

CEIOPS-SEC-14/10 29 January 2010

Consultation on Draft Level 2 Implementing Measures for Solvency II: Summary Feedback Statement on the Outcome of the Public Consultation on the Third Set of Advice

Introduction

- 1. In its letter of 12 June 2009, the European Commission requested CEIOPS to provide final, fully consulted advice on the vast majority of Solvency II Level 2 implementing measures for October 2009 and agreed on a third set to be finalized by January 2010 on other areas where changes had been made to the Level text in the last stages of negotiation. At the same time, the Commission recommended CEIOPS to develop future Level 3 guidance on certain areas with the aim of fostering supervisory convergence.
- 2. With this third set of advice, CEIOPS is providing its final advice on the Level 2 implementing measures as requested by the Commission. CEIOPS has aimed at providing advice which is consistent among the different Pillars and risk modules and eventually, all pieces of advice have to be read together to ensure an appropriate view of CEIOPS' position. Further Level 3 guidance is already being considered in several areas by CEIOPS, which should help a smooth transition to Solvency II.
- 3. This note summarises the main feedback received from stakeholders on the public consultation of the third set of Consultation Papers that took place between 2 November 2009 and 11 December 2009, and the major changes made to the "Draft advice for Level 2 Implementing Measures on Solvency II" as a result of these comments.
- 4. The full list of comments received, together with resolutions taken by CEIOPS, is available on CEIOPS' website, except where respondents specifically requested that their comments remain confidential (see CEIOPS' <u>Statement of Consultation Practices</u>).
- 5. CEIOPS provides summary resolution templates per Consultation Paper. The resolutions range from "agreed" to "partially agreed" and "not agreed", accompanied where relevant by a short explanation. Various comments are also being addressed with "noted", to point out that CEIOPS has taken up the comment, but this does not necessarily lead to a change in its advice or would require some further consideration. Revisions were made to the papers, which after approval by CEIOPS' Members have been renamed as "CEIOPS-DOC-XX-10" to indicate that the papers contain final advice. The final advice is being submitted to the European Commission.

In addition, the final advice has been amended to reflect the final Level 1 text, which includes a renumbering of some Article references.¹

- 6. CEIOPS encourages stakeholders to read the published advice, and not to rely exclusively on the feedback statement in order to get a full view of the changes made to the paper. The feedback statement only reflects those changes that CEIOPS' considers to be of key importance; many other changes have been made, which are not reflected in this feedback statement and which could have a large impact on specific stakeholders.
- 7. CEIOPS thanks the stakeholders for having actively participated to the consultation on this third set of advice. Many valuable comments were made and have helped CEIOPS to improve its advice. CEIOPS would also like to thank the stakeholders for observing the strict consultation schedule and formats.

Facts and key figures

- 8. CEIOPS published a total of 16 Consultation Papers and received 424 submissions of comment templates on the individual papers from 126 stakeholders. More than 6,856 comments were received during the third wave of consultation (CP 63 – 77 and 79).
- Chart 1 shows that Consultation Paper No. 69 Draft L2 Advice Design and calibration of the equity risk sub-module- and Consultation Paper No. 70 -Draft L2 Advice on calibration of Market risk module- received comments from most of the stakeholders (27% of the total number of stakeholders). Consultation Papers 65, 74, 75, and 76 also received a large number of comments.

Chart 1. Submissions received per Consultation Paper

(Number of stakeholders that commented on a CP compared to the total number of stakeholders that provided comments – not all stakeholders commented on all CP's and the same stakeholders commented on different papers)

¹ Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), Official Journal, L 335, 17 December 2009, <u>http://eur-lex.europa.eu/JOHtml.do?uri=OJ%3AL%3A2009%3A335%3ASOM%3AEN%3AHTML</u>



10. Most of the submissions were provided by insurance undertakings, mutuals and insurance groups (36.5%) and other (for example consultants, legal practitioners, academia...; 31%). 23% of the submissions were provided by national trade associations or actuarial associations while the remaining 10% of submissions were made by European trade associations (see Chart 2).





Calibration of the standard formula – general remarks

- 11. In general, stakeholders commented on the limited time available for the consultation and the split between the advice on the calibration (third set) and the structure and design of the risk modules (second set). CEIOPS considered this was a pragmatic approach to the tight time schedule set by the European Commission and has published its time schedule and the areas to be covered by the different sets of advice in advance
- 12. Following the consultation, CEIOPS has revised its calibration papers taking into account stakeholder comments and recognising concerns with regard to the increase in calibration of the SCR standard formula compared to QIS4. To ensure that the parameters and correlation coefficients in the formula are set commensurate with the aim of the 99.5 % VaR, CEIOPS has undertaken extensive **further statistical analysis** for those areas where data was made available, also taking into account the relevant information gathered during the financial crisis. This does not preclude that in the future, when more data will have been collected, further improvements shall be made to the calibration proposals and adequate review mechanisms shall be established in order to reflect the evolution of risks.
- 13. A **first assessment** was carried out to establish the impact of the proposed changes to the SCR as calculated according to the standard formula. CEIOPS notes, however, that it would not be sufficient to only consider the SCR for such an impact assessment. The effect of the Level 1 principles and Level 2 measure on the valuation of assets, the level and quality of own funds and the amount of technical provisions also have to be taken into account when assessing the capital surplus that will be available for undertakings under Solvency II. Furthermore, any overall estimate on the impact of the changes would need to consider the assumptions and limitations with regard to the chosen benchmark (such as QIS4) and is unlikely to fully capture the impact on individual insurers, which is likely to differ depending on the insurer's risk profile. The overall assessment of the impact of the proposals on the undertakings' balance sheets will be **extensively tested in QIS5**.

