Federation of European Accountants
Fédération des Experts comptables Européens

Mr. Carlos Montalvo Rebuelta
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Ref.: *CEIOPS-CP-64, 65, 67, 75, 76, 77/09*

11 December 2009

Our Ref.: INS/HvD/LF/ID

Dear Mr. Montalvo Rebuelta,

Re: FEE Comments to CEIOPS on CEIOPS-CP-64/09, CEIOPS-CP-65/09, CEIOPS-CP-67/09, CEIOPS-CP-75/09, CEIOPS-CP-76/09 and CEIOPS-CP-77/09

(1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the CEIOPS Consultation Papers Nos. 64, 65, 67, 75, 76 and 77. We have focussed on matters that may have an impact for the audit or financial reporting.

Generic observations

(2) We have considered as we have been developing our detailed responses to individual Consultation Papers whether there are any matters which come to mind as generic observations that CEIOPS and the European Commission might find helpful.

(3) We are mindful that the general principle underlying the regulatory framework is to develop Level 2 and Level 3 regulation and guidance which supports the intention of the Directive. Whilst we recognise the challenge faced by CEIOPS in sustaining where possible a principles based regulatory framework, our sense is that the detail developed in most of the Consultation Papers have tended to be more prescriptive than might initially have been envisaged. There is little doubt that to achieve consistency of application a degree of clarification is necessary. Accountants and auditors face the same challenge when interpreting Accounting Standards with many correspondents seeking greater clarity. However, the temptation to publish detailed supplementary guidance or rules should be strenuously avoided where possible.

(4) We suggest that the European Commission in making the final Level 2 regulation might best be focused on narrowing down rather than extending the guidance proposed by CEIOPS where possible. This would have the added advantage of reducing the apparent and ever increasing weight of the regulatory text.

Consultation Paper No. 64 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Extension of the Recovery Period

Paragraphs 3.10 to 3.24

(5) During the extension period, where the undertaking does not comply with SCR requirements, it should be useful to consider the information to include in the Solvency and Financial Conditions Report (SFCR): eligible own funds and SCR, causes of a breach, measures to re-establish the eligible own funds and the progress to achieve re-compliance in consistency with the progress report to the Supervisor. As it could be difficult to identify a breach due to an exceptional market fall from other factors more internal or specific to undertakings, we agree that causes have to be assessed, described and documented properly.

(6) In accordance with article 136 - 3a of the Directive, CEIOPS proposes in paragraphs 3.10 to 3.24 the maximum period of time which Supervisors should be able to allow, with a view on market stability and policyholders' protection. Four options are considered for the extension period; 6, 15, 27 and 51 months period. CEIOPS is of the opinion that, as the recovery period should be neither very short, nor very long, the middle ground between option 2 (a 15 months period) and option 3 (a 27 months period) provides the best solution. In the impact assessment, CEIOPS considers that options 2 and 3 offer a more appropriate extension period, with little to choose between them (paragraph 4.24).

(7) In our view, an exceptional market fall should require maximum flexibility for supervisors in the decision making, so that a longer maximum period (option 3 or 4 by example) seems better. An argument presented for a short maximum period (paragraph 3.20) is that a reduced period will enhance harmonisation of supervisory practices and limit the use of national discretion. However, a longer maximum period could also be possible if supervisory practices are harmonised with a re-enforced coordination process on the definitive period adopted by each supervisor.

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Consultation Paper No. 65 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Partial internal models

General comment

(8) We consider the paper's proposal to be comprehensive and capable of practical and consistent application. In particular, we agree with the conclusions on the necessary adaptations of articles 118 to 124. We observe that the Consultation Paper takes into account the important flexibility and freedom in the definition of the scope of the partial internal model allowed by the Directive.

(9) From an audit perspective, we reiterate our comments in our answer to the CEIOPS Consultation Paper 58 on Supervisory Reporting and Public Disclosure Requirements (FEE comment letter issued on 11 September 2009), in which we suggested further consideration of assurance and audit implications of modelled SCR requirements, taking in account:

1. considerable education needed for users regarding the role of supervisors in approving internal models;
2. the relation with the undertaking's internal control and risk management on the financial reporting framework and the work carried out by the auditor; and
3. information that specifically supports the model assumptions and processes.

Regarding the last point, we note that information on partial internal models should also take in account scope of the partial internal model and integration techniques used.

