

## CEA paper on Capital Add-ons

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### Executive summary

- Our view is that capital add-ons should be exceptional and must only be applied when other supervisory tools have been exhausted. These tools would depend on national legislation but could include requesting firms to undertake independent reviews, withdrawing authorisation of persons holding significant functions, and requesting firms to carry out actions as part of the regular supervisory relationship. The emphasis should always be on mitigating risk rather than simply requiring additional capital to be held.
- Capital add-ons will be mostly appropriate for undertakings using the standard formula to calculate their SCR. Capital add-ons resulting from the SCR calculated on the basis of an internal model or from governance failings will be very rare in practice. By definition an approved internal model is one that is agreed to match the firm's risk profile. When the risk profile changes, the model will be adapted and re-approved. Governance failings could be addressed by using other supervisory tools and capital add-ons should be a last resort measure.
- The criteria for assessing whether a capital add-on is required should be clearly defined in order to ensure convergence of supervisory practices. In addition, we would like that a peer review process for supervisors is established, as well as a database on capital add-ons.
- Appropriate measurement of risks is a key issue. Certain risks are by nature less quantifiable than others; for these, clearly defined qualitative criteria should be established. Defining what constitutes a material deviation is important.
- Supervisory authorities should have a formal process in place for deciding on add-ons, including a well defined appeal process for firms. This will ensure that decision-making is transparent.

### Introduction

The CEA is pleased to have the opportunity to submit comments to CEIOPS on the application of capital add-ons under the proposed Solvency II directive. The subject is a contentious one.

We believe that the arrangements for applying capital add-ons as set out in the directive proposal are balanced and sensible. We have also been heartened by the measured and helpful comments made by

CEIOPS in, amongst other places, the advices to the Commission dated November 2006<sup>1</sup> and March 2007<sup>2</sup>. Please note that the views given in this paper are based on the European Commission's original proposal for Solvency II. Our position could change depending on the outcomes of political negotiations, in particular on those concerning the group support regime.

Our key message is that it is important to build confidence around this important provision of the directive. We should do this primarily by improving the clarity around how a capital add-on might be appropriate and why it should in practice be a last resort. A key part of this will be to develop a comprehensive and harmonized framework governing the consideration of an add-on.

Our comments in this paper are intended to be complementary to and supportive of the CEIOPS published advice. The comments are general in nature and outline a framework within which much detail remains to be added. We intend to submit a second, more detailed, paper to CEIOPS in March.

## 1. General principles governing capital add-ons

### 1.1 Capital add-ons should be exceptional

There appears to be complete consensus that add-ons should be exceptional and must only be applied where there are no other tools available to the supervisor and the problem is both pressing and material.

We strongly agree with CEIOPS' publicly stated view that the priority should be to mitigate risk directly rather than simply requiring additional capital to be held. No add-ons should be contemplated until the firm has had reasonable opportunity to modify the risk profile, use entity specific parameters in the standard formula, implement an internal model or adjust its system of governance.

The criteria for assessing each step must be clearly established and firms must have the opportunity to challenge or appeal against supervisory decisions (see section 3 of this paper and annex A). That said the process must be sufficiently flexible so that supervisors are not constrained from taking decisive action where appropriate and justified.

### 1.2 Capital add-ons are mainly appropriate for firms using the standard formula

Add-ons will be appropriate in practice, almost without exception, to firms using the standard formula. This is because approval of an internal model by definition assumes recognition by the supervisor that the firm is able to measure, model and manage risk to a high standard. Conversely, a single standard formula applied across the entire European insurance sector cannot possibly give the correct answer for all firms. We would therefore expect to see that for some firms, whose business does not fit the standard template, the deviation will be material.

An add-on under these circumstances therefore must not be seen as a penalty or as the result of a failing. However even here, the default option, as set out in article 37, is to require the firm to implement a full or partial internal model.

By definition an approved internal model is one that is agreed to match the firm's risk profile. Where the risk profile changes the model will be adapted and re-approved. Add-ons are unlikely to be necessary in the interim.

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<sup>1</sup> CEIOPS-DOC-06/06

<sup>2</sup> CEIOPS-DOC-05/07

### 1.3 Capital add-ons for governance failures will be rare

Finally it is possible that the supervisor will lose confidence in the firm's internal governance and would like to apply add-ons for failures related to Pillar II issues rather than the calculation of the SCR. However, we believe that add-ons related to governance failings would be rare and that simply requiring more capital to be held would not compensate for poor governance. Other remedial measures, such as asking the firm to remedy the problems within a given timeframe or requiring the firm to have an independent review of the problems, would be more appropriate and a capital add-on should be a last resort measure.

