CEA Response to CEIOPS' CP 20 on Pillar I issues

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Introduction

The pace of Solvency II is increasing and the Industry recognises the valuable work that CEIOPS has been doing in advising the European Commission in the Solvency II project. The CEA looks forward to continuing its constructive dialogue with supervisors and other stakeholders.

CEIOPS has released a series of Consultation Papers (CP 15 to CP 20) covering Pillar I, II and III. The period of Consultation runs from early November to 12 January 2007, which has been extended to 19 January 2007 for CP20 following the subsequent publication of a supplement to CP20. This paper forms the CEA response on CP 20 which focuses on quantitative valuation of assets and liabilities, the standard formula of the SCR, the MCR, the use of partial and full internal models and safety measures.

In a number of areas, CEIOPS presents alternative views without reaching a conclusion, i.e. there is no draft advice. In order to progress the development of Pillar I we have provided comments on some of these issues.

The relatively short consultation period and the timing of the consultation have restricted the extent to which the Industry has been able to provide feedback. As such, these views should not be treated as final and we expect to produce more detailed comments on CP 20 as part of a separate paper as well as additional comments when the QIS3 technical specification is issued.

We would emphasise that Pillar I issues cannot be viewed in isolation and need to be considered in the context of the whole Solvency II framework. Also, it is important to note that 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.

It should be noted that the comments in this document should be considered in the context of other publications by the CEA listed in the Appendix. Some of these documents are of direct relevance to CP 20 and in such cases we include explicit references.

Finally, the comments expressed in this document represent the CEA's views at this 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.

1. Executive Summary

1.1 The Industry has always advocated an economic approach for Solvency II as:

- It aligns regulatory capital requirements with best practice internal risk management processes
- It rewards good risk management
- It is transparent and will avoid arbitrage opportunities.
- Systems that confuse the prudence and capital requirements are more opaque and likely to lead to double counting to the detriment of consumer and competition
- It can be calibrated to provide a balance between protection to policyholders and encouraging competition, hence enhancing efficient operations of companies
- It can cope with evolution in the financial environment, increasingly sophisticated product design and capital markets innovation.
- It is cost effective for the Industry whose benefits can be passed on to customers

1.2 CEIOPS has released CP 20 detailing its further draft advice on Pillar 1. This together with the recently completed QIS 2 exercise represent important pieces of work on a complex range of issues that will certainly require further debate.

1.3 While we still have some major concerns that we highlight below, there are also significant elements within the CP 20 that represent major steps forward and which the Industry supports, for example;

- Greater explanation of the rationale and underlying analyses behind CEIOPS decisions: This allows a more informed discussion among the stakeholders. Nevertheless, we recognise that there are still areas where greater transparency would be welcomed in the future, especially in the aspects relating to the calibration of the factors.
- Recognition of the Cost of Capital Approach: In CP 20, CEIOPS recognises that for solvency purposes, the technical provisions should be based on market consistent techniques and recognises that the Cost of Capital methodology is suitable for developing a Market Value Margin ("MVM") for non-hedgeable risks.

1.4 There are also a number of elements of CP20 that the CEA has qualified support for:

- Modular approach: In general the CEA supports the modular approach; however, we recognise that it gives rise to certain difficulties, for example assessing the risk absorption of future profit sharing. The alternative integrated approach may alleviate some of these difficulties, but may introduce other difficulties. This requires further investigation and there may be a role for a limited integrated approach to supplement the modular approach to determine the risk absorption of future profit sharing.
- Risk mitigation and diversification: CP 20 recognises that risk mitigation and diversification effects need to be incorporated both in the Standard Approach and Internal models. However, CP20 infers that group diversification benefits might be restricted, which we strongly disagree with.
- Risk absorption of future profit sharing: CP 20 recognises that the ability to pass risk on to future profit sharing in life business must be taken into account when assessing the risk exposure of the insurer. However, the approach proposed potentially understates the extent that liabilities can absorb risk as it does not take into account diversification. Given that diversification is one of the key ways in which companies can mitigate risk the CEA strongly advocates that the full risk absorbing capability of profit sharing business is recognised.