Consultation Paper No. 67 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Treatment of participations

General Comment

(10) We understand that the intention of the draft advice is to mitigate the risk of double gearing. However, we would encourage CEIOPS to be cautious in addressing this on a solo level. Introducing measures beyond the scope of Art. 92 (2) of the Solvency II Level 1 text, could contradict a principle based approach and lead to inconsistencies if benefits, such as diversification, are not considered.

(11) Subject to the general concern above, our detailed comments as provided below relate mainly to some items that in our opinion need further clarity.

Paragraph 5.2

(12) Paragraph 5.2 presents what CEIOPS sees as a suitable way of categorising the different types of participations and subsidiaries. We note that in this categorisation, a distinction is made between "Regulated" and "Unregulated". For the avoidance of doubt, we would recommend to specify that "Regulated" relates to prudential regulation and not to other forms of regulation.

Paragraph 5.7

(13) This paragraph provides an example as to why the treatment of participations is a relevant issue also for the sub-modules within the SCR. In the context of the example, it is mentioned "own funds derived from a participation". We find the terminology used confusing with respect to whether it is the undertaking or its participation that this is referred to. It would be helpful to confirm that it relates to "own funds invested in a participation".

Paragraph 5.8

(14) In this paragraph the terminology "own funds arising from a participation" is used. We refer to our comments on paragraph 5.7. It would be helpful to confirm that what it is meant by this is "own funds invested in a participation".

Paragraph 5.9

(15) Paragraph 5.9 advocates a full derecognition (including goodwill of) the participations in financial and credit institutions. While we understand the background of this approach in relation to the prevention of double gearing, we note that doing so may also represent a disincentive for capitalising financial and credit institutions that are investees of insurance undertakings. We would therefore encourage CEIOPS to consider possible ways of recognising excess solvency as eligible assets, in situations where the participation's required solvency is sufficiently responsive to risk in the context of Solvency II.

Paragraph 5.22

(16) Paragraph 5.22 refers to the "availability" test. It would be helpful having further detailed guidance regarding the "availability test" on the share in free solvency in insurance participations. In our view, without further detailed guidance, there is a risk of double counting between asset charges in the required solvency of the participation and an availability haircut to the share of the participating undertaking in the participation's free surplus.

Paragraph 6.7

(17) Paragraph 6.7 states that "the own funds arising from participations" in financial and credit institutions should not be recognised as eligible funds. See our comments on paragraph 5.9.

Paragraph 6.11

(18) As stated in paragraph 6.11, we agree that "any inherent goodwill in the valuation should be excluded from own funds of the participating undertaking". We assume that this exclusion cannot exceed the total book value of the participation in the balance sheet of the participating undertaking.

Consultation Paper No. 75 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: SCR Standard formula - Article 109 h, i Undertaking - specific parameters

Paragraph 3.2

(19) According to paragraph 3.2, CEIOPS advised in section 10.151 of the "Answers to the European Commission on the Second Wave of Calls for Advice in the Framework of the Solvency II project" (October 2005) that the level of reserve risk might be reflected in the run-off results, assuming that the claims provisions are consistently valued in line with the general rules on the valuation of technical provisions within the solvency framework.

(20) It is not yet clear whether the credibility factors have to be used based on the length of the claims triangles currently used or the length of the time series of the run-off results. If the latter should be the case, the quality of the run-off results might i) require to reperform the valuation of claims provisions for prior periods as the historical data (based on the valuation of technical provisions in the past) of the undertaking might not be in line with the general rules on the valuation of technical provisions within the solvency framework and ii) the quality of these valuations depends again on the length of data used to perform the triangle valuation.

Paragraphs 3.37 and 3.75

(21) The use of net premium and net claims as described in paragraph 3.37 or of net paid or net incurred triangles as defined in paragraph 3.75 might not satisfy the requirement that undertaking-specific historical data shall be relevant to the associated reinsurance programme.

(22) Consequently, an analysis of gross figures and of the relevant reinsurance programme should be performed separately and accordingly combined to evaluate the Premium Risk as well as the Reserve Risk. It should also be pointed out as that "stoploss"-contracts generally are not included in run-off triangles as they either cover a portfolio of different lines of business or even cover not only claims risk but a certain combined ratio.

Paragraph 3.151

(23) Non-life Reserve Risk strongly depends on the length of the pay-out period for the claims. It is therefore not in line with the statistical approach taken to perform a valuation of claims provisions to set the credibility factors at certain levels depending on the length of the time series (e.g. paragraph 3.151) without taking into account the length of the pay-out period for the claims of the individual portfolio. We would therefore encourage using different credibility factors for individual lines of non-life business, distinguishing at least between short and long tail lines.

