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NOTE TO THE IC SOLVENCY SUBCOMMITTEE

Subject: Solvency II – Organisation of work, discussion on pillar I work areas and suggestions of further work on pillar II for CEIOPS

Issues paper for the meeting of the IC Solvency Subcommittee on 12 March 2004

Purpose of this paper

The purpose of this Discussion Paper is to clarify organisational aspects, to elaborate on certain overarching issues, to initiate discussion on Pillar I technical issues, and to suggest areas on some Pillar II issues on which CEIOPS could start working.

Members of the European Parliament, Member States, CEIOPS, the actuarial profession, industry, and other interested parties are invited to comment on this Issues Paper. The Services would appreciate receiving written comments by 16 April 2004.

All responses will be put on the Commission website unless the respondent requests confidentiality.

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1. INTRODUCTION

1.1. Brief background

1. In their previous paper MARKT/2539/03 the Commission Services presented an inventory of the main changes that the Solvency II reform could introduce to the current insurance directives and outlined technical issues to be analysed further in CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors). The paper was discussed in the IC Solvency Subcommittee meeting on 23 October 2003. As agreed in the Solvency Subcommittee and in the Insurance Committee on 26 November 2003, the Services' work will next concentrate on two areas: first, drafting a proposal for a framework directive (for 2005) and second, analysing suggestions for further technical work to be carried out by CEIOPS. Once the new regulatory framework would be approved, these requests for preparatory work could become formal mandates for the preparation of implementing measures. This paper deals with the second objective.
2. The Services have found that on certain pillar I work areas (technical provisions and target capital in life and non-life insurance), further issues must be discussed before the exact contents of the requests for preparatory work can be defined. Nevertheless, on some pillar II work areas, some suggestions are raised for comments. However, this paper does not deal with all the work areas identified in the previous paper (see points 6 and 7 below).
3. The suggestions will become formal mandates, if and only if the co-legislators decide to extend the new regulatory framework to insurance. They may be revised, or completed, according to further developments in the drafting of the framework directive (e.g. due to the negotiation process in Parliament and Council, in the light of the results¹ of the technical analysis by the supervisors' working group tasked with the work, international developments, etc.).
4. International aspects related to the work areas of technical provisions and target capital must be underlined: this work will include close monitoring of the developments within the International Association of Actuaries (IAA), International Association of Insurance Supervisors (IAIS)², and International Accounting Standards Board (IASB), integrating EU work with them to the extent possible. One major reference for target capital is the approach proposed by the IAA Insurer Solvency Assessment Working Party³.

¹ For this reason it is important that the Commission takes an active part as observer in the working group.

² The IAIS Solvency Subcommittee is in particular a useful source of inspiration.

³ The report of the working party is available at the IAA website: www.actuaries.org.

1.2. Purpose of this paper

5. The goal of this discussion paper is fourfold:
- Firstly, to clarify organisational aspects
 - Secondly, to elaborate on four overarching issues
 - Thirdly, to discuss several issues regarding technical provisions and target capital.
 - Fourthly, to seek advice on suggestions for requests for further preparatory work on certain pillar 2 issues.

1.3. The structure of the paper

6. The paper includes a chapter on the envisaged new committee architecture and the organisation of the project (chapter 2), and the following main parts:
- General overarching issues (Chapter 3)
 - Life assurance technical provisions (Chapter 4)
 - Non-life insurance technical provisions (Chapter 5)
 - Target capital (at this stage, issues are still general enough for life and non-life to be treated together) (Chapter 6)
 - Some suggestions for requests for preparatory work on pillar 2 themes (Chapter 7) including a tentative discussion on the general formulation of the relevant articles of the directive.

In a first annex there is a reference table linking the proposed new articles in the future Solvency II directive, and the relevant IAIS and Basle II principles. In a second annex, the relevant IAIS principles are reproduced in extenso.

Other areas of work that are not included in this paper will be addressed shortly in coming papers:

- Investment management and ALM
- Safety margin and safety nets
- Internal models and
- Validation criteria for internal models by supervisory authorities
- Target level intervention
- Supervisory authorities' powers
- Peer reviews

7. Other important aspects to be addressed in a third paper are the questions related to pillar III disclosure, small insurance undertakings, procyclicality, independence of the supervisory review process of insurance companies, cooperation and communication between supervisors and group and cross-sectoral issues. Reinsurance-specific issues will also be addressed at a later stage.

Question:

Do you agree that the lists above in points 6 and 7 contain all the work areas or should other be added?

