7 September 2005

Chief Risk Officer Forum

Response to CEIOPS Second Wave Calls for Advice

Solvency II public hearing, Frankfurt

This presentation is based upon the consolidated responses of the Chief Risk Officer Forum 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.

Contents

Section 1

Context and objectives of CRO Forum response

The Chief Risk Officer Forum Response – A Large Company View

The Chief Risk Officer Forum

- The Chief Risk Officer Forum (‘CRO Forum’) is comprised of risk officers of the ***major European insurance companies and financial conglomerates***, and was formed to work on key relevant risk issues for advanced practitioners. The membership comprises: Aegon NV, Allianz AG, Aviva PLC, AXA Group, Converium, Fortis, Generali, ING Group, Munich Re, Prudential PLC, Swiss Re, Winterthur and Zurich Financial Services.
- It is a ***professional risk management group*** focused on developing and promoting ***industry best practices in risk management***

A large company view – 3 core aims

- Alignment of regulatory requirements with sophisticated / best practice risk management
- Acknowledgement of ***Group synergies*** (especially diversification benefits)
- ***Simplification of regulatory interaction*** (as part of the Group aspect)

Today's objective: sharing with you our specific concerns wrt some of the recommendations and finding a way to arrive at agreement

- Having read and discussed amongst ourselves the 2nd wave of calls for advice, we would like to provide our advice in the hope that you find it constructive and providing insight into the ***practical implications on large Groups***
- We embrace the overall concepts outlined and therefore – to make the meeting as productive as possible – we focused on those issues most relevant at this stage
- Recognising today's tight timing, we would like to offer both follow-up meetings (potentially with the specific working Groups) and to provide more detail on how we arrived at our implications and how our ***advice could be implemented***
- Finally, we would hope to have a discussion at the end – on your ***initial reaction*** to our response as well as how we can can assist you in arriving at your ***recommendations***

Section 2

Summary feedback

We embrace CEIOPS’ direction and advice in several areas

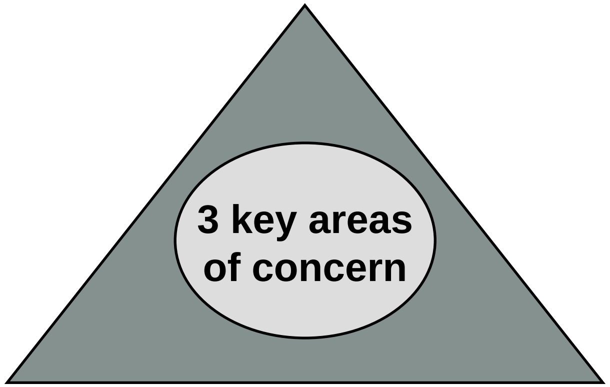
Major areas of agreement

- ✓ **Harmonising** supervisory approach across geographies
- ✓ Moving towards **market-consistent valuation** for the regulatory balance sheet
- ✓ Moving towards **a truly risk-based approach** for setting capital requirements
- ✓ **Incentivising** good practice in risk management and continuous improvements (e.g. use of internal models)
- ✓ Introducing **Group Lead Supervisor** concept
- ✓ Embedding risk management in business decision-making by prescribing **active involvement of senior management and board of directors**

However, the CRO Forum has 3 key areas of concern

Solvency capital requirements only partially aligned with risk

- Excessive prudence and detachment from true risk in setting technical provisions
- SCR and risk margin concepts not presently linked
- Risk mitigation tools not sufficiently recognised in MCR / Standard SCR



Safety levels duplicative / possibly contradictory

- Excessively prescriptive asset restrictions duplicate the purpose of the SCR
- Critical levels appear to be linked to Solvency I system rather than QIS results

Governance / supervision insufficiently clear

- Lead vs. local supervision does not distinguish between
  - model review
  - Group diversification
  - intervention

The proposed 'risk margin' introduces excessive prudence

CEIOPS advice
(our interpretation)

- Adopting **market / economic value** approach to liability valuation and provisioning better reflects the risk profile and is a positive step toward harmonisation with (anticipated) IFRS developments
- Risk margins are an additional policyholder protection to enable an orderly transfer of liabilities in event of distress
- Stochastic modelling as a desirable innovation