### 1.4 Defining what constitutes a material deviation is important

Article 37(1) of the directive proposal cross refers<sup>3</sup> to the overall calibration standard of 99.5% VaR over a one year time horizon. Article 37(2) makes clear that any add-on must be no more than is required to correct any deviation from this standard. In practice, the timeframe should be flexible and take into account, where necessary, the assumptions on which an internal model is based.

Therefore there are some challenging measurement issues for firms and supervisors in establishing exactly what a firm's risk profile is, especially where an internal model is not available. The ORSA may provide some indication. However, in order for the process to work credibly and in order to avoid disagreement, supervisors will need to develop sophisticated quantitative tools. This is an area where further work and guidance is required in order for there to be supervisory convergence and transparency.

In practice, some pragmatism will be required. However it would not be acceptable to propose add-ons based on intuition without any hard evidence. In the absence of a measurable deviation the emphasis must be firmly on changing the risk profile or improving the accuracy of measurement through an internal model.

It is clear that capital add-ons are not intended to be used as a routine part of the supervisor's toolkit. We would expect therefore that materiality is a relevant consideration. Where the deviation is not significant, it is doubtful whether action would be required, given the general uncertainties involved in estimating risk. We would therefore expect this error to be simply taken into account in the normal discussions between the firm and its supervisors.

The financial strength of the firm is also relevant to the timing and urgency of a response. Supervisors should adopt a risk based approach in deciding on action. It is important to consider whether the firm holds capital well in excess of the SCR and its financial position is stable over time.

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<sup>3</sup> Chapter VI, Section 4, Subsection 2

## 2. Practical issues

### 2.1 Capital add-ons resulting from the SCR calculated on the basis of an internal model will be rare

In principle, there are a very limited number of reasons why a firm with an approved internal model should require a capital add-on. If a deviation or omission is suspected that then the first stage of course is to revise the model. We envisage that temporary add-ons will be appropriate only where the model is found to have a fundamental flaw that had not been suspected before and which could not be readily corrected. Add-ons for internal models are therefore an interim measure to be taken whilst the internal model is being developed further.

Standard formulae may materially understate a firm's risk, though this should be rare. A minor deviation should be tolerated, given the likely measurement uncertainty in the absence of an internal model, assuming the financial position of the firm is sound. If the standard method simply does not work for a given firm even after the use of entity specific adjustments of parameters, then the firm should be required to develop a full or partial internal model instead.

### 2.2 Holistic approach should be taken when considering materiality of deviation

The materiality of any deviation by an undertaking's risk profile should be considered in a holistic fashion. Thus all underestimated and overestimated risks should be taken into account and netted. The overall SCR should be the basis for comparison.

### 2.3 The criteria for assessing the need for a capital add-on should be clearly defined

Certain risks are by their nature less readily quantifiable than others. In particular it may be very difficult to quantify the precise impact of a control and governance failure. Work is required to produce an acceptable methodology so that supervisory intervention on Pillar 2 failures follows a justifiable and harmonized approach. The minimum standards, which will be developed by CEIOPS in the future on all qualitative requirements, will be important. Further work is required on these and, in particular, on how to take account of proportionality when benchmarking firms against the standards. CEIOPS' Issues Paper on Implementing Measures on System of Governance provides a useful starting point for looking at governance.

### 2.4 Transitional period for disclosure is important

Article 50(2) requires the annual disclosure of the amount of a capital add-on. Add-ons occurring in-year therefore, that are resolved and removed prior to the reporting date, do not require disclosure.

The Directive of course provides a 5 year transitional provision, at the discretion of member states, to ease the introduction of reporting capital add-ons. We stress our support for that and would urge a consistent approach by supervisors that takes full advantage of the full 5 years available. This is an important safeguard while the directive settles down and harmonisation is achieved.

## 2.5 Convergence of supervisory practices is crucial

It is critical that the process leading up to the possible application of an add-on is under the overview of the group supervisor and coordinated within the college. This is tied up with the discussion on the group support regime in Solvency II.

