| Comments Template on CEIOPS-CP 42<br>Consultation Paper on the Draft L2 Advice on TP – Risk Margin | | Deadline<br>11.09.2009<br>4 p.m. CET |
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| Name of Company: | European Insurance CFO Forum | |
| Disclosure of comments: | CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential.<br>Please indicate if your comments should be treated as confidential: | No, The CFO Forum comments are not confidential. |

Please follow the following instructions for filling in the template:

- ⇨ <u>Do **not** change the numbering</u> in the column "reference".
- ⇨ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph, keep the row <u>empty</u>.
- ⇨ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below.
  - o If your comment refers to multiple paragraphs, please insert your comment at the first relevant paragraph and mention in your comment to which other paragraphs this also applies.
  - o If your comment refers to sub bullets/subparagraphs, please indicate this in the comment itself.

**Please send the completed template, <u>in Word Format</u>, to <u>secretariat@ceiops.eu</u>. Our IT tool does not allow processing of any other formats.**

The numbering of the paragraphs refers to Consultation Paper No. 42 (CEIOPS-CP-42/09).

| Reference | Comment | |
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| General Comment | **Our general comments highlight key areas where the CFO Forum takes a different stance to the views of CEIOPS:** | |

**Diversification benefits should not be limited to the line of business level**

Diversification effects should be allowed between lines of business. Pooling of risks is central to an insurance company's business and thus, diversification benefits should be allowed for at the company or group level. Diversification should be computed on a going concern basis at a level that takes into account risks that are managed together. Transfer values include such diversification effects.

See further comments in 3.130.

**Loss absorbing capabilities of deferred taxes should be included within the valuation of the risk margin**

Deferred taxes accounted for prior to the valuation date do not have any loss absorbing capacity. However, deferred taxes deducted on the estimation of future cash flows should have an absorbing capacity. As such, loss absorbing capacity of deferred taxes should be included for consideration when assessing the risk margin.

See further comments in 3.130.

**The CFO Forum supports a cost of capital in the range 2.5%-4.5% rather than "at least 6%".**

CFO Forum believes that the cost of capital should be lower than 6% as this is higher than the rates currently being considered under the cost of residual non hedgeable risk (CRNHR) methodology by the CFO Forum.

See further comments in 3.134.

**Unavoidable market risk should be excluded from the calculation of risk margin in the technical provisions until more reliable estimation techniques are developed, but should be assessed separately as part of the ORSA.**

In principle all unavoidable risk should be covered by the Risk Margin. Given the practical difficulties of

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| | separately measuring unavoidable market risks, due to the complexity and immaturity of the techniques available, the CFO Forum recommends that unavoidable market risk is excluded from the calculation of the risk margin in the technical provisions. Unavoidable market risk is included in the overall market risk charge in the SCR. Where unavoidable market risk is indentified as a key risk this should be separately identified and assessed in the ORSA and disclosed in the Report to Supervisors.<br><br>See further comments in 3.130.<br><br>**Excessive prudence is not consistent with the economic basis in the Level 1 Directive.**<br><br>An excessive prudence margin is implicit in the level 2 implementing guidance proposals, due to the combination of various prudent requirements. The combination of a few factors such as the disallowance of diversification between lines of business, the inclusion of unavoidable market risk, the disallowance of deferred taxes and the application of a cost of capital rate of at least 6% are likely to result in an excessively prudent margins that are not be able to be justified using economic theories in accordance with the Level 1 Directive requiring a 99.5% confidence over a one year time horizon.<br><br>**Transfer to an empty reference undertaking is not appropriate. The transfer should be to a reference undertaking identical to the supervised entity/group after the transfer.**<br><br>Empty reference undertaking is not an appropriate basis as it does not recognise the economics of the portfolio on a going concern basis.<br><br>Risk margin by line of business should be calculated assuming transfer to a reference entity/group that will be identical to the supervised entity/group after the transfer. | |
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| 3.12. | **The segmentation suggested for Cost-of-Capital calculations is too onerous.**<br>Segmentation is required into 16 and 14 lines of business for life and non-life business respectively. A simpler segmentation should be considered.<br>For reinsurance contracts, if the main risk driver is proportional, the contract should be treated as proportional in its entirety.<br>Disclosure at the segmentation level would be too onerous. As noted above, the segmentation level | |

