

<b>Comments Template on CEIOPS-CP 39 Consultation Paper on the Draft L2 Advice on TP - Best estimate</b>		<b>Deadline 11.09.2009 4 p.m. CET</b>
Name of Company:	<b>PricewaterhouseCoopers LLP</b>	
Disclosure of comments:	CEIOPS will make all comments available on its website, except where respondents specifically request that their comments remain confidential.  Please indicate if your comments should be treated as confidential:	No
<p>Please follow the following instructions for filling in the template:</p> <ul style="list-style-type: none"> <li>⇒ <u>Do not change the numbering</u> in the column "reference".</li> <li>⇒ 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>.</li> <li>⇒ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below. <ul style="list-style-type: none"> <li>○ 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.</li> <li>○ If your comment refers to sub bullets/subparagraphs, please indicate this in the comment itself.</li> </ul> </li> </ul> <p><b>Please send the completed template, <u>in Word Format</u>, to <a href="mailto:secretariat@ceiops.eu">secretariat@ceiops.eu</a>. Our IT tool does not allow processing of any other formats.</b></p> <p>The numbering of the paragraphs refers to Consultation Paper No. 39 (CEIOPS-CP-39/09).</p>		
<b>Reference</b>	<b>Comment</b>	
General Comment	Overall, we welcome the consultation paper as it provides useful guidance on a number of matters. However, we do have a number of significant comments relating to various paragraphs. We highlight in particular:	

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	<ul style="list-style-type: none"> <li>▪ Paragraphs 3.51-55 on the treatment of expense assumptions.</li> <li>▪ Paragraphs 3.52, 57-63 on the calibration of stochastic asset models.</li> </ul> <p>Our response relates to Consultation Paper 42 (Risk Margin) where explicitly referenced.</p>	
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3.25.	<p>We refer to our submitted comments on Consultation Paper 26.</p> <p>It should be asserted that the choice of method is subjective and a final reserve estimate could, for example be based on a blend of methods.</p>	
3.26.		
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3.30.	We welcome acknowledgement that expert judgement is required.	
3.31.	We welcome acknowledgement that full reliance should not be placed on use of models.	

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3.32.		
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3.34.	We believe that proportionality and materiality should be borne in mind when documenting “ <u>All</u> steps of the process....”	
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3.51.	<u>Expense assumption – Future cost reductions</u> We note our comments under 3.55 in relation to this paragraph.	

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	<p>We welcome the statement: "<i>assumptions about expenses should not allow for future cost reductions where these have not been yet been realised</i>" as it clarifies a potentially significant area of judgement.</p> <p>The only exception to this statement relates to newly established entities where for the first 5 years after licensing expected cost reductions may be anticipated provided they are realistic, objective and verifiable. Given this, we question why existing entities are not allowed to make an allowance for a reduction in future expenses. If existing entities can demonstrate that their assumptions are realistic, objective and verifiable then should this be permissible? We also question the selected period of 5 years and whether there is any evidence to support the assumption. In addition, it would be helpful to have further guidance on what would constitute appropriate evidence to support anticipating cost reductions, as this will be a particularly judgemental assumption.</p> <p>Assuming the Level 2 text remains unchanged, we also question whether there should be an allowance for the expected short term expense overruns for newly established entities in the Solvency II regime. For example, the capital requirements could capture the risk that the long term expense level is not achieved in the first 5 years. However, this could potential cycle back into the technical provisions due to the cost of capital method used to determine the risk margin.</p> <p>This comment also refers to 3.102.</p>	
3.52.	See comments under 3.55	
3.53.	<p><u>Expense assumptions - Allocation of overheads</u></p> <p>We note our comments under 3.55 in relation to this paragraph.</p> <p>In determining the allocation of overhead expenses, there is reference to "<i>the undertaking continuing to write new business in the same amount as previous year unless a decision has been made to cease writing further new business.</i>" We query whether assuming the same level of new business is correct in an economic valuation framework, for example, there may be one-off non-recurring factors in the previous years' new business volumes. We also question whether instead formally approved (objective and verifiable) internal business plans should be permitted in the allocation of overheads. This is particularly the case where these plans form part of the ORSA.</p>	
3.54.	See comments under 3.55	