2. THE NEW COMMITTEE ARCHITECTURE AND ORGANISATION OF WORK

2.1. The new committee architecture

2.1.1. Background

8. Under the regulatory approach now used in the securities sector, there are four levels⁴:
 - Level 1: legislative acts, namely Directives or Regulations, adopted in co-decision by the Council and the European Parliament, and setting the nature and extent of implementing measures to be decided by the “comitology” procedure;
 - Level 2: technical implementing measures adopted by the “comitology” procedure set out in Council Decision 1999/468/EC ;
 - Level 3: consistent and timely guidance is issued by enhanced co-operation and networking among EU securities regulators;
 - Level 4: Commission work with Member States, the Parliament and industry to strengthen the enforcement of Community law.
9. Another forum set up by ECOFIN is the Financial Services Committee (FSC)⁵ where high level policy issues are discussed.
10. The goal of the new architecture is to ensure the effective and prompt delivery of the Financial Services Action Plan⁶ and to build “an accountable and efficient regulatory structure that will be able to match the best in the world”⁷.

⁴ See the report of the Committee, chaired by Baron Lamfalussy:
http://europa.eu.int/comm/internal_market/fr/finances/general/lamfalussy.htm.

⁵ See for example the article at:
<http://ue.eu.int/pressData/en/misc/75677.pdf>.

⁶ The new architecture has already been put into practice in the securities area with a number of “framework directives” such as that on Market Abuse.

⁷ In December 2002, the Council invited the Commission to extend the committee structure recommended by the Lamfalussy report to other financial sectors (insurance, banking, UCITS).

11. Currently, the new committee organisational structure outlined above applies only to the securities' sector. On 5 November 2003, the Commission has approved a package of measures⁸ designed to extend the new committee architecture to other financial sectors, in particular to banking and insurance. However, such extension will only take place after the European Parliament and the Council have adopted the amending Directive to establish a new organisational structure; this Directive is part of the previously cited overall package of measures. This paper does not in any way intend to prejudge the outcome of the discussions between the European Parliament and the Council.
12. Among the proposed measures adopted by the Commission on 5 November 2003, was a decision to create a supervisory committee for the insurance and pension sectors (CEIOPS) and a legislative proposal to amend the Directive establishing the Insurance Committee to change this committee into a regulatory committee in a comitology capacity (the European Insurance and Occupational Pensions Committee, EIOPC). A further Commission decision establishes this new regulatory committee in an advisory capacity. This decision has suspensive effect in that it will only come into force if and when the above mentioned amending Directive creating EIOPC is adopted. In this way the new committee structure will be extended to insurance when the Council and the European Parliament will have agreed on the proposal for the directive. The Services are progressing work on this hypothetical basis, but without prejudice to the outcome of the discussions among the co-legislators.
13. As for the supervisory committee, it should be noted that the former Conference of European Insurance Supervisors has already taken the necessary steps to reform itself into CEIOPS and fulfil the new role envisaged for it. The Commission Decision was thus effective from 24 November 2003.

2.1.2. Why we need the new committee architecture for Solvency II

14. In the banking sector, the current work on a new Capital Adequacy Directive ("CAD 3" or "Basle II") will include articles stating general principles as well as a series of annexes describing detailed implementing rules. In the future, these annexes may be amended when needed by regulatory committee decisions. However, initially, the whole package of regulation – principles and technical measures – will be drafted and negotiated at the same time.
15. In insurance, there is no definitive reference project such as Basle II in the banking field. Although the IAIS has produced a number of useful principles and standards and is working on solvency issues at present, much of the work will have to be done at the EU level.

⁸ Commission press release IP/03/1507 and MEMO/03/220 of 6 November 2003, both available at: <http://www.europa.eu.int/rapid/>.

16. In the approach used in the securities sector, the Council and the Parliament negotiate framework directives focusing on essential principles. Technical details are to be adopted after the adoption of the framework directive, through the comitology procedure with the assistance of the expertise of the committee of supervisors, and subject to monitoring and reporting requirements to the Parliament. A parallel approach needs to be applied to insurance.

2.2. Proposed organisation of the work

17. If the new committee architecture is extended to insurance, the work in the second phase could be split between the various “levels” as follows.

