Chief Risk Officer Forum

11 January 2007

CEIOPS Secretariat
By email secretariat@ceiops.org

Dear Sir / Madam

CRO Forum's response to CEIOPS Consultation Paper no. 17: draft advice to the European Commission in the framework of the Solvency II project on Pillar 2 capital add-ons for solo and group undertakings

We welcome this Consultation Paper from CEIOPS. The CRO Forum supports the inclusion of powers for a capital add-on in the Solvency II framework directive. However, we must emphasise that capital add-ons should be seen as a last resort as expressed, for example, in article 136(2) of the EU's Capital Requirements Directive.

It is crucial that EU supervisors use the power for setting a capital add-on so that the principle of 'same risk, same charge' that CEIOPS has suggested also applies in this area. If so, Solvency II will capitalise on an opportunity to develop a truly harmonised application of Pillar 2 that improves EU's approaches to financial supervision.

Our detail comments are attached in an Annex. Here we would like to highlight the following comments:

1. it is not always clear in the advice that capital add-ons are regarded a last resort;

2. a multi-year perspective may be a useful aspect of the Pillar 2 review, provided it builds on firms' approaches to provide additional insights and does not simply aim to produce a time series of SCRs;

3. we are strongly concerned about a multi-year perspective leading to a situation where the capital add-on is the highest of the SCR and the capital needs that take into account a multi-year perspective;

4. we are concerned that, in practice, the application of the harmonised steps to establish capital add-ons in the paper to firms using an approved internal model will have the undesirable effect of opening the process of model validation on a regular basis;

5. the same process (steps 1 to 5) should apply to solo and groups but we are not in favour of the application of capital add-ons at solo level.

The comments in this letter and in the Annex are in line with the CEA comments to this CP.

The CRO Forum will be happy to assist CEIOPS further in this work.

Yours sincerely,

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Chairman, CRO Forum
Chief Insurance Risk Officer
ING Group

Annex: Comments to CEIOPS Consultation Paper 17 on capital add-ons for solo and group undertakings

CEIOPS' draft advice (grey boxes)	**CRO Forum response**
7.1 In addition to CEIOPS' final advice on harmonised supervisors' powers and tools, CEIOPS supports the inclusion of further high-level principles on the application of a capital add-on in the future Framework Directive.	The CRO Forum supports the inclusion of powers for a capital add-on in the framework directive. It is, however, crucial that this is done so that the principle of "same risk, same charge" that CEIOPS has suggested also applies in this area. However, we emphasise that capital add-ons should be seen as a last resort as expressed, for example, in article 136(2) of the EU's Capital Requirements Directive. It states that a capital add-on should be imposed "if the solo application of the other measures [listed in article 136(1)] is unlikely to improve the arrangements, processes, mechanisms and strategies sufficiently within an appropriate timeframe". We believe that Solvency II represents an opportunity to develop a truly harmonised application of Pillar 2 supervisory review process that improves financial supervision in the EU.
CEIOPS' advice on potential implementing measures	
<u>IRCA and SCR interlinkage</u>	
7.2 CEIOPS expects insurers to be required to provide information to supervisory authorities that will assist those authorities in understanding the actual risk profile of the insurer so as to be able to assess the adequacy of the SCR. The supervisory review will be a review of a bundle of information provided by the insurer. This will include assessments of matters which are internal to the insurer – i.e. for business rather than regulatory purposes – and also information provided by the insurer giving the insurer's view on regulatory capital needs.	We agree. We would like to see the key requirements for the IRCA, including the policy on solvency capital, in level 2 measures to ensure that the requirements are harmonised and that there is convergence of supervisory practice. We believe that supervisors should allow firms to use existing documentation to fulfil these requirements.
7.3 Insurers should provide as part of their IRCA a comparison between	Pillar 1 capital requirements and the capital needs of the business

