ECO-SLV-09-232

Comments on Consultation 28 Draft L2 Advice on SCR standard formula - Counterparty default risk module	
Name company: CEA	
Reference	**Comment**
Comments on CEIOPS' advice	
Introductory remarks	The CEA welcomes the opportunity to comment on the Consultation Paper (CP) No. 28 on SCR standard formula - Counterparty default risk module. It should be noted that the comments in this document should be considered in the context of other publications by the CEA. Also, the comments in this document should be considered as a whole, i.e. they constitute a coherent package and as such, the rejection of elements of our positions may affect the remainder of our comments. These are CEA's views at the current stage of the project. As our work develops, these views may evolve depending in particular, on other elements of the framework which are not yet fixed.
Key comments	**Clarification is requested on the thresholds between type 1 and type 2 risks** The segmentation into type 1 and type 2 risks is good step forward, however, we request further clarification on the thresholds to apply to split counterparties between type 1 and type 2 exposures. **The calculations are too complex** We are concerned that the calculations need substantial simplification, particularly in relation to the LGD where there are a large number of counterparties. **The details of the calibration are requested as soon as possible** The absence of calibration (or description of the methodology to be used to calibrate the formula) makes it difficult to comment on appropriateness of capital requirement.
General comments	**Segmentation of type 1 and type 2 risks -** There is general agreement that the segmentation of type 1 and type 2 risks is good step forward and this segmentation has been well received by undertakings. Further clarification is still required on the thresholds to apply in the split between type 1 and type 2 exposures.

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	The new approach appears to improve on the QIS4 approach by offering incentives for diversification of counterparty default risk for type 1. The simplified approach to Type 2 risks is also welcome, and in general appears proportionate to the risks involved. **Complexity of calculations –** The CEA expresses a strong view that the calculations need substantial simplification, particularly in relation to the LGD where there are a large number of counterparties. The CEA response to CEIOPS paper on LGD outlined suggested simplifications to the calculation of LGD which we understand that CEIOPS are happy to include in the Level 2 advice, however, they were not included in this advice. The CEA would encourage CEIOPS to include these simplifications in further advice. **We understand deterioration in credit standing (or downgrade) is implicitly considered** - The CP assumes that the only reduction in net asset value in respect of credit risk on reinsurance and derivative counterparties relates to default within the 12 month time horizon of the SCR calculation. Article 80 of the Framework Directive requires that, in assessing the value of amounts recoverable from reinsurers for the technical provisions, adjustments be made to reflect the probability of default and the loss given default in respect of reinsurance counterparties. Adverse events may increase this prospective adjustment to the amounts recoverable from reinsurers even if no default has occurred, i.e. from downgrade. This risk is currently not explicitly mentioned in the counterparty default risk sub-module. We assume that this risk has been implicitly allowed for in the illustrative calibration parameters. However, it is not clear that this risk could be rigorously allowed for in the calibration of the proposed "ter Berg" model, as this is driven by default rather than downgrade probabilities. **Interaction with spread risk module** - Any comments made on CP28 should also be assessed when any implementing measures are published relating to the "spread risk" module, as the two modules should be assessed in conjunction with each other. The CEA also expects that there will be further clarification with respect to what risks (and what instruments) are covered in the two modules, to ensure there is no double counting. **Interaction with recoverables in art 80 -** The counterparty default risk is dealing with "unexpected default". This is directly interlinked with the "expected default", mentioned in articles 80 ("Recoverables from reinsurance and SPVs). There is not yet a consultation paper on the "expected" default for above mentioned recoverables which could help in deriving a clearer basis for a consultation of the "unexpected default".