1.5 We note that in many ways the CP 20 should be read in conjunction with the QIS 2 exercise. We therefore make reference to our initial feedback on the QIS 2 exercise provided in CEA Preliminary Feedback from QIS2 (16 October 2006).

1.6 Our main concerns relating to CEIOPS' draft answer are as follows:

- Double counting: There is a potential to double count capital requirements by requiring both capital requirements and restrictions on asset eligibility. Under a risk based economic approach, there should be no need for supplementary asset limitations provided that the risks are adequately captured within the SCR and Pillar II. We therefore believe that decisions on specific asset limitations should be postponed and considered in the context of the overall, holistic approach to Solvency II.

- Approach for the MCR: In its supplementary advice CEIOPS supports the modular approach. QIS 2 indicated substantial concerns on the modular approach and as a result, the Industry favours the alternative approach of deriving the MCR as a percentage of the SCR. The CEA Working Paper on the MCR and Proposed Ladder of Intervention dated 16 October 2006 discusses this in more detail.

- Eligible elements: It is not clear if the discussion on the eligible elements of capital is consistent with a Total Balance Sheet Approach.

- Unnecessary layering of prudence: In a number of areas CEIOPS has indicated that different approaches are possible and in such cases, has often opted for the more "prudent" or "conservative" methodology. This includes items relating to the calibration, cost of capital, assessment of the risk absorbing nature of future profit sharing and the assessment of correlation assumptions. A risk based economic approach does not need implicit prudent or conservative margins as all risks are explicitly allowed for. Having layers of individual prudence will lead to capital requirements in excess of the target with knock on effects on policyholders and markets.

- Failure to recognise company's own experience: Our feedback on QIS 2 also indicated that companies should have the option of using their own experience (assuming the own company data is of sufficient quality), which would more accurately reflect the risk exposure of the company. Doing so will result in companies seeing the benefit of risk mitigation and diversification via a SCR which gives an appropriate capital requirement, e.g. if a company implements reinsurance that will reduce the volatility of its future claims it should have a lower SCR.

- Failure to recognise non-life expected profits: In its supplementary advice, CEIOPS indicates requirements that would limit the positive impact of future expected non-life profits on the capital assessment. We believe that the inclusion of future expected non-life profits/losses is necessary to take into account the premium level when calculating the SCR. We believe that expected future profits are a valuable risk mitigant which should be fully taken into account.

- Group issues: There is insufficient focus on issues specific to insurance groups such as reflecting the impact of group level diversification. Although we recognise that CP 20 may not be designed to explicitly cover group issues, these remain important elements, for example group diversification across countries, and these should be reflected within the Standard Approach. The issues discussed in the joint submission by the CRO Forum and CEA on CEIOPS Consultation Paper 14 (dated 22 September 2006) are particularly relevant here

- Flexibility within the Standard Approach: Our feedback is that for many companies, improvements in risk measurement will be incremental. As such, we support some flexibility within a Standard Approach where for certain risks, both formula and scenario based approaches would be possible. However, in the Supplement to CP20 CEIOPS specify that a scenario approach should be used for market and life underwriting risk (except Cat risk), with a factor approach being required to be used for other risks. This therefore removes any flexibility, which could be problematic for companies with less sophisticated modelling capabilities and doesn't necessarily take into account how material a risk is for a particular company.

1.7 These concerns are discussed further in the following sections. We however note that it is difficult to comment on the proposed Pillar 1 structure until the details are better defined.

The rest of this paper focuses on aspects of CP20 that we believe need to be developed further. We look forward to do so in a constructive dialogue with CEIOPS.

2. Adequacy of financial resources, Valuation standards and Capital

2.1 The CEA believes that the following working documents provide valuable insight into the CEIOPS work in this area

- "CEA Working Paper on the risk measures VaR and TailVaR" (7 November 2006)"
- "CEA Elaboration of the Total Balance Sheet Approach" (Date)
- "Assessing the Impact of Solvency II on the Average Level of Capital" (16 October 2006)

We draw on the comments within these papers as part of the response to CP 20.

Preference for VaR as a risk measure (Paragraphs 1.54 – 1.55)

2.2 CEIOPS has expressed its preference for using Tail Value at Risk ("TailVaR") as a risk measure, as opposed to Value at Risk ("VaR").