CRO Forum feedback

✓ **Agreement:** Overall direction in line with market-consistent liability value approach

- Market values where available
- Where market-consistent values are not directly available, using best estimate values plus a margin to reflect the cost of risk
- Embedded options to be reflected through simulation approaches

✗ **Concerns:** 'Risk margin' approach differs from our 'market value margin' approach and introduces excessive prudence

- Several non-economic and excessively prudent valuation elements such as using government rates (7.18), artificial floors on valuations (7.12) and excessive "one size fits all" approach to setting 'risk margins' (7.31-7.34)
- Technical provisions should not contain prudence in excess of market consistent risk margins; that is role of solvency capital

CRO Forum recommendation

The liabilities should be defined so that a rational and well-diversified counterparty would be willing to take them on their own books:

- Where available use of <u>market prices</u> (if frictional costs incl.)
- Where not: confidence level in line with cost of capital approach

Non-life technical provisions rely more heavily on 'mark-to-model' approaches but the advice imposes many structural constraints

CEIOPS advice (our interpretation)

- Adopting **market/economic value** approach to liability valuation and provisioning as a step toward harmonisation with (anticipated) IFRS developments
- Risk margins as an additional policyholder protection to enable an orderly transfer of liabilities in event of distress
- Reflection of reinsurance counterparty risk closes important gap in risk coverage
- Methodology specification for reserve calculation
  - Leveraging statistical methods
  - For more complex business, two methods to be used

CRO Forum feedback

✓ **Agreement:** Overall direction in line with market-consistent value approach

- Market value approach, including discounting of technical provisions
- Using best estimate values plus a margin to reflect the cost of risk

✗ **Concerns:** Risk margin approach introduces excessive prudence

- Several arbitrary approaches suggested for setting 'risk margins' (8.101-8.103) e.g. standard confidence intervals (e.g. 75%); adjustments to discount rates
- Several suggestions of non-economic elements such as use of government rates for discounting or 'floors' to liability values e.g. present level of provisions (8.76-8.78)
- Requiring future claims inflation different from past experience may not be feasible
- Reserve calculation: requiring use of two approaches and imposing 'traditional' methods where this is not appropriate for some business[1]

The same basic concerns about risk margins apply as in CfA 7

[1]For example, asbestos claims or finite business

Prescriptive rules for assets do not promote sound risk management, inhibit innovation and put the insurance industry at a disadvantage

CEIOPS advice (our interpretation)

- Quantitative limits on investments
- Use of parallel, transitional approaches
- Methodology for calculating MCR
  - MCR alternatives include one which is not risk sensitive
  - MCR might not include investment risk
- Imposition of specific investment objectives
- Same classes of admissible assets covering technical provisions, MCR and SCR specified by a list approach and including a liquidity adjustment

CRO Forum feedback

✓ **Agreement:** Structural / organisational elements

- Documented investment strategy
- Introducing a continuity test as a means of managing liquidity risk (albeit this is a Pillar II issue)
- MCR as absolute safety net

✗ **Concerns:** Safety measures may not promote good risk management

- Prescriptive approach for assets duplicates role of the SCR
  - Asset admissibility: principles-based approach recommended rather than a list of admissible assets
  - Concentrations / diversification: prescriptive rules likely to lead to ‘double-counting’ / penalise good risk management
- MCR should not be excessively prudent so as to interfere with the SCR

Risk margins and the SCR should not be additive

CEIOPS advice (our interpretation)

- Use of VaR and Tail VaR risk measures
- Validated risk models can be used for SCR
- Incentives for better risk management
- Insurance classes of business
- Capital factors
- SCR should be based upon time horizon of one year

CRO Forum feedback

Agreement:

- Use of either VaR or TailVaR risk measures
- Validated risk models can be used for SCR
- Incentives for better risk management
- One year time horizon as basis for SCR

Concerns: Risk margins and solvency capital do not appear to be aligned

- SCR and risk margin calibrations must be linked
  - Danger of double-counting ‘prudence margins’ (10.27)
  - Calibration confidence interval and the risk measure to use is not clear
  - Unclear as to links with proposed stress tests
- Unclear incentives for risk management e.g. risk mitigation
  - Premiums / reserve factors need to be net of reinsurance
  - ALM risk capital requirements need to be net of hedging and other risk mitigation techniques
  - Factor-based approaches (e.g. for ALM risk, embedded options and non-proportional reinsurance) do not capture the impact of risk mitigation