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	Interaction with future premiums CP. The account policyholder debtors should not be increased by renewals recognised under future premiums CP. These renewals should only be assessed when the payments are due and not before. We are concerned that the difficulty of **internal reinsurance does not seem to be addressed** anywhere in the paper. Concerns linked with this include how to rate an internal reinsurer and what the corresponding default assumptions and loss given default values may be in this situation.
Para 1.3	With regard to CEIOPS' ongoing work and in particular on calibration, in the light of ensuring a level playing field between financial institutions, we would recommend that CEIOPS refer to the analysis already undertaken as part of the process for Basel 2 in this area.
Para 3.6	We understand that credit default swaps fall under this paragraph. Where the unbundling of credit and counterparty default risk is burdensome, we suggest treating the credit derivative under the counterparty default risk module.
Para 3.8	We recommend making clear that under "risk mitigating contracts, such as reinsurance", the concept of internal reinsurance arrangements is added as an additional example.
Para 3.11	We agree with this paragraph.
Para 3.12 - 3.16	**Guarantees -** As mentioned in 3.16, guarantee received by the undertaking which may be recognised as eligible elements of capital and which have not been activated should not fall under the scope of the counterparty default risk module (see comments to 3.6 in CP29). This should be explicitly reflected in 3.8.
Para 3.19	**Treatment of unrated counterparties** - The CP does not appear to contemplate the possibility of reinsurance arrangements with unrated counterparties, for example arrangements with internal reinsurance entities in other parts of the same group. In QIS4 unrated entities were wrongly given a "CCC" rating which lead to excessive capital requirements for unrated subsidiaries. We urge CEIOPS to consider alternatives for the unrated counterparties. For unrated entities within a group, including internal reinsurers, we would expect the rating to be derived from the parent company.

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Para 3.20	**The frontier between type 1 and type 2 exposures needs checking**. The threshold for deposits and guarantees could be difficult to find, arbitrary, or even needing to change over time. We would recommend checking the issue and classifying such types of exposures in type 2 if the analysis gives sufficient background to this solution. Another advantage would be making the calculation of SCR on type 1 exposures simpler and potentially more accurate. We would ask for clarification whether "reinsurance exposures on large risks" can be included under type 2 exposures since such risks are highly diversified and ceded with a large number of reinsurers, though we see the difficulties in separating such exposures and we also acknowledge that the underlying shock assumed by ter Berg model would impact all types of exposures. Type 2 exposures may be with rated entities (eg brokers, banks acting as intermediaries for bank-insurers). It is not clear how the proposals include an allowance for such cases.
Para 3.30, 3.31	More details of this model need to be provided before we can state that this model is fully appropriate. The assumptions for the various distributions would need checking in order to ensure stability of results.
Para 3.34, 3.61, 3.62	**The term "rating" must be clearly defined** – The CEA views favourably a potential move away from ratings provided by credit ratings agencies. The CEA suggests using ratings bands based on SCR coverage ratios (for counterparties under Solvency 2). As a consequence, undertakings currently unrated by rating agencies would not have CCC status anymore.
Para 3.39	**A more granular approach to the variables x and y could be helpful** while avoiding the risk of the formula becoming unduly complex. In particular, it should be possible these variable to be entity specific. This would provide an incentive for diversification or management of counterparty default risk for Type 2 exposures. The specific treatment of amounts due from intermediaries for more than T months should be reviewed and eliminated in case the granularity/complexity threshold is tilted too much towards complexity. At this moment in the consultation process, it is difficult to see what the impact of this method would be without more details on the likely values of the parameters.
Para 3.29, 3.64, 3.77, Annexes A &	**Details of the calibration are requested as soon as possible** - The absence of calibration (or description of the methodology to be used to calibrate the formula) makes it difficult to comment on appropriateness of capital requirement. Further, comments with regards to when this will be addressed (level 2 or level 3) would be welcome.

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B	**Initial views on the proposed model** - The ter Berg model structure appears to be a useful structure with which to construct a formula for capital requirements for counterparty default risk (however note the general comment above). In our view, the proposed model has the following favourable characteristics: ● The model results in a capital charge which is a decreasing function of the number of counterparties, avoiding the unusual effects of the QIS4 approach for some ratings categories ● The model is based on a portfolio approach and a covariance structure between default indices ● The model results in expected defaults for each rating category equal to the input default probabilities In general the updated approach for calculating the capital requirement for type 1 exposures is found to be a step in the right direction, given the partly inconsistent results from QIS 4 especially relating to correlation and diversification effects (3.23 and 3.24). However, in the new approach the calculation makes use of two important (for the result) but in practice unobservable parameters. At this point in time it is not very clear how to calibrate these which opens up for both substantial model and parameter risk. Specific comments which relate to the calibration of the model include: ● The assumption that correlation between probability of defaults for type I exposures is driven by relative sensitivities across exposures to a single shock random variable is open to challenge – particularly between reinsurance and derivative counterparties, but also between predominantly life and non-life reinsurers. No justification is provided for the beta-like distribution of this shock random variable. ● The example in Annex B assumes the same values of the alpha and tau parameters for all ratings categories – it is not clear whether this is a reasonable assumption. ● There is no comment in the CP on the possible procyclical effects of downgrades of type I exposure counterparts. Capital requirements would increase if the counterparties are downgraded. This may incentivise the recapture (and rebroking) of the reinsurance treaties with the affected counterparties which may in turn further worsen the position of those reinsurers. Also if the downgrade of derivative counterparties is the result of large financial shocks (as currently) the increase in capital requirements for counterparty default risk may add further pressure to already weakened capital positions of insurers - this may increase the pressure to dispose of risky assets. This could be allowed for in the calibration of the model, for example