Consultation Paper No. 76 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions – Article 85 c Simplified methods and techniques to calculate technical provisions

Paragraph 3.77

(24) The concern with the assessment of the model error (risk of error) implicit to the calculations is that often the "parameter" causing the error is not identified as being a parameter. This means that there is a specific aspect of the risk with no past experience data. That applies also if circumstances change and it has not been assumed that there could be a change. The proposed measures will not capture this type of issues. Having said this, using less or more sophisticated approaches would not normally allow an assessment of such model errors. On simplification, the relevant question is whether risks that are identifiable are considered, since the simplified approach would ignore them.

(25) Regulators may consider how the knowledge about risks, that have been identified by entities applying more sophisticated approaches, must be considered by other entities that apply simplifications in order to test whether such simplifications are (still) suitable.

Paragraph 3.80

(26) Paragraph 3.80 notes that in some circumstances it may be unavoidable for the undertaking to apply a valuation method which leads to an increased level of estimation uncertainty in the valuation, and that this would be the case where the undertaking, to carry out the valuation, would need to make assumptions which are uncertain or conjectural and which cannot be validated. If as in the example provided, there are deficiencies in the data, the issue is not related to simplification, since a more sophisticated approach would not lead to better quality data but rather relate to the unavoidable uncertainty of a particular situation.

Paragraph 3.82

(27) Addressing the increased level of estimation uncertainty in the setting of the risk margins means ultimately that a simplified approach might result in higher technical provisions. It is accepted that risk margins would be higher if the knowledge that is available is very limited, for the reason that such an environment of uncertainty represents a threat to any potential acquirer, regardless of the degree of sophistication that would be applied. However, it is not explicitly assumed that an acquirer would increase the risk margins to cope with effects of simplification. We believe that doing so might be a suitable pragmatic solution, and we recommend that this be stated as such.

Paragraph 3.173

(28) Paragraph 3.173 points out that independency between the surrender time and the evaluation of economic factors is not a realistic assumption since policyholder behaviour is not static and is expected to vary as a result of changing economic environment. We believe that variations of policyholders' behaviour as a result of changing economic environment are highly speculative. Moreover, while in some circumstances such a relationship may exist, it is likely to be hardly quantifiable and there is often likely to be little evidence in which way the variations would react to changes. Therefore, assumptions about such relationship are likely to represent guesses. For this reason, in our view, a similar level of quality is likely to be achieved with simplified methods, since the more sophisticated methods would only expand on subjective but not well founded estimations. Stochastic models regarding policyholders' behaviour are often based on poor objective information and highly speculative assumptions. They describe merely possible scenarios and were originally developed in an area of speculation to describe the sensitivities. Neither the runtime of a stochastic calculation nor the number of economic scenarios considered may compensate for lacking objective data as input.

Paragraph 3.177

(29) We suggest refraining from stating that the surrender option and the minimum guarantees are clearly dependent for with-profit contracts, as suggested in paragraph 3.177. Experience in many cases has demonstrated that policyholders' surrender behaviour is unchanged if the guarantees are significantly in the money. This might significantly depend on the transparency of the product. Specifically, an implicit interest guarantee inherent in a premium and a benefit is hardly to understand for policyholders. In addition, we note that management actions are not necessarily relevant here. Furthermore, there are often management actions which have little impact, if any, to the individual policyholder or management actions which are assumed to be neutral to the profitability of contracts. For example, if an insurer decides to provide additional information to policyholders, even if the information demonstrates that contracts are favourable, the fact that policyholders are reminded that they have a contract with an immediately withdrawable surrender value might motivate them to execute the option.

Paragraph 3.179

(30) Paragraph 3.179 states that the benefits of with-profit contracts are for instance linked to a reference fund that is influenced by the undertaking's strategy. We note that this represents only one example out of many and very diversed participating features. The variety of participating features is so wide across different countries that in our view it might be preferable to avoid providing such a specific example.

Paragraph 3.381

(31) The advice referred to in paragraph 3.381 is not really clear. That the "calculation by insurance and reinsurance undertakings of amounts recoverable from reinsurance contracts … shall comply with Articles 76 to 80" (as stipulated in Art. 81 of the final Directive) needs interpretation. The reinsurance recoverable is an asset and normally uncertainty is a reducing element of the current exit value of an asset.

