The CEIOPS Public Hearing and Consultative Panel meeting of 11 January 2006
Overview

• General context of the Solvency II Project
• Solutions to major issues for Solvency II
  - Joint submission by the CRO Forum and CEA
• CEA Preliminary Comments on CEIOPS Draft Answers to the Third Wave of the Solvency II Project
• CEA Comments on the importance and challenges of the QIS 1
General context: What are/should be the aims of Solvency II?

• The industry strongly supports a Solvency II framework which aims to achieve the following:
  ➔ “Enable an institution to absorb significant unforeseen losses and gives reasonable assurance to policyholders” (Framework for Consultation on Solvency II)
  ➔ “Give an incentive to the supervised institutions to measure and properly manage their risks” (Framework for Consultation on Solvency II)
  ➔ Contribute to a “better managed and more competitive insurance industry that can better perform its key function of accepting and spreading risk” (Commissioner McCreevy)
  ➔ Encourage a single European market for financial services (European Union Lisbon Strategy 2000)
General context: What are/should be the aims of Solvency II?

- In this context, the following key elements are required to achieve these aims:
  - A coherent risk-based framework
  - Economic Valuations of assets and liabilities
  - Recognition of diversification and risk mitigation
  - A two tier approach with an absolute minimum (MCR), a target (SCR) and a ladder of intervention between the two
  - Internal models should be allowed from the outset in parallel with the Standard Approach
  - Solvency II should be designed for groups as well as stand-alone entities from the outset, incorporating the lead supervisor principle
  - The aim should be for harmonisation in the application of Solvency II (across all pillars) in Europe so that the outcome is dependent on the risks involved and neither on the location nor on the structure of the company
Overview

• General context of the Solvency II Project
• Solutions to major issues for Solvency II
  - Joint submission by the CRO Forum and CEA
• CEA Preliminary Comments on CEIOPS Draft Answers to the Third Wave of the Solvency II Project
• CEA Comments on the importance and challenges of the QIS 1
10 January 2006

Solutions to major issues for Solvency II

Joint submission by the CRO Forum and CEA

Chief Risk Officer Forum
This presentation includes elements of the original responses as well as further comments of the Chief Risk Officer Forum and the Comité Européen des Assurances to CEIOPS-CP-04/05, “Draft Answers to the European Commission on the ‘second wave’ of Calls for Advice in the framework of the Solvency II project.”

Support was provided by Mercer Oliver Wyman in the presentation of the results and conclusions.

Copyright © 2006 Chief Risk Officer Forum, Comité Européen des Assurances

Note that this document supersedes ‘Major Solvency II Issues Joint Submission 20051223 v02’ to correct minor errata.
<table>
<thead>
<tr>
<th>Country</th>
<th>Association</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT – Austria</td>
<td>Verband der Versicherungsunternehmen Österreichs (VVO)</td>
</tr>
<tr>
<td>BE – Belgium</td>
<td>Union Professionnelle des Entreprises d’Assurances (ASSURALIA)</td>
</tr>
<tr>
<td>CH – Switzerland</td>
<td>Association Suisse d’Assurances (ASA/SVY)</td>
</tr>
<tr>
<td>CY – Cyprus</td>
<td>Insurance Association of Cyprus</td>
</tr>
<tr>
<td>CZ – Czech Republic</td>
<td>Česká asociace pojišťovní (ČAP)</td>
</tr>
<tr>
<td>DE – Germany¹</td>
<td>Gesamtverband der Deutschen Versicherungswirtschaft (GDV)</td>
</tr>
<tr>
<td>DK – Denmark</td>
<td>Forsikring &amp; Pension (F&amp;P)</td>
</tr>
<tr>
<td>EE – Estonia</td>
<td>Eesti Kindlustusseltside Liit</td>
</tr>
<tr>
<td>ES – Spain</td>
<td>Unión Española de Entidades Aseguradoras y Reaseguradoras (UNESPA)</td>
</tr>
<tr>
<td>FI – Finland</td>
<td>Suomen Vakuutusyhtiöiden Keskusliitto</td>
</tr>
<tr>
<td>FR – France</td>
<td>Fédération Française des Sociétés d’Assurances (FFSA)</td>
</tr>
<tr>
<td>GR – Greece</td>
<td>Association of Insurance Companies-Greece</td>
</tr>
<tr>
<td>HU – Hungary</td>
<td>Magyar Biztosítók Szövetsége (MABISZ)</td>
</tr>
<tr>
<td>IE – Ireland</td>
<td>The Irish Insurance Federation (IIF)</td>
</tr>
<tr>
<td>IS – Iceland</td>
<td>Samband Íslenskr Tryggingafélaga</td>
</tr>
<tr>
<td>IT – Italy</td>
<td>Associazione Nazionale fra le Imprese Assicuratrici (ANIA)</td>
</tr>
<tr>
<td>LI – Liechtenstein</td>
<td>Liechtensteinischer Versicherungsverband e.V</td>
</tr>
<tr>
<td>LT – Lithuania</td>
<td>Lietuvos draudikų asociacija</td>
</tr>
<tr>
<td>LU – Luxembourg</td>
<td>Association des Compagnies d’Assurances du Grand-Duché de Luxembourg (ACA)</td>
</tr>
<tr>
<td>LV – Latvia</td>
<td>Latvijas Apdrošinatāju Asociācija</td>
</tr>
<tr>
<td>MT – Malta</td>
<td>Malta Insurance Association</td>
</tr>
<tr>
<td>NL – Netherlands</td>
<td>Verbond van Verzekeraars in Nederland (VVN)</td>
</tr>
<tr>
<td>NO – Norway</td>
<td>Finansnæringens Hovedorganisasjon (FNH)</td>
</tr>
<tr>
<td>PL – Poland</td>
<td>Polska Izba Ubezpieczeń (PIU)</td>
</tr>
<tr>
<td>PT – Portugal</td>
<td>Associação Portuguesa de Seguradores</td>
</tr>
<tr>
<td>SE – Sweden</td>
<td>Sveriges Försäkringsförbund</td>
</tr>
<tr>
<td>SI – Slovenia</td>
<td>Slovensko Zavarovalno Združenje (SZZ)</td>
</tr>
<tr>
<td>SK – Slovakia</td>
<td>Slovenská asociácia poistovní</td>
</tr>
<tr>
<td>TR – Turkey</td>
<td>Türkiye Sigorta ve Reasürans Sirketleri Birligi</td>
</tr>
</tbody>
</table>

