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**ANNEX to Framework for  
Consultation**

**SPECIFIC CALLS FOR ADVICE FROM CEIOPS**

**(First Wave)**

**Purpose of this document**

This document includes a first set of Specific Calls for advice from the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in connection with the development of a new solvency system (Solvency II) for life and non-life insurance undertakings and reinsurance undertakings.

Subsequently this document will be updated to include further specific calls for advice and amendments.

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## ***SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N° 1***

### **1. INTERNAL CONTROL AND RISK MANAGEMENT**

This Specific Call for advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice. This Specific Call for advice is also linked to cross-sectoral topics such as Corporate Governance and Company Law, addressed by other EU initiatives.

#### **1.1. Introduction**

Solvency II requires a more risk-focused approach. This can only be built on the basis of a thorough knowledge by the insurance undertaking of the risks it incurs. To ensure that the undertaking has a clear vision of the risks it faces, it is suggested to strengthen the existing requirements (Article 10 point 3 in the codified life directive 2002/83/EC and Article 9 in the third non-life directive).

#### **1.2. References**

- International Association of Insurance Supervisors (IAIS)<sup>1</sup>:
  - Insurance Core Principles: 10, 18 and 19<sup>2</sup>
  - Stress testing by insurers Guidance Paper (October 2003)<sup>3</sup>
- Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)<sup>4</sup>:
  - Report on internal control for insurance undertakings (December 2003), under the chairmanship of Carlos Montalvo (to be published)
  - Report on prudential supervision of insurance undertakings (December 2002), under the chairmanship of Paul Sharma<sup>5</sup>

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<sup>1</sup> <http://www.iaisweb.org/>

<sup>2</sup> [http://www.iaisweb.org/133\\_358\\_ENU\\_HTML.asp](http://www.iaisweb.org/133_358_ENU_HTML.asp)

<sup>3</sup> <http://www.iaisweb.org/185stresstesting03.pdf>

<sup>4</sup> <http://www.ceiops.org/>

<sup>5</sup> [http://europa.eu.int/comm/internal\\_market/insurance/docs/solvency/solvency2-conference-report\\_en.pdf](http://europa.eu.int/comm/internal_market/insurance/docs/solvency/solvency2-conference-report_en.pdf)

- European Commission<sup>6</sup>:
  - "Review of capital requirements for banks and investment firms", Commission Services Third Consultation Paper, Working Document, 1 July 2003: article 116, 117 and annex I, sections 1 and 11-14<sup>7</sup>
  - Report of the Working Group on life technical provisions to the IC Solvency subcommittee (MARKT/2528/02)<sup>8</sup>

### 1.3. Background: Preliminary proposal for principles for draft directive

Two new articles are suggested.

Article on Internal control (N2 in document [MARKT/2539/03](#)):

“Insurance undertakings are required to have in place internal controls that are adequate for the nature and scale of the business.”

Article on Risk management (N3 in document [MARKT/2539/03](#)):

“Insurance undertakings shall identify and assess the nature and the significance of the risks they face. Insurance undertakings shall manage these risks to provide reasonable assurance of maintaining the undertaking’s overall financial soundness. In order to achieve this, insurance undertakings shall have in place effective strategies and processes, comprehensive and proportionate to the nature and scale of the risks.”

### 1.4. Specific Call for advice

The Commission Services would like CEIOPS to advise on detailed rules by which supervisors can ensure that undertakings have proper internal control system and risk management procedures. CEIOPS should incorporate as far as possible the criteria of the Insurance Core Principles and make them operational. CEIOPS should address the following recommendations in the preparatory work.

#### *Internal control*

Ensure that a comprehensive internal control system is in place. This implies at least that:

- Major types of risks are identified, such as underwriting, provisioning, asset, reinsurance and operational risks.
- Accounting and other records provide complete, accurate, verifiable and timely information
- Transactions are only entered into with appropriate authority

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<sup>6</sup> [http://europa.eu.int/comm/internal\\_market/insurance/index\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/index_en.htm)

<sup>7</sup> [http://europa.eu.int/comm/internal\\_market/regcapital/cp3/2003-consultpaper3\\_en.htm#workingdoc](http://europa.eu.int/comm/internal_market/regcapital/cp3/2003-consultpaper3_en.htm#workingdoc)

<sup>8</sup> [http://europa.eu.int/comm/internal\\_market/insurance/solvency/solvency2-workpapers\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-workpapers_en.htm)

- Clear hierarchical lines, delegations and responsibilities have been defined
- An investment policy document and its implementation has been approved and assets are safeguarded
- Reporting to management is comprehensive and adequate
- Regular checks are conducted on the respect of the existing limits and guidelines
- Internal control deficiencies are reported in a timely manner and addressed promptly
- Strict separation between risk management and risk controlling
- Internal audits are periodically performed and the ensuing report's recommendations are followed up.
- Management is able to promptly adapt the strategy to the circumstances.

