Federation of European Accountants
Fédération des Experts comptables Européens

Mr. Carlos Montalvo Rebuelta
Secretary General
CEIOPS
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Westhafenplatz 1
D-60327 Frankfurt Am Main

Ref.: *CEIOPS-CP-40, 41, 42, 44, 45, 54/09*

11 September 2009

Our Ref.: INS/HvD/LF/ID

Dear Mr. Montalvo Rebuelta,

Re: FEE Comments to CEIOPS on CEIOPS-CP-40/09, CEIOPS-CP-41/09, CEIOPS-CP-42/09, CEIOPS-CP-44/09, CEIOPS-CP-45/09 and CEIOPS-CP-54/09

(1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the CEIOPS Consultation Papers Nos. 40, 41, 42, 44, 45 and 54.

Consultation Paper No. 40 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Article 85 b - Risk-free interest rate term structure

General comments

(2) The determination of discount rate for insurance liabilities is still to be discussed by the IASB. Currently, a debate is taking place on pension liabilities under IAS 19, but is not yet clear what will be the impact on the Insurance Project. We suggest reviewing this issue at a later stage, once the IASB has come to a position in these other areas.

Detailed comments

Paragraph 3.30

(3) Under normal circumstances, most bonds traded in active markets have full liquidity, i.e. can be sold at any time. The cash flows that are considered in actuarial models are fully fixed regarding timing, since any possibility of premature payment is already considered in the probabilities associating payments to periods. As a consequence, the observed interest rates on AAA-government bonds need to be adjusted for illiquidity to match the cash flows to be discounted. If the uncertainty of the timing of cash flows, especially caused by policyholders' behaviour in case of discontinuation options, is reflected by estimated probabilities and made risk-free by specific risk margins for the deviation risk inherent in the estimated probabilities, the resulting cash flows scenarios are entirely deterministic and illiquid.

Consultation Paper No. 41 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions - Article 85 c Circumstances in which technical provisions shall be calculated as a whole

Detailed comments

Paragraph 4.2

(4) We agree generally with the guidance provided in CP 41 but we would like to emphasise that a measurement claiming to be market-consistent should use for the whole or separately hedgeable parts directly observed market prices, if they are observable in active markets, as a default, not as a choice. In any case, the measurement, if a valuation technique (three building blocks) is applied, has to be calibrated to this observed market price. An observed price in an active market should have in any case precedence rather than using speculative estimates.

Paragraph 4.11

(5) We recommend using the term "active market" as defined in IFRS. Deviations from this term may raise the question as to whether these deviations are intentional.

(6) The need of the "permanent"-requirement is not included in the IFRS-definition. We do not believe that it is useful to prohibit the use of current market prices if the properties specified are not expected to be permanent, since otherwise less objective estimates of non-existing market prices are used. It would be sufficient to restrict the consequence of the "permanent"-requirement to the decision that in absence of a permanently available market those internal cost models are to be used, even if temporarily market prices are available.

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Paragraph 4.14 i.

(7) This condition (i.e. that "one or several features of the future cash depend on any type of biometric development or on the behaviour of the policyholder") is not principle based. Instead of referring to biometric risks, it should refer to insurance risk. It does not matter which risk type is present. The reference to the behaviour of policyholders is correct if it refers to expected irrational behaviour. Otherwise, a contract part that is equivalent to a traded put or call option would not qualify, since a put or call option depends on the behaviour of the counterparty. However, it is usually assumed that the counterparty acts fully rational.

Paragraph 4.14 ii.

(8) We note, that the ownership of any financial instrument causes to a minor extent internal expenses. That applies as well to any part of an insurance contract, even if it is purely financial.

Paragraph 4.16

(9) The assumption (i.e. "there could be very limited cases…") is only valid if the surrender value deviates from the fair value. If the surrender value is the fair value, lapses do not affect the value of the obligation.

Example in paragraph 4.1.2

(10) Reinsurance contracts are, at least in the definition of IFRS, financial instruments, but they are not traded in active markets.

Consultation Paper No. 42 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Article 85(d) - Calculation of the Risk Margin

General comments

(11) We understand CEIOPS proposals to use a cost-of -capital measure and to determine its calculation for reasons of objectivity and simplification. However, the outcome of such calculation can hardly claim to be a true current-exit-value reflecting the price in an arms-length-transaction with another market participant. As a consequence of the different measurement attributes and measurement objectives defined for financial reporting under IFRS and Solvency II, the additional margin will be the major source of deviation between IFRS and Solvency II.

Detailed comments

Paragraph 3.66

(12) We do not believe that it is adequate to calculate the risk margin in technical provisions net of reinsurance only as proposed in Assumption 10. As a result, it is impossible to disclose the current exit value of the business gross and the reported risk feature will depend on the reinsurance taken currently, eliminating any comparability over time if the entity changes frequently its reinsurance coverage.