Impact of proposed calibration changes for market risks

- 14. Following consultation, CEIOPS has revised its calibration for each of the main sub-risks of the **market risk module**.
- 15. With regard to the interest rate charge, further analysis led to a decrease of the stresses to the interest rate curve. Also, the level of the correlation between the interest rate volatility and term structure stresses has been reduced. Overall, this is expected to reduce the resulting capital charges in comparison to the Consultation Paper while maintaining a calibration in line with the 99.5% VaR standard.
- 16. Concerning spread risk, a reduction of the risk charge has resulted from the use of another benchmark. However, the resulting capital charge is expected to still exceed the level of the QIS4 calibration of spread risk, which is considered to be too low against the 99.5% VaR target of the Level 1 text.

- 17. For equity risk, CEIOPS has lowered the volatility parameter and the correlation between the equity volatility and the equity risk, which will lead to a decrease of the overall capital charge for equity risk as compared to the Consultation Paper. Concerning the overall level of the shock for "global", the majority view supports a 45% stress. A minority view proposes a stress of 39%, and one Member State proposes to keep the stress at 32%. For "other" equity investments the final advice recommends a charge of 55%, reduced from the figure of 60% in the Consultation Paper. Despite industry feedback, CEIOPS has not increased the granularity in the "other" equity module, due to concerns regarding the lack of homogeneity within granular risk classes, and the practical definitional problems which would arise in categorising equities into a more granular level in many states.
- 18. The overall impact of these changes to the SCR for market risk therefore will result on average in a significant decrease of the market risk charge compared to the charge proposed in the initial Consultation Paper.

Impact of proposed changes to correlation parameters

19. Overall, the diversification effect for market risk under the revised advice has increased due to lower correlation parameters and, where possible, these parameters have been justified by extensive technical analysis. CEIOPS believes that the diversification effect in the market risk module is consistent with the 99.5th VaR target. For example, for an insurer which is vulnerable to a rise in interest rates, following the revised analysis the correlation between interest rate risk and equity risk would be assumed to be zero, as compared to 50% in the Consultation Paper. This is expected to lead to a significant increase in the diversification effect between these sub-risks. In addition to the introduction of two-sided correlations for interest rate risk, other correlation parameters have also been adjusted downwards, for example with respect to concentration risk. Non-market correlations have also reduced in many areas, particularly for independent risks. This will further increase the diversification effect across different risks.

Calibration of underwriting risks in Non-Life and Health insurance

- 20. Many stakeholders commented on the limited data available supporting the calibration, in particular with regard to the calibration of underwriting risks in non-life and health insurance. In view of the scarcity of concrete data submitted by stakeholders, CEIOPS has been further collecting data from its Members, which should result in more than doubling the number of Member States providing input. CEIOPS has also aimed to provide further clarification on its methodology.
- 21. In order to progress the analysis of those new data, CEIOPS has asked the Commission to finalise its **advice on non-life risk**, **as well as on health and MCR calibration for the QIS5 draft technical specifications by the end of March 2010**. The Commission has agreed for CEIOPS to continue its analysis and to involve stakeholders for providing support.

Main changes made to the draft advice following the consultation

Main comments and revisions to CP 63 - Repackaged loans investment

- 22. Stakeholders felt that the scope of the advice was not clear enough and it was not obvious to which financial products the requirements applied. CEIOPS has added a paragraph further explaining the scope of the advice and has also changed references to specific financial products in order to clarify the applicability of the advice, stating that the advice is intended only to capture those financial instruments that transfer credit risk from originators to undertakings. CEIOPS' position on exemptions has also been adapted.
- 23. Feedback suggested that the definitions used in the advice were potentially confusing and that using the definitions of the CRD would ensure that cross-sectoral consistency of the advice would be achieved. CEIOPS has therefore made the appropriate changes to the advice to reflect these comments.
- 24. Some stakeholders were of the opinion that the advice was overly restrictive and in conflict with Articles 132 and 133 of the Level 1 text (Prudent person principle and Freedom of investment, respectively). CEIOPS has included a new paragraph confirming the importance of applying the principle of proportionality. Having considered the comments, CEIOPS does not believe that the advice is inconsistent with the Directive and has reiterated that the prudent person principle and freedom of investment articles remain relevant in addition to the requirements imposed by the advice.
- 25. Some stakeholders believed that supervisory authorities should be responsible for checking the compliance of originators with Article 135(2a) or that compliance could be assumed if the originator concerned was subject to the CRD. The importance of undertakings having to understand their investments led CEIOPS to decide against changing the advice, but rather re-emphasising the importance of undertakings having to carry out thorough due diligence when making investment decisions.
- 26. The stress testing on undertaking's portfolios containing such financial products was felt to be overly burdensome by some stakeholders; CEIOPS did not change the majority of the advice due to the importance of stress testing, but has altered some of the wording to remove what was perceived by some stakeholders to require additional stress testing of undertakings in relation to all positions in financial products subject to the advice.
- 27. There was some confusion amongst stakeholders as to the implications of the breach of the requirements (by the originator or undertaking, either prior to or after the investment had been made). CEIOPS has added a new section on this subject containing a significant amount of detail on the situations in which breaches may occur and the consequent actions. This section has also sought to address one of the primary concerns of many respondents: that a forced sale of the financial products in question would be the outcome of any requirements being breached. The breach would have to be covered by the capital requirements.