#### *Risk management*

Ensure a company correctly manages the risks incurred and has a prospective view on the risks that might possibly occur. This implies at least that:

- Management is able to identify, assess, manage and control the risks of the business and hold sufficient capital for these risks
- Clear guidelines are given, including limits to risk taking
- The reinsurance program is adequate to cover the company's business and the reinsurers chosen are regularly assessed.
- Rules do not encourage excessive financial commitments or risk-taking (for example, counter-signatures are compulsory above certain thresholds)
- Stress testing is regularly conducted, including both scenarios and sensitivity tests.

Some of these principles on internal control and risk management may have to be applied in a flexible manner for smaller insurance undertakings, if the nature and scale of their business allows it.

These principles have to be applied at group level as well as at legal entity level, with perhaps some adaptations in view of the specific risks that may be encountered at group level.

### **1.5. Reporting modalities**

CEIOPS should provide regular progress reports under this specific call for advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 31st October 2004. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 30 June 2005.

## **2. SUPERVISORY REVIEW PROCESS (GENERAL)**

This Specific Call for advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice.

### **2.1. Introduction**

European regulation has created an internal market with mutual recognition of prudential control systems and the principle of supervision by the home Member State. It implies that supervisors are confident that all supervisors respect a certain agreed standard of supervision. However, supervisory standards and methods vary considerably throughout the EU. Increasing the convergence of the supervisory process of the Member States towards a best practice process is consequently essential. To initiate EU regulation on this aspect, it would be useful to set agreed standards that all supervisors must at least respect for both off-site and on-site supervision and to ensure that every supervisor has the necessary powers and tools, including quantitative tools, addressing both specific undertakings and the whole market.

This Call for advice is very broad because the supervisory review oversees all of the company's activity. Two aspects of this supervisory review process will be treated by separate Calls for advice in view of the objective to aim at maximum harmonization: the quantitative tools to be used in the supervisory review process (see Specific Call for advice n°3) and the implementation of the fit and proper criteria (to be presented in the next wave of Specific Calls for advice).

### **2.2. References**

- IAIS
  - Insurance Core Principles 4, 11, 12, 13, 14, 15 and relevant elements of ICP 17 to 28
  - Supervisory standard on on-site inspections (October 1998)
- CEIOPS
  - Report on internal control for insurance undertakings (December 2003), under the chairmanship of Carlos Montalvo
  - Report on prudential supervision of insurance undertakings (December 2002), under the chairmanship of Paul Sharma
- European Commission



- "Review of capital requirements for banks and investment firms", Commission Services Third Consultation Paper, Working Document, 1 July 2003: article 116, 117 and annex I, sections 1 and 11-14<sup>9</sup>
- Report of the Working Group on life technical provisions to the IC Solvency subcommittee (MARKT/2528/02)
- Report of the Working Group on non-life technical provisions to the IC Solvency subcommittee (September 2002) MARKT/2529/02<sup>10</sup>

### **2.3. Background: Preliminary proposal for principles for draft directive**

An article on the supervisory review process (N4 in document [MARKT/2539/03](#)) could be developed along the following lines:

“In order to achieve its objectives, the supervisory authority supervises the financial soundness of individual insurers. This requires a forward-looking analysis of individual insurers, insurance groups, the market as well as the environment in which they operate. The analysis of individual insurers is both off-site and on-site.

The supervisory authority receives the necessary information to conduct effective off-site monitoring and to evaluate the financial condition of each insurer as well as the insurance market. The supervisory authority carries out on-site inspections to examine the business, internal controls and financial condition of an insurer and its compliance with legislation and supervisory requirements.

The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision. Where needed, the supervisory authority imposes sanctions based on clear and objective criteria that are publicly disclosed. In the case of a crisis affecting two or more national authorities, information is shared and actions are coordinated.”