It is very important that supervisors take a consistent approach in appraising the justification for add-ons against the application of other supervisory tools. Harmonisation of supervisory practices with regards to capital add-ons is important and having well defined criteria for applying capital add-ons will help to ensure supervisory convergence. It is also important that add-ons, where they are used, are calculated on a consistent basis. We therefore strongly support an active role for CEIOPS in collating and publishing information with a view to promoting harmonization. This should ideally require supervisors to maintain a database of capital add-on related activity. In addition, there should peer review processes in place. These could take the form of discussions within CEIOPS on which supervisory authorities look like outliers based on the submitted data and asking the supervisors to explain the reasons for any divergence from the norm.

We believe that, in addition to transparency, CEIOPS should have powers to require supervisors to demonstrate that they comply fully with level 2 measures.

## 3. Processes governing capital add-ons

In this section we outline some general principles to form the basis of a framework for the supervisory response to a deviation from capital calibration requirements and to governance failures.

This should follow a decision tree approach, an initial version of which is in annex A. A process discipline of this type helps ensure that a consistent and harmonized approach is taken. CEIOPS' five step approach outlined in Consultation Paper 17 also provides this process discipline. Any process developed at Level 2 for Solvency II capital add-ons should ensure that all supervisory tools are exhausted before a capital add-on is applied. Many problems can be corrected through regular supervisory relationship and requiring firms to undertake actions.

### 3.1 Identification

Initial identification of an issue may be by the firm or by the supervisor as a result of the supervisory review process. If the issue is a simple error or oversight, the emphasis should be on correction. It may then be that some disclosure is required, depending on materiality.

### 3.2 Materiality & timing

If the deviation from the risk profile is significant, or the issue is related to a failure of governance, then judgment is required. Preference must be given to addressing the issue. If it is probable that the issue can be put right in a reasonable timeframe then the firm should be given a clear objective and reasonable time to make the necessary changes. What is reasonable will depend on the scale of the issue, in proportion to the capital resources of the firm. Where the position of the firm is less secure and the issue is material then an add-on may be justified where alternative supervisory tools have been considered and have been found to be an insufficient response.

Supervisory tools would naturally partially depend on legislative differences at national level. Supervisors can require firms to undertake actions within a certain timeframe as part of their normal supervisory relationship and failing to undertake such actions can lead to enforcement proceedings, depending on national legislation. Supervisors can also request independent reviews of certain functions by auditors, ask firms to change the composition of their boards, review the reporting lines and reporting of different functions, approve or withdraw authorisation of persons holding significant functions (e.g. risk, actuarial), and so on. Firms have an incentive to cooperate as they know that supervisors can use capital add-ons as a last resort measure.

### 3.3 Quantification

It is a key requirement that add-ons can be justified against the directive calibration standard. This is potentially a significant practical problem and to some extent a conflict with article 37(1)(a) which sets as a condition for an add-on that an internal model has not been implemented. In practice we assume that some degree of approximation may be appropriate, provided the assumptions can be justified.

### 3.4 The process within supervisory authorities for applying capital add-ons

Where supervisors are minded to recommend a capital add-on, the decision should be taken within a formal process that is designed to allow transparency of decision making and against the possibility of appeal and challenge. The key elements of this are:

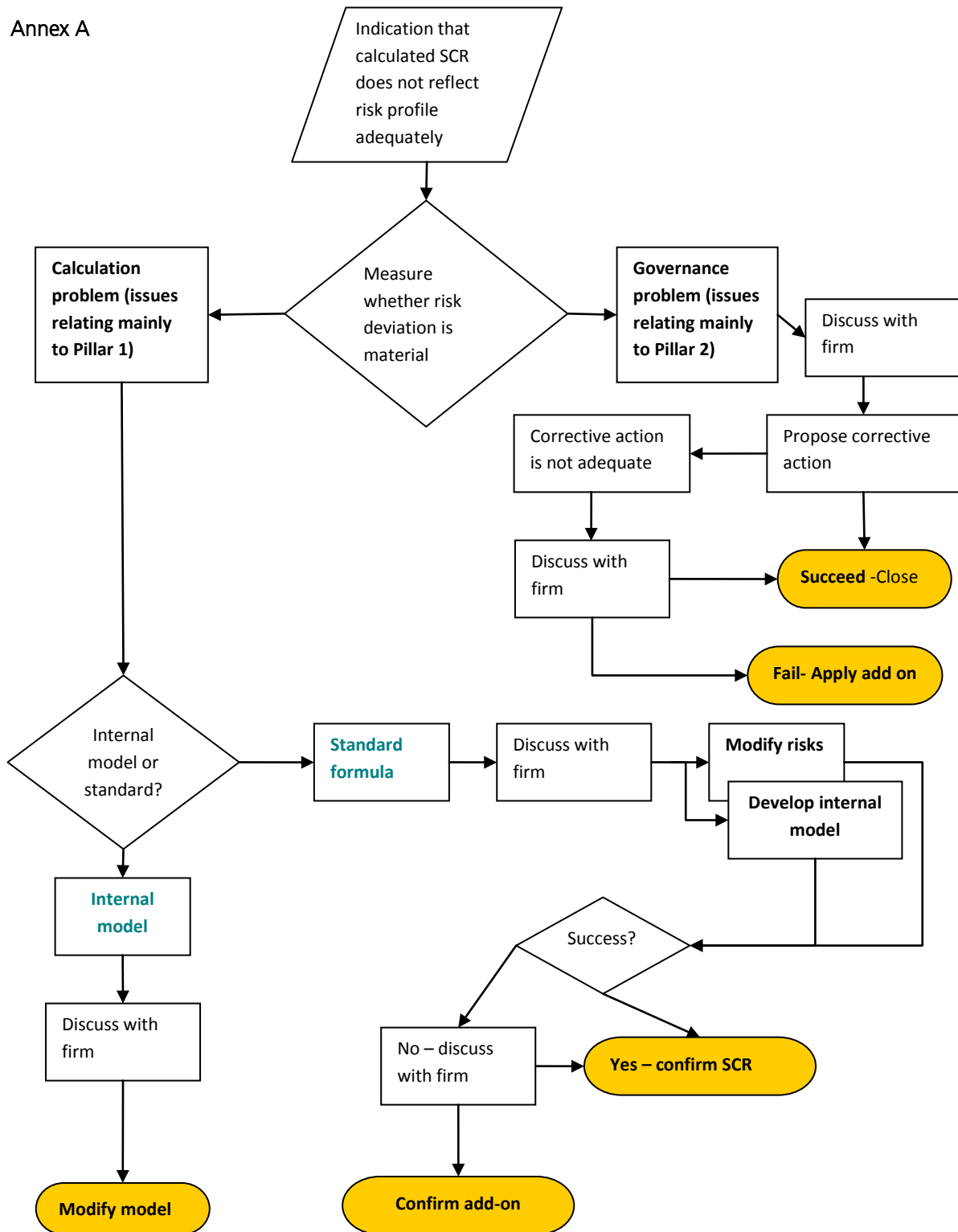
- A formal process must be followed against clear and established criteria, which follows CEIOPS guidance.
- The decision making must be taken by a supervisory committee independent of the normal supervisory team. The membership of the committee should be of seniority proportionate to the importance of the firm.
- The burden of proof is on the supervisor to justify an add-on. This is both with regard to the amount of the add-on and to justify why the use of alternative tools has not been successful.
- The committee must have clear terms of reference and the ability to refer complex decisions to higher authority.
- Records must be kept of the proceedings and all relevant documentation retained for a predetermined minimum period.
- Supervisory appeals procedures should be adapted and modified to allow a well defined process for firms to challenge add-ons, provided that this is possible within national legislation. The process must be transparent for firms and not unduly burdensome. The membership of the appeal body must be functionally independent from the original body and drawn from separate reporting lines.
- Appeal proceedings must be subject to appropriate transparency and have clear deadlines for both firms and supervisory authorities.
- Individuals in firms and supervisors must take personal accountability for personal conduct and probity.

### 3.5 Review and withdrawal

The Directive requires review of an add-on “at least once a year” with a view to removal. Often issues may be resolved much quicker. We suggest that review timing is agreed between firm and supervisor against a mutually accepted timetable to review deficiencies with a view to removing the add-on as quickly as possible.

In addition, we would propose that there is a maximum time limit for which an add-on can be in place. This would ensure that add-ons are temporary measures, incentivising firms to improve the way their SCR reflects their risk profile or to address their governance failures.

Annex A



About the CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, e.g. pan-European companies, monoliners, mutuals and SMEs. The CEA represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 065bn, employ over one million people and invest more than €6 900bn in the economy.