28. A number of stakeholders expressed their confusion or concern about the grandfathering provision contained in the advice, in particular on the treatment of substitutions and additions to the assets underlying such financial instruments. Following the comments received, CEIOPS has made several additions to the relevant section, outlining four different scenarios and stating where the grandfathering provisions would apply. The advice has also been changed to provide clarity on CEIOPS' position regarding substitutions and additions, which also contains a statement on the materiality and intention of such actions being taken.

Main comments and revisions to CP 64 - The extension of the recovery period – Pillar II dampener

- 29. A fair number of stakeholders agreed with the proposed maximum timeframe of 30 months in total. Other respondents considered that the maximum timeframe should be longer, 36 or even 60 months in all. The list of relevant factors to be taken into account in the decision for the extension in individual cases was criticised by a number of respondents for its lack of potential for harmonisation. However, CEIOPS considers that no sufficient justification was brought forward to change the recommendation for the maximum timeframe of the recovery period.
- 30. With regard to external factors to be taken into consideration, two additional external factors have been added: the availability of an active and liquid market and the detrimental impact on policyholders.
- 31. Another factor that was criticised in a number of comments was the size or significance of an undertaking relative to the market, which would give larger undertakings an advantage over smaller ones. However, CEIOPS considers that market impact is a relevant element for justifying a different treatment in view of the objective of Article 138 (4) to give the supervisor a tool for avoiding procyclical effects.
- 32. Some of the proposals were not fully in line with the Level 1 text and could therefore not be accepted by CEIOPS:
 - A number of comments suggested that withdrawal of an extension period granted should not be immediate upon failure to demonstrate significant progress but should rather be preceded with a supervisory warning and a period of grace in which to improve. According to the Level 1 text the withdrawal is however mandatory upon an undertaking's failure to show evidence of significant progress at a quarterly reporting date. This already provides a clear warning to undertakings that lack of success cannot be tolerated.
 - Stakeholders also strongly objected to the public disclosure of a withdrawal of an extension of the recovery period. While CEIOPS is fully aware that the disclosure could have a negative effect on the undertakings concerned and on the perception of the insurance market as a whole, the Level 1 text does not allow for any exceptions to the disclosure requirement in case of a significant breach of the SCR.
- 33. For a larger number of respondents the "definition" of an "exceptional fall" as outlined by CEIOPS seemed too narrow. They want the definition to be broad enough to allow for more situations where the power to grant an extension would be applicable, e.g. in severe downturns or in times of high market volatility. However, this view fails to recognise that the power to

extend the recovery period was not introduced in order to provide undertakings with more time to re-establish compliance whenever difficult market conditions render meeting the SCR more difficult. Rather it is a tool to avoid procyclical effects. As such, the power is only applicable in comparatively rare circumstances and the definition of an exceptional fall has to allow for this fact.

- 34. CEIOPS considers that several important issues can be further developed in in order to ensure an adequate level of harmonisation in the application of the supervisory power to grant an extension. These issues were identified by stakeholders in the consultation and CEIOPS was asked to elaborate on a number of questions. CEIOPS acknowledges the desire of stakeholders to learn more about what CEIOPS envisages in this regard and has endeavoured to address these issues. However, these could not be further developed yet in the final Advice:
 - Supervisors should have a common understanding of what constitutes an exceptional fall in financial markets. CEIOPS will consider developing a definition or examples of financial markets on the one hand – the question whether e.g. national market, non-EEA markets or markets for certain assets would qualify – and the distinction between a "normal" and an "exceptional" fall.
 - The details of this consultation process, in particular the question of who has the final decision-taking power, should be decided and the process implemented well ahead of any exceptional fall taking place under the Solvency II regime.
 - As a withdrawal of the extension is mandatory in cases of failure to demonstrate significant progress and is quite a severe measure that could seriously distort the level playing field if applied differently, supervisors should agree on what represents significant progress.
 - What measures can and should be taken by the supervisor is a question that not only arises when the extension is withdrawn but also when undertakings fail to remedy a breach of the SCR within the normal recovery period. What measures are available and appropriate needs to be considered as part of the future work on the Supervisory Review Process.
 - Supervisors should take their decisions on the time for which the recovery period is extended on the basis of comparable information. Hence supervisors should seek a common understanding of the information to be provided by undertakings asking for an extension of the recovery period.