---

¹ Gesamtverband der Deutschen Versicherungswirtschaft (GDV) did not yet give its final support to the paper “Solutions to major issues for Solvency II – Joint Submission by the CRO Forum and CEA”
Objective: describe our highest priority issues for Solvency II, and the solution for the highest priority issue that we all support on the basis of sound economics and practicality

Rationale for this paper

- We have noted the large quantity of material submitted to CEIOPS, by ourselves and other stakeholders, in response to the “Draft Answers to the European Commission on the ‘second wave’ of Calls for Advice in the framework of the Solvency II project”

- We realise that stakeholders often use different terminology for the same concepts and opinions. To help focus the debate and clarify positions we have prepared this joint submission which covers our position on the **overall framework and the highest priority issue** for Solvency II regarding Pillar I valuation of insurance liabilities, as well as pointing out other high priority issues
  - Detailed technical papers on other high priority issues will subsequently be produced

- While representing different groups or sub-groups of stakeholders we have a common commitment to helping to ensure that **Solvency II is based on sound economic principles** and develops into a workable and appropriate risk-based supervisory system capable of addressing the current and future needs of the European Insurance industry
  - Any other system restrictions or mixed models that increase the regulatory capital burden or inhibit risk mitigation will put the insurance industry at a relative disadvantage to other financial institutions that operate under Basel II

- **The views expressed are supported by** the Chief Risk Officer Forum (CRO Forum) and the Comité Européen des Assurance (CEA)
Executive summary: Overall Framework

- Pillar I Solvency Capital Requirements should be based on a total balance sheet, market-consistent value based approach. This means that:
  - All assets and liabilities are valued based on a market value where one exists and, where not, on projected best estimate cash flows valued using market-consistent techniques\(^1\)
  - Available Solvency Capital is defined as Market Value of Assets minus Market Value of Liabilities (MVL)
  - Solvency Capital Required (SCR) is defined as the value at risk over one year to a 1 in 200 confidence level, taking into account diversification across the risks and risk mitigation in place. In other words, it represents the amount of assets needed on top of technical provisions calculated on a market-consistent basis (and therefore including Best estimate + MVM) to ensure that there will be sufficient assets to cover projected technical provisions (BEL + MVM) in one year’s time in 99.5% of the cases

- The valuation of assets and liabilities and the SCR can be determined either by approved internal model or by a Standard Approach, in either case the core principles above are the same but clearly the Standard Approach will be more approximate and therefore more conservative

- While Pillar I and the SCR will be based on a one-year value based approach, any risks not taken into account in Pillar I should as a separate requirement be taken into account in Pillar II\(^2\)

- All three Pillars should be sufficiently harmonised so that it is the nature of the business and the risks that determines solvency and reporting requirements and not the location of the company

- There should be no prudence included on top of the market value of liabilities to cover the risk that the actual values over time vary from the current market value estimates – it is the purpose of the solvency capital requirement to cover this risk – a mixed approach where some risk is put within the valuation of liabilities or assets and some within the solvency requirement will not work for an industry as complex and varied as the insurance industry and is likely to have a range of unintended and inappropriate consequences including reducing transparency, creating excess capital burden and encouraging solvency arbitrage.
  - We recognise that for regulatory intervention in extreme situations there is a need for absolute legal certainty and prudence. However, we believe these issues are covered by the role of the MCR rather than impacting the valuation of economic liabilities.

- While it is important that the accounting definition of liabilities and that used for solvency are consistent and reconcilable it should be recognised that they may not be the same – accounting considerations should not affect the definition used for solvency calculations

---

1. ‘Market values’ and ‘projected best estimate cash flows using market-consistent techniques’ are each cases of an ‘economic value’ as defined in the attached glossary of terms
2. Note that failure to meet such requirements (should they be necessary), should be tackled firstly by requiring adequate action by the company. Any capital add-ons within Pillar II will need careful design and implementation in European legislation to ensure adequate harmonisation.
Executive summary: Top priority issue discussed in this paper

1. The valuation of insurance liabilities

- Technical provisions\(^1\) for solvency purposes should be set equal to the market-consistent value of liabilities (MVL), including the value of both hedgeable and non-hedgeable risks
- The value of hedgeable risks should be determined by mark-to-market approaches, i.e. where market prices can be observed they should be used; this is conceptually identical to a best estimate plus market value margin (MVM) approach as employed for non-hedgeable risks except that in this case the observed market price already includes the MVM
- The value for non-hedgeable risks is determined by an appropriate mark-to-model approach:
  - For non-hedgeable non-financial risks, liability values are determined as best estimate plus MVM and we recommend a ‘cost of capital’ approach for determining the MVM rather than setting arbitrary confidence interval standards
  - For non-hedgeable financial risks, using appropriate economic methods to extend market prices (e.g. discount rates, volatility surfaces) is also an option in addition to the ‘best estimate plus MVM’ approach
- As long as risk absorption capacity of product features is taken into account, the MVL should not include arbitrary liability floors such as surrender value floors and should not be based on the market values of minimum guaranteed liability cash flows, as this may not appropriately reflect the value of the liabilities\(^2\)
  - If any guarantee floors are required for regulatory purposes, this should be within the MCR or SCR capital requirements
- Additional prudential margins for solvency should be reflected in the MCR and SCR rather than the technical provisions
- The MCR automatically provides a prudence level above the MVL

---

1. Technical provisions refer to the balance sheet items representing the reserves, and can be calculated differently according to the framework e.g. traditional technical provisions include some prudence whereas “economic” technical provisions consist of the MVL (so including risk margins) without inclusion of any further prudence.