2.3 In the above referenced paper, the CEA explains the difference between both VaR and TailVaR and indicates why the Industry believes as a starting point that the practical advantages of VaR outweigh any theoretical advantages associated with TailVaR.

2.4 VaR has already become the generally accepted risk measure for financial risk management partly because of its simplicity and ease of communication. It is consistent with the way that many insurance and other financial institutions currently measure and manage their risk and the development of internal models within the Industry.

2.5 Finally, although the aforementioned document highlights below a number of practical advantages of using the VaR measure, we recognise that certain companies may prefer to use alternative risk measures, such as TailVaR, if these were thought to be more suitable to their business. This is important as Solvency II should not limit companies the ability to manage their business as they see fit.

Hence, the adoption of VaR should not preclude the use of TailVaR for internal models if this is chosen by companies/groups and acceptable to the supervisor. However companies would need to demonstrate that the calibration approach used was equivalent to that of the regulatory minimum.

Technical provisions are based on a market consistent approach

2.6 We strongly support the use of market-consistent valuation techniques. Such techniques use available market information to value the underlying liability cash flows using modern financial economic theory and can be used to value liabilities even if there are not actively traded market instruments. The criterion used to determine whether market-consistent techniques can be applied needs to reflect this.

We also support the cost of capital approach as a proxy to derive the market value margin for non hedgeable risks including the work done by CEIOPS in QIS 2 and subsequent recognition that the cost of capital approach forms a suitable methodology for the market value margin.

2.7 We however believe that further work is required in order to refine the cost of capital approach (particularly in light of the concerns raised on the calibration of QIS 2) and to ensure that the approach will be interpreted consistently across different jurisdictions.

2.8 From a policyholder perspective, the market consistent value of other liabilities should include future discretionary benefits that are expected to be paid to policyholders. In this sense the Industry welcomes CEIOPS advice in the Supplement to CP20 (S.3).

This approach has implications for determining the capital requirements. The future profit sharing liability is a special form of liability as it can be reduced given certain conditions in adverse circumstances thereby reducing the capital requirement.

2.9 In relation to the best estimate liability, CEIOPS advises that "whenever there is more than one reliable and relevant actuarial method for the portfolio to calculate the best estimate, the one with the highest result shall be retained". We strongly disagree with this statement and instead believe that the most appropriate (and not the highest) method should be applied.

Available capital (Eligible Elements) is given as the difference between the market-consistent values of assets and liabilities

2.10 We recognise that the analysis of risk within an insurance company will vary depending on the stakeholder. For example, policyholders, secured bondholders, unsecured bondholders and shareholders may all have different perspectives on expected return and associated risk.

2.11 The Industry supports an economic framework based on a Total Balance Sheet Approach where the available capital is given as the difference between the market-consistent values of assets and liabilities.

2.12 The "Total Balance Sheet Approach" paper (referenced at the start of this section) makes the case that the appropriate starting point to determine eligible capital elements is the ability to absorb risk from a policyholders' perspective.

2.13 In such a framework, the market consistent value of other liabilities should relate only to other obligations that are at equal to or rank higher in priority than policyholder claims.

For the other liabilities that rank equal or ahead of policyholders, we would expect market consistent valuation techniques to be used to determine these liabilities and to assess in the SCR any risks associated with these liabilities in extreme circumstances.

2.14 We note that a main focus of Solvency II is on policyholder protection. Therefore, the economic balance sheet (market-consistent, total balance sheet) is the appropriate starting point to determine eligible capital elements.

2.15 This is very different from the current Solvency I approach which aims to apply eligibility limits on certain elements of the balance sheet (e.g. 50% of subordinated debt) and the tiering structure outlined by CEIOPS.

In general we do not believe that for the SCR, there should be artificial limits (e.g. fixed percentages) on the eligible elements of capital unless these can be economically justified.

2.16 We however recognise that certain items that may be appropriate to meet the SCR may not be necessarily suitable to meet the MCR in case of potential ultimate supervisory action.