2.2.1. The framework directive

18. The work at this level should not differ very much from the usual drafting of current directives. In concrete terms, the Commission Services will draft texts and will consult the future regulatory committee (the Insurance Committee's successor, EIOPC). As before, a Commission solvency working group (the current IC Solvency Subcommittee) is expected to prepare the work of EIOPC by preliminary technical discussions on draft texts. The Commission will maintain an open and transparent process as it has done in the past.
19. As is the case today, major policy issues will be discussed in the regulatory committee before the Commission adopts the proposal for a directive and transmits it to the Council and Parliament for adoption under the Co-decision Procedure. Clearly, a future framework directive could only be adopted with the agreement of both the Parliament and the Council.
20. Work at directive level can start rapidly on the basis of the Services' previous working document MARKT/2539/03 taking into account the replies received by interested parties.

2.2.2. Implementing regulation: comitology

21. Implementing measures will be of a more technical nature and require in some areas a considerable amount of further preparatory work before the drafting can be started. Once the new committee architecture would be in place, detailed work in these areas could be formally delegated to CEIOPS via a mandate established by the Commission. CEIOPS would clearly be responsible for defining its own working methods.
22. Ensuring consistency between the work performed by CEIOPS and the directive would be the responsibility of the Commission Services together with the regulatory committee. Here again, the work of IC/EIOPC would, where necessary, be prepared by a Commission solvency working group.

2.2.3. Role of the Commission and the regulatory committee

23. It should be noted that implementing measures have the same legal value as a Directive. At both levels, the Commission has the monopoly of regulatory initiative. When EIOPC fulfils the role of the regulatory committee and CEIOPS the role of the supervisory committee, the mechanism to be introduced by the new committee architecture – once in place – would be the following:

- The Commission, after consulting EIOPC, requests advice from CEIOPS. In practice, the Commission Services together with the Commission solvency working group would draft several provisional mandates or "requests for advice" on technical measures necessary to implement the principles envisaged for the directive. EIOPC, CEIOPS and other stakeholders would then be consulted (through the Commission's Insurance website) and the mandates would be sent subsequently by the Commission to CEIOPS.
- As an independent body, CEIOPS determines the most appropriate way to fulfil the mandates of the Commission, in accordance with the principles of the new committee architecture (in particular, as emphasised by the European Parliament in the securities sector, market participants, consumers and "end-users" must be consulted). Again CEIOPS will decide on the resources appropriate to successful completion of the mandate. CEIOPS will give regular progress reports. Its work finished, CEIOPS then forwards its advice to the Commission.
- In the light of the advice given by CEIOPS, the Commission draws up its proposal of implementing measures. This proposal may be subject to an additional consultation. Clearly, the European Parliament can render an opinion on this draft. The Commission then presents it to the regulatory committee EIOPC; the committee acting in comitology capacity votes on the proposal.
- Depending on the results of this vote, different procedures can be followed until final adoption of the measure.

2.2.4. *Role of CEIOPS*

24. In accordance with the principles of the new committee architecture as well as to benefit from its considerable technical expertise, CEIOPS will provide technical advice on implementing measures.
25. More precisely, the Commission Services have identified a number of areas in their document MARKT/2539/03, which require further work. To respond to the requests for preparatory work CEIOPS is planning to create in February 2004 four working groups for Solvency II technical issues: pillar I life assurance, pillar I non-life insurance, pillar II issues, and group and cross-sectoral issues.

2.2.5. *Role of other parties – Importance of transparency*

26. So far, insurance companies, actuaries and other players of the insurance sector have followed actively the development of the Solvency II project. They have made valuable suggestions on the different issues discussed. The Commission Services consider that this dialogue with interested parties is essential: it provides ideas and meets the requirement of the European Parliament for wide consultation.

27. The most difficult technical issues in the Solvency II, namely technical provisions and mathematical modelling of capital requirements, need to be studied extensively and discussed widely and in-depth with the actuarial profession⁹. Furthermore, benefit should also be derived from the insights and experience acquired by major insurers in developing internal models for their own risk management.
28. Transparency is also an important element of the new committee architecture. Clearly to respond to Parliament's demands, CEIOPS will have to consider how best to organise consultation with interested parties (industry, insurance experts, consumers, end-users) and also provide information to the European Parliament in conformity with the transparency principles agreed under the future new committee architecture. In this light, the Commission Services will expect CEIOPS to adopt an active policy of wide consultation, allowing third parties to provide input as work develops rather than only immediately prior to the formal issue of technical advice.
29. In parallel, the Commission will maintain its existing policy of full transparency when preparing the directive (and within the Commission solvency working group).

