calibrated on an economic basis is the most effective method for deriving the Pillar I quantitative requirements.

In cases where the risk is not adequately captured in Pillar I, then the main effort should be to improve the Pillar I design, structure or flexibility in order to address the issue.

Standard Approach / Internal Model

Par 4.38: Any general limits should be applied regardless of whether the SCR is calculated using the standard formula, partial internal models or full internal models. However, if an internal model takes sufficiently into account the risk associated with some assets and/or some categories of assets, the corresponding rule could be waived totally or partially, on a case-by-case basis.

As described above in the response to paragraph 4.36, the CEA does not see the need for artificial limits within a risk based economic approach for both Pillar I and II. This applies for both the Standard Approach and internal models.

Insurance where the investment risk is held by the policyholder

Par 4.39: CEIOPS considers that in this case the prudent person principle implies a greater freedom of investment than in the case where the investment risk is held by the undertaking. This means that all the qualitative requirements on investments should apply but there should be no restriction on the type of investments and no limits as the investments should be in accordance with contractual obligations.

As described in the response to paragraph 4.36, the CEA does not believe that the "prudent person" principle/rule advocated by CEIOPS is necessarily consistent with a risk based economic approach. For all types of insurance business, asset limits do not necessarily capture potential offsets between assets and liabilities as well as diversification and risk absorption effects.

Par 4.40: In cases where the contracts include a guarantee of investment performance or some other guaranteed benefit, the corresponding additional technical provisions and the SCR shall be subject to the provisions described in chapter 4.

The reference to Chapter 4 needs to be made more precise as Chapter 4 includes two alternative views on asset limits: a "narrower context" (4.5 to 4.22) and a "broader context" (4.23-4.35). We assume the comments relate to the broader context.

CEIOPS split insurance business between business where investors bear all of the investment risk and business where investors bear none of the risk (2.3). However, for many companies the majority of the business falls in between these categories, i.e. profit sharing business where the investor typically bears most of the investment risk, but has underpinning guarantees.

For the reasons given in our response to paragraph 4.36 above, the CEA does not support arbitrary asset limits on any business, including that with guaranteed benefits.

In cases where the risk is not adequately captured in Pillar I, then the main effort should be to improve the Pillar I design, structure or flexibility in order to address the issue. For example, we note that CP20 now introduces allowance for concentration risk in the SCR calculations and the potential to use scenarios within the Standard Approach would also address the majority of concerns over non linearity of derivatives.

Liquidity risk and undertaking specific risks are better addressed under Pillar II by the undertaking performing appropriate analyses taking into account the specific circumstances as opposed to artificial limits on assets.

Proposal for a minimum set of investment limits (the "plus"), concentration and liquidity risk

Par 4.41: CEIOPS agrees that limits on concentration and liquidity risk should be considered in a broader frame. CEIOPS therefore decided to link the concept of technical provisions to the safety measures. All in all, the new framework should be viewed as a totality. In this light, the concept of technical provisions may also be linked with some limits on assets.

The CEA agrees that the new framework should be viewed in its totality. However, the CEA neither agrees with nor understands why under a risk based economic approach, the concept of technical provisions should be linked to safety measures such as asset limits.

Asset liability mismatch risks should be addressed in the SCR using a risk based economic approach, i.e. as described in the response to paragraph 4.36 above. .

Par 4.42: Therefore the broader context of limits recommended in paragraphs 4.23 – 4.30 applies.

For the reasons given in the response to paragraph 4.36 above, the CEA does not support or see the need for arbitrary asset limits in the context of a risk based economic approach.

Paragraphs 4.24 to 4.29 cover the calculation of technical provisions using market-consistent and cost of capital techniques. The CEA strongly supports CEIOPS' decision to use market-consistent valuation techniques and the cost of capital approach.

We note that market consistent techniques use available market information to value the underlying liability cash flows using modern financial economic theory and can be used to value liabilities even if they are not actively traded market instruments. This should help alleviate concerns on the "deep liquid and transparent markets" criterion.