2.17 In general, the Industry supports the aim of harmonisation to ensure a level playing field and to foster a single market for financial services. Convergence between banking and insurance regulation is supported, but not at the cost of inappropriate solvency rules.

As a result, CEA only supports the alignment of banking and insurance principles where the principles are economically justified and appropriate for insurance. We recognise that in certain cases, items such as hybrid debt currently receive a more favourable treatment within the current banking framework. In such cases, convergence with banking rules could be an intermediate step within the existing Solvency I framework but this should not pre-empt a reassessment of such items as part of the Solvency II framework and more importantly, the removal of any arbitrary limits which are not consistent with an economic approach.

3. SCR and Standard Formula

3.1 The CEA believes that the working document "CEA Preliminary Feedback from QIS2" (16 October 2006) and the "CEA working document on the standard approach for calculating the solvency capital requirement" (22 March 2006) will provide valuable insight into the CEIOPS work in this area.

3.2 In the previous section, the CEA indicated its support for technical provisions to be based on a market consistent approach.

The risk that the technical provisions are inadequate is included in the capital requirements. The SCR should ensure that there are sufficient assets to cover the market consistent value of liabilities following adverse circumstances.

Support for a modular approach but recognition that some flexibility is required within the Standard approach

3.3 We support the recommendation that the standard approach should have a modular structure, i.e. having separate modules for each risk, as this will facilitate a more transparent risk management process and help companies transition from the standard approach to partial or full internal models.

CEA however recognises that the application of the modular gives rise to certain difficulties when assessing the risk absorption of future profit sharing. In such case, further work may be required in order to overcome any limitations identified.

3.4 The challenge is to develop an approach that can be applied across European territories, which is as simple as possible and at the same time sufficiently sophisticated to capture the underlying economic risk factors. As a result the emerging consensus is that for certain risks, a flexible approach may be necessary for the Standard Approach so that the SCR could be calculated either via:

- A simple method involving factors, which would be particularly helpful for companies which do not need or are unable to perform cash flow modelling
- The option to make use of scenarios, company specific information and prospective views in certain circumstances. This would be particularly helpful for companies which perform cash flow modelling

We would expect that both factors and scenarios would be calibrated consistently.

3.5 The advantage of such an approach is that companies would be able to incrementally improve their risk measurement as it would transition from simple factors to scenarios to partial models and then on to full internal models. This would be of particular value to the small and medium sized companies where the risk measurement development is likely to be incremental.

3.6 Our initial impression of CEIOPS' supplementary advice (S.7 and S.8) of a prescribed scenario approach including guidance on possible calculation ***methods*** is that this is in line with the Industry's request for certain degree of flexibility within the Standard Approach. This is subject to the further details which should become clearer as part of the QIS 3 pre test.

Usage of company specific data

3.7 We strongly support the usage of company specific data in combination with prospective/judgemental views (a personalised approach) as described in (5.328) for assessing the risks. Since the risk profile of companies differ, companies should have the option of using their own experience (assuming the own company data is of sufficient quality), which would more accurately reflect the risk exposure of the company. One of the risk types where company specific data could lead to more appropriate results is reserve risk, for which currently a standard factor based approach is suggested only.

3.8 Doing so would result in companies seeing the benefit of risk mitigation and diversification via a SCR which gives an appropriate capital amount, e.g. if a company implements reinsurance that will reduce the volatility of its future claims it should have a lower SCR. This will provide appropriate incentives for companies to better manage their risks.

Calibration of the Standard Approach

3.9 The Industry has expressed concern on the calibration of certain parameters in the CEA initial feedback on QIS 2. We note that in the main concerns have not been explicitly addressed in CP20. The Industry would welcome more transparency and explanation in the development of the calibration underlying QIS 3 and future Solvency II calibrations.

3.10 We recognise that further work is required but highlight that certain issues may be better addressed by a combination of changes in the structure and calibration of the Standard Approach. For example:

- Individual market calibrations should be reviewed in conjunction with the underlying correlation assumptions and the application of market stresses on assets in excess of the SCR
- For non-life insurance products such as property and general liability, a major source of variability are catastrophes and large losses. If these are separated the resulting residual volatility should be much lower and company specific reinsurance can be applied to the catastrophes and large losses.
- We recognize that smaller portfolios may have lower diversification but such companies tend to write specialised products and also tend to buy more reinsurance protection. There is a significant concern that the size factors do not capture the underlying risk and as a result may not be appropriate. This could be potentially addressed with greater use of company specific information.