All these questions are outside the scope of the Level 2 Advice and also need careful consideration. Therefore CEIOPS proposes to address these issues further on Level 3 before the start of the Solvency II regime.

Main comments and revisions to CP 65 - Partial internal models

- 35. Stakeholders broadly welcomed the advice provided by CEIOPS.
- 36. The major area of disagreement is the choice by CEIOPS of Option 2 for the integration of partial internal models. Stakeholder prefer Option 3 (which would allow for the use of other integration techniques subject to supervisory approval), as, according to them, it would me more flexible than Option 2 (list of integration techniques to be provided by CEIOPS),

and, taking into account that firms will have developed the partial models, they will be better placed to design the most appropriate approach. CEIOPS still recommends Option 2, after having deeply analyzed and discussed the cost and benefits for each of the Options, but is keen on working constructively with stakeholders on the Level 3 aggregation techniques in order to ensure that such techniques are feasible and adequate, and with a degree of flexibility that will allow undertakings' risk profile to be adequately captured.

- 37. An important question regarding the application of the Use test to the Level 3 techniques was raised by some stakeholders. The CP has been changed in order to clarify that the use test does not apply to integration techniques prescribed by the supervisory authority (Step 4 of the process). However, the use test, as adapted for integration techniques between the partial internal model and the standard formula, does apply to integration techniques selected from the Level 3 list of integration techniques (Step 2 of the process). CEIOPS considers that the use test as adapted for integration techniques shall be applied in a manner proportionate to the integration technique selected from the Level 3 list, reflecting the degree of modelling freedom in the integration technique.
- 38. Stakeholders have raised the concern about the consistency between partial internal models and undertaking's specific parameters (CP75). In fact they are two distinct frameworks. The idea in CP75 was to justify that undertaking's specific parameters shall not be used in conjunction with a simplified method. A clarification to explain this issue has been inserted in CP75. Undertaking specific parameters are in fact in the framework of standard formula, which means that assumptions are basically consistent with its assumptions, and requirements from Articles 120-126 are not applicable. Therefore the aligned and consistent requirements between partial internal models and undertaking specific parameters are neither possible nor necessary.

Main comments and revisions to CP 66 - Group solvency for groups with centralised risk management

- 39. Stakeholders have commented that the main benefits of applying for the sub-section on centralised risk management (CRM) were not clear in the consultation paper. CEIOPS considers that applying for the articles pursuant to subsection 6 of the Level 1 text does not result in any significant change in the way that groups are supervised. Groups are neither required to set up a centralised risk management nor to apply for CRM in the Level 1 text.
- 40. Stakeholders also expressed concerns that the requirements for centralised risk management are too restrictive and do not serve to reduce the overall regulatory burden. CEIOPS considers that all risk management systems, being centralised or not, must be sufficient to achieve the standards set by the Level I text.
- 41. Cooperation processes between the group supervisor and the supervisory authorities concerned are described in more detail in the Level 1 text in the case of CRM. CEIOPS points out that more detailed cooperation processes can also be used by all colleges of supervisors for their coordination arrangements.

- 42. CEIOPS has clarified that CRM only applies to groups with the ultimate parent undertaking located in the EEA, and to EEA subsidiaries of those EEA groups.
- 43. Following concern expressed by stakeholders, CEIOPS has also added an explicit statement relating to the proportionality principle in order to high-light the requirement to maintain the necessary flexibility for the system of risk management.
- 44. Stakeholders also commented that the decision on the application for centralised risk management is the discretion of supervisory authorities and will be taken on a case-by-case basis. CEIOPS would like to highlight that the same principles will apply consistently across the European Economic Area to take such decisions but also considers that a case by case approach is necessary due to the heterogeneity of group structures and systems.
- 45. CEIOPS has also clarified that the option to carry out a single group ORSA or group SFCR is not restricted to groups that apply for CRM. On the contrary, the Level 1 text foresees the authorisation to carry out a single group ORSA and SFCR as a pre-requisite to apply for CRM.

Main comments and revisions to CP 67 - SCR Standard Formula and Own Funds: Treatment of Participations

