

ECO-SLV-09-235

Comments on Consultation CP 31-09 Draft L2 Advice on Allowance for Financial Mitigation Techniques	
Name company: CEA	
Reference	Comment
Introductory remarks	<p>The CEA welcomes the opportunity to comment on the Consultation Paper (CP) No. 31 on Allowance for Financial Mitigation Techniques.</p> <p>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.</p> <p>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.</p>
Key comments	<p>There should not be a restrictive application of the "prudent person principle" We are concerned that there appears to be a more restrictive application of the "<i>prudent person</i>" investment principle in the treatment of assets considered when being used as "<i>financial mitigation techniques</i>". Such an approach could lead to inconsistencies between the treatments of different instruments.</p> <p>Instruments should be appropriately recognised in the SCR. All financial mitigation techniques should be fully allowed for on an economic basis. The consultation paper implies that instruments which do not meet the five principles stated in the paper in full will not generate reductions in capital requirements. We strongly believe that the effect of all financial mitigation techniques should be recognised in the SCR (as well as in the Best Estimate) for their economic value. Correspondingly, all restrictions in the risk mitigation effects provided by these instruments should also be taken into account in the SCR (as well as in the Best Estimate).</p> <p>We have concerns with the proposal that financial mitigation techniques are completely ruled out of the SCR if there is a material basis risk. Techniques that do not perfectly match exposure should be recognized for their economic value.</p> <p>Care is needed in judging the liquidity and credit principles. What is important is that an effective risk transfer happens following the implementation of various financial mitigation techniques.</p>

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General comments	<p>The CEA welcomes the high level principles set out. In particular the CEA appreciates the principle of “substance over form”.</p> <p>The philosophy behind Solvency II is not to restrict eligibility of assets. There appears to be a more restrictive application of the “<i>prudent person</i>” investment principle in the treatment of assets considered “<i>financial mitigation technique</i>” which could lead to inconsistencies between instruments deemed to need not meet the principles and those required to meet the principles but failing to do so.</p> <p>All financial mitigation techniques should be fully allowed for in the Solvency II calculation on an economic basis. The CP implies that instruments not meeting in full the five principles will not generate reductions in capital requirements. We believe though that the mitigation effect of all financial mitigation techniques should be appropriately recognised in the SCR calculation (as well as in the BE calculation) for its economic value. In parallel, all restrictions to the risk mitigation effect should also be taken into account in the SCR calculation (as well as in the BE calculation) for their economic value.</p> <p>There are concerns that financial mitigation techniques are fully ruled out of the SCR calculation if basis risk is material. CEIOPS has taken the approach that financial mitigation techniques should be only included in the standard model SCR calculation only if the assets match perfectly the exposures of the undertaking or the basis risk is not material to the mitigation effect.</p> <p>This seems to run counter to a number of principles under Solvency II as follows:</p> <ul style="list-style-type: none">• Solvency II is designed to encourage and reflect good risk management practices. Even where partial mitigation is achieved it should be allowed for within the standard model SCR.• In the underlying equity stress tests, there is no allowance for basis risk compared to the indices used. <p>The scope and definition of “<i>financial risk mitigation</i>” are not fully clear.</p> <p>We believe it is critical that the level 2 implementing measure and level 3 guidance should be set at a sufficiently high level in order to make sure that evolving and new instruments would not fall out of its scope</p> <p>This CP places great reliance on the documentation of financial mitigation techniques including related procedures. This requirement should be applied proportionately, taking account of the materiality and complexity of the financial mitigation techniques.</p> <p>We understand that this CP applies only to the case of the standard formula. Though it is not explicitly stated in some parts of</p>