Reduction for profit sharing / applying the k-factor

3.11 The risk mitigating effect of profit sharing business (5.389) is a feature that is strongly supported by the Industry, because it reflects important product features. We note that CEIOPS is considering changing the approach to calculate the so called "k-factor" (5.61 and 5.390) to cope with some of the issues identified in QIS 2.

In particular, CEIOPS is considering replacing the current 'top-level' adjustment with an analysis of the risk absorption of the future profit sharing for individual risks.

3.12 CEIOPS states that although this approach could overcome certain constraints in the calculation, it is likely to understate the risk absorption of the future profit sharing and overstate the capital requirements.

The actual impact is difficult to discern without quantitative testing but we recommend that CEIOPS and the Industry to continue to look together at other ways to ensure that the full benefit of risk absorptions is captured. This may involve, for example, the option to use integrated scenarios in order to assess the risk absorbing nature of the liabilities.

3.13 We note that S22 in the Supplement to CP20 states that "the modular MCR should reflect in a robust manner the risk absorption properties of future non-guaranteed bonuses included in the technical provisions". However, in order to create a truly risk-based approach, the full potential for risk absorption - not only "in a robust manner" - must be allowed for.

Allowance for expected profits/losses in non-life

3.14 As indicated in 8.29 and 5.388, allowing for non-life expected profits/losses from next years' non-life business in the standard formula is controversial with some CEIOPS members being against this. The CEA is strongly in favour of allowing expected profits/losses.

3.15 An insurance undertaking is exposed to additional insurance risks related to policies (renewals and new business) that are written over the next year. Hence, one might expect that some allowance for this risk (premium risk and catastrophe risk) to be included in the SCR calculation. If the SCR requires additional capital for premium risk, the value creation arising from next year's business should also be recognised as this is potentially available to absorb losses in the first instance.

Treatment of non-proportional reinsurance

3.16 For non-life risk, factor based approaches are recommended for the assessment of both premium risk and reserve risk per line of business (5.440). The benefits of non-proportional reinsurance cannot properly be addressed using this approach.

Some potential methods to address this issue (a combination of changes in design and greater use of company specific information) are discussed above in the "Calibration of the Standard Approach" section.

Calculation of a capital requirement for operational risk

3.17 CEIOPS advocates that there should be explicit allowance for operational risk within the standard formula using a simple function, which incorporates a limit to avoid the possibility that operational risk dominates the overall SCR, which the CEA supports. However, operational risk has been moved from being a risk component to a top level adjustment, which effectively excludes it from the calculation of the diversification benefits and fails to take into account any risk mitigation or absorption that may be in place. We do not understand this exclusion and maintain that diversification benefits and risk mitigation / absorption should be fully allowed for

3.18 The CEA suggests that in order to reward and encourage sound risk management, a possible approach might be to apply a factor to the operational risk capital amount with this depending on the quality of the company's risk management processes and procedures.

3.19 This factor would need to be assessed qualitatively and could be part of the supervisory review process under Pillar II.

4. Full and Partial Internal models

4.1 The further guidance on internal models and the differentiation between "statistical quality test", "calibration test", and "use test" are significant step forwards, which the Industry welcomes. We are still considering the criteria from a practical point of view. In return, companies will need to engage in dialogue with supervisors to explain the development and basis of their internal risk management procedures and in order to gain regulatory approval.

4.2 These activities are likely to require supervisors to acquire significant new skills and expertise both for Pillar 1 and Pillar 2. The effectiveness of supervisors will therefore depend upon how quickly and adequately they acquire such skills.

As a result, supervisors should start working with the Industry as soon as possible to establish a learning process and to familiarise themselves with the key aspects of the Solvency II framework such as internal models and risk management processes ahead of the framework's implementation.

In addition, it may be helpful for supervisors to set up an "awareness framework" whereby supervisors can co-operate and/or exchange expertise and experience especially when they have to consider specific specialist lines of business.