- 46. This paper aims at proposing a treatment for participations in the own funds of solo (re)insurance undertaking. The definition of participations is based on the definition included in the Level 1 text and consistent with the definition used in CEIOPS' advice on the assessment of group solvency (see CEIOPS-DOC-52/09).
- 47. CEIOPS' advice takes as a starting point the need to prevent double gearing of capital elements at solo level. Respondents commented that double gearing is addressed at group level and would not need to be addressed at solo level. The deduction approach proposed by CEIOPS, which aims at ensuring that each company is solvent on a solo basis would, according to stakeholders, significantly reduce the diversification benefits available to parent companies with wholly-owned subsidiaries that exhibit complementary risk profiles to the parent, even when capital is fungible between entities. Therefore, the view held by a significant number of respondents is that it would be preferable to allow the parent to look-through into the balance sheet of the subsidiary in determining the SCR. The revised advice clarifies why CEIOPS did not recommend the 'look through' approach, as it does not allow supervisors to identify the own funds held by the undertaking that would be commensurate to the risks it faces on a stand-alone basis. The look-through approach would create an overlap between solo and group SCR, which would be inconsistent with the Level 1 text. Diversification benefits of such nature are part of the group regime, which also takes into account group specific risks; any recognition of such diversification benefits at solo level would reduce the aim to mitigate double gearing.
- 48. There was broad support from stakeholders for treating participations in the equity risk module with a reduced equity shock and for all participations included within the scope of group supervision to be treated as equity investments at solo level, subject to a reduced equity charge as it was felt

that this is the only approach that takes into account diversification effects and is in line with the economic and risk based approach of solvency II. However, the majority of CEIOPS remains convinced that an equity risk charge would only be a partial mitigant in respect of participations in insurers; this is because it is designed to address only the risk relating to the valuation of the investment, and does not address the nature of the participation.

- 49. Stakeholders criticised the treatment of financial and credit instruments, where CEIOPS advises to derecognise participations in financial and credit institutions. Stakeholders were of the view that such a treatment would encourage firms to move surpluses to the participating undertaking while holding minimum assets within the participation. However, having regard to the different regulatory regime applying to those institutions, CEIOPS considers this treatment to be appropriate.
- 50. With regard to the treatment of non-financial and non-regulated participations, respondents agreed that the treatment of non-financial nonregulated participations should be based on the equity shock method as it allows for the recognition of equity/market value in the balance sheet. But the view was expressed that the method used to determine the equity shock should be based on the economic substance of the participation, for example, respondents did not consider it logical to apply a standard equity charge to a participation in real estate holding. CEIOPS agreed with this comment and the advice now makes reference to the treatment of property within the market risk module.
- 51. Furthermore, CEIOPS provides clarity on the participations in intermediate holding companies, which according to the revised advice, should be treated as financial institutions. If the participation is an insurance holding company, it should be treated as if it is an insurance undertaking.
- 52. Finally, with regard to the treatment of goodwill, the majority of respondents felt that eliminating goodwill does not recognise the fact that goodwill has an economic value and it would be impractical to eliminate goodwill as there are different methodologies to value it. Respondents argued that goodwill will be included in the value of the participation consistent with the market value approach and proposed an approach that is performed at the group level, allowing the recognition of the excess surplus within the solo undertakings solvency calculation. CEIOPS is of the opinion that notwithstanding the different valuation bases that might apply to participations, there should be a consistent treatment for own funds purposes which is based on the elimination of any goodwill element.

Main comments and revisions to CP 68- SCR Standard Formula and Own Funds: Treatment of Ring Fenced Funds

53. This Paper aims at providing advice with regard to adjustments that should be made to the SCR and own funds of an undertaking to reflect the lack of transferability of own funds and the reduced scope for risk diversification related to ring-fenced funds. Taking into account the answers CEIOPS received to the specific questions included in the Consultation Paper, the revised advice adopts a principles-based approach to capture the nature of ring-fenced funds. This approach should allow capturing the variety of ring-fenced funds across the EEA, without unintended exclusion or inclusion of specific funds existing under national law, contractual agreements or products. For clarity, CEIOPS has however explicitly excluded unitlinked funds and reinsurance business from the application of the principles laid out in the advice. The examples provided by CEIOPS in the Consultation Paper have been revised accordingly.

- 54. CEIOPS welcomes stakeholders' offer to provide support in developing Level 3 guidance which should allow identifying the specific structures and arrangements in Member States. This will be especially relevant in view of QIS5.
- 55. Furthermore, stakeholders explicitly asked for a treatment of shareholder value which should ensure that policyholders' share of future profits would not be subject to any ring-fencing restriction where these future transfers are reflected in the technical provisions. CEIOPS has included this exception in its advice.

Main comments and revisions to CP 69 - SCR Standard Formula – Design and calibration of the Equity Risk Sub-Module

- 56. This Paper aims at providing advice with regard to the calibration of the equity risk module.
- 57. With regard to the overall level of the shock for "global" and "other", CEIOPS has received mixed feedback from stakeholders on whether 45%, 39% or 32% was appropriate. The final advice contains a majority and minority view for the "global" equity risk charge, ranging from 45% to 39%, with one member supporting a 32% stress.
- 58. With regard to the overall charge for the "other", stakeholders mentioned that for certain equity exposures contained in the category "other", the charge should be equal to the "global" charge or that the granularity of this bucket should be increased. CEIOPS considers that introducing the same treatment between "global" equity and some "other" equity exposures is doubtful and the increase in granularity presents practical obstacles today. CEIOPS considers that there should be a significant gap between the charge for "global" and "other" equity exposures. Furthermore, there are practical difficulties arising from the definition of the "other" exposures and the availability of data on these exposures. The exposures on hedge funds and private equity are not clearly defined for the time being, and regroup funds with vastly different strategies and volatility of performance. More evidence on specific types of such exposures would be needed for revision of the charge. However, considering the critique expressed by stakeholders, CEIOPS agreed on revising the charge for "other" equities. The vast majority of CEIOPS agreed on the charge for "other" to be fixed at 55%, without restructuring of the charge for "other" into more granular buckets.
- 59. With regard to the equity volatility parameter, stakeholders were keen to ensure that this charge would not lead to a double counting of the equity stress. Although CEIOPS has taken care in its Consultation Paper to ensure that shocks are independently and separately calibrated, CEIOPS has taken into account stakeholder comments and has revised downwards the volatility parameter (from 60% to 50%) and the correlation between the equity volatility and the equity risk (correlation of 0.75 applied between