2. This discussion on arbitrary floors relates to individual contract-level valuations, where the imposition of minimum values/floors without regard to portfolio effects would significantly overstate the portfolio-level value of the liabilities.
Executive summary: Other priority issues, that will be reviewed in detail at a later date

2. The standard approach
   – Should be based on the same economic principles as an internal model but simplified as far as possible
   – Should incorporate risk mitigation, diversification and other best practice modelling elements; avoid perverse incentives; yet still be practical to apply

3. Diversification
   – Risk concentration contributes to insurer insolvency and diversifying strategies are the basis for sound risk management
   – Ignoring diversification in solvency assessments for companies and groups leads to a material excess capital burden, above what is economically required to meet obligations (even in stress scenarios)
   – Consequently, diversification should be recognised in both the solo and group solvency tests

4. Risk mitigation
   – Should be fully recognised in both Pillar I and Pillar II capital requirements
   – A principles-based approach to admissibility of risk mitigation instruments will ensure that some forms of mitigation are not arbitrarily favoured over others

5. Principle-based and not rule-based
   – e.g. with respect to investment rules, the standard approach and internal model take market and credit risk into account, so there should be no further arbitrary restrictions on investment flexibility (apart from large concentrations akin to the banking rules)

6. Group lead vs. home supervisors
   – In order to keep Solvency II’s original spirit of harmonised and common regulation, the roles and authorities of the group lead and home supervisors should be clarified and role of lead supervisor strengthened to guarantee adequate harmonisation and keep the framework practical and efficient. Some of these changes can be made in advance of Solvency II with the review of the IGD

1. Technical provisions refer to the balance sheet items representing the reserves, and can be calculated differently according to the framework e.g. traditional technical provisions include some prudence whereas “economic” technical provisions consist of the MVL without inclusion of any prudence
Contents

1. Pillar I capital requirements – conceptual overview
2. No prudential margins in technical provisions
3. Valuation of MVL
4. Cost of capital approach for MVMs

Appendix

a) Product examples for proposed MVL calculation
b) Glossary of key terms
Section 1

**Pillar 1 capital requirements – conceptual overview**
This discussion focuses on the capital requirements for Pillar I purposes

- We recognise the need and value of the additional Pillar II requirements on top of Pillar I

- However, Pillar I and Pillar II serve different purposes, and therefore will be treated separately

- Pillar I requirements are currently being considered and will form the basis upon which this paper is written

- Pillar II will be addressed in a later CFA by CEIOPS

---

**Pillar I**

**Financial Resources**

Basic principles:
- Economic value based approach
- Capital requirement over a 1-year time horizon, however includes impact on all future liabilities and therefore represents "fair value"
- Capital calculated to a confidence interval of 99.5% (i.e. 1 in 200 year event)*
- Accounts for diversification effects across risks and risk mitigation

---

**Pillar II**

**Supervisory Review**

Additional requirements:
- Multi-year continuity testing
- Run-off sensitivity analysis over lifetime of the product

---

*This is based on the assumption of a VaR measure. A TailVaR measure would be a lower confidence level
Overview of the Economic Balance Sheet

ASSETS

Available for SCR/MCR

Market value of total assets (MVA)

LIABILITIES

Excess capital

Min. Capital Requirement (MCR)

Market value margin (MVM)

Solvency Capital Requirement (SCR)

Market-consistent value of liabilities (MVL)

Best estimate

Valuation of MVL - focus of this paper

Section Key issues:

1. No inclusion of additional arbitrary prudential margins in technical provisions on top of MVMs
2. Valuation of MVL
3. Cost of Capital approach for MVMs

1. It should be noted that for prices directly inferred from market prices, the price already includes the risk margin (or market value margin)
Section 2

No prudential margins in technical provisions
Technical provisions should consist of the market value of liabilities (MVL) and exclude any additional prudential margins

Possible components of the technical provisions

- **Market-consistent value of liabilities**
  - Based on expected present value of future liability cash flows
  - For hedgeable risks in an efficient market, value determined by mark-to-market approaches, i.e. using observed market prices (which already include a MVM)
  - For non-hedgeable risks, value determined by mark-to-model approaches including a modelled MVM

- **Additional risk margin for prudence**
  - This quantity should be included in the SCR to protect against adverse outcomes

- Includes value of embedded financial obligations, including options and guarantees
- Includes an MVM for non-hedgeable financial and non-financial risks
- Market prices for hedgeable financial and non-financial risks already include a margin over Best Estimate
- Not affected by surrender value floors
- Not based on minimum guaranteed cash flows as this may not appropriately reflect the value of the guarantee and the legally binding policyholder share of profits

*Definition: The Market Value Margin (MVM) is the cost of risk, i.e. risk margin in addition to the best estimate liability (i.e. the expected present value of best estimate future cash flows) required by the market. It is necessary in order to correctly value best estimate cash flows*
Under our proposal, margins for prudence are either absorbed into the MCR / SCR, or kept separate but labelled as capital.

Prudence included in the liabilities

- Required capital: 30
- Technical provisions: 110

Prudence included in the capital

- SCR: 40
- MCR: 15
- Prudence: 10
- Technical provisions (market value of liabilities): 100

Our proposed approach can be reconciled easily to whatever definition of technical provisions is decided on for IFRS accounting purposes.

Definition of SCR: In the context of the Solvency II regime, is the value-at-risk (VaR) measured over one year to a 1 in 200 confidence level taking into account diversification and risk mitigation in place. The SCR may be derived using either an approved internal model or a standard approach, but in both cases it is based on the principles of economic capital and economic value.

Consists of:
1. Liabilities with an easily observable market price
2. Liabilities with an implicit market price requiring detailed modelling
3. Liabilities with no market price for which a MVM must be estimated

Provisions are conservative⁴. Part of the capital is explicit and part is embedded within the provisions. Most static solvency models (e.g. Solvency I, UK FSA non-profit life) are based on current local rules for technical provisions²

Provisions are at the MVL (reflecting economic value). Prudence, if any, in addition to MVM must be set as part of the capital base

¹. Note: these may not necessarily be conservative enough in times of stress as the elements of prudence are by reference to arbitrary features such as discount rate rather than being risk sensitive
². Source: CEA, Solvency Assessment Models Compared, Essential groundwork for the Solvency II project, page 17

Copyright © 2006 Chief Risk Officer Forum, Comité Européen des Assurances
Rationale for proposed inclusion of prudence margins within the MCR / SCR

- Technical provisions should be transparent for harmonisation across the EU, and in line with market (transfer) prices

- Other financial services sectors do not include prudence into the valuation of the liabilities, but rather into the required capital

- As the MCR corresponds to the level of capital below which the regulator is required to take action, the MCR acts as the prudence level desired above MVL to cover against model error, timing error and run-off margin, if appropriate.