2.2.6. *Role of the European Parliament*

30. Pending the discussion between the Parliament and the Council on the extension of the new committee architecture to insurance, there will be a need to involve Parliament much more closely in the technical analysis than in the past.
31. Therefore, to maintain maximum transparency while the proposed new committee architecture is being considered by Parliament, it would be necessary to keep Parliament fully apprised of all file developments and progress with the extensive technical work to be carried out. The Commission services would therefore undertake to provide Parliament with copies of all technical papers prepared by the Commission and would also, upon Parliament's request, provide regular oral briefings as well as respond to any queries Parliament might wish to raise. In particular, it should be noted that the primary purpose of the present paper is to start work on the necessary technical analysis, without prejudice to the discussions on the new committee architecture.
32. It should also be stressed that first, no legislative measures could be adopted until Parliament has approved the future framework directive, and secondly, that no formal provisional mandates in the new committee architecture could be given to CEIOPS until Parliament has approved the proposal to amend the Insurance Committee into EIOPC.

⁹ Among the actuarial associations, the Groupe Consultatif Actuariel Européen has made available extensive resources in the past. Cooperation on actuarial issues will be maintained. Their website can be found at: <http://www.gcactuaries.org>.

2.2.7. *Ensuring coordination*

33. To ensure proper coordination between the different levels, it is important that information be exchanged easily by the different players participating in the project. The requests for preparatory work, as well as the subsequent mandates, will include milestones and deadlines, and provide for regular reporting and feedback.
34. CEIOPS will be represented in EIOPC through its Chair and will therefore be in a position to report regularly to EIOPC on progress. The Commission Services consider that a representative from CEIOPS should also attend the meetings of the Commission solvency working group.
35. Conversely, the Commission Services will participate as active observers in the working groups established by CEIOPS. The observer will in particular provide guidance to CEIOPS on the Commission's thinking with regard to the future Solvency II framework Directive. Subject to respect of CEIOPS' confidentiality requirements, the Commission delegation may also include technical advisors.
36. At a later stage, provided the co-legislators have endorsed the new committee architecture, requests for preparatory work will be transformed into provisional formal mandates. The requests for preparatory work are still tentative at this stage. The aim of this first round is to reflect on the draft requests for preparatory work to CEIOPS and to identify all timing and co-ordination issues that need to be taken into account.
37. On pillar I issues, no requests for preparatory work have been drafted. However, major issues requiring discussion have been identified. On pillar II areas, the Commission services think it appropriate to make directly draft suggestions for requests for preparatory work by CEIOPS. At this stage, no proposals are made on the split between advice on implementing measures to be decided by the regulatory committee and guidance to be decided by the supervisory committee. Interested parties are invited to give their opinion as to whether advice or guidance should be asked for.
38. The provisional mandate will have a wide scope; it could ask for advice on implementing measures in certain subjects and for guidance in other subjects. Also, it should be considered that the separation between implementing regulation and supervisory guidance could be seen as unfolding in time: some rules could be "field-tested" in a first stage in non-binding supervisory guidance, before giving implementing measures.
39. Before converting the requests for preparatory work into provisional mandates, the Commission will take into account the feed-back from stakeholders. However CEIOPS is asked to start working on these proposals for further work as early as feasible.

40. The process will be in steps:
- the Commission Services, consulting IC/EIOPC (and the Commission solvency working group), will draft an early text to show what the principles directive could broadly include – this is also an occasion to discuss which elements are to be included in the directive, implementing measures and supervisory guidance;
 - simultaneously, the Commission Services will start to draft requests for preparatory work to CEIOPS. At this first stage, however, CEIOPS would as a general rule be invited to comment, for each area, on the principles submitted to them (the draft directive) as well as on the corresponding suggestions. CEIOPS representatives would be invited to comment, suggesting improvements or underlining technical problems as well as preparing a roadmap of how CEIOPS intends to organize its work. At this stage other interested parties could give their comments on the Commission Services' proposals;
 - the Commission would then discuss the input received from CEIOPS and other parties with the regulatory committee (and the Commission solvency working group). The Commission would then be able to draft the detailed provisional mandates.
41. In this way, the Commission, advised by the regulatory committee, could prepare the framework directive, while CEIOPS starts studying areas where its advice has been requested.

2.3. Next steps and timing issues

42. The intention is to discuss this paper in the IC Solvency Subcommittee in March 2004. Subsequently, comments from CEIOPS, the Groupe Consultatif, industry, and other interested parties will be taken into account when preparing requests for preparatory work to CEIOPS. The Commission Services would like to underline the importance of feedback and constructive input at this stage as it will help the Services, IC and CEIOPS to plan a roadmap for the next phases of the Solvency II project. At subsequent meetings of the IC Solvency Subcommittee