

**Comments Template on CEIOPS-CP 42  
Consultation Paper on the Draft L2 Advice on TP – Risk Margin**

**Deadline  
11.09.2009  
4 p.m. CET**

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 <b>not</b> 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. 42 (CEIOPS-CP-42/09).</p>		
<b>Reference</b>	<b>Comment</b>	
General Comment	<p>We set out below specific comments on a number of the matters raised in the Consultation Paper. We refer to our comments on Consultation Paper 39 (Best estimate) where explicitly referenced. We refer also to our comments on Consultation Paper 45 (Simplifications) and in particular that</p>	

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	approximate methods should be permitted in the projection of the SCR for the purpose of the risk margin to reflect proportionality, materiality and practicality of implementation. Appropriate safeguards over the accuracy of the calculation should also be in place.	
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3.35.	<p><u>"Unavoidable market risk"</u></p> <p>Assumption 4 in Paragraph 3.35 states: <i>"The reference undertaking should only be subject to market risk that is unavoidable in practice."</i> We accept the principle that an allowance should be made in the framework for market risk to the extent that the market risk is non-hedgeable. Further, we agree with paragraph 3.39 that the reference undertaking can be assumed to hold assets which minimise the market risk as this is consistent with the transfer value measurement articulated in Article 75 of the Level 1 text.</p> <p>However, it is not clear to us what the definition of <i>"unavoidable"</i> is and how this relates to the <i>"deep, liquid and transparent"</i> financial market concept used in the best estimate liabilities (as defined in Consultation Paper 39). Paragraph 3.41 provides examples where there are no long dated markets from a recent CRO Forum publication. In such circumstances, in the best estimate liability following Consultation Paper 39 there is a requirement for prudent, objective and reliable corrections for distortions [CP39.3.260] and to do something <i>"appropriate"</i> and in line with Level 1 text [CP39.3.261]. Further, in the application of extrapolation techniques in an economic coherent manner there is likely to be an implicit allowance for the market price of risk captured in the best estimate liability. Therefore there is a risk of double counting the exposure allowance in the technical provisions unless there is a clear definition of <i>"unavoidable."</i> This may also apply to an extent in the use of statistical techniques for non-observable parameters (e.g. correlations and property volatilities) used in stochastic asset models to determine the best estimate liability.</p> <p>We agree with paragraph 3.46 that the allowance should be practical, proportionate and reflect materiality. However, there is no established basis for calculating the allowance and as noted above a significant risk of double counting the exposure. A simple approach as used in QIS3 could be considered provided it is representative of the exposure. We recommend the selected method is tested before a final decision is made. We also recommend that the Level 2 text describes the principles in allowing for <i>"unavoidable market risk"</i> with further guidance at Level 3 over the calculation method to</p>	

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	ensure a consistent approach is applied across the industry. This comment relates to 3.36 – 3.47	
3.36.	See comments under 3.35	
3.37.	See comments under 3.35	
3.38.	See comments under 3.35	
3.39.	See comments under 3.35	
3.40.	See comments under 3.35	
3.41.	See comments under 3.35	
3.42.	See comments under 3.35	
3.43.	See comments under 3.35	
3.44.	See comments under 3.35	
3.45.	See comments under 3.35	
3.46.	See comments under 3.35	
3.47.	See comments under 3.35	
3.48.		
3.49.	Paragraph 3.49 states that for reasons of practicality it is assumed that the reference undertaking does not carry any risk of default of counterparties to financial derivative contracts. Given recent market events, in particular the failure of Lehman Bros, CEIOPS will need to rationalise this approach carefully.	
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3.52.		
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3.54.	<p><u>Line of business and diversification benefits</u></p> <p>Assumption 8 states that the insurance and reinsurance obligations of each line of business are transferred to the empty reference undertaking in isolation. Hence, no diversification benefit between lines of business arises. The assessment for the exclusion by line of business relies on Article 85(e) which states: <i>"the commission shall adopt implementing measures laying down the following", "the lines of business on the basis of which insurance and reinsurance obligations are to be segmented in order to calculate technical provisions."</i> We recommend CEIOPS articulate the rationale for why they believe this directs them to assume no diversification benefit can be recognised. We note that the Consultation Paper does not refer to the principles in Article 75 (4) which states: <i>"Technical provisions shall be calculated in a prudent, reliable and objective manner."</i> If prudence is a basis on which no diversification benefit is allowed then this should be explicitly considered and stated. A clear rationale in the context of the Level 1 directive is required.</p> <p>There are various approaches to diversification and the definition of the reference undertaking considered in the Consultation Paper. Each approach has advantages and disadvantages. The proposed approach is likely to lead to the greatest policyholder protection and potentially the greatest harmonisation, however, it will also lead to the highest cost to firms.</p> <p>Consultation Paper 27 introduced segmentation for life and non-life business. We question whether this segmentation is appropriate for the risk margin. In particular:</p> <ul style="list-style-type: none"> <li>▪ It is not clear to us how structures in the original undertaking that act across lines of business would be allowed for in the risk margin calculation. For example, a stop loss reinsurance treaty operating over life protection contracts covering death and/or critical illness benefits. This example applies equivalently to the non life lines of business.</li> <li>▪ In relation to non life business, the proposed segmentation does not split risks into homogeneous groups, for example, "Marine, Aviation, and Transport."</li> </ul> <p>This comment relates to 3.55 to 3.61</p>	