CEIOPS' draft advice (grey boxes)	CRO Forum response
(1) their business plan and business capital needs and (2) the regulatory requirements including the policy on solvency capital and the SCR calculation result. 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.	serve different purposes. As a result, differences between them should not necessarily lead to a capital add-on being imposed. For example, the capital needs of the business would reflect business growth and a multi-year perspective. We are not sure what is meant by "the standard assumptions made within the SCR". If this really refers to the assumptions in the standard approach to the SCR, we believe that these assumptions would be inappropriate for these comparisons in the case of an insurance firm using a validated internal model to calculate the SCR.
<u>Multi year perspective</u>	
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.	The CRO Forum discussed a multi-year perspective in its paper on models of 2005. We noted:[1] • advantages such as providing deeper understanding of dynamic, path-dependent exposures; • disadvantages such as high sensitivity to assumptions and computationally complex when checking for economic solvency every year during the simulation. On balance, the CRO Forum recommended that a multi-year perspective should be a feature of Pillar 2.[2] Further, we believe that a multi-year perspective should: • concentrate on the existing book of business, which is the focus of policyholder protection;

[1] See page 18 in CRO Forum, "Principles for regulatory admissibility of internal models", June 2005 (available from www.croforum.org under publications).

[2] See page 25 in CRO Forum (2005)

CEIOPS' draft advice (grey boxes)	CRO Forum response
	• take account of new business in an appropriate manner and by reference to the firms' own business plans. The CRO Forum believes that supervisors should see a multi-year perspective as a planning tool used by firms to understand the implications of deviations from the firm's own business plan that provides further insights about the solvency position of the firm or the group that are not necessarily provided by the SCR approach. We do not believe that a multi-year perspective should necessarily require firms to produce a time series of SCRs. We would therefore emphasise the importance of flexibility in modelling approaches and of discussions about how to manage deviations from the business plan to ensure that this exercise truly adds value. Finally, any requirements should be cost-effective and take into account the specific needs of small and medium insurance enterprises. **However, we are very concerned about supervisors applying in practice capital add-ons that reflect the highest of the one-year SCR and the multi-year perspective (see comment to 7.6).**
7.5 It is a refutable presumption that an undertaking will be able to raise capital at that time when it is needed however 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.	We agree with the discussion of the white text underpinning this point (paragraph 3.14) saying that there would be circumstances where "in the supervisor's judgement [the firm] has no credible prospect of replacing that subordinated debt". However, we wish to caution that there is a material leap between making that judgement at a point in time and the assumption that subordinated debt must be replaced. Such assumption should not be part of level 1 or level 2 texts.
7.6 CEIOPS Members agree that there is a distinction between the one-	**We welcome CEIOPS recognition that there are differences**

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year time horizon calculation of the SCR and a potential multi-year perspective of the IRCA and the SRP, 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.	**between the one-year SCR and the potential multi-year perspective for IRCA. We are very concerned about** • **how to ensure that the use of multi-year analysis does not lead to capital add-ons that reflect the maximum of the one year VaR and the multi-year approach; and** • **how supervisors would use the multi-year analysis in practice.** **These concerns could be addressed by:** • **recognising in the framework directive (level 1 text) that the capital add-on should not be the maximum of the one year VaR and the multi-year approach;** • **setting out how supervisors should use a multi-year perspective to ensure a harmonised application of the requirements and supervisory convergence.**
Harmonised steps on potential implementing measures to establish a capital add-on	
7.7 In accordance with the previous paragraphs 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:	We agree that steps 1 and 2 and steps 3 to 5 should be seen as parallel. However, it is essential that each step is structured in a way that it is consistent with the view that capital add-ons are a last resort as in Article 136 of the EU's CRD. We believe that an important aspect of the supervisory review process and harmonisation is that supervisors apply these steps in a transparent manner and communicate to the firms their reasoning for the imposition of a capital add-on or other risk mitigation measures. We also expect these steps to apply analogously where the supervisory regime of the parent of a third country insurance group is recognised as providing equivalent supervision.

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7.8 **Step 1**: Is the risk profile of the undertaking sufficiently captured by the standard formula or internal model? If yes, no adjustment should be performed, supervisors have to follow step 3. If no, then step 2 should be applied.	We are not sure we understand how this step would work where an internal model has been validated by the supervisor and is therefore used to calculate the SCR. We believe that the essence of model validation would be verifying that the actuarial model and the risk management interaction underpinning the model capture the risk profile of the firm.[3] As a result, it would be inappropriate for the supervisor to open that decision and conclude in the Pillar 2 review that the risk profile of the undertaking is not captured by the internal model that it has validated earlier. There are two caveats to the above: • when we are dealing with a partial internal model (and not a full internal model); if so, Step 1 should focus on the risks / business lines not covered by the internal model; • when there has been a change in business, such as the acquisition of some new business since the supervisor approved the internal model; if so, modifications to the internal models could be necessary but this should be happening anyway independently of the Pillar 2 review.
7.9 **Step 2**: If the risk profile of the undertaking is not sufficiently captured by the standard formula or by the internal model there are a number of possible solutions to solve the problem. The solutions are different for companies using the standard formula or the internal model.	See previous comment on internal models.
7.10 For companies using the standard formula the options are: • Use of entity specific adjustments of parameters (especially the entity specific parameters) in accordance with the Pillar I	We agree that using entity specific parameters would be an open and transparent approach to set capital add-ons for firms using the standard approach to calculate the SCR. We are not generally in favour of supervisors requiring that firms