(13) We believe that IFRS will likely require to determine insurance liabilities to be presented gross and to report the difference to the net position as a reinsurance asset, including consequently positive margins on top of the current estimate of cash flows. In so far, IFRS already requires that the calculation is made twice, on a gross and a net basis. In fact, a cession is always to be presented separately, but measured consistently with the ceded item to avoid accounting mismatch.

Consultation Paper No. 44 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical provisions- Article 85 g Counterparty default adjustment to recoverables from reinsurance contracts and SPVs

Counterparty Default Adjustment

(14) The paper proposes to provide an adjustment on a best estimate basis. In theory one would expect a deviation risk needs to be reflected as well in order to measure all assets and liabilities at current exit value or fair value. However, in practice available data on the possible default of reinsurers and SPV puts any way in question a kind of expected default approach.

Consultation Paper No. 45 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Technical Provisions – Article 85 h Simplified methods and techniques to calculate technical provisions

General comments

(15) We recommend including the availability and quality of input information as a further factor that may justify the application of simplified methods. Highly sophisticated and complex approaches do not provide actually suitable results in absence of sufficient high-qualitative input information. Simple methods may provide in such cases as transparent and reliable results. Without suitable input information, even the best mathematical valuation tool cannot contribute to the quality of the outcome.

(16) Consequently, the useful sophistication of the approaches is generally subject to the quality of the available information.

(17) Furthermore, high sophistication, e.g. regarding market scenarios, is only suitable if cash flows are actually sensitive to market developments. In many cases, the use of a (unavoidably deterministic) risk-free market interest rate simply based on the duration of the cash flow (which is, considering the weighting with probabilities and application of risk margins) that is assumed to be deterministic (i.e. risk-free) makes any market scenario generating superfluous. In most cases, market sensitivity of policyholders' behaviour, the sole market sensitive feature of many insurance contracts, is so speculative and the interdependencies so little observable, that any sophisticated calculation is practically an arbitrary assumption rather than a derivation from observed and reliable data.

(18) Therefore, we recommend, in favour of transparency, auditibility and comparability, to emphasise that the sophistication of approaches should be conceptually restricted to that level in which it actually contributes to the reliable information value of the outcome, considering the quality of available information.

Detailed comments

Chapter 3.2.3

(19) As stated in our comments on CP 39, we would not consider the Gross-to-Net technique as an simplified or "indirect" approach for calculating the value of reinsurance recoverables, but as the most appropriate measurement approach for a cession, since the reinsurance recoverable is directly linked to the technical provision and only for legal reasons, i.e. a legally different counterparty where legal off-setting is not permitted, an expanded presentation is to be used. Economically, only the net position is relevant information and therefore the reinsurance recoverable need to reflect the difference between the gross position presented as technical provision and the actually relevant net position.

Consultation Paper No. 54 Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: SCR standard formula Loss-absorbing capacity of technical provisions and deferred taxes

General comments

(20) As stated in our comments on CP 39, the definition of "discretionary benefits" and the terms used is in our view not reflecting the obligatory participating features and voluntary benefits. This may be an explanation why the outcomes in the various countries with very different legal position and contract features are inconsistent. Consequently, we recommend an entire review which considers conceptually different features. The entire range of features from, over insurance at cost, some forms of mutual insurance, investment-linkage (i.e. a direct linkage to specific investments held by the insurer, where performance is transferred at 100% to policyholders), performance-linkage (a contractual obligation to forward a specified share in performance of the insurer after providing guaranteed benefits to policyholders), to premium or benefit adjustment clauses (permitting to increase premiums or decrease benefits, both otherwise guaranteed, in specific situations of deficiency), require a conceptual consideration. We could provide further input if considered helpful.

(21) Specifically obligatory participation features are by construction loss absorbing. Voluntary benefits are loss absorbing, except if the actual intention triggering the voluntary does not allow a modification in loss cases, e.g. if economic compulsion (marketing pressure) is too strong. It is insufficient to consider obligatory participating features as being merely a question of management actions, as it is done in the paper mainly. They are conceptually similar automatic adjustments as the value of a unit-linked contract would adjust to unit prices.

Detailed comments

Paragraph 3.41

(22) The paper states that the gross calculation is a usual tool in the analysis of complex situations and provides reinsurance as an example of these situations since technical provisions are usually calculated gross and net of reinsurance. In our view reinsurance in this context does not provide a proper example. The reasoning in case of reinsurance is not due to complex situations because there is a direct liability to policyholders, which is not fully off-set by the cession. If the reinsurer fails to pay, regardless of the reason for this, the insurer remains liable. This is the reason for requiring a gross presentation of the direct liability and the recoverable to the reinsurer. In contrast, in case of participating features, since the obliged and entitled party are the same, rights and obligations result evenly from the same contract and can therefore be legally fully off-set.

For further information on this letter, please contact Ms. Saskia Slomp, Technical Director.

Yours sincerely,

Hans van Damme
President

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