4.3 S17 of the supplement to CP20 states that for non transitional partial models the risk contribution of the non-modelled part of the total SCR cannot exceed 20%. In practice this will mean that the cost of implementing a partial model is likely to be little different to that for implementing a full internal model. This will act as a significant disincentive for companies unable to afford such large upfront costs. Given that partial models are likely to better capture a company's risk exposure (otherwise presumably they will not be approved) it is hard to understand why companies are not allowed to adopt a more incremental approach to developing partial models as this is likely to encourage more companies to do so? More generally, the limit of 20 % seems arbitrary and not in line with the intention to strengthen incentive to recognise and control risks.

In this context, it is worth noting as discussed in 3.16 above, that the standard approach does not properly allow for non proportional reinsurance. Companies with such reinsurance or considering it will therefore need to develop a partial model in order to see an expected capital reduction. This form of reinsurance can be a very important risk mitigant especially for smaller companies. The same point would also apply for some specialist lines of insurance business, such as Trade Credit Insurance and Surety, for which partial models are more likely to be appropriate than the standard approach.

It is therefore vital that the use of partial models is made more attainable and practical in order to appropriately encourage and reward companies to use this important form of risk mitigation.

The power of solo supervisors to overrule approved internal model by the group supervisor

4.4 CEIOPS seems to imply that a solo supervisor would have the power to effectively overrule an approved internal model at the group level e.g. by applying a capital add-on at a solo level. We believe that this would be disruptive for groups trying to manage their business.

4.5 Co-operation between supervisors should be a requirement and not a target / aspiration. The solo supervisors will have an important role with access to group information but it would not be acceptable if decisions approved by the lead supervisor together with the coordination committee, are de facto overridden by local supervisors.

4.6 We recommend that the lead supervisor should have the ultimate authority to approve (and disapprove) internal models.

Granularity and limits related to partial models

4.7 In advice (7.24 - 7.25) CEIOPS allows usage of partial models across SCR components and across controlling units of an undertaking (see 7.12).

4.8 In reality we expect companies move to internal and partial models to be incremental i.e. first for the major products for the major risk types. The fixed approach described by CEIOPS could result in restrictions in some circumstances,

For example, where companies have 3 or 4 large products and several smaller products, for which the risk is less material and the data less reliable. In such cases we believe that it would be reasonable to use partial models for the larger products (even though not all risks can be modelled) and to use the standard approach for the smaller products.

We suggest that CEIOPS takes a pragmatic approach that also takes into account materiality.

5. MCR and Other Safety Measures

5.1 The CEA believes that the working document "CEA Working Paper on the MCR and Proposed Ladder of Intervention (16 October 2006)" will provide valuable insight into the CEIOPS work in this area.

Interplay between the MCR and the SCR

5.2 The QIS2 exercise highlighted that the approaches suggested in QIS2 to calculate the MCR did not allow for some companies an effective supervisory ladder of intervention approach. CEIOPS acknowledges this in CP20.

5.3 In the supplement to CP20 CEIOPS has expressed their preference for a factor modular approach calibrated to a lower level of confidence (i.e. 90%). Our feedback on QIS 2 indicated substantial concerns on the modular approach and as a result, the Industry has favoured a different methodology.

5.4 The CEA, as proposed in its paper "CEA Working Paper on the MCR and Proposed Ladder of Intervention (16 October 2006)" is in favour of calculating the MCR as a percentage of the approved SCR. This is similar to the "compact" approach outlined in CP20 except that CEIOPS bases the SCR (at t-1) on the Standard Approach (8.71).

5.5 We would strongly advise CEIOPS to reconsider its approach to the MCR as the simplified modular approach described is likely to give conflicting signals (i.e. if the MCR and SCR are not designed consistently then actions that impact the SCR may not impact the MCR making it more difficult for companies to manage their solvency position). In addition, such an approach will not guarantee an appropriate ladder of intervention.