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3.55.	<p><u>Expense assumptions – “Going concern” versus “Run-off” basis</u></p> <p>The relevant aspects of the Level 1 text are:</p> <ul style="list-style-type: none"> <li>▪ Article 75 (2): <i>“The value of technical provisions shall correspond to the current amount ... undertakings would have to pay if they were to transfer their ... obligations immediately to another ... undertaking.”</i></li> <li>▪ Article 76(2): <i>“... The cash-flow projection used in the calculation of the best estimate shall take account of all the cash in- and out- flows required to settle the ... obligations over the lifetime thereof.”</i></li> <li>▪ Article 76(3): <i>“The risk margin shall be such as to ensure that the value of technical provisions is equivalent to the amount ... undertakings would be expected to required in order to take over and meet the ... obligations”</i></li> <li>▪ Article 77(1): <i>“... technical provisions ... shall take account of ... all expenses that will be incurred in servicing ... obligations.”</i></li> </ul> <p>Given the relevant Level 1 text, we concur with the CEIOPS conclusion that the expense assumptions should be determined on a “going concern” basis unless the risk of closure is imminent. The risk that the expense assumptions could be higher on a “run-off” basis could be captured in the SCR to avoid undue strain on closure to new business. However, this could potential cycle back into the technical provisions due to the cost of capital method used to determine the risk margin. Further, the point at which “run-off” is assumed from would need to be specified, for example, 1 year from the point of valuation.</p> <p>We caution that the application of the “going concern” principle applies to concepts other than expense assumptions (e.g. provisions, tax, future premiums etc.) and that it should be applied consistently in the framework. This comment also refers to 3.52-4, 3.56 and 3.99-101.</p>	
3.56.	See comments under 3.55	
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3.59.		
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3.63.	<p>We agree that permitting a negative best estimate liability in certain circumstances and no surrender value floor is acceptable in an economic framework.</p> <p>This comment refers also to 3.110-11.</p>	
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3.71.	<p>In principle the proposed approach appears reasonable; however, the concepts of materiality and proportionality should be a key consideration. We also note that there maybe practical issues in performing the proposed split.</p>	
3.72.	See comments under 3.71	
3.73.	We welcome the acknowledgement of the difference between life and non-life actuarial techniques.	
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3.76.	We question whether these techniques are the only acceptable techniques. For example, there is no mention of exposure based methods.	
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3.80.	We refer to our submitted comments on Consultation Paper 30.	
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3.101.	See comments under 3.55	
3.102.	See comments under 3.51	
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3.106.	It would be helpful in Level 2 or Level 3 text to define the term "agreed (but not yet implemented)" in relation to the implementation of changes to taxation requirement. We note that International Accounting Standard 12 paragraph 46 (IAS 12.46) considers the term, "substantially enacted." This would be a useful concept to introduce and would aid consistency with financial reporting.	
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3.113.	Clearer definition of 'future premium' is required, particularly clarifying what impact this has between the consistency of the claims and premium reserves where premium is written/pipeline/earned etc.	
3.114.		

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3.121.	This would appear to be somewhat onerous. The principles of materiality and proportionality should be applied in the valuation of technical provisions separately by currency. Simplifications should be permitted so that separate currency projections are only required where amounts denominated in such currencies are material.	
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3.131.	The principles of materiality and proportionality should be applied in the identification, assessment of risk drivers (for frequency and "moneyness") and valuation of options and guarantees (including the split between intrinsic and time value). Therefore simplifications on these grounds should be permitted.	

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	This comment also refers to 3.132-49.	
3.132.	See comments in 3.131	
3.133.	See comments in 3.131	
3.134.	See comments in 3.131	
3.135.	See comments in 3.131	
3.136.	See comments in 3.131	
3.137.	See comments in 3.131	
3.138.	See comments in 3.131	
3.139.	See comments in 3.131	
3.140.	See comments in 3.131	
3.141.	See comments in 3.131	
3.142.	See comments in 3.131	
3.143.	See comments in 3.131	
3.144.	See comments in 3.131	
3.145.	See comments in 3.131	
3.146.	See comments in 3.131	
3.147.	See comments in 3.131	
3.148.	See comments in 3.131	
3.149.	See comments in 3.131	
3.150.	We assume that, where not material, approximate methods can be used for non-financial guarantees.	