We also support the cost of capital approach as a proxy to derive the market value margin for non hedgeable risks including the work done by CEIOPS in QIS 2 and subsequent recognition that the cost of capital approach forms a suitable methodology for the market value margin.

We however believe that further work is required in order to refine the cost of capital approach (particularly in light of the concerns raised on the calibration of QIS 2) and to ensure that the approach will be interpreted consistently across different jurisdictions.

The underlying reasoning on the CEIOPS approach to calibration in the document is not clear and we suggest that Appendix D of the "The Swiss Experience with Market Consistent Technical Provisions - the Cost of Capital Approach" is a useful reference.

We would expect the Industry to assist further refinement the cost of capital approach for the QIS 3 exercise.

In paragraph 4.30 of CP19 CEIOPS propose various asset limits to protect against concentration risk. For the reasons given in paragraph 4.36 above, we do not see the need for these limits. We note that the inclusion of a concentration risk module within the standard formula should, provided it is well designed, give adequate protection thereby removing the need for asset limits. Also, we note that the one of the main advantages often cited for alternative investments is their diversification benefits and as such it seems strange to single them out as giving rise to concentration risk.

The term "alternative investments" is vague and open to interpretation, as is to a lesser extent the term "hedge fund".

Paragraph 4.30 of CP19 proposes asset limits to protect against liquidity risk. We agree that liquidity risk is not captured in the SCR. However, we believe that this is best considered under Pillar II rather than via arbitrary asset limits. This would allow the future need for liquidity (i.e. expected future liability cashflows and the extent to which these might vary) and the overall available liquidity (i.e. allowing for liquid assets to compensate for any illiquid assets) to be taken into account on a company specific basis. We note that the 10% limit on securities not traded on a regulated market or one with very low liquidity, could, if strictly interpreted, be inappropriately restrictive and potentially capture a relatively wide range of assets such as infrequently traded corporate bonds, infrequently traded equity shares, commercial property, private equity, hedge funds, over-the-counter derivatives (e.g. as used for hedging), CDO debt, etc.

Par 4.43: The concentration risk model which has still to be tested under Pillar I calculates the capital charge for concentration risk. In addition it is an important part of risk management that companies should consider for themselves how to manage their concentration risk. Supervisory authorities will develop the Supervisory Review Process under Pillar II to assess insurers' concentration risk management policies and procedures.

The CEA agrees that managing concentration risk is an important part of risk management and that companies should do this. Within a risk based economic approach, concentration risk can be captured within the SCR. In such a case there is no need for artificial restrictions on assets.

The CEA does not support arbitrary asset limits for the reasons given in the response to paragraph 4.36 above.

Par 4.44: As already stated by CEIOPS liquidity risk is not covered by the SCR standard formula. However, the qualitative requirements on the investments clearly assure that the company should take into consideration the liquidity risk.

We agree that liquidity risk is not considered in the SCR. However, asset limits are relatively ineffective means of protecting policyholders against liquidity risk as they do not take into account the nature of the liabilities and the extent to which the liquidity of other assets could compensate.

It would be more appropriate to consider this risk under Pillar II as that would enable the specific circumstances of the company to be taken into account.

Non-linearity risk: new financial instruments / derivatives

Par 4.45: A risk measure considered in the SCR may provide a misleading measure of the risk, in case of derivatives not proportional to the value of the underlying assets.

Par 4.46: This non-linearity risk may not be covered by the SCR and […] derivatives and similar financial instruments may have a leverage effect that could lead to a higher risk […]. Companies should assess the extent to which they are exposed to non-linear risk and develop an appropriate risk based approach to measure such risk and quantifying the amount of capital needed to cover it and/or the use of other mitigation techniques. The adequacy of this assessment will be reviewed under the Supervisory Review Process.

Under the recently concluded QIS 2, the impact of simple derivatives were captured in the Standard Approach while the use of scenarios would allow companies to calculate the impact on the balance sheet of both simple and more complex derivatives for the specified stress.

Given that this risk can be assessed within the SCR, the need for additional Pillar II requirements should be limited.

About CEA

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