- Should CEIOPS desire a legally certain measure that is prudent for regulatory intervention purposes, then this should be addressed within the capital framework but not within the technical provisions
Section 3

Valuation of MVL
For MVL valuation purposes, hedgeable and non-hedgeable risks should be treated differently

### Management options

<table>
<thead>
<tr>
<th>Hedgeable&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Non-Hedgeable&lt;sup&gt;2&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial</strong></td>
<td></td>
</tr>
<tr>
<td>10 year USD, EUR, Yen cash flow or interest rate option</td>
<td>60 year USD, EUR, Yen cash flow or interest rate option</td>
</tr>
<tr>
<td>10 year equity option</td>
<td>15 yr emerging markets cash flow</td>
</tr>
<tr>
<td>Rational lapse behaviour</td>
<td>30 year equity option</td>
</tr>
<tr>
<td><strong>Non-financial</strong></td>
<td></td>
</tr>
<tr>
<td>Screen or exchange traded CAT risks</td>
<td>Most insurance risks, e.g. mortality, property, casualty, etc.</td>
</tr>
<tr>
<td>Actively traded securitised risks</td>
<td>Irrational lapse behaviour</td>
</tr>
</tbody>
</table>

### Sources of exposure

- **Financial**
- **Non-financial**

### Mark-to-market approach
- MVM implicit in observed market prices

### Mark-to-model approach
- Requires calculation of explicit MVM

---

1. A risk that a party can reduce their exposure to by purchasing a hedging instrument or transferring the exposure to a willing, rational, diversified counterparty in an arms’ length transaction under normal business conditions (i.e. securitisation e.g. derivatives, options, futures etc)
2. Risks that cannot be hedged or easily transferred to a third party due to market liquidity or interest
In practice, MVL valuation methods should be tailored to the nature of the risk

Component parts of MVL calculation

**Theory**

- **Market value of Liabilities (MVL)**
  
  \[ \text{MVL} = \text{Best Estimate cash flows} + \text{MVM Hedgeable Financial Risks} + \text{MVM Hedgeable Non-financial Risks} + \text{MVM Non-hedgeable Financial Risks} + \text{MVM Non-hedgeable Non-financial Risks} \]

- **MVL, Hedgeable only**
  
  \[ \text{MVL} = \text{Best Estimate cash flows} \]

- **MVL, Non-hedgeable only**
  
  \[ \text{MVL} = \text{Best Estimate cash flows} + \text{MVM Non-hedgeable Financial Risks} + \text{MVM Non-hedgeable Non-financial Risks} \]

**Practice**

- **MVL, Both hedgeable & non-hedgeable**
  
  \[ \text{MVL} = \text{Best Estimate cash flows} + \text{MVM Non-hedgeable Financial Risks} + \text{MVM Non-hedgeable Non-financial Risks} \]

- **MVL, Neither**
  
  \[ \text{MVL} = \text{Best Estimate cash flows} \]

**Examples**

- One-year investment contract with embedded guarantee
- Auto insurance contract or One-year term life insurance
- Equity-indexed annuity
- Guaranteed investment contract

In the next section we propose a Cost of Capital approach for the calculation of MVMs for Non-hedgeable Non-financial risks.
Section 4

Cost of capital approach for MVMs
Where an explicit MVM is applicable\(^1\), we believe that arbitrary ‘confidence intervals’ is not the best available valuation approach.

**Market Value Margin (MVM):** By definition, the cost of risk, i.e. risk margin in addition to the best estimate liability (i.e. the expected present value of best estimate future cash flows) required by the market.

**Additional risk margin for prudence:** This quantity may be positive, negative, or zero (shown here as positive).
- No reason to believe that the “confidence interval” value is market consistent.
- Underlying volatility obscured.
- Risk-taking obscured.

---

1. An explicit MVM is not applicable for hedgeable liabilities, which are always valued at market price. The MVM is already included in the market price and no further adjustment is necessary. An explicit MVM is only applicable for non-hedgeable non-financial risks and (possibly) non-hedgeable financial risks.
Consequently, other ways of estimating the market value margin must be considered

- We are in agreement that using 75% or 90% confidence levels cannot be assumed to provide an appropriate estimate for the Market Value Margin across all insurance liabilities and that other methods should be considered.

- A good alternative is the cost of capital (CoC) approach, already adopted by the Swiss in the Swiss Solvency Test. The CoC merits further investigation before fixing the final approach for Solvency II.

- The cost of capital approach has a number of theoretical and practical advantages over a confidence level approach e.g.
  - Cost of capital approach is directly linked to a view of what a rational investor would demand in excess of best estimate valuation.
  - Cost of Capital approach is in fact easier to apply (unlike confidence level approach it does not require stochastic modelling).

- There are various methodological options which would need to be decided, including the definition of capital to be used and the rate or cost of capital to apply.
  - A final choice from among these options requires additional work and we welcome the opportunity to cooperate with CEIOPS and national regulators on this question.
Proposed solution

We propose that a ‘cost of capital’ approach be used to estimate the market value margin

- When market prices are available (for hedgeable risks), the MVM is already included in the market price and does not need to be estimated
- The cost of capital approach assumes that a company in financial distress at the end of its (one-year) capitalisation horizon might need to transfer its remaining assets and liabilities to another insurer, an industry pool vehicle, or into a separate run-off entity
- For non-hedgeable risks (including non-financial risks such as mortality and financial risks such as unavoidable asset-liability mismatch) the receiving entity cannot, by definition, construct an asset portfolio that perfectly replicates the liability cash flows
- Consequently, capital must be held to protect against adverse outcomes
- The entity will require a return on the capital held. The cost of the future capital amounts to be held will form part of the price of the liabilities at the point of transfer
- The market value margin is defined as the cost of risk, i.e. A risk margin in addition to the best estimate liability (i.e. the expected present value of best estimate future cashflows) required by the market. It is estimated by the present value of the cost of future capital requirements for non-hedgeable risks and is already included in observed market prices for hedgeable risks.
- The market-consistent value of liabilities will be defined as expected present value of best estimate future liability cash flows, plus this market value margin
- The elements to be determined are therefore the best estimate liability value, the path-values of future solvency capital requirements, and the appropriate cost of capital charge
- A caveat can be made that a simplified approach can be used as an appropriate proxy for small businesses where calculation and projection of Economic Capital is difficult or impractical
The Cost of Capital approach has been introduced in the Swiss Solvency Test (SST), where it is applied by all insurers across the range of measurement capabilities.