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3.162.	The current wording could be interpreted to mean that the impact of the policyholders' behaviour within the best estimate liabilities should be identified separately. We do not believe that this was the intention of the wording and recommend that the terminology is amended to reflect this.	
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3.179.	From a consistency perspective, it would be helpful to link the definition of conditional and pure discretionary benefit to the IFRS definition of "discretionary participation feature."	
3.180.	It would be helpful to have guidance (potentially in Level 3 text) over the practical application of splitting discretionary benefits between "pure" and "conditional." For participating contracts in certain countries this is not an obvious split.	
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3.205.	The principles of materiality and proportionality should be applied in the modelling of reinsurance recoverables. Therefore simplifications should be permitted on these grounds. This comment also refers to 3.205.	
3.206.		

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3.207.	The treatment of expenses appears to contradict the approach in 3.209. It would be helpful to clarify this point.	
3.208.		
3.209.	See comments under 3.207	
3.210.	It may not always be possible to distinguish between events that relate to market risk and underwriting risk. Further it is not clear how market risk events should be allowed for.  This comment also refers to 3.224.	
3.211.		
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3.215.	It would be helpful to have a definition of "finite reinsurance." Also, it is not clear why this calculation should be performed separately from other reinsurance.	
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3.221.	See comments under 3.205	
3.222.		

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3.224.	See comments under 3.210	
3.225.		
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3.237.	<p>We welcome the inclusion of general principles for setting assumptions in section 3.9.2.</p> <p>We have the following comments:</p> <ul style="list-style-type: none"> <li>▪ Paragraph (a) states that assumptions should be set in a realistic manner and paragraph (c)(iii) states one should be "prudent" in the selection of alternative assumptions. This seems internally inconsistent and inconsistent with the philosophy of valuing technical provisions as the "<i>sum of a best estimate and a risk margin</i>" - Level 1: Article 76(1). More generally according to Level 1 text, the best estimate should be the "<i>probability-weighted average of future cash flows</i>" - Article 76(2). We therefore believe that allowance for uncertainty in estimate, model error etc. should be part of the risk margin (through the SCR requirements) as opposed to an additional loading onto the best estimate.</li> </ul>	

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	<ul style="list-style-type: none"> <li>▪ The validation requirements for external data in paragraph (g) appear somewhat onerous. We also question whether this criteria should consider in addition:             <ul style="list-style-type: none"> <li>▪ The materiality of the assumption and the level of credibility that is being placed on the external data in setting the assumption.</li> <li>▪ The practicality of getting data from external providers, particularly, in terms of time scales and where it is market sensitive.</li> </ul> </li> </ul> <p>This comment also refers to 3.274</p>	
3.238.		
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3.244.		
3.245.		
3.246.	See comments under 3.252	
3.247.	See comments under 3.252	
3.248.	See comments under 3.252	
3.249.	See comments under 3.252	
3.250.	See comments under 3.252	