equity volatility up and equity, and 0% for equity volatility down and equity). In line with the principle of proportionality, undertakings do not have to perform volatility parameter when it is not material for their risk profile.

- 60. Mixed support was provided by stakeholders for the averaging period of 1 or 3 years as a basis to calculate the symmetric adjustment mechanism. Evidence was presented to support a 3 year period, but the same evidence has been used to support a 1 year period. Therefore, CEIOPS decided not to change its advice in this respect. With regard to the comments that the equity charge including the dampener should equal 99.5% VaR, CEIOPS considers that in order to reach its aim to reduce procyclicality, the dampener will be applied on top of the charge calibrated at 99.5%; it is impossible to calibrate the charge to always be 1:200 and maintain the counter-cyclical aim of the dampener.
- 61. Some of the stakeholder comments were disregarded because they are not in line with the Level 1. For example with regard to the symmetric adjustment mechanism: the suggestion to apply the symmetric adjustment mechanism not only to equity risk but also to other market risks, to leave the adjustment to procylical effects to Pillar II or to consider a short period on the 'down' of the cycle, and a long period on the 'up' (this would lead to an asymmetric adjustment). Or with regard to the duration dampener, where some stakeholders were of the opinion that this was against the Level 1 text (enshrined in Article 304). Other comments were considered to introduce too much complexity in the standard formula (for example: development of the parameter based on a moving average). Furthermore, where the impact of suggested changes would seem to be insignificant, CEIOPS decided not to change its proposal (for example, the use of price index rather than total return index). Further clarification has been given on the assumptions and choice made for the selection of data and indices.

Main comments and revisions to CP 70 - SCR Standard Formula – Calibration of Market Risk

- 62. This Paper aims at providing advice on the treatment of interest rate risk, currency risk, property risk and spread risk.
- 63. In general, stakeholders commented on the overall increase of the market risk charge in comparison to QIS4. Especially the increase of the spread risk charge was highly criticised and stakeholders questioned some aspects of the interest rate calibration.
- 64. With regard to interest rate risk charge, stakeholder feedback has generally supported the relevance of interest rate volatility shocks, but commented on the level of the shocks. CEIOPS has agreed to revise the volatility shock from a multiplicative formulation of 95% upwards and 20% downwards to an additive formulation of 12% upwards and 3% downwards. The correlation between volatility and the interest rate term structure has been set to zero, in line with stakeholder comments that in practice these parameters are not perfectly correlated but changes in terms structures do tend to correspond with increased volatility. The interest rate term structure stress has been revised following stakeholder feedback, and is comparable with that tested in QIS4.

- 65. For currency risk, reduced charges have been kept for the Baltic currencies in the revised advice, reflecting the central bank commitment for these countries to strictly control the exchange rate to the Euro.
- 66. The property risk charge calibration was solely based on UK data and accordingly many stakeholders argued that this calibration would not be representative for the European market. Several stakeholders also questioned the need for the high level of granularity in this charge (categorising property would be burdensome and in some cases arguably artificial). CEIOPS acknowledges that the calibration makes use of a limited set of data, but has not received any evidence of more or better data. However, to take into account the concerns mentioned above, the revised advice, although retaining the analysis based on a more granular level, has set the overall charge for all types of property to 25%.
- 67. With regard to the treatment of spread risk, CEIOPS has listened to the strong concerns from stakeholders regarding the very high increase of the risk charge compared to QIS4. Without denying that the charge in QIS4 was on the low side and that the financial crisis has shown the vulnerability of the financial sector to this specific risk, CEIOPS agrees with the general comments made by the industry. Therefore, the revised risk charge is based on CDS spreads instead of bond spreads, as CDS markets are considered more liquid and hence the calibration of the spread risk better reflects the credit risk. As a result, the charge is reduced to a certain extent.
- 68. Following a comment from some stakeholders, CEIOPS has further developed a treatment for exposures secured by real estate, which aims at being consistent with the treatment under Directive 2006/48/EC. Under this approach, an additional category Mkt_{sp}^{re} has been introduced, which relates only to direct exposures to borrowers covered by real estate collateral (for example in the case where life insurers can lend money to policyholders against collateral). Exposures via structured products such as Mortgage Backed Securities and exposures through covered bonds do not fall within the scope of this sub-module however.
- 69. Finally, in line with CEIOPS advice on repackaged loans, the advice on spread risk states that if the originator of a structured credit product does not comply with the 5 % net retention rate foreseen in the CRD, the capital charge should be 100%.