Promotion of internal models is fundamental to large companies but their benefits could be undermined by overly prescriptive structural requirements

CEIOPS advice (our interpretation)

- Validated internal models can be used for SCR
- Partial use of internal models allowed
- Internal model structure should approximate SCR standard formula
- SCR can be adjusted by Supervisor
- Validation process based on bilateral and relatively flexible formulated process
- Senior management and Board of Directors responsible to engage in active risk management / controlling based on adequate understanding of company's risk profile

CRO Forum feedback

✓ **Agreement:** General framework

- Use of internal models for the SCR
- Allowing use of partial models
- Pillar II discretion on internal models
- Engagement and understanding of senior management and Board of Directors

✗ **Concerns:** Internal model approach is too prescriptive

- Approach to internal models is overly prescriptive[1], creating a variant of the standard formula (11.24, 11.68)
- Clarification desired on basis for supervisor applying Adjusted SCR
- Clear European supervisory guidelines needed to ensure "Adjusted SCR" applied evenly (11.59-60, 11.66-67)

1 CEIOPS advice proposes a framework for internal models that is too similar to the Basel II IRBA

Reinsurance is well-considered in the advice but care must be taken not to discourage risk mitigation

CEIOPS advice (our interpretation)

- Principle-based approach towards risk mitigation
- Standard formula to reflect risk mitigation
- Beyond calculating an equivalent to the SCR without the impact of risk mitigation, also impact of various programmes to be assessed; however, simplified (onerous) approach standard formula targeted
- TailVar to be used in order to appropriately reflect risk mitigation
- At least on an annual basis, reinsurance strategy to be reviewed

CRO Forum feedback

✓ **Agreement:** General approach

- General acceptance of risk mitigation techniques within calculation of capital requirements
- Principle-based approach towards risk mitigation

✗ **Concerns:** Improved capturing of incentives / reflection of more complex risk structures

- More complete approach needed on risk mitigation within MCR and Standard SCR, e.g.
  - Factor-based / Solvency I approaches will not be able to reflect anything other than simple (e.g. Q/S) risk mitigation
  - Double standard in treatment of credit risk without full recognition of risk mitigation
- Basis for assessment of diversification should look beyond # of reinsurers
- Allowance needed for use of either VaR or TailVaR risk measures to reflect the effects of risk mitigation

The QIS is welcomed but the objectives must be clear and findings need to be considered in their entirety

CEIOPS advice (our interpretation)

- Quantitative impact studies (QIS) will be run in various, successive stages
- CEIOPS Financial Stability will conduct the QIS and seeks co-operation from industry

CRO Forum feedback

✓ **Agreement:**

- QIS are a necessary step to ensure appropriate calibration of standard formulae and internal models
- Large companies will participate

✗ **Concerns:**

- Clarification desired on specific objectives of the various QIS
- Drawing incomplete observations from a single element of QIS results, without regard for the outcomes of the over-arching study

The scope of supervisory powers is reasonable but harmonisation should not be jeopardised by supplemental national objectives

CEIOPS advice (our interpretation)

- Supervisory authority may ask the parent undertaking of a group to provide information concerning solo undertakings
- Authority should be able to remove the responsible actuary
- Solvency capital requirement may be increased and insurer compelled to set up an internal model if the risk situation deviates from the assumptions underlying the standard formula
- Member States may promote national supervisory objectives through exercise of additional powers
- Third parties which assume functions outsourced by an insurer should be subject to supervision

CRO Forum feedback

✓ **Agreement:**

- Parent may provide requested information on solo entity, where allowed by corporate law
- Internal models may be required for certain risk exposures

✗ **Concerns:**

- National objectives should not jeopardise Solvency II aim of harmonisation
- “Technical arbitrator” needed in cases where the supervisor and the undertaking’s experts cannot agree on technical grounds
- Aspects of ‘due process’, ‘rule of law’ and proportionality need further consideration
- Clarification desired on ‘role of actuary’: hiring and firing should be responsibility of the Board rather than the supervisor

Control levels should adequately address risk mitigation

CEIOPS position (our interpretation)

- 150% of current solvency ratio representing critical level for SCR
- Determine similar trigger point for intensified supervision / action, now risk-sensitive rather than just % of current solvency ratio
- ***Supervisor ladder*** defined with increasingly more drastic measures as available capital deteriorates and hence fails to meet SCR, MCR . . .