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	the advice (e.g. paragraphs 3.29-3.34) we therefore assume that no advice is being given in relation to internal model users.
Para 1.2	We are waiting with interest CEIOPS' proposals on securitisation. We expect such a proposal will take into consideration the specificities of insurance securitization
Para 2.1	The draft advice is on the treatment of financial mitigation techniques although the advice is in support of Article 109 1f) which refers only to " <i>risk mitigation techniques</i> ". Will there be other guidance for other risk mitigation techniques, like reinsurance and other non-financial mitigation techniques?
Para 3.8	We would agree this advice needs to be as much principles based as possible as the techniques will evolve. If this were a new practice for the undertaking we would imagine that more information would be shared with supervisors.
Para 3.32	<p>The CEA agrees with the principles in this paragraph and believes they should be applied proportionately to the financial effects of the risks and risk mitigation techniques involved. We would expect these criteria to apply rigorously to novel instruments or practices, while we believe that they should apply more softly when the financial mitigation technique constitutes an accepted practice.</p> <p>We consider the complete analysis of functioning and inherent risks of the financial mitigation technique to be the key pre-condition for using a financial mitigation technique and it should therefore constitute the main point of focus.</p>
Para 3.40	We believe that dynamic or rolling hedging programs and other dynamic investment strategies, like cash-flow matching, should be considered in the SCR calculation. If the hedging program is well documented and is expected to be effective then it should be considered as financial mitigation technique.
Para 3.41-3.46	We agree with the 5 principles set out by CEIOPS. However, we believe care is needed on judging liquidity (principle 3) and credit (principle 4). They are not always relevant risks in judging the effectiveness of the financial mitigation technique.
Para 3.43	There is a requirement for the basis risk under a financial mitigation technique not to be material compared to the mitigation effect. We believe that such a requirement is not aligned with an economic view of financial mitigation techniques and we recommend CEIOPS to recognize the existence of capital reduction for all cases and not only when basis risk is immaterial.
Para 3.43	Allowance for basis risk within the SCR is required, but no guidance is given on how this is to be achieved. This could be seen as requiring the use of unapproved internal models and is also inconsistent with the treatment of unhedged risks in the

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	standard formula SCR (where, for example, differences between actual equity portfolios held and the indices used to derive the equity shock are ignored). More guidance is required on quantifying <i>"basis risk"</i> .
Para 3.45	A <i>"sufficient legal review"</i> may not be needed for standard contracts.
Para 3.49	Undertakings having appropriate internal policies on liquidity at entity level should not be obliged to monitor liquidity at instrument level.
Para 3.51	We have found this paragraph difficult to understand. Can this be clarified?
Para 3.53-3.55	<i>'...the financial mitigation instrument should be capable of liquidation in a timely manner or retention'</i> . We believe this needs to be applied sensibly and proportionately as a rigorous application of this requirement could have unintended and counterproductive pro-cyclical effects.
Para 3.54	While the CEA agrees that only highly rated counterparties should be used for risk mitigation, we expect that the risk of default (along with an allowance for collateralisation) would be included in the counterparty default module rather than being a restriction on assets. In addition, for the case of downgrades, there may be provisions for the contingency of such downgrading.
Para 3.55	It is impractical to require insurers to determine the correlation between the value of the financial mitigation instruments and the credit quality of their provider. Furthermore, if credit default swap spreads are to be taken as a proxy for the credit quality of the provider, then events of the last 12 months are likely to mean that few financial mitigants can demonstrate no material positive correlation and so few instruments would pass this test. Could CEIOPS give more inputs on this correlation?
Para 3.33, Para 3.45	More detailed guidance on what constitutes <i>"a sufficient number of appropriately qualified staff"</i> (3.33) and <i>"sufficient legal review"</i> (3.45) would be helpful as would guidance on the application of proportionality in these assessments.
Para 3.56	In relation to the requirements of <i>"irrevocable feature"</i> and <i>"unconditional feature"</i> , the existence of <i>"break clauses"</i> shouldn't give rise to the exclusion of the risk mitigating effect if such clauses are not under control of either of the parties (for example the break clause is based on observable market data and is executed automatically by both parties).

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Para 3.57	The definitions of " <i>generally applied procedures</i> " and " <i>generally admitted criteria</i> " need to be included.