Main comments and revisions to CP 71 - SCR Standard Formula – Calibration of Non-Life Underwriting Risk

- 70. One area which was clearly lacking sufficient data was the calibration of the non-life underwriting risk. In the absence of concrete data submitted by stakeholders, CEIOPS has been further collecting data from its Members, which should result in more than doubling the number of Member States. However, in order to progress the analysis, CEIOPS has asked the Commission for more time to finalise this advice in view of QIS5 consultation. The Commission has agreed for CEIOPS to continue its analysis and to involve stakeholders in providing support.
- 71. Therefore, revised advice on non-life risk, as well as the health and MCR calibration will be provided in time for the QIS5 consultation.
- 72. See also general remarks above.

Main comments and revisions to CP 72 - SCR Standard Formula – Calibration of Health Underwriting Risk

73. See comment on CP71.

Main comments and revisions to CP 73 - MCR – Calibration

74. See comment on CP71.

Main comments and revisions to CP 74 - SCR Standard Formula – Correlation Parameters

- 75. This paper aims at providing advice on the correlation matrix for the SCR standard formula. The impact of the correlation parameters on the overall capital charge for the SCR cannot be underestimated. Therefore, any changes which have been proposed in the revised advice need to be read in light of the change made to the individual risk modules, which will allow for an overall assessment of the standard formula capital charge.
- 76. CEIOPS acknowledges that coefficients should not be solely based on crisis experience and that a more systematic methodology, including more historical data, should be developed. However, crisis experience should be recognised, as it showed that correlations increase under adverse circumstances, so the issue of "tail dependence" is a legitimate concern.
- 77. In order to respond to stakeholder comments, CEIOPS has undertaken further statistical analysis, which is included in annex to the revised advice and shows that the overall level of diversification effect resulting from the correlation matrix as proposed in the Consultation Paper is broadly adequate and at various occasions consistent with concrete suggestions from stakeholders (for example, the analysis made by the CRO forum).
- 78. However, CEIOPS agrees that some coefficients may be lowered in light of the further research undertaken by both CEIOPS and other stakeholders since the release of the Consultation Paper. For the setting of correlation parameters between specific pairs of sub-risks in the market risk module, CEIOPS has complemented its qualitative assessment set out in its draft advice by a quantitative statistical analysis.
- 79. CEIOPS has clarified that where a standard formula correlation parameter has to be specified between two risks which can be assumed to be independent but there are uncertainties as to the exact nature of the independency, it appears to be acceptable to choose a low correlation parameter, reflecting that model risk may lead to an over- or under-estimation of the combined risk. CEIOPS has also further elaborated its advice on the possibility to introduce bi-directional or two-sided correlation factors for some risks to express the difference of the correlation in times of upward or downward movements of the risks. As a result of the analysis, CEIOPS proposes following correlation factors for <u>market risk</u> (with the correlation from the consultation paper added for comparison):

	interest rate	equity	property	spread	currency	concentration
interest rate revised advice	1					
interest rate CP	1					
equity revised advice	0.5/0	1				
equity CP	0.5	1				
property re- vised advice	0.5/0	0.75	1			
property CP	0.5	0.75	1			
spread re- vised advice	0.5/0	0.75	0.5	1		
spread CP	0.5	0.75	0.75	1		
currency re- vised advice	0.5	0.5	0.5	0.5	1	
currency CP	0.5	0.5	0.5	0.5	1	
concentration revised advice	0.5	0.5	0.5	0.5	0.5	1
concentration CP	0.75	0.75	0.75	0.75	0.5	1

- 80. Compared to the QIS4 choice of the calibration factors, the proposed factors would lead to an increase of the market risk capital requirement of about 26% (32% in proposal made in Consultation Paper). This results in an increase of the Basic SCR of about 21% for life insurance and about 6% for non-life insurance (12% in proposal made in Consultation Paper).
- 81. The correlation factors for life underwriting risk were lowered in general in the revised advice, taking into account the low correlation between independent risks. On average, for life insurance undertakings an increase of the life underwriting risk capital requirement by 4% (11% in proposal made in Consultation Paper) and an increase of the Basic SCR by 1% (2% in proposal made in Consultation Paper) can be expected compared to QIS4 proposals.
- 82. Non-life correlations have not been modified, as sufficient support exists for the proposals made.

- 83. Finally, with regard to health risk, CEIOPS is currently reconsidering the structure of the health module in light of progress made in the development of CAT scenarios. An integration of the CAT sub-module besides the HealthSLT and HealtNonSLT modules can be anticipated.
- 84. Based on the results of QIS4, the combined impact of the suggested changes to all correlation matrices can be assessed. On average, an increase of the Basic SCR by 21% can be expected (25% in proposal made in Consultation Paper). For non-life insurance, the impact is 9% (13% in proposal made in Consultation Paper) and for life insurance 21% (23% in proposal made in Consultation Paper).