Swiss Solvency Test framework

- The SST is based on a market value of liabilities including a risk margin calculated using a CoC approach.
- The risk margin is based on the cost of holding the **minimum required capital** assuming that the book is being run off and that the assets have been gradually switched in order to reduce the risks in the book as far as possible.¹
- This is intended to represent the cost a third party would incur when purchasing the book in case of insolvency.
- In the SST itself: “the risk margin is calculated as being the discounted value of the future costs of maintaining the SST target capital level if the insurance portfolio was being run off by a third party. For the field test 2004, cost of capital was set at 6%”²

Implementation progress

- Initiated in 2003
- 2004: initial field test
- Summer 2005: new field test involving 45 insurance companies, including small companies
- The SST will be introduced in conjunction with the revised Insurance Supervision Act (ISL) planned for 1 January 2006 (a transition period for adjusting to the SST will also feature)³

---

¹ Source: CEA and MOW ‘Solvency Assessment Models Compared: Essential groundwork for the Solvency II project’, 2005, page 17
Appendix A

Product examples for proposed MVL calculation
Example 1: Life products without options or guarantees

Illustration of concept

<table>
<thead>
<tr>
<th>Liability cash flow</th>
<th>=</th>
<th>Hedgeable financial component (incl. MVM)</th>
<th>+</th>
<th>MVM Non-hedgeable non-financial component</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>=</td>
<td>€ 9,524</td>
<td>+</td>
<td>€ 134</td>
</tr>
</tbody>
</table>

Practical example: Term life assurance

- 1,000 identical pure protection policies
- All policies have a remaining term of exactly one year, starting today
- Each pays a benefit of €1,000 at the end of the year if death occurs during the year, and nothing otherwise
- The probability of death for all assured lives is 1%
- The swap rate is 5% per annum
- The liability cash flows can be decomposed into:
  - Expected PV of future liability cash flows (including a MVM for hedgeable financial component (FC)) with a fixed payout of $1,000 x 1% x €1,000 = €10,000 in one year
  - Additional MVM for the non-hedgeable non-financial component (NFC) with an expected value of zero (when exactly 10 deaths occur), a positive (negative) value with more (fewer) than 10 deaths and a diversified economic capital requirement of €3,360
- These components are valued separately
  - FC: €10,000 in one year, valued today at €10,000 / (1.05) = €9,524
  - NFC: CoC x Capital = 4% x €3,360 = €134

Source: ING Corporate Insurance Risk Management, Mercer Oliver Wyman. Tax effects not included in example

1. Frictional Cost of Capital assumption of 4% to cover agency costs and cost of double taxation. Further study is required.
Example 2: Savings products with options and guarantees

Illustration of concept

Liability cash flow = Guaranteed liabilities = Best Estimate and implicit MVM + Hedgeable financial component (incl. MVM) + MVM Non-hedgeable non-financial component

- Value = € 10,651 + € 0

Practical example: One-year investment contract

- A € 10,000 single-premium one-year investment contract that pays the rate of increase on a major stock market index, subject to a minimum guaranteed return of 2%. Volatility of stock index = 20%.

- There is a lapse clause that allows investors to withdraw at any time before contract maturity, but they receive only a return of their initial premium should they do so.

- The liability can be decomposed into:
  - Expected PV of future liability cash flows (including a MVM for hedgeable financial component (FC)), including
    - A guaranteed liability of 102% of the initial premium
    - A call option held by the investor on the underlying stock index, with an exercise price equal to 102% of the current index value
  - No additional MVM for the non-hedgeable non-financial component with an expected value of zero (since no early withdrawals are expected), as there is no economic capital requirement.

- These components are valued separately
  - FC: € 10,200/(1.05) + Call option = € 9,715 + € 936
  - NFC: 0

Source: ING Corporate Insurance Risk Management, Mercer Oliver Wyman. Tax effects not included in example

Copyright © 2006 Chief Risk Officer Forum, Comité Européen des Assurances
Example 3: P&C products without options or guarantees

Illustration of concept

\[
\text{Liability cash flow} = \text{Hedgeable financial component (incl. MVM)} + \text{MVM Non-hedgeable non-financial component}
\]

\[
\text{Value} = € 6,831,301 + € 80,000
\]

Practical example: Retail motor insurance

- A small retail motor portfolio with total premium of € 10 MM per annum that has not been reinsured
- Expected claims on the book are 70% of earned premiums. It is assumed that claims are incurred on average halfway through the year and there are no reporting or settlement delays
- The liability cash flows can be decomposed into:
  - Expected PV of future liability cashflows (including a MVM for hedgeable financial component (FC)), a fixed payout of € 10 MM x 70% = € 7 MM in six months’ time
  - Additional MVM for the non-hedgeable non-financial component (NFC) with an expected value of zero (when the claims ratio is exactly 70%) and a positive (negative) value with a claims ratio of more (less) than 70%; and a diversified economic capital requirement of 20% of premium
- These components are valued separately
  - FC: € 7 MM in six months, valued today at € 7 MM / SQRT(1.05) = € 6,831,301
  - NFC: CoC x Capital = 4% x € 2 MM = € 80,000

Source: ING Corporate Insurance Risk Management, Mercer Oliver Wyman. Tax effects not included in example
Example 4: Annuity products

Illustration of concept

Liability cash flow = Fixed payouts + Explicit MVM

Non-hedgeable financial component (incl. MVM) + MVM Non-hedgeable non-financial component

Value = € 2,500,000 + € 4,000

Practical example: Annuity in payment

- An annuity pays an income stream of € 10,000 per month for the rest of a pensioner’s life
- The pensioner’s remaining life expectancy is greater than the maximum term for which there is a well-defined yield curve, but the company has ‘completed the market’ by producing a set of yields which it believes are applicable at longer terms and are consistent with all current market information
- The company has projected that the diversified economic capital requirements in future time periods in respect of non-hedgeable longevity risk have a PV of € 100,000
- The liability cash flows can be decomposed into:
  - Expected PV of future liability cashflows (including a MVM for hedgeable and non-hedgeable financial components (FC): the PV of future expected payments, using the mark-to-market and mark-to-model yield curve, is 250 times the monthly pension
  - Additional MVM for the non-hedgeable non-financial component (NFC) with an expected value of zero (when annuitant mortality is as expected) and a positive (negative) value with lighter (heavier) annuitant mortality
- These components are valued separately
  - FC: € 10,000 x 250 = € 2.5 MM
  - NFC: CoC x Capital = 4% x € 100,000 = € 4,000

Source: ING Corporate Insurance Risk Management, Mercer Oliver Wyman. Tax effects not included in example

Copyright © 2006 Chief Risk Officer Forum, Comité Européen des Assurances

Solutions to major issues for Solvency II
Example 4: Annuity products cont’d

- Multi-year products require the calculation and projection of Economic Capital for the MVM (or NFC) calculation

**Illustration of concept**

Economic Capital

MVM = PV of Economic Capital * CoC

**Practical example: EC projection for Annuity product**

- For multi-year products, EC run-off is estimated
- Longevity risk beyond the first year is estimated by shocking the liabilities under the worst case mortality shock at every point in the future such that an EC profile is calculated
- Assuming the pensioner’s expected cash flows have a 10-year duration then:
  - EC₁ = 20,000
  - EC₂ = 18,000
  - …
  - EC₁₀ = 2,000
- Such that the PV of EC = €100,000
Appendix B