### **2.4. Specific Call for advice**

The Commission Services would like CEIOPS to give technical advice on appropriate standards for increasing the level of convergence of the supervisory process. This process should allow "to identify problems or irregularities in a range of areas, including asset quality, accounting and actuarial practices, internal controls (including those dealing with information technology and outsourcing), quality of underwriting (both the prudence of the underwriting policy and the effectiveness of its implementation in practice), valuation of technical provisions, strategic and operational direction, reinsurance, and risk management" (explanatory note 13.2 of ICP 13). It must also allow the supervisor to evaluate the quality of management. CEIOPS must incorporate as far as possible the

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<sup>9</sup> [http://europa.eu.int/comm/internal\\_market/regcapital/cp3/2003-consultpaper3\\_en.htm#workingdoc](http://europa.eu.int/comm/internal_market/regcapital/cp3/2003-consultpaper3_en.htm#workingdoc)

<sup>10</sup> [http://www.europa.eu.int/comm/internal\\_market/insurance/solvency/solvency2-workpapers\\_en.htm](http://www.europa.eu.int/comm/internal_market/insurance/solvency/solvency2-workpapers_en.htm)

criteria of the Insurance Core Principles and make them operational. The advice should involve the following areas:

- main steps of the off-site supervisory monitoring process.
- main steps of the on-site inspection, differentiating between a “full scale” and a “focused” inspection. A “full-scale” on-site inspection includes, at a minimum, the following activities:
  - evaluation of compliance with legal requirements,
  - evaluation of the internal control system
  - analysis of the nature of the insurer’s activities, e.g. the type of business written
  - evaluation of the technical conduct of insurance business, of the organisation and the management of the insurer, the commercial policy and the reinsurance cover and its security
  - analysis of the relationships with external entities, such as through outsourcing or with respect to other undertakings in the same group
  - assessment of the insurer’s financial strength, notably the technical provisions
  - evaluation of compliance with corporate governance requirements
  - adequate follow-up to on-site inspection
- non-quantitative supervisory tools, both retrospective and prospective.
- relations with third parties (auditors, independent actuaries, entities to which the undertaking has outsourced some of its functions, etc.)

## **2.5. Reporting modalities**

CEIOPS should provide regular progress reports under this specific call for advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 31st October 2004. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 30 June 2005.

### **3. SUPERVISORY REVIEW PROCESS (QUANTITATIVE TOOLS)**

This Specific Call for advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice such as those referring to the calculation of the solvency capital requirement.

#### **3.1. Introduction**

Although quantitative tools are part of the supervisory review process (at this stage, there is no proposal for a separate article in the Framework directive on this subject; however, the question remains open), this is treated separately because of the prominent role of quantitative tools in the harmonization of national supervisory review processes and in undertakings' own long-term solvency assessment. National supervisors each use their own early-warning indicators, even if they are not always formalized and named as such, or their own market references, sometimes implicit, to evaluate potential problems in an insurance company.

#### **3.2. References**

- IAIS
  - Insurance Core Principles 11, 12 and 13
  - Stress testing by insurers Guidance Paper (October 2003)
- CEIOPS
  - Report on prudential supervision of insurance undertakings (December 2002), under the chairmanship of Paul Sharma

#### **3.3. Specific Call for advice**

The Commission Services seek CEIOPS' advice on a detailed description of the essential tools necessary for the supervisory process to be efficient. These tools should at least include:

- early-warning indicators to alert the supervisory authority on the situation of certain undertakings,
- stress testing, sensitivity testing and scenarios analysis,
- projections to evaluate the long-term resilience of the undertakings (e.g. continuity testing and solvency reports), and
- common market statistics for benchmarking purposes both between undertakings and across jurisdictions.

The Commission Services also seeks CEIOPS' advice on the quantitative references these tools should have and whether these references should be harmonized at EU level.

#### **3.4. Reporting modalities**

CEIOPS should provide regular progress reports under this specific call for advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 31st October 2004. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 30 June 2005.

#### **4. TRANSPARENCY OF SUPERVISORY ACTION**

This Specific Call for advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice.

##### **4.1. Introduction**

Increased transparency will help to harmonize supervisory practices. Publishing supervisory procedures will promote “best practice” convergence. Transparency of supervisory action goes hand in hand with the proposal to recognize, in the directive, explicit powers to increase the required solvency capital under the supervisory review process. These explicit powers will be treated in the next wave of calls for advice.

##### **4.2. References**

- IAIS
  - Insurance Core Principles 2d, 4
- European Commission
  - "Review of capital requirements for banks and investment firms", Commission Services Third Consultation Paper, Working Document, 1 July 2003: article 129 and annex J, section 3

##### **4.3. Background: Preliminary proposal for principles for draft directive**

Article on transparency of supervisory action (N5 in document [MARKT/2539/03](#)):

“The supervisory authority conducts its functions in a transparent manner.”

