Chief Risk Officer Forum

16 January 2007

Henrik Bjerre-Nielsen
Chairman
Committee of European Insurance and Occupational Pension Supervisors

Dear Mr Chairman,

CRO Forum comments on Consultation Paper no. 16 "Pillar II issues relevant for reinsurance"

Please find attached the CRO Forum´s comments on CEIOPS Consultation Paper no. 16. We agree with CEIOPS that the discussion about the treatment of third country reinsurers under the Solvency II framework needs further in-depth analysis and consideration. We welcome that CEIOPS considers its advice as being preliminary and we would encourage CEIOPS and the EU Commission to enter into an open dialogue with the reinsurance industry about the treatment of third country reinsurers under the Solvency II framework.

The discussion currently is somewhat opaque because reinsurance has not been supervised at all until the adoption of the Reinsurance Directive (RID) back in 2005. As of today, most EU Member States have not completely implemented major parts of the RID into national law. In particular, Art. 49 RID that deals with the treatment of third country reinsurers, has not been implemented in Member States. Therefore, there are currently no rules in place regarding the treatment of third country reinsurers.

As the reinsurance industry truly is an international business, the treatment of third country reinsurers is highly important. This is also true for third country reinsurers that intend to sell reinsurance cover in the EU on a cross border basis. The way the EU will treat third country reinsurers will inevitably have an impact on how EU reinsurers are being treated abroad. This interdependency is crucial for the success of every reinsurer operating internationally. On the other hand, parallel to the goals of Solvency II like in the EU, lawmakers need to ensure a level playing field between reinsurers from different jurisdictions. In particular, there should be no competitive disadvantages for EU reinsurers.

We have included detailed comments to the draft advice in the attached Annex. These comments are based on various assumptions taking into account national, European and Worldwide developments. The CRO Forum does not consider these considerations as being an idea that could instantly be implemented. Instead, they should serve as a starting point for a comprehensive discussion about the future treatment of third country reinsurers in the EU. The CRO Forum will be happy to contribute further to this discussion.

Yours sincerely

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Annex: Detailed comments to CEIOPS Consultation Paper 16 "Pillar II Issues relevant for reinsurance"

CP 16 paragraph	CRO Forum response
12. (Second bullet point): • While the direct insurer assesses directly the risks that it is going to underwrite, the reinsurer relies on data and information supplied by the direct insurer, on the basis of "utmost good faith";	While the point made is correct no negative conclusion, e.g. regarding modelling or quality of business, should be drawn from this fact. Reinsurance is different from direct insurance and professional reinsurers have learned to deal with the differences and how to compensate for possible lack of closeness to the ultimate insured.
12. (Fourth bullet point): • Reinsurance operating results are potentially more volatile than those of direct insurers;	The CRO Forum wonders about what this statement intends to express. As we recall it was already refuted during the process to develop the (Fast track) Reinsurance Directive. A direct insurer or a reinsurer of same size and managed at the same level of risk appetite and tolerance will exhibit similar volatility of results. There are many different business models and management styles among reinsurers (and insurers). The goal of Solvency II has to be to identify and assess these differences by a rational, risk based, realistic and economic approach. Such an approach has to reveal e.g. life insurers with large asset liability mismatches as well as undiversified reinsurers with large risk concentrations, both possibly exhibiting "volatile results", whatever this may mean.
12. (Last bullet point): • Generally, internationally active reinsurers are assessed by at least one rating agency; supervisors should seek to benefit from information by rating agencies.	The CRO Forum supports the sharing of information between rating agencies and supervisors in both directions. Under Solvency II, it is quite likely that supervisors that audit a reinsurer's internal model from the perspective of the "use test" will gain a far greater insight into the reinsurer's risk management practices relative to a rating agency that can only afford to conduct a rather superficial review of the reinsurer's internal model and risk management practices. The CRO Forum considers that supervisory risk management assessments (esp. internal model audits) will be shared with rating agencies, in the spirit of increased transparency and efficiency. It would probably be beneficial for CRO Forum member companies if they would not be required to undergo multiple audits from numerous constituencies. At present, some Member States prevent the sharing of similar assessments with third parties.