Glossary of key terms

**This glossary was prepared for the purpose of supporting this joint paper and the intention is to support the wider CEA - Groupe Consultatif glossary project after careful review and discussion**
## Glossary of key terms (1 of 4)

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approved internal model</td>
<td>An <em>internal model</em> that may be used to fully or partially replace the <em>standard approach</em> to the <em>Solvency Capital Requirement (SCR)</em> when supervisory approval is granted. Both quantitative and qualitative requirements set by the regulator have to be met for an approved internal model.</td>
</tr>
<tr>
<td>Available solvency capital</td>
<td>The market value of assets minus the <em>market value of liabilities</em></td>
</tr>
<tr>
<td>Best estimate liabilities</td>
<td>The expected liabilities, as represented by the arithmetic mean of a distribution, projected over the run-off period, taking into account all up-to-date financial market and actuarial information. Best estimate values do not include any <em>risk margins</em> whatsoever.</td>
</tr>
<tr>
<td>Confidence level</td>
<td>The critical point on the probability distribution of liability amounts (or some other quantity) before which the required capital is adequate to cover losses</td>
</tr>
<tr>
<td>Cost of capital (CoC) approach</td>
<td>An approach by which the <em>market value margin (MVM)</em> is determined, by applying a cost of capital charge to the present value of all future <em>solvency capital requirements</em> in order to run the liabilities off fully</td>
</tr>
<tr>
<td>Economic capital</td>
<td>The amount of <em>market-consistently valued assets</em> that an insurer judges it should hold in excess of <em>market-consistently valued liabilities</em> to ensure a non-negative economic surplus at a pre-determined time horizon and <em>confidence level</em></td>
</tr>
<tr>
<td>Economic value</td>
<td>The value of asset or liability cash flows, derived in such a way as to be consistent with current market prices where they are available or using market consistent principles, methodologies and parameters.</td>
</tr>
</tbody>
</table>

*NOTE: Italicised terms are defined elsewhere in the glossary*
## Glossary of key terms (2 of 4)

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedgeable risks</td>
<td>A risk that a party can reduce their exposure to by purchasing a hedging instrument or transferring the exposure to a willing, rational, diversified counterparty in an arms’ length transaction under normal business conditions (i.e. securitisation e.g. derivatives, options, futures etc)</td>
</tr>
<tr>
<td>Internal model</td>
<td>Model developed by an insurer to determine the capital requirement on the basis of the company specific risk profile.</td>
</tr>
<tr>
<td>Market-consistent value</td>
<td>The market-consistent value of assets is its observed market value when available (mark-to-market). If such values are not available, a market-consistent value is determined by examining comparable market values, taking account of liquidity and other product-specific features, or on a model basis (mark-to-model). In particular, market-consistent means that up-to-date values are used for all parameters and that the valuation replicates the market prices of the calibration assets within an acceptable tolerance. The market consistent value of liabilities is the sum of the discounted best estimate and the market value margin.</td>
</tr>
<tr>
<td>Market value of liabilities (MVL)</td>
<td>The market-consistent value at which the liabilities could be transferred to a willing, rational, diversified counterparty in an arms’ length transaction under normal business conditions. The MVL consists of: 1. The expected present value of future liability cashflows (which implicitly includes the MVM for hedgeable risks), and 2. An additional, explicit cost of risk for non-hedgeable risk (calculated as the MVM for non-hedgeable risks)</td>
</tr>
</tbody>
</table>

NOTE: Italicised terms are defined elsewhere in the glossary
## Glossary of key terms (3 of 4)

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value margin (MVM)</td>
<td>The cost of risk, i.e. <em>risk margin</em> in addition to the <em>best estimate</em> liability (i.e. the expected present value of <em>best estimate</em> future cash flows) required by the market.</td>
</tr>
<tr>
<td>Minimum capital requirement (MCR)</td>
<td>The capital level representing the final threshold that could trigger ultimate supervisory measures in the event that it is breached.</td>
</tr>
<tr>
<td>Non-hedgeable risks</td>
<td>Risks that cannot be hedged or easily transferred to a third party due to market liquidity or interest.</td>
</tr>
<tr>
<td>Risk</td>
<td>Potential of a deviation away from expectations, typically involving earnings or value in financial services.</td>
</tr>
<tr>
<td>Risk-free rate</td>
<td>Theoretical interest rate at which an investment may earn interest without incurring any risk.</td>
</tr>
<tr>
<td>Risk margin</td>
<td>A generic term, representing a buffer above discounted <em>best estimate</em> cash flows. A risk margin may be used for various reasons, e.g. to protect against worse than expected outcomes. One case of a risk margin is a <em>market value margin (MVM)</em>; in the case of the MVM it is calculated using <em>economic valuation</em> techniques.</td>
</tr>
<tr>
<td>Solvency capital requirement (SCR)</td>
<td>In the context of the Solvency II regime, is the <em>value-at-risk (VaR)</em> measured over one year to a 1 in 200 <em>confidence level</em> taking into account diversification and risk mitigation in place. The SCR may be derived using either an <em>approved internal model</em> or a <em>standard approach</em>, but in both cases it is based on the principles of <em>economic capital</em> and <em>economic value</em>.</td>
</tr>
</tbody>
</table>

*NOTE: Italicised terms are defined elsewhere in the glossary*
## Glossary of key terms (4 of 4)

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard approach</td>
<td>In the context of the Solvency II regime, a risk-based model prescribed by the regulator for generating a capital requirement</td>
</tr>
<tr>
<td>Tail Value-at Risk (TailVaR)</td>
<td>Expresses the expected (i.e. arithmetic average) size of the loss if it exceeds the Value-at-Risk threshold</td>
</tr>
<tr>
<td>Value-at-Risk (VaR)</td>
<td>The threshold value that losses to a certain confidence level (e.g. in 99% of cases), would not exceed</td>
</tr>
</tbody>
</table>

NOTE: Italicised terms are defined elsewhere in the glossary
Overview

• General context of the Solvency II Project
• Solutions to major issues for Solvency II
  - Joint submission by the CRO Forum and CEA
• CEA Preliminary Comments on CEIOPS Draft Answers to the Third Wave of the Solvency II Project
• CEA Comments on the importance and challenges of the QIS 1
CEA Preliminary Comments on CEIOPS Draft Answers to the Third Wave of the Solvency II Project
11 January 2006