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| | should be simplified however the option to aggregate these lines of business at the reporting level should be available. | |
| 3.13. | | |
| 3.14. | Comments in 3.130 are also relevant here. | |
| 3.15. | Comments in 3.130 and 3.134 are also relevant here. | |
| 3.16. | Comments in 3.130 are also relevant here. | |
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| 3.18. | Comments in 3.130 are also relevant here. | |
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| 3.35. | Comments in 3.54 are also relevant here. | |
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| 3.38. | The CFO Forum supports the points made in this paragraph. | |
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| 3.45. | The CFO Forum supports the point made in this paragraph | |
| 3.46. | Comments in 3.129 are also relevant here. | |
| 3.47. | **Response to CEIOPS' question to stakeholders on the treatment of market risk in the risk margin.**<br>The CFO Forum believes that unavoidable market risk should be allowed for in Pillar II rather than in Pillar I. This is commented on further in 3.130. | |
| 3.48. | Comments in 3.130 are also relevant here. | |
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| 3.52. | Comments in 3.130 are also relevant here. | |
| 3.53. | Comments in 3.130 are also relevant here. | |
| 3.54. | **When determining the risk margin, an internal model should not be constrained by the segmentation requirements of the standard model.**<br>The third paragraph implies that an internal model must use a segmentation that is the same as or more granular than the standard model. We do not agree with this treatment.<br>From a methodology point of view, the risks of the company may not be best captured using prescribed lines of business.<br>There are also practical implications of this treatment. The standard model would have to be retained and used even after internal model approval which would be labour intensive. | |
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| 3.56. | Comments in 3.54 are also relevant here. | |
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| 3.58. | Comments in 3.130 are also relevant here. | |
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| 3.61. | Comments in 3.54 are also relevant here. | |
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| 3.94. | Comments in 3.15 are also relevant here. | |
| 3.95. | Comments in 3.134 are also relevant here. | |
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| 3.98. | Comments in 3.134 are also relevant here. | |
| 3.99. | Comments in 3.100 are also relevant here. | |
| 3.100. | **The Cost-of-Capital calculation should consider both the cost of equity and debt.**<br>CEIOPS sets out that the risk margin under a Cost-of-Capital approach should be funded solely with equity capital. The CFO Forum believes that in an adverse situation, a company should have the choice to use either the cost of equity or a weighted average cost of equity and debt based on the level of distress experienced. | |
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| 3.124. | Comments in 3.130 are also relevant here. | |
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| 3.127. | | |
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| 3.129. | **The risk margin calculation should not be unduly onerous. Principles outlining permissible methods of simplification are required.**<br>The risk margin calculation should not be unduly onerous; therefore, simplifications regarding estimation of the Solvency Capital Requirement ("SCR") over the future run-off of the liabilities are necessary.<br>Level 2 implementing measures should include principles on how estimation of the SCR in future time periods is linked to underlying risk drivers. | |
| 3.130. | **Transfer to an empty reference undertaking is not appropriate. The transfer should be to a reference undertaking identical to the supervised entity/group after the transfer (Assumption 2).**<br>Empty reference undertaking is not an appropriate basis as it does not recognise the economics of the portfolio on a going concern basis.<br>Risk margin by line of business should be calculated assuming transfer to a reference entity/group that will be identical to the supervised entity/group after the transfer.<br><br>**Diversification benefits should not be limited to the line of business level (Assumption 8).**<br>Diversification should not be limited to the line of business level. The ability to combine independent risk is the basis for pricing insurance. Consolidation has been driven by the costs and benefits of managing diverse portfolios of business together.<br>Ignoring the economic benefits of being part of a group is contradictory to the objectives of Solvency II. Diversification benefits should be allowed for at the company or group level, subject to fungibility of | |

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| | capital (covered in CP60).<br><br>**Loss absorbing capabilities of deferred taxes should be included within the valuation of the risk margin (Assumption 7).**<br>The Solvency Capital Requirement ("SCR") used to calculate the risk margin should take into account not only the loss absorbing capabilities of the technical provisions but also deferred tax and tax credits.<br>The exclusion of the loss absorbing capabilities of deferred taxes appear to conflict with the Framework directive.<br>To be consistent with our response to CP54, credit should be taken for deferred tax and for tax credits subject to applicable current and expected future tax rules consistent with anticipated profits or losses.<br>Under IAS 12, a test for recoverability is mandatory when recognising deferred tax assets. Only when the net tax asset is deemed to be recoverable can it be recognised. The CFO Forum recommends that such net tax assets should also be recognised for regulatory reporting purposes under Solvency ll.<br><br>**Unavoidable market risk should be excluded from the calculation of risk margin in the technical provisions until more reliable estimation techniques are developed, but should be assessed separately as part of the ORSA.**<br>In principle all unavoidable risks should be covered by the Risk Margin. Given the practical difficulties of separately measuring non-hedgeable market risks, due to the complexity and immaturity of the techniques available, the CFO Forum recommends that unavoidable market risk is excluded from the calculation of the risk margin in the technical provisions. Unavoidable market risk is included in the overall market risk charge in the SCR. Where unavoidable market risk is indentified as a key risk this should be separately identified and assess in the ORSA and disclosed in the Report to Supervisors. | |
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| 3.133. | | |
| 3.134. | **The CFO Forum supports a cost of capital in the range 2.5%-4.5% rather than “at least 6%”.**<br>The return on capital selected should reflect the rate of return expected on capital held for bearing insurance risks and should not include other costs.<br>The CFO Forum supports a cost of capital rate of 2.5-4.5% as per the CRO Forum paper “Market Value of Liabilities for Insurance Firms” dated 28 July 2008 see http://www.croforum.org/publications/20082807_resource/File.ecr?fd=true&dn=croforummvlpaperjuly2008 | |
| 3.135. | Comments in 3.130 are also relevant here. | |
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