CRO Forum feedback

✓ **Agreement:** Overall framework

- Escalation nature of measures to be taken
- Appropriateness of measures at given levels

✗ **Concerns:**

- Role of risk mitigation should be considered in ladders e.g. SCR on gross basis ignores risk mitigation
- Critical levels should be calibrated to QIS results and concerns for policyholder protection rather than linked to Solvency I system

Emphasis should be on composite, required make-up of professional skills and expertise rather than individual traits

CEIOPS advice (our interpretation)

- Harmonisation of the relevant criteria within the EU, also to avoid an abuse of the Test to prevent cross-border takeovers
- Harmonisation within the three financial sectors desirable
- Extension of the Test to all key functions, of which the personnel should be proper, but also possess experience specific to the insurance sector.
- Extension of the Test to the supervisory board, at least regarding properness
- Sufficient proficiency in the national language should be a prerequisite

CRO Forum feedback

✓ **Agreement:**

- Harmonisation, within the EU and across sectors
- Ability to communicate with the Lead Supervisor, but through interpreters if necessary

✗ **Concerns:** tests may be too focused on individual traits

- Emphasis should be on composite, required make-up of professional skills and expertise rather than individual traits
- Board candidates with ‘financial services’ knowledge should suffice
- National language requirement is overly restrictive

Peer review amongst supervisors is welcomed as it promotes harmonisation of practice

CEIOPS advice
(our interpretation)

- Introduction of peer reviews amongst national supervisors to promote consistent practical implementation of its standards and other level 3 measures across all the Member States
- Cooperative process conducted on voluntary basis
- Peer review to be complete, i.e. on supervisory practices for
  - Single entities
  - Insurance Groups
  - Financial Conglomerates
- A permanent "Review" Panel reporting to CEIOPS that decides on reviews' content

CRO Forum feedback

✓ **Agreement:**

- Peer reviews and resulting convergence of national supervisory working methods

✗ **Concerns:**

- For permanent review panel, industry views should be taken into account
- Peer reviews related to single entities operating a specific business in a national context are considered as less effective (since mutual learning effect might be limited)

Group Lead Supervisor concept is critical for internal model review

CEIOPS advice (our interpretation)

- "Same risk, same charge" principle; i.e. consistency across sectors, but not necessarily same approaches
- Group level capital requirements, also to account for diversification effects or additional capital charges and should allow / encourage use of internal models combined with qualitative requirements
- Floor concept to SCR potentially excl. diversification benefits
- Group diversification benefit not to reduce solo SCR
- Group Lead Supervisor defined being responsible for approving Group internal model and in close cooperations with solo supervisors to verify Pillar II requirements

CRO Forum feedback

✓ **Agreement:**

- Strongly support Group Lead Supervisor concept
- Recognition of group diversification benefits

✗ **Concerns:** Lack of clarity on solo-Group supervisory relationships

- Lead vs. local supervision should distinguish between activity
  - Model review: should be responsibility of lead supervisor
  - Intervention: important role for local supervisor
- Should recognise diversification benefits in available capital to meet solo SCR
- Apparent asymmetry in group issues e.g. concentration penalties and limits applied across group but diversification effects may be ignored

We endorse the proposals put forth by the European Financial Services Roundtable[1]

1'On the lead supervisor model and the future of financial supervision in the EU: Follow-up recommendations of the EFR,' June 2005

Section 3

Discussion – the way forward

Discussion

- The CRO Forum wishes to continue this constructive dialogue on Solvency II, with the following aims
  - Leaving Solvency I behind
  - Resolving foundation questions for Solvency II
  - Establishing a framework for ongoing discussion (i.e. avoiding need for Solvency III to advance framework)
- Next steps
  - CRO Forum to meet with CEIOPS Pillar I working group (September 13)
  - CRO Forum offer to meet with other CEIOPS working groups as requested
  - CRO Forum to provide a detailed responses on each of Calls for Advice 7-18