Comité Européen des Assurances

Note that the views expressed here are consistent with the Joint Paper ‘Solutions to major issues for Solvency II-joint submission by the CRO Forum and CEA’. Given time constraints, the views provided here are provisional and we expect these views to be further developed in our final submission on Wave III.
CFA 19: Eligible elements to cover the capital requirements

• Eligible elements of capital cannot be considered in isolation and must be considered in the context of the overall Solvency framework
  ➔ The CEA strongly supports a Solvency framework based on an economic approach
  ➔ Under an economic approach, the capital requirements are calculated based on a total balance sheet approach taking into account the risks of the assets and liabilities and their interactions
  ➔ Capital requirements are based on the value of assets required in excess of the economic value of liabilities which would be needed to cover policyholder obligations following a 1 in 200 event
  ➔ In such a system, prudence in the technical provisions will have no impact as the capital requirement targets economic liabilities without allowance for prudence and any prudence is recognised as part of the available capital.
CFA 19: Eligible elements to cover the capital requirements

• The eligible elements to cover the capital requirements must be consistent with the economic approach previously described
  ➔ For example, unrealised gains and hidden reserves should be treated consistently in the value of assets, liabilities and available capital

• The underlying principle for the eligible elements should be the economic ability to absorb risk when required (as indicated in the SCR calculation)

• The details of the mechanism to be used to derive the eligible elements (e.g. prudential filters based on the accounting framework as in §19.22 and §19.139) is still under discussion but we note that any such mechanism must be fundamentally consistent with the underlying economic approach.
CFA 19: Eligible elements to cover the capital requirements

• The CEA supports the alignment of banking and insurance rules where the rules are economically justified and appropriate for insurance. This might include:
  ➔ Recognition of recent financial innovations for example hybrid capital and deeply subordinated debt
    ⇧ The differences in the treatment of deeply subordinated debt between banking and insurance has been already highlighted in CP12
    ⇧ We note that onerous limitations on the structure of hybrid capital (for example the elimination of step ups discussed in §19.45) would compromise the ability of the company to raise capital at favourable prices
  ➔ There should only be limits on the eligible elements where these can be economically justified (although the needs and details of any such limits are still to be discussed)
    ⇧ Limits cannot be based on arbitrary levels
    ⇧ We challenge the assumption that there necessarily needs to be a difference between the company and supervisory assessment of eligible capital (§19.167) as both should be based on an economic approach
CFA 19: Eligible elements to cover the capital requirements

• In relation to the Suggested Categorisation of capital elements (§19.46 to §19.60) we make the following observations:
  ➔ Under an economic approach, the value of the policyholder liabilities will allow for future profit sharing and the cost of any embedded options and guarantees
  ➔ This approach has implications for calculating for the capital requirements:
    ⇒ In deriving the capital requirements, the ability for the liabilities to absorb potential risks in adverse circumstance must automatically be taken into account
    ⇒ In such a case, we would expect that any unallocated policyholder assets (e.g. orphan estates) will be eligible to meet the capital requirements of the fund
  ➔ In many with profit funds, shareholders are entitled to a share of the distributed surplus. This shareholder share should be included as an eligible element of capital providing that it can be explicitly quantified
CFA 19: Eligible elements to cover the capital requirements

<table>
<thead>
<tr>
<th></th>
<th>Base</th>
<th>Stressed</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value of assets</td>
<td>1000</td>
<td>800</td>
<td>-200</td>
</tr>
<tr>
<td>Policyholder Guaranteed Benefits</td>
<td>500</td>
<td>500</td>
<td>0</td>
</tr>
<tr>
<td>Policyholder Future Profit sharing (Variable)</td>
<td>450</td>
<td>320</td>
<td>-130</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>950</td>
<td>820</td>
<td>-130</td>
</tr>
<tr>
<td>Net Economic Value</td>
<td>50</td>
<td>-20</td>
<td>-70</td>
</tr>
</tbody>
</table>

- In this simple example, the reduction in the value of assets of 200 is transmitted to both the liabilities (130) and the net economic value (70).
- In calculating the risk absorbing ability of the liabilities in stressed circumstances we would take into account any reinsurance hedge or other risk mitigation that might be in place.
- The reduction in net economic value of 70 only requires an additional 20 to cover the capital requirements as the starting net economic value is 50.
  - The additional 20 may be met by a combination of pure equity, quasi or hybrid equity and other approved instruments.
CFA 19: Eligible elements to cover the capital requirements

- Further consideration is also required on the “tier” structure described (§19.49 to §19.59). However we note:

  ➔ Any separation of eligible capital into different categories must be based on the economic ability to absorb risk when required (although any such categorisation is still to be discussed)
  ⇒ A “cut and paste” of the banking requirements will not be acceptable

  ➔ The process to be applied for items which may require prior supervisory approval (“so called tier 3”) needs to be open, transparent and consistent across Europe
  ⇒ Supervisors should not consider such discretionary powers as a means to override other elements of the Solvency system.
CFA 19: Eligible elements to cover the capital requirements

- The CEA believe that diversification of risk is a key component of risk management of an insurance company and **all** forms of diversification including group level diversification should be included as part of a Solvency II framework.
  - The CEA supports the work performed by the CRO Forum in developing its core principles in relation to diversification in its document “A framework for incorporating diversification in the solvency assessment of insurers”.
- One possible mechanism for group level diversification is to increase the available group capital support at the solo entity level (§19.109).
  - This option requires further investigation but appears to have certain desirable features and provides a workable, pragmatic and supervisable solution.
  - We note that in the current directives, uncalled capital is already allowed and so, the downstreaming of the group support to the individual entities (§19.160) simply represents a refinement to current practice.
- CEIOPS suggests that this contingent capital should be categorised as “Tier 3” (§19.57).
  - To the extent that such capital requires supervisory approval, the supervisory approval process should be transparent, economically based and harmonised.
  - We also believe that this capital support should reflect a higher quality if certain criteria can be met, for example, formalised agreements for capital support from a highly rated financially robust parent company.
CFA 20: Co-operation between supervisory authorities

• In general, the CEA support the concept of co-operation between supervisory authorities as well as the intended resulting convergence of national supervisory working methods.

• The CEA strongly believes that for insurance groups the lead supervisor should form the **cornerstone** of the supervisory system.
  