##### **4.4. Specific Call for advice**

The Commission Services seek CEIOPS' advice on the nature and the level of transparency of supervisory action. CEIOPS must incorporate as far as possible the criteria of the Insurance Core Principles and make them operational. This transparency may concern different areas:

- the supervisory authority publishes its objectives
- annual report, including the results of the evaluation process (inasmuch as the confidentiality requirements towards the supervised entities allow it).
- changes in objectives or approaches should be explained
- internal organisation
- elements of the general work program

This transparency can be directed towards different audiences (the supervised entity, the insurance profession, the general public), according to the areas concerned.

#### **4.5. Reporting modalities**

CEIOPS should provide regular progress reports under this specific call for advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 31st October 2004. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 March 2005.

## **5. INVESTMENT MANAGEMENT RULES**

This Specific Call for advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice.

### **5.1. Introduction**

The rules regarding the assets covering technical provisions should be extended to the assets representing the solvency capital requirement. Furthermore, prudent management of assets in an insurance undertaking is promoted by requiring a written statement of investment policy principles. Although this Specific Call for advice addresses only these two points, several other work areas will deal with the general topic of investment management from different angles, e.g. safety measures, risk management, internal controls, capital requirements, ALM, supervisory review process.

### **5.2. References**

- IAIS
  - Insurance Core Principle 21
  - Supervisory Standard on Asset Management by Insurance Companies
  - Supervisory Standard on derivatives
  - Papers from the Investment Subcommittee, e.g. the coming Guidance Paper on Investment Risk Management
- European Commission
  - Solvency II working documents (see Schedule 1 of the “roadmap” document for the Insurance Committee on 30 June 2004).

For the "prudent person" approach, the recent EU directive for occupational pension funds ([2003/41/EC](http://europa.eu.int/comm/internal_market/insurance/index_en.htm), Article 18) should be consulted<sup>11</sup>.

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<sup>11</sup> [http://europa.eu.int/comm/internal\\_market/insurance/index\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/index_en.htm).

### **5.3. Background: Preliminary proposal for draft directive wording**

It is envisaged that the current articles on the prudent management of assets would be strengthened as follows (Article 22 in the codified life directive and Article 20 in the third non-life directive):

"The assets covering the technical provisions and the solvency capital requirement shall take account of the type of business carried on by an assurance undertaking in such a way as to secure the safety, yield and ~~marketability~~ liquidity of its investments, which the undertaking shall ensure are diversified and adequately spread. To this end an assurance undertaking shall have an appropriate investment plan."

### **5.4. Specific Call for advice**

The Commission Services seek CEIOPS' advice on the investment management rules covering the capital requirements (the minimum capital requirement MCR and the solvency capital requirement SCR). Analysis is needed if different rules for different purposes (technical provisions, MCR, SCR) should be defined. Further analysis is needed if these rules should differ for the standard approach and internal models.

Moreover the Commission requires CEIOPS' advice on the requirements concerning the (minimum) content of an appropriate investment plan as well as its relationship to general business planning, internal control and risk management processes (including quantitative, e.g. ALM and capital adequacy, as well as qualitative, e.g. prudent person, aspects). Practical issues concerning reviews, proportionality (small companies, non-life insurance) etc, have to be taken into account. In addition an investment plan must be compatible with the chosen general principles underlying the new solvency regime such as the going-concern or the run-off approach.

### **5.5. Reporting modalities**

CEIOPS should provide regular progress reports under this specific call for advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 31st October 2004. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 March 2005.



## **6. ASSET-LIABILITY MANAGEMENT**

This Specific Call for advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice and may of course be subject to subsequent amendments in the light of CEIOPS' work (on Pillar 1 and 2 issues in particular).

### **6.1. Introduction**

In the future all insurance undertakings need to have an asset-liability management system (ALM) as part of their general business and risk management processes. General principles concerning A/L analysis shall be harmonised at the EU level. However, proportionality and business line specificities would have to be taken into account.

### **6.2. References**

- IAIS
  - Insurance Core Principles 18, 21, 23 and 26.
  - Papers from the Investment Subcommittee, including a forthcoming paper on ALM
  - Papers from the Solvency Subcommittee, in particular the one on stress testing as well as a forthcoming work on the matching of assets and liabilities.
- European Commission
  - Solvency II working documents (see Schedule 1 of the “roadmap” document for the Insurance Committee on 30 June 2004).
  - Report of the Working Group on life technical provisions to the IC Solvency subcommittee (MARKT/2528/02), especially Annex 1 on "Best practice" in existing national regulations and industry.
- IASB standards and proposals.