(32) However, reinsurance recoverable is an asset, which hedges exactly the ceded cash flows and is contractually linked to the losses of the cedant. It is impossible to transfer the reinsurance asset without the ceded business. Reinsurance is a risk-reducing tool, i.e. it off-sets the risk inherent in the ceded liability. Therefore, an asset reflecting a cession is not increased by the risk margin, but reinsurance reduces the risk margin needed by the entity for a price, since the asset compensates the risk provided for in the risk margin of the ceded liability. The net position does not include a risk margin for the ceded risk, since it is not born by the cedant. Therefore, the requirement that the measurement of the reinsurance recoverable "shall comply with" the measurement of the ceded liability, means that the reinsurance recoverable should have the same value (i.e. current estimate plus risk margin) as the actually ceded part of the liability. As a consequence, the difference between the liability and the reinsurance recoverable equals the direct measurement of the net position.

Paragraph 3.183

(33) In our opinion, a disadvantage of stochastic simulations is that it increases the subjectivity of the measurement significantly. For this reason, we believe that stochastic modelling without adequate objective information is not necessarily "better" than deterministic approaches. On the contrary, it could be of lower quality despite the significantly higher calculation costs. Only when it is possible to observe and estimate the interdependencies in each individual scenario, the additional cost of measurement can be justified with the additional information value that would result from making use of available objective information, which would be otherwise ignored when applying deterministic approaches.

Paragraph 3.385

(34) Annex E of the paper contains a detailed analysis of the gross-to-net techniques ("proxies") developed. The gross-to-net technique does not represent a simplification but the correct current exit value of reinsurance recoverable which is a contractual off-setting of the ceded liability. Clearly, there needs to be a deduction based on the credit standing of the reinsurer.

Consultation Paper No. 77 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: SCR Standard formula - Article 109 j, Simplified calculation in the standard formula

Paragraph 3.39

(35) We encourage using the concept of "materiality" for Solvency II. Nevertheless we would see some need to clarify how that concept might be applied to Solvency II-requirements especially what the relevant parameter would be to measure materiality. With respect to the wording, we suggest to use the term International Financial Reporting Standard (IFRS) instead of International Accounting Standards (IAS) as used in 3.39.

Paragraphs 3.47 and 3.52

(36) We share the opinion that it will not be easy in practice to perform an assessment of the model error, although we would rather use the term estimation error instead of model error (3.47). Consequently, a quantitative proportionality requirement might be reasonable. However, the example given in paragraph 3.52 according to which the simplified calculation for a sub-module can only be used if the requirement obtained by means of the simplification does not exceed 10% of the Basic Solvency Capital Requirement, would increase the risk of an underestimation of capital requirements, as the undertaking might be inclined to reduce the result of the simplified approach for the sub-module below the 10% threshold.

Paragraph 3.126

(37) According to paragraph 3.126, the undertaking is responsible to determine the SCR by using appropriate methods, taking into account the nature, scale and complexity of the risks. The range of potential methods is given by a selection ranging from internal models through partial internal models, undertaking specific parameters, standard formula to simplifications.

(38) It has to be pointed out that the original idea was to create a reasonable standard formula which should be used by all undertakings. However, an undertaking should be encouraged by prudent calibration of the standard formula to develop an internal model to prove a lower solvency requirement. In order to allow for the application of the internal model the supervisory authorities should have approved the internal model of the undertaking.

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(39) The approach taken now is more demanding for the undertaking as well as for the supervisory authority, as it has to be proven, for each individual undertaking, whether a more sophisticated approach has to be applied.

(40) Even though we welcome that some flexibility is given for going from a "simple" standard model to more advanced models, we would like to point out that comparability between undertakings will be very limited. This might be contradictory to Article 109, which asks for implementing measures in order to ensure that the same treatment is applied by all insurance and reinsurance undertakings.

Paragraph 3.131

(41) Paragraph 3.131 explains that simplifications introduce additional estimation uncertainty, which makes it more difficult to verify that it is suitable to achieve the objective of deriving a 99,5% VaR. As the potential simplification is a deviation from the standard formula and by definition should simplify the calculation, it has to be pointed out that the need to prove that the result is in line with the theoretical concept of a 99,5% VaR should not be higher than for the standard formula itself.

For further information on this letter, please contact Ms. Saskia Slomp, Technical Director or Leyre Fuertes, Project Manager.

Yours sincerely,

Hans van Damme
President