Main comments and revisions to CP 75 - SCR Standard Formula – Undertaking Specific Parameters

- 85. This Paper aims at providing advice on the parameters and criteria for using undertaking-specific data for the underwriting risk modules.
- 86. Where stakeholders expected to see general principles for the use of undertaking specific parameters or more freedom in choosing methods, CEIOPS has underlined the distinction between partial internal models and undertaking-specific parameters. However, several methods are allowed for premium risk and reserve risk, which addressed the stakeholders' request to be allowed to use different methods for different LoBs.
- 87. With regard to the approval process, CEIOPS has taking into account stakeholders' comments in relaxing to a certain extent the criteria for the approval process. However, to prevent cherry-picking, undertakings are required to assess the suitability of the methods used for the calculation since several methods have been allowed to calculate the undertaking specific parameters.
- 88. Stakeholders further criticized the level of credibility attached to the parameters and the shape of the credibility curve. CEIOPS has taken these comments into account and has amended the credibility parameters in line with stakeholders' comments.
- 89. Stakeholders criticized the inclusion of a "tau" component as representative of the model error, and its value for unexpected extreme events within undertaking specific parameters for the reserve risk sub-module. In this respect, CEIOPS will develop further work and advice will be provided in time for the QIS5 consultation.

Main comments and revisions to CP 76 - Technical Provisions – Simplifications

- 90. This Paper aims at providing concrete simplifications for the calculation of the best estimate and the risk margin. The application criteria had already been consulted upon in the second set of advice, so no comments were required on these, and no changes have been made.
- 91. Next to modifications to the specific simplifications based on stakeholders' suggestions, CEIOPS advises in its revised advice not to introduce an exhaustive list of methods and techniques as Level 2 for the estimation of the best estimate, and would prefer to keep such methods and techniques as Level 3 guidance. This reflects not only many stakeholder comments,

but such a principles-based approach also appears to be more appropriate for Level 2, particularly since the methods illustrated may not be appropriate for all risk profiles. Furthermore, in line with stakeholder comments, methods continue to develop and prescription could hinder innovation of actuarial practices.

- 92. However, CEIOPS recognizes that the risk margin is a specific area where additional considerations should be included at Level 2, due to the complexity and uncertainty surrounding the calculation methodology. Accordingly, a hierarchy of simplifications is described in the advice together with some illustrative examples. Moreover, CEIOPS would support flexibility for undertakings to use other simplified methods or techniques, provided they can demonstrate that these are appropriate.
- 93. Together with the final advice on CP76, CEIOPS will publish the resolutions template to Consultation Paper 45, on which CEIOPS consulted until September 2009 and which has been integrated in CP 76.

Main comments and revisions to CP 77 - SCR Standard Formula – Simplifications

- 94. This Paper aims at providing concrete simplifications for the calculation of SCR. The application criteria had already been consulted upon in the second set of advice, so no comments were required on these, and no major changes have been made, unless to clarify further in light of comments received or to ensure consistency with the application criteria for technical provisions, where relevant.
- 95. CEIOPS has made modifications to the specific simplifications based on stakeholders' suggestions, but realises that further work may be needed in the form of guidance. However, CEIOPS advises the inclusion of simplifications for the SCR in the Level 2 advice to ensure a harmonised approach, which is very relevant with regard to formulaic simplifications.

Main comments and revisions to CP 79 - Simplifications for captives

- 96. This Paper aims at providing advice on specific simplifications for captive (re)insurers.
- 97. Most of the comments related to the requirements CEIOPS has proposed for captives in order to benefit from the concrete simplifications. Much less comments were received with regard to the simplifications themselves. On the substance, CEIOPS did not consider it justified from a prudential perspective to delete the requirements which required that in order to benefit from the use of simplifications in accordance with the principle of proportionality, the (re)insurance obligations of the captive should only relate to contracts where all insured persons and beneficiaries are legal entities of the group of the captive undertaking and where all insured persons and beneficiaries (of the underlying direct insurance contracts in case of reinsurance captives) were legal entities of the group at the time the contract was entered into. Further explanation on the definitions of 'insured person' and 'beneficiary' has been provided.

- 98. Some progress has been made on the second requirement, which is now limited to insurance obligations of direct insurance captive undertakings, excluding thus reinsurance captive undertakings. A majority of CEIOPS' Members is of the opinion that third parties which could claim directly against a captive need more protection than it would be the case for 'traditional' risks that captives accept. To reflect this concern, requirement (b) has been extended to any third party liability instead of only compulsory third party liability.
- 99. CEIOPS has deleted the initial third requirement, which required that the default of the captive undertaking should not cause a loss to the cedent. The concentration risk exemption has been kept, whilst removing the 3 million EUR exemption for term deposits since a majority of CEIOPS' Members is of the opinion this special treatment for captives would not ensure a level playing field with small and medium sized undertakings.
- 100. Furthermore, CEIOPS has attempted to provide concrete examples of situations and businesses in which captives could benefit from the use of simplifications under the requirements set in the advice.