The new professional actuarial specialty guide of the Society of Actuaries (SOA) can be found at their website: <http://library.soa.org/library/pasg/spg0308alm.pdf>.

Although some specific material on ALM originating from industry, actuaries and consultants can be found on relevant websites, more in-depth information should be gathered through active communication with these organisations.

### 6.3. Background: Preliminary proposal for principles for draft directive

A new article (N8 in [MARKT/2539/03](#)) could be introduced along the following lines (a new article after the current Article 22 in the Codified Life Directive, and its equivalent in non-life.):

"To control its present and future exposure to financial and insurance risks, an insurance undertaking shall perform an asset-liability analysis appropriate for its business."

### 6.4. Specific Call for advice

As ALM practices are currently very diverse in the EU, priority should be given to the objectives of solvency supervision and risk management in the new rules. However, the development of comprehensive ALM models should be encouraged, and ultimately ALM should have a role to play in all three supervisory pillars of the Solvency II system.

One major use for ALM in pillar I is to contribute to investment planning. The role of ALM models depend on the structure and methods chosen for the calculation of the solvency capital requirement (SCR) formula and the technical provisions. Consequently, at this stage this issue cannot be addressed in full detail but must be revised later in the light of CEIOPS' work. Because asset-liability mismatch is a major risk, particularly in traditional life assurance, the standard formula for calculating the SCR should capture the ALM risk in a sufficiently prudent way. However, a more accurate calculation using an internal model approach (including the validation and approval processes) would be another option.

The pillar II supervisory review process should encompass the undertaking's ALM. Furthermore, some information regarding the company's ALM procedures as part of its general risk management process could be given under pillar III.

Rules concerning the definition and general principles of an ALM system should be given in EU regulations. These would be amplified with supervisory guidance.

The Commission Services require CEIOPS' advice on more detailed rules concerning ALM, taking into account the above-mentioned general issues, and including at least the following specific aspects for **life assurance**:

- ALM analysis should be taken into account when preparing the investment plan of a life assurance company. The main objects of analysis would include asset allocation (and resulting expected investment returns and volatility) in relation to the nature of liabilities (solvency and mismatch issues, guaranteed interest rates, bonus policy, liquidity, diversification, etc).
- An insurance undertaking should be able to model its future cash-flows in order to manage its financial and insurance risks in an integrated fashion and for different time frames. ALM would be a tool to achieve this.
- Continuity and stress testing (e.g. sensitivity to interest rate changes) and other quantitative analyses in the pillar II supervisory review could make use of ALM models (see separate call for advice).

- ALM should be used when addressing some of the risk management issues of life assurance, e.g. reinvestment risk, profitability analysis of new products, business and bonus planning, etc. In sophisticated models hedging strategies and other more complex risk management techniques could also be incorporated into ALM.
- An internal model approach for calculating the SCR for the asset-liability mismatch risk should include ALM modelling techniques. ALM could be used for detailed modelling and analysis of cash-flows and investment related parts of life assurance contracts (e.g. interest rate guarantees, bonuses, embedded options).
- Requirements concerning ALM models, i.e. the integration of ALM into management and control processes, validation criteria etc, should be appropriate and proportional to the role of ALM. If an ALM model is used in Pillar I, rules concerning internal models have to be applied (the topic of internal models will be addressed in a Specific Call for advice). On the other hand, if the ALM model is used only in Pillar II, more general guidelines might be adequate. Both quantitative and qualitative aspects should be included as well as technical and human resource requirements.

As regards **non-life insurance**, the use and the role of ALM are different because the nature of liabilities is different. In many cases, elementary methods of analysis and simple models would be appropriate. However, there are lines of business where ALM analysis is crucial (high severity claims; lines which generate significant amounts of technical provisions and/or have long tails etc). The results of this ALM analysis should be taken into account when preparing an investment plan.

As for life assurance, the Commission requires CEIOPS' advice on more detailed rules. The links between ALM and the general solvency framework, e.g. the SCR calculation, need to be taken into account as well.

The regulatory framework for ALM should be both practical enough to be applied in the whole EU and fit in the new overall solvency regime by motivating better risk management.

## **6.5. Reporting modalities**

CEIOPS should provide regular progress reports under this specific call for advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 31st October 2004. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 30 June 2005.