CP 16 paragraph	CRO Forum response
27. While recognising the intentions behind these provisions in the RID in terms of the liberalisation of reinsurance services, it is difficult to see how they can be implemented in practice in respect of major third country markets, where insurance supervision is for example a State prerogative. Nevertheless, the European Commission has produced draft guidance that equivalence assessments - and compensating measures where sub equivalence is found – are required for third country reinsurance that has been sold even on a cross-border services basis.	At the present time, CEIOPS advice has regard to the intentions behind Art. 50 of the Reinsurance Directive (RID) for Agreements with Third Countries, but does not mirror those intentions because of a reluctance to proceed this way where Third Country insurance supervision is currently a State prerogative. By way of background, Art. 50 of the RID reads : Paragraph 1: "The Commission may submit proposals to the Council for the negotiation of agreements with one or more third countries regarding the means of exercising supervision over ... (a) reinsurance undertakings which have their head offices situated in a third country, and conduct reinsurance business in the Community, and (b) reinsurance undertakings which have their head offices in the Community and conduct reinsurance business in the territory of a third country" Paragraph 2: "The agreements ... shall in particular seek to ensure under conditions of equivalence of prudential regulation, effective market access for reinsurance undertakings in the territory of each contracting party and **provide for mutual recognition of supervisory rules and practices on reinsurance**". In short, CEIOPS' proposal does not provide for mutual recognition of Third Country supervisory rules and practices where supervision is State based as opposed to being Federal based. Whilst respecting the need to err on a cautious side, we see considerable potential future disadvantages with this approach (see comment regarding CEIOPS draft advice in Paragraph 44 below).
b. (preceding 28): What equivalence procedure should apply in relation to group supervision in the situations described in paragraph 4c above, second and third bullet point ?; i.e.	The CRO Forum's 2005 Benchmarking Study for the Admissibility of Internal Models (refer study titled "Principles for Regulatory Admissibility of Internal Models, published by the CRO Forum 10 June 2005) provides a valuable reference point for making such assessments regardless of whether the reinsurer is a European or a Third Country reinsurer. The principles that were developed by the

CP 16 paragraph	CRO Forum response
• reliance on assessments of third country supervisory regimes in the context of “advanced approaches” (i.e. internal models), both with respect to their implementation of a similar regime to Solvency II and the review validation work surrounding actual implementation; and • equivalence assessments of third country supervisory regimes for a reinsurance subsidiary based in a third country forming part of a group headed by a company in the EU.	CRO Forum, being risk based, apply to global (re)insurance groups irrespective of their domicile. It would not be unreasonable to expect that reinsurers that wanted to provide “certainty” of capital relief for their cedants in cross border territories, be required to have an internal model that can be audited and assessed against the benchmarking requirements outlined in the CRO Forum paper. Such models would also need to satisfy the “use test”, which in our view should be a central part of the equivalence assessment. The advantage of this approach is that the assessment of equivalence could incorporate also a more objective/quantitative element related to how economic financial strength will be determined and used. The current CEIOPS proposals appear highly subjective, whereas with an internal model, there is the possibility of calibrating measures of financial strength (e.g. as determined by the ratio of the Available Solvency Margin to Solvency Capital Requirement for the Group) to a common international standard –e.g. using Value at Risk measured at the 99.5% level or TailVar measured at the 99% level on a market consistent basis. We consider it important and necessary that such a measure (which we call the Regulatory measure of financial strength) be available and calibrated consistently for the purposes of determining the credit risk haircut that should apply to reinsurance protection purchased by cedants in the EU. It would not create a level playing field for EU reinsurers were Third Country reinsurers permitted to use a more favorable measure of financial strength derived from a less intensive external rating agency assessment, for example. On the other hand, where a more conservative measure is used the respective Solvency ratio should be adjusted accordingly. We therefore consider it problematic to adopt the “pragmatic” proposal of CEIOPS outlined in its draft advice para 44 & 45 as a long term solution. Before drafting a short term (and probably interim) solution, we suggest to start working on a long term objective. One possible long term approach would be to have as its central pillar, the aim of achieving “mutual recognition of supervisory

CP 16 paragraph	CRO Forum response
	schemes" under the following two premises: - Premise 1: Use Art. 50 RID: "The agreements ... shall in particular seek to ensure under conditions of equivalence of prudential regulation, effective market access for reinsurance undertakings in the territory of each contracting party and provide for mutual recognition of supervisory rules and practices on reinsurance" - Premise 2: Under a new Solvency structure it could possibly be required for jurisdictions to issue a "supervisory rating" of reinsurers within their territory under consideration of a regulatory (i.e. officially verified) CAR (capital adequacy ratio). We envisage that the most likely satisfactory and consistent way of doing this would be via the internal model route. Thus under this alternative proposal, the following would ensue: - Two (or more) jurisdictions enter into an agreement according to which those jurisdictions acknowledge each other's supervisory ratings of reinsurers´ capital adequacy. - Cedants from Third Countries doing business with EU reinsurers would have to rely on the rating that was issued by the lead supervisory authority of the parent reinsurer in the EU. - EU Cedants ceding business to Third Country reinsurers would have to rely on the rating that was issued by the supervisory authority of the Third Country where the reinsurer is domiciled. - Art. 50 and the forthcoming framework directive pave the way so that the EU can enter into bilateral agreements dealing with the mutual recognition of supervisory ratings/assessments of the financial strength of reinsurers.
40. CEIOPS believes that at the current stage of development, in the future Solvency II Directive the high level principles for governance, fit and	We agree with this point. A principles & risk based solvency regime ought to focus on the inherent features of the risks written by the