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3.55.	See comments under 3.54	
3.56.	See comments under 3.54	
3.57.	See comments under 3.54	
3.58.	See comments under 3.54	
3.59.	See comments under 3.54	
3.60.	See comments under 3.54	
3.61.	See comments under 3.54	
3.62.	<p><u>Use of internal models</u></p> <p>Paragraph 3.62 permits the use of the original undertaking’s internal model (fully or partially) to measure the SCR of the reference undertaking to the extent this model covers the risks in Assumption 5. We welcome this approach as the internal model may better reflect the characteristics of each line of the business transferred to the reference undertaking. However, it is likely that many internal models will include characteristics specific to the original undertaking that it would not be appropriate to apply to the empty reference undertaking. We recommend that there is a principle in Level 2 text to ensure such characteristics are removed in the risk margin calculation.</p> <p>As noted in paragraph 3.63, for the purpose of the risk margin calculation a projection of the SCR calculated by an internal model will be required. To perform this accurately will be particularly complex and onerous. Simplifications should be permitted and further guidance is required on this matter. We also query whether the ability to project the SCR using an internal model will be part of the model approval process.</p> <p>Further, we caution that it will be complex (and therefore maybe not practical) to split internal model calculations of the SCR and its projection by the line of business segments prescribed in Consultation Paper 27.</p> <p>This comment relates to 3.63-3.65</p>	
3.63.	See comments under 3.62	

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3.64.	See comments under 3.62	
3.65.	See comments under 3.62	
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3.89.	<p><u>Cost of capital rate</u></p> <p>We welcome the inclusion of a framework in the form of a three stage approach to determine the rate. Paragraph 3.114 proposes a 6% minimum cost of capital rate. There are a number of subjective assumptions in the derivation of the minimum rate and therefore a wide range of potential rates. We caution that the three stage framework may not provide a stable platform to determine the rate. We recognise market views will differ as to the absolute rate; however, CEIOPS may need to consider commissioning an independent analysis to provide better support for their own views.</p> <p>Further:</p> <ul style="list-style-type: none"> <li>▪ It is unclear to us how a rate of "at least 6%" meets the requirements of the Level 1 text: "<i>The rate used in the determination of the cost ... (Cost-of-Capital rate) shall be the same for all ... undertakings ...</i>" (Article 76(5)). Assuming the assertion of "at least 6%," it would be helpful to have additional guidance as to how the rate should be determined to ensure harmonisation.</li> <li>▪ Paragraph 3.132 states: "<i>The Cost-of-Capital rate has to be a long-term average rate, reflecting periods of both stability and period of stress.</i>" We question whether this is in line with the Level 1 text which refers to "<i>the value of technical provisions shall correspond to the current amount ... undertakings would have to pay ... to transfer their ... obligations immediately to another ... undertaking.</i>" - Article 75(2). The Level 1 text could be interpreted as requiring a current rather than long-term average rate. A potential approach could be to set the rate with reference to a benchmark (and so varying over time) rather than a prescribed fixed rate.</li> </ul> <p>Paragraph 3.100 refers to the CEIOPS view that the SCR is funded solely with equity capital, as opposed to the assumptions in the CRO Forum publication. We support the view expressed by CEIOPS that in adverse circumstances the SCR capital requirement could not be entirely funded by debt investors at costs substantially below equity costs. This is particularly relevant given the evidence of the current market conditions and cost of corporate debt.</p>	

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	<p>We agree with paragraph 3.95 that the procedures to be followed in reviewing the charge should be developed. Given the significance of the charge we recommend that the procedures (at least at high level) are detailed in Level 2 text.</p> <p>We agree with paragraphs 3.113-5, that the cost of capital rate may need to be adjusted to reflect any systematic bias in the projection of the SCR. However, we do caution that this may be spurious accuracy given the subjectivity of the rate itself.</p> <p>This comment relates to 3.90-3.115</p>	
3.90.	See comments under 3.89	
3.91.	See comments under 3.89	
3.92.	See comments under 3.89	
3.93.	See comments under 3.89	
3.94.	See comments under 3.89	
3.95.	See comments under 3.89	
3.96.	See comments under 3.89	
3.97.	See comments under 3.89	
3.98.	See comments under 3.89	
3.99.	See comments under 3.89	
3.100.	See comments under 3.89	
3.101.	See comments under 3.89	
3.102.	See comments under 3.89	
3.103.	See comments under 3.89	
3.104.	See comments under 3.89	

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3.105.	See comments under 3.89	
3.106.	See comments under 3.89	
3.107.	See comments under 3.89	
3.108.	See comments under 3.89	
3.109.	See comments under 3.89	
3.110.	See comments under 3.89	
3.111.	See comments under 3.89	
3.112.	See comments under 3.89	
3.113.	See comments under 3.89	
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3.130.	See comments under 3.35, 3.49, 3.54, 3.62 and 3.89	
3.131.	See comments under 3.89	
3.132.	See comments under 3.89	
3.133.	See comments under 3.89	
3.134.	See comments under 3.89	
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