5.6 CEA intended approach would solve these issues and we encourage CEIOPS to refer to the aforementioned paper.

Safety Measures

5.7 CEIOPS suggests that for Pillar 1 a "prudent person plus" approach should be used to determine what assets undertakings should be allowed to hold. As per 1.2 of CP19, "this implies that safety, yield and liquidity of the investment must be secured and that it must be diversified and adequately spread".

5.8 In CP20 CEIOPS argue that the "prudent person plus" requires assets covering technical provisions, MCR and SCR to be both listed (on a list of eligible asset classes) and meeting certain principles. In contrast, in CP19 CEIOPS advocate having transitional safety measures (asset limits with a revision clause) only where the risks are not sufficiently captured in the SCR.

5.9 The approach proposed in CP19 avoids double counting and ensures that a risk based economic approach for assessing the capital requirements for insurance companies, which we support because:

- Assets are not assessed in isolation both also consider the underlying risk exposures of the liabilities supported by the assets. For example long term bonds may be volatile in isolation but are a match for long term fixed liabilities.
- Similarly looking at asset limitations in isolation does take into account the impact of risk mitigation (e.g. hedging); any risk absorption from liabilities (e.g. profit sharing)
- More risky investment strategies would be captured within the SCR calculation within a risk based economic approach and this should be acceptable provided that the company has sufficient capital to support such risks.

In general Solvency II should not constrain the way companies run their business.

5.10 The CEA does not support the eligible list of assets approach proposed in CP20 and believes that asset limitations (as suggested in CP19) should not be required if Pillar 1 and Pillar II sufficiently capture the underlying risks. In the current Solvency I framework asset limits have lagged behind market innovations, have been open to interpretation and did not necessarily provide effective policyholder protection.

5.11 The Industry's preference would be to improve the Standard Approach rather than have arbitrary asset limits. For example, the inclusion of concentration risk within the SCR should mitigate the need for asset limits.

The CEA also believes that certain other risks such as liquidity risk and possible undertaking specific concerns are best assessed under Pillar II where the particular circumstances of the company can be taken into account.

Annex A: Alternative proposal for an integrated approach to life insurance activities under the standard SCR

6.1 In general the CEA supports the modular approach; however, we recognise that it gives rise to certain difficulties, for example assessing the risk absorption of future profit sharing. The alternative integrated approach may alleviate some of these difficulties, but may introduce other difficulties. Further work is required in assessing what the advantages and disadvantages of the integrated approach are, before a final opinion can be made on the usefulness of including the integrated approach in QIS3.

In particular, benefits could be achieved by supplementing the modular approach with elements of the so-called integrated approach, particularly in assessing the risk absorption of future profit sharing i.e. the two approaches should not necessarily be viewed as pure alternatives.

Appendix

It is important to note that the comments in this document should be considered in the context of other publications by the CEA. These can be found under the Solvency II section of the CEA website (www.cea.assur.org) and include:

- Solvency II: Structural Issues (1 March 2005)
- Solvency II - Building Blocks for the Solvency II Project CEA Working Document in Progress (18 May 2005)
- CEA's comments on the CEIOPS' Draft Answers to the 'Second Wave' of Calls for Advice (30 September 2005)
- CEA's comments on the CEIOPS' Draft Answers to the 'Third Wave' of Calls for Advice (9 Feb 2006)
- Solutions to Major Issues for Solvency II – Joint submission by the CRO Forum and the CEA (17 February 2006)
- CEA working document on the standard approach for calculating the solvency capital requirement (22 March 2006)
- CEA document on Cost of Capital (21 April 2006)
- CEA guidance on Quantitative Impact Study 2 (15 May 2006)
- CEA's Pillar II Principles and Comments on Consultation Paper no. 13 (15 September 2006)
- Feedback on CEIOPS Consultation Paper 14 – Joint submission by the CRO Forum and CEA (22 September 2006)
- Assessing the Impact of Solvency II on the Average Level of Capital (16 October 2006)
- CEA Preliminary Feedback from QIS2 (16 October 2006)
- CEA Working Paper on the MCR and Proposed Ladder of Intervention (16 October 2006)
- CEA Working Paper on the risk measures VaR and TailVaR (7 November 2006)
- CEA Elaboration of the Total Balance Sheet Approach (January 2007)

These documents together constitute a coherent package.