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3.251.	See comments under 3.252	
3.252.	<p><u>Principles for the calibration of stochastic asset models</u></p> <p>We agree that principles for the calibration of stochastic asset models should be included in Level 2 text with further guidance in Level 3. This is an area where best practice will evolve over time and maybe specific to the economic conditions of certain Member States.</p> <p>In many markets, the duration of financial options and guarantees in insurance liabilities is longer than relevant financial assets. By relevant, we are referring to assets similar to the nature and term of the liabilities, for example, equity index options and swaptions. As a consequence it is necessary to generate "mark to model" prices.</p> <p>The approach used by many practitioners in calibrating market consistent stochastic asset model can be summarised in the following high level principles:</p> <ol style="list-style-type: none"> <li>1. To fit to current, observed and reliable market prices wherever available. This includes consideration of potential errors in observed prices.</li> <li>2. To set long-term limiting assumptions for ultra-long-term prices based on economic fundamentals and a view of how long-term prices are established. This would include historical analysis and expert judgment.</li> <li>3. To set a path for intermediate prices that is consistent with the short-term objective market evidence and the long-term subjective assumptions. The extrapolation would be designed to ensure no arbitrage opportunities are introduced and that implied market risk margins are incorporated where possible.</li> </ol> <p>These guiding principles applied in a coherent and consistent manner would be used in all situations. For example, where there is no market such as property volatilities and correlations; and where there are limited markets such as emerging economies and longer dated cash flows in developed economies. We recommend that these concepts in appropriate form are included in the Level 2 text. We refer to these principles in our later comments on 3.257 to 3.263.</p>	

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	<p>Clearly, there will be a level of judgement in such calibrations, it is therefore important that there is appropriate disclosure and independent scrutiny.</p> <p><b>The approach to the calibration of stochastic asset models also affects the “avoidable market risk” allowance in the risk margin. Please see our separate response to Consultation Paper 42.</b></p>	
3.253.	See comments under 3.257	
3.254.	See comments under 3.257	
3.255.	See comments under 3.257	
3.256.	See comments under 3.257	
3.257.	<p><u>Implied versus historic option volatilities</u></p> <p><b>We believe that in “reliable” markets implied volatilities at the valuation date should be used to calibrate stochastic asset models and that this should be defined in Level 2 text.</b> If there is a departure from this approach in such markets then this would contradict Article 75 (3) of the Level 1 text: “... <i>consistent with information provided by the financial markets ... (market consistency)</i>”. In addition, following Recital 31: “... <i>calculation of technical provisions should be consistent with valuation of assets and other liabilities, market consistent and in line with international developments in accounting and supervision</i>” there would be an inconsistency with the valuation of assets. For example, equity options would be held at market value on the asset side, whilst options and guarantees with equivalent characteristics would be valued differently on the liability side.</p> <p>The question is then to consider up to what term option market prices are “reliable” and the methods to apply when this is not the case. We provide comment on the definition of “reliable” in CP 39 under 3.260. On the methods to apply:</p> <p><u>No reliable prices (e.g. some developing economies)</u> Where there are no relevant reliable option market prices, a range of factors would need to be considered, for example:</p> <ul style="list-style-type: none"> <li>▪ Historical volatilities.</li> </ul>	

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	<ul style="list-style-type: none"> <li>▪ Historic links between implied and historical volatility in differing conditions.</li> <li>▪ Economic fundamentals.</li> <li>▪ Implied volatilities from countries with similar sovereign risk and market stability.</li> <li>▪ Insight gained from available prices (though not fully reliable, but may exist)</li> </ul> <p><u>Some reliable prices (e.g. some developed economies)</u> In such economies, the consideration would include:</p> <ul style="list-style-type: none"> <li>▪ Insight gained from available prices (though not fully reliable, but may exist)</li> <li>▪ Technical features relating to the model chosen (e.g. ability to reproduce the characteristics of the implied volatility surface such as the trend across both the term and strike).</li> <li>▪ Use of long term limiting assumptions set based on economic fundamentals. This is the second principle noted in 3.252.</li> <li>▪ Insight gained from the structure of the implied volatility surface in similar economies.</li> <li>▪ Extrapolation (or interpolation) methods should ensure no arbitrage possibilities are introduced.</li> </ul> <p>In both situations, there will be significant judgement applied so appropriate disclosure and independent scrutiny should be required.</p> <p><b>The approach to the calibration of stochastic asset models also affects the “avoidable market risk” allowance in the risk margin. Please see our separate response to Consultation Paper 42.</b></p>	
3.258.	<p>We query whether 3.258(a) should refer to reproducing asset prices for the most significant liabilities by nature and term rather than the whole asset price universe. We refer to 3.249 which states the following from the QIS 4 Technical Specification: <i>“TS.II.D.59 It should be noted that few (if any) asset models can replicate all the observable market values for a wide range of asset classes.”</i></p> <p>This comment refers also to 3.275</p>	
3.259.	<p>We agree with the high level principles specified in 3.259. We refer to 3.257 and our request that</p>	