[3] See CEIOPS conceptual framework for an internal model in paragraph 11.14 of its advice to the Commission on the call for advice on internal models.

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approach; • Development of a partial internal model; where that insurer is capable of developing a partial internal model then it should do so and that model should capture the risks identified in a better way; • Development of a full internal model; where that insurer is capable of developing a full internal model then it should do so and that model should capture the risks identified in a better way. In 2. and 3. it should be assessed if a capital add-on is necessary during the process. The add-on may be expressed in more than one way e.g. a fixed amount of an add-on may be made to the SCR formula or a percentage of the SCR formula may be added. Alternatively, the insurer may choose to change its risk profile. Even so, a capital add-on may still be appropriate during the change process.	develop internal models (full or partial) but we believe that it could be a useful power in extreme and/or complex situations. As a result, we believe that it is important that the framework directive sets out conditions that supervisors must meet before requesting the development of an internal model to ensure supervisory convergence. Equally, we are not persuaded that the options listed here are the only ones available; article 136 of the CRD lists other options that may be relevant. For example, if the risk profile of the firm is not captured by the standard formula supervisors should consider requiring the firm to strengthen its risk management processes (regardless of the approach to risk measurement). Capital add-on should be expressed in a harmonised way. Ideally, the way it is expressed would be such that if the insurer chooses to reduce risks, then the capital add-on goes down in a proportionate matter. Finally, we believe that any capital add-on should be set for a fixed period of time with the presumption that it would lapse unless another supervisory review process has taken place.
7.11 For companies using an internal model the options are: • Recalibration based on Pillar I criteria or change of the "actuarial" model; where that insurer uses an approved internal model for the SCR, that internal model should be adjusted to reflect changes in risks since it was first approved; • Entity specific adjustment of parameters; where that insurer uses an approved internal model for the SCR, that internal model should be adjusted to reflect changes in risks since it was first approved; In 1. and 2. it should be assessed if a capital add-on is necessary during	As noted in response to paragraph 7.8, the Pillar 2 review should take into account that the internal model has been validated by the supervisor and should not effectively lead to a re-opening of the process of model validation (subject to the two caveats mentioned above in our response to paragraph 7.8). As also noted in our response to paragraph 7.10 we are not persuaded that these are the only options available. And, as noted in our response to paragraph 7.8, CEIOPS view of internal models includes an interaction with risk management that may need improvements. We also refer to our comments in response to paragraph 7.10 about

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the change process. The add-on may be expressed in more than one way e.g. a fixed amount of an add-on may be made to the SCR formula or a percentage of the SCR formula may be added. Alternatively, the insurer may choose to change its risk profile. Even so, a capital add-on may still be appropriate during the change process.	expressing the capital add-on and setting it for a fixed period of time.
7.12 **Step 3**: Deficiencies can credibly result, either directly or indirectly, in a reduction of the protection of the policyholders. Are there deficiencies in the qualitative requirements on governance, internal control, risk management, conduct of business? If no, no capital add-on has to be set. If yes, then step 4 has to be fulfilled.	We agree with this consideration. However, we note that if there are no deficiencies in any of the areas mentioned in 7.12 (qualitative requirements on governance, internal control, risk management, conduct of business) then there should be no supervisory intervention, including no capital add-ons.
7.13 **Step 4**: Can the deficiencies be remedied within an appropriate timeframe? If the deficiencies are not severe and can be remedied within an appropriate timeframe then the supervisor should use other supervisory tools than the capital add-on. If the deficiencies are severe or cannot be remedied within an appropriate timeframe, then the supervisor should apply step 5.	We agree.
7.14 **Step 5**: Capital add-ons can be set in proportion to the severity of the deficiencies. For all the qualitative requirements a minimum standard has to be developed in future by CEIOPS, and in accordance with the non-fulfilment of those an add-on (a percentage of the SCR) has to be set. This should be the same process for each supervisory authority. Any adjustment should use the information of the evaluation done by the company in its IRCA, as well as of the assessment done by the supervisor in the SRP and should be discussed between the company and supervisors. In order to identify such minimum standards, CEIOPS has commenced developing a framework to support convergence of supervisory approach to the determination of a capital add-on. Whilst the structure of such a framework might be permanently established, the calibration and details will need to be frequently updated to respond to market changes and supervisory experience.	We agree and we look forward to discussing with CEIOPS these minimum standards. We would expect some of these minimum standards to be in level 2 measures to ensure harmonisation and convergence of supervisory practices. We note that the SCR would already include capital for operational risks and it is important that there is no double counting as a result of a capital add-on. We believe that there should be explicit conditions in EU legislation to ensure that there is no double counting.