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	via the distribution of the shock variable, but it is not currently clear how this would be achieved.
Para 3.42	It's not clear if "*lower*" rather than "*higher*" was intended in the paragraph.
Para 3.43 - 3.52	References to the capital requirements for underwriting risks and market risk respectively possibly indicate that diversification effects against other risks may be excluded from the calculation of loss given default in the future. Such diversification would need to be excluded if the counterparty default risk module is to produce a 99.5% VaR measure. For example, if we assume that a currency exposure is hedged by a forward FX contract. Take two otherwise identical companies, where one has a large equity exposure and the other hasn't. The market risk calculation of the first company is dominated by the equity exposure and the forward FX contract has only a relatively small effect on the resulting market risk. For the other company, the forward FX contract may well have a much larger effect on the resulting market risk, if the currency exposure that is hedged is of prime importance to the market risk of the company. The resulting LGD will thus potentially differ substantially between those two companies, although they have the same forward FX contract and thus the same counterparty default risk. Hence, the way LGD is specified – by reference to how much market risk is reduced by the FX contract – does not meet the requirement in article 104.4 that each module should be specified to produce a VaR 99,5 % measure.
Para 3.45	In connection to the existing consultation paper on financial mitigation techniques (CP 31), the CEA argues that such techniques should be taken into account in the calculation of the risk capital under the counterparty default risk. As a consequence, if there is a policy of the undertaking to ensure immediate replacement of the lost cover due to default of counterparty, the RM should be replaced by the premium paid for such a replacement.
Para 3.46	We question whether the sentence on recovery rates should be better rephrased as *"… the LGD is reduced by a factor RR where RR denotes the recovery rate …".*
Para 3.47, 3.50	The Recovery rate on default is difficult to estimate due to the lack of historical data, the variability of the historical recovery rates from one default to the next, and the need to estimate recovery rates in a stressed scenario. The recovery rate and default rate are potentially dependent assumptions. (i.e. the same counterparty can be calculated with a lower probability of default and lower recovery rate or a higher probability of default and higher recovery rate) The recovery rate is currently defined to apply to the whole counterparty exposure rather than to the outstanding exposure net of

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	collateralisation. Depending on how the recovery rate is to be defined and calibrated it may be more appropriate to express the LGD as, for example: $LGD_i = \max((1 - RR_{re})(Recoverables_i + RM_{re,l} - Collateral_i) ; 0)$
Para 3.48	Further guidance is requested on the netting off of recoverables against liabilities, to ensure that unreasonably adverse effects are avoided. Consideration will need to be given to a range of common practices in a number of members states with respect to loans and prepayments, including: • Ensuring that policy loans are offset against policy liabilities. • Considering prepayments, such as the practice of insurers reimbursing hospitals for claims which will arise in the coming year. These claims will be made on behalf of the policyholder rather than the hospital. It makes a significant difference whether these pre-payments are considered as IBNR claims or as receivable for Solvency II purposes, and in the latter case whether they can be offset against liabilities. For IFRS purpose such claims are netted off against technical provisions.
Para 3.52 & 3.53	**The CEA asks for further simplification of the methods in the calculation of loss given default**, as otherwise the calculation could be very onerous (particularly where there are many Type I counterparties).
Para 3.54	We welcome the opportunity to comment on the calculation put forward by CEIOPS later.
Para 3.58	We agree with this recommendation.
Para 3.59	We suggest different legal entities of a group should be treated the same.
Para 3.64	The CEA would like to emphasize that the industry would like to be involved in any discussions on the thresholds, parameters, factors, rating classes and risk factors.
Para 3.69	The assessment of guarantees should be clarified including both the definition and module allocation
Para 3.70	It is not clear why the exemption should only apply to exposures in the currency of the government.
Para 3.35, 3.89	The formula should be corrected with j replacing i in the last term, to conform to the correct formula stated under A.14

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B.9	Formula is missing