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	<p>further guidance over the volatility assumption is provided in Level 2 text.</p> <p>This comment refers also to 3.276</p>	
<p>3.260.</p>	<p><u>Definition and application of "deep, liquid and transparent"</u></p> <p>The definition of deep, liquid and transparent is identical to Consultation Paper 41 (Circumstances in which technical provisions shall be calculated as a whole) – please see our separate response to this paper. Many of the assets used to calibrate market consistent stochastic models are unlikely to meet the definition of deep, liquid and transparent. For example, equity options in the UK are only publicly available for short durations (less than 1 year) although there are Over The Counter (OTC) quotes on major indices available for up to 10 years.</p> <p>Consequently, there will be a need for any "<i>distortions</i>" to be corrected in a "<i>prudent, objective and reliable manner</i>" [3.260] and for companies to justify that the calibration is "<i>appropriate and in line with all relevant criteria set out in the Level 1 text</i>" [3.261]. We welcome the sentiment in these statements, however, further guidance on the application would be helpful to achieve greater consistency and harmonisation. For example:</p> <ul style="list-style-type: none"> <li>▪ Are "<i>distortions</i>" referring to rejection of rogue data, supply and demand imbalances or other aspects?</li> <li>▪ What methods could be used to correct distortions? We caution the use of "<i>prudent</i>" methods as there is a potential double count in the allowance for the risk exposure given the inclusion of "<i>unavoidable market risk</i>" in the risk margin. Please see our separate response to Consultation Paper 42.</li> <li>▪ What is "<i>appropriate</i>" measured against? Could "<i>appropriate</i>" be used to justify a move away from reliable OTC equity implied options to historic volatilities? We would be concerned by this.</li> </ul> <p>We note that this guidance may need to be at Member State level given the uniqueness of different markets.</p> <p>As a concluding remark, to facilitate comparability and harmonisation, it may be helpful for an industry or regulatory body to collate and publish derivative prices for various markets on a regular basis for the purpose of benchmarking OTC option prices in market consistent valuations.</p>	

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	This comment also refers to 3.261 and 3.277-79.	
3.261.	See comments under 3.260	
3.262.	<p>We agree that for the parameters illustrated in this paragraph (e.g. correlations) there are currently no market instruments to calibrate to and therefore other methods need to be considered. We question whether this paragraph permits the use of statistical analysis when there is reliable market data, though we do not believe it is the intention of it.</p> <p>This comment also refers to 3.280.</p>	
3.263.	<p>We would welcome further guidance in the Level 3 text on all the aspects specified in 3.263. We refer also to our comments in 3.252, 3.257 and 3.260. We caution that due to the uniqueness of each market this guidance may need to be prepared by each Member State (perhaps with guiding principles from CEIOPS).</p> <p>We make one further remark with regards to basis risk:</p> <ul style="list-style-type: none"> <li>▪ Often implied volatility assumptions are derived from standard indices (e.g. FTSE 100) and from price rather than total return indices. In assessing the appropriateness of a calibration, due consideration should be made as to how reflective these asset class assumptions are of the business. It may be helpful to consider this in Level 3 text.</li> </ul>	
3.264.	In relation to technical risks, 3.264(c) states: " <i>Undertakings shall consider whether the assumptions adequately reflect the uncertainty underlying the cash-flows.</i> " We query whether this is referring to setting best estimate liabilities using " <i>probability-weighted average of future cash flows</i> " as detailed in Article 76(2) of the Level 1 text or whether this is referring to the application of prudence. The latter would not be consistent with the philosophy of valuing technical provisions as the " <i>sum of a best estimate and a risk margin</i> " - Level 1 text Article 76(1).	