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Capital add-on in a group context	
7.15 In principle, CEIOPS believes that the principles laid down in the explanatory text of the consultation paper concerning the aim, 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.	We entirely agree that the same principles should apply to solo and groups. However, we strongly disagree with the application of capital add-ons at solo level. As noted in the joint response of CEA and CEIOPS to CP14, we believe that "any potential application of the Pillar 2 actions at the solo level should be a transparent process with safeguards and taken in the context of any applicable group supervision".[4] We strongly disagree as well with the application of capital add-ons where a solo supervisor does not agree with the approval of an internal model at group level. We believe that this is not consistent with Solvency II's intention of furthering the cooperation and trust between supervisors. We also believe that the approach suggested here is not consistent with the spirit of a joint approach to model validation as in article 129 of the CRD.
7.16 Apart from that, CEIOPS notes that further work will be needed on the SRP for a group including the issues of diversification between individual undertakings that are members of a group, the extent to which practical, legal, or regulatory barriers to the transfer of capital between group members exist and the additional risks which individual members of a group face by virtue of their group membership.	We agree that, regardless of the approach to group supervision, transferability of capital and group risks should be considered in Pillar II.
Transparency issues (not grey text)	
5.1 Generally disclosure requirements in the insurance sector should be convergent between insurance supervisory authorities and the banking regime as far as it is justifiable as regards content. Detailed information	CEIOPS has raised this issue in the white text of this CP so we understand that CEIOPS is not providing formal advice to the Commission on this issue.

[4] See page 5 in CEA and CRO Forum, "Feedback on CEIOPS consultation paper 14", September 2006.

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about disclosure will be addressed by Pillar III capitalisation. 5.2 Information about the capitalisation of an insurance company including the SCR should be an obligatory part of information given in annual accounts. This refers both to listed and non-listed undertakings. The SCR after a capital add-on is the SCR. Concerning the disclosure of a capital add-on CEIOPS has identified different alternatives. It could be achieved either by making the add-on an integral part of the final SCR the derivation of which remains private between supervisory authorities and insurers, or by disclosing the add-on separately to the SCR. Further discussion is however needed under Pillar III, taking into account company law, national legislation, IASB discussions, etc.	However, the text suggests that the SCR – including the capital add-on – would be disclosed in the "annual accounts" and under Pillar 3 disclosures. We believe that the decision to include the capital add-on in the SCR means that insurance firms would need to explain movements in the capital add-ons in annual financial statements. As this paper and our response suggests there are many considerations that the supervisor would need to take into account to impose a capital add-on. We are concerned, for example, about the potential implications of an obligation to explain the supervisors' own judgement in our annual financial statements. Thus the implications of disclosing a capital add-on could be material and really depend on how Pillar 2 and other aspects of Solvency II that are currently being designed, including the practical application of the capital add-ons, work in practice. We therefore believe that any disclosure requirements of capital add-ons under Pillar III should be phased-in gradually to enable firms and supervisors to understand how the various elements of Solvency II link in practice. In addition, whilst we are supportive of disclosure and genuine breaches of the Pillar I SCR, regulators need to provide a clear and meaningful definition of what constitutes a breach of the SCR. If not, significant potential consequences might arise out of the interplay with listing rules, potentially resulting in the "effective" capital requirement being above the SCR. Whilst supervisors could take a lenient view of technical breaches, quickly reversed, there are wider implications, for example, IFRS disclosures and debt covenants, of regulatory breaches.