  ➔ The CEA supports the view that for every insurance group a single lead supervisor is appointed. This lead supervisor represents a single point of contact for the insurance group and will be responsible for amongst other things, supervising group solvency, approval of internal models and assessing group level diversification benefits and potential reallocation to the solo entities.

  ➔ Care should be taken to ensure that there is no duplication of effort between group and local supervisors and that there are systems in place to resolve any disputes arising.
CFA 20: Co-operation between supervisory authorities

- Areas that are likely to require supervisory co-operation include approval of internal models, allowance for diversification and capital allocation within a group. To this end:
  - CEIOPS members should be encouraged to start working with their industry as soon as possible to acclimatise and prepare for supervision with internal models
  - Supervisors develop a central resource of European expertise so as to facilitate an efficient model approval process
    - This might include a database of “pre approved” modelling techniques and methods which could be fast tracked for approval
    - This would be particularly helpful for jurisdictions where modelling techniques and supervisory knowledge are not yet well developed
  - Care is required to ensure that the co-ordination of input from local supervisors does not impede an efficient process for model approval
  - It would not be acceptable if decisions approved by the lead supervisor are de facto overridden by additional capital requirements under Pillar 2 set by local regulators
  - We will provide comments on the guidelines to facilitate co-operation between group and solo supervisors when these become available.
CFA 21: Supervisory Reporting and Public Disclosure

• The details of supervisory reporting and public disclosure are still to be considered. We have therefore limited our response to high level comments:
  ➔ It is possible that the economic value of assets and liabilities used for Solvency purposes may be different to the accounting values
    ⇒ In such a case, management should be able to reconcile the values of assets and liabilities used for solvency purposes to those used for accounting purposes
  ➔ The supervisory reporting regime should allow for a smooth evolution as companies move from a standard approach to partial models and finally to internal models.
  ➔ In terms of public disclosure:
    ⇒ We expect public disclosure will be at a suitably aggregate level
    ⇒ Disclosure requirements would exclude commercially sensitive information
    ⇒ We expect the confidentiality of interaction between supervisor and insurance entity to be respected.
CFA 22: Procyclicality

- In many countries, the insurance industry comprises a sufficiently influential position in both the financial services sector and the wider economy so that the impact of procyclicality will be a concern.
- However we believe that there are some mechanisms within the new solvency framework which can help mitigate the potential impact:
  - An economic risk sensitive approach for Solvency II will take into account a number of risks (plus associated risk mitigation and diversification impacts) which are not currently part of Solvency I.
  - A solvency framework based on an economic approach will encourage good risk management.
    - This focus on risk management should in the longer term result in companies adjusting their product offering / risk retention where the value added is inconsistent with the capital required.
  - Not all companies will operate at the minimum required capital level.
    - Companies may have own internal objectives for example targeting a particular rating. As a result, not all companies will necessarily be in danger of regulatory breach at the same point.
CFA 22: Procyclicality

• Other mechanism that might reduce the impact of procyclicality in the new system include:
  ➔ Using a two tier approach (with the MCR and SCR) and a range of increasing regulatory intervention between these tiers
    ⇒ This avoids “cliff edge” requirements while allowing timely supervisory interaction commensurate to the situation.

• For the system to function sufficiently well, flexibility and discretion will be required by supervisors when intervening between the SCR and MCR
  ➔ Guidelines as to the intended supervisory actions is helpful for companies to understand the consequences of supervisory breach. However, it is equally important for supervisors to understand the reason for the breach
    ⇒ This requires dialogue with the companies and should allow supervisors to identify one-time rare events or short-lived fluctuations that require special consideration.
  ➔ We do not however support any intervention level in excess of the SCR

• The risks of procyclicality can increase if companies do not follow an economic approach (for example companies may be forced to de-risk much earlier than economically justified if forced to target arbitrary levels of prudence)
CFA 23: Small Undertakings

• The CEA believe that differential treatment of companies should be based on levels of risk and not only on size
  ➔ We would support the current exemption regime to the extent that this is based on underlying risk factors, for example, undertakings which can demonstrate no risk such as pooling organisations should be exempted from the Directive
  ➔ For other lower risk businesses, lighter requirements in the context of a risk based approach may be appropriate

• We do not believe that smaller companies should be exempted from the Directive based solely on premium income
  ➔ Premium income by itself is not necessarily an indicator of the risk profile
  ➔ Exempting companies from the directive in favour of domestic standards is not consistent with the aim of European harmonisation. We note that the exemptions in the current legislation are not applied consistently across Europe.
  ➔ As a result, the CEA believe the Solvency II framework should be applicable for all market segments, including small undertakings (with appropriate lighter requirements for companies which can demonstrate lower risk).
CFA 23: Small Undertakings

• With regard to the lighter requirements previously discussed:
  ➔ We refer to the principle of proportionality where companies with lower risk would be subject to ‘same principles, different execution’
    ⇒ To this end, some high level principles elaborating on the concept of proportionate regulation would be welcome
  ➔ Process of demonstrating that lighter requirements are appropriate should be kept as simple as possible
  ➔ Lighter requirements should ensure that the recognition of risk transfer is not compromised as this is often very important to smaller companies
  ➔ Risk reporting based on an economic approach should be aligned with good management practices and therefore should not create undue administrative burden.
Overview

• General context of the Solvency II Project
• Solutions to major issues for Solvency II
  - Joint submission by the CRO Forum and CEA
• CEA Preliminary Comments on CEIOPS Draft Answers to the Third Wave of the Solvency II Project
• CEA Comments on the importance and challenges of the QIS 1
CEA Comments on the Importance and Challenges of the QIS 1

• CEA has strongly encouraged industry to take part in the QIS 1
• However, the CEA would like to highlight the **challenges** facing firms in responding:
  ➔ New data being requested in new formats
  ➔ Little guidance on methodological issues such as how to apply a confidence approach to mortality risk
  ➔ Time pressure with simultaneous year-end reporting requirements and the impact of major events such as the Katrina hurricane
  ➔ The often required formal process of internal review and sign-off has been made more difficult by the Christmas holiday period
• **Key messages:**
  ➔ The industry asks for support in **encouraging supervisors to work with their firms where there are difficulties in meeting the QIS 1 deadline** (i.e. flexibility as regards the deadline)
  ➔ Focus was only on liabilities therefore the fact that changes in asset value may match any changes in liabilities has been ignored, leading to risk of incorrect conclusions to be drawn from the results. The industry is **keen to discuss with CEIOPS the initial results before publication, to assist in their interpretation and to help understand their significance.**
  ➔ The industry is asking to be **involved in developing and preparing for QIS 2**