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	This comment also refers to 3.286(e)	
3.265.		
3.266.		
3.267.		
3.268.		
3.269.		
3.270.		
3.271.	<p>In response to the feedback requested:</p> <p><u>Stochastic Asset Models</u></p> <ul style="list-style-type: none"> <li>▪ We would welcome further guidance in the Level 3 text on the aspects specified in 3.263. However, we caution that due to the uniqueness of each market this guidance may need to be prepared by each Member State (perhaps with guiding principles from CEIOPS).</li> </ul> <p><u>Mortality Tables</u></p> <ul style="list-style-type: none"> <li>▪ We would welcome general principles on the construction of mortality tables. This would promote harmonisation. The principles should consider all decrements (e.g. critical illness, income protection etc.) and not just mortality. In a number of Member States there are well developed methods for the construction of such tables (e.g. the Continuous Mortality Investigations of the UK actuarial profession) which could be considered as a benchmark.</li> </ul> <p><u>Other areas of potential guidance</u></p> <ul style="list-style-type: none"> <li>▪ We would welcome additional guidance in Level 3 text over the setting of expense assumptions (especially the treatment of overheads and future cost reductions) and general principles in setting demographic assumptions</li> </ul>	
3.272.		

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3.273.		
3.274.	See comments under 3.237	
3.275.	See comments under 3.258	
3.276.	See comments under 3.259	
3.277.	See comments under 3.260	
3.278.	See comments under 3.260	
3.279.	See comments under 3.260	
3.280.	See comments under 3.262	
3.281.		
3.282.		
3.283.	There is no mention of the cost to undertakings in performing such an analysis. Also, it is unclear how an undertaking would sure to have included " <u>all</u> relevant available data."	
3.284.		
3.285.	We believe that in many cases undertaking's internal data in relation to technical risks should be used in the first instance because it is most likely to exhibit the behaviour specific to the undertaking's risks. This is particularly true for non-life liability measurement.	
3.286.	See comments under 3.264	
3.287.		
3.288.		
3.289.		
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3.291.		

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3.292.		
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3.299.	We question whether validation should be " <i>carried out at least as frequently as the best estimate calculation</i> " – this may not be practical for all undertakings. Time and cost constraints should be considered, as well as proportionality and materiality.	
3.300.		
3.301.		
3.302.		
3.303.	Materiality and proportionality should be borne in mind. It would appear cumbersome to validate every assumption (even where statistically possible).	
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3.332.		
3.333.		
3.334.		
3.335.	<p>We welcome the tools that are detailed in 3.335 to 3.339. We believe that these are essential in testing whether a stochastic calibration is market consistent. We therefore question whether there should be some compulsion over performing these tests.</p> <p>Additionally, we note:</p> <ul style="list-style-type: none"> <li>▪ The tools noted are statistical in nature. There is no mention of qualitative checks on the base calibration that may be helpful.</li> <li>▪ There is no mention of reproducing property volatility, credit risk (where applicable) and correlation calibrations. These are also key tests that may be worthy of explicit note. For the correlation calibration, we note that consideration should be given to the period of assessment (e.g. monthly, annually etc.) and to the treatment of inter-economy correlations which can be significant at group level.</li> <li>▪ The use of tolerances (or hurdles) around the test results is often helpful in setting benchmarks as to the accuracy of the calibration. It may be worth considering this in Level 3 text.</li> <li>▪ In all aspects of the calibration, the impact on the value of financial options and guarantees relative to appropriate levels of materiality should be considered.</li> </ul> <p>This comment also refers to 3.336-39</p>	
3.336.	See comments in 3.335.	
3.337.	See comments in 3.335.	
3.338.	See comments in 3.335.	
3.339.	See comments in 3.335.	
3.340.	This should include qualitative information where relevant.	

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3.341.	We welcome the validation tests in Section 3.10 (3.287 – 3.339). However, in the “CEIOPS’ advice” box, there is no explicit mention of validating the results themselves as there is throughout the explanatory text. We recommend that a separate part (d) on the assessment of the results is included.	
3.342.		
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3.347.		
3.348.	We agree that proportionality is an important aspect. See comments in 3.299 and 3.303.	
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3.358.	We question whether “immediately available” data would always be possible in practice.	
Annex A		

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A.1.		
A.2.		
A.3.		
A.4.		