CP 16 paragraph	CRO Forum response
proper testing, risk management and internal controls, management of technical provisions, investment policy, retrocession, validation of internal models, solvency control levels and capital add-ons for reinsurance undertakings should be the same as the qualitative requirements already recommended in CEIOPS' previous answers to the European Commission 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.	primary insurer or reinsurer as opposed to the institutional form of the risks in the (re)insurer's portfolio.
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: • If the results of the supervisory assessment procedure is positive, and the reinsurer has a rating of more than BBB (or equivalent), it will be treated in the same way as an EU reinsurer; • If the supervisory assessment procedure is negative, but the reinsurer has a rating of more than BBB (or equivalent), it could be treated in the same way as an EU reinsurer. However please note paragraph 39 <45> still applies. • If the third country reinsurer has a rating below BBB (or equivalent) or is unrated, but the supervisory assessment procedure is positive, it will be treated the same way as an EU reinsurer in the same circumstances; • If the third country reinsurer has a rating below BBB (or equivalent) or is unrated, and the supervisory assessment procedure is negative, the supervisory authority will ask the direct insurer to	Solvency I (RID) rules regarding the treatment of third country reinsurers are currently being implemented in EU member states. For the first time in the reinsurance business, EU countries will conduct an "equivalence" assessment regarding the supervisory scheme of a third country jurisdiction for the purpose of cross-border business admission. The implementation of the RID will have an impact on the way in which EU reinsurers will be treated outside the EU as the reinsurance world is closely following the implementation of the RID and the discussion about Solvency II in the EU. It has not yet been evaluated what the likely impact will be. We therefore caution that EU stakeholders should carefully and comprehensively evaluate the situation before taking any steps that might jeopardize the standing of EU reinsurers in the future. We therefore agree that CEIOPS advice should remain preliminary at this stage, in light of the high complexity and the international aspect of the subject matter. Specifically, with respect to the proposed use of rating agency assessments coupled with equivalence assessments performed by CEIOPS, we have the following three reservations: - Problem 1: This is not in line with the RID as no mutual recognition is involved. By 2010, countries such as the US will most likely have changed the way that they supervise reinsurers. (There are currently two initiatives in the US Congress that were unanimously adopted at committee level

CP 16 paragraph	CRO Forum response
justify placing reliance on this reinsurance in its Internal Risk and Capital Assessment (IRCA). 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.	and would provide for federal supervision of reinsurance). - Problem 2: Instead of rating agencies being relied upon to perform an assessment of financial strength for some reinsurers and regulators for others, for the reasons mentioned in our comment under Para 12, the group supervisor may possibly issue a financial strength rating based on a consistently calibrated economic measure of financial strength (see comment under Para b. preceding 28) as determined by the regulator periodically via the regulatory returns. In contrast to a rating done by rating agency, a supervisory rating process would be transparent and harmonized throughout Europe. CEIOPS should develop implementing measurers in order to ensure consistency and monitor the so called regulatory rating process. - Problem 3: Eventually, if other jurisdictions follow a similar CEIOPS approach, EU reinsurers will need to be rated/assessed by all supervisors throughout the world under the CEIOPS proposal as CEIOPS is not advocating “mutual recognition”. This would create a tremendous burden for reinsurers that invariably conduct their business globally. Further, in the absence of a global “lead regulator concept”, this development would have the potential to be a compliance nightmare for EU reinsurers. At the moment, the EU is in the fore to introduce a new risk based Solvency System, but the IAIS has also already started to deal with a Solvency II-like modernization of existing supervisory schemes and also the US is expected to launch a similar modernization process shortly. Once those processes have gained momentum, other jurisdictions throughout the world are likely to require that cedants take into account (quantitatively) a reinsurer’s credit risk for the purposes of determining the cedant’s solvency capital requirements. As a result, EU Reinsurers may then need to undergo individual/parallel assessments by Third Country jurisdictions (e.g. US supervisors) that require local primary insurance companies to take into account a reinsurer´s credit risk. Such a development is not in the

CP 16 paragraph	CRO Forum response
	interest of any EU reinsurer operating on a world-wide basis and has the potential to be completely unworkable if operated at a reinsurer level as opposed to a jurisdictional level. Thus, we recommend that with respect to CEIOPS´ preliminary proposal, there should remain some room for other innovative ideas that could create a more coordinated way in which global reinsurers are supervised. The alternative proposal we have outlined in our response above to b. (preceding para 28) would acknowledge the international nature of reinsurance in a better way. Of course, there are also open questions with respect to the considerations presented in this statement, but we would like to encourage CEIOPS and the EU Commission to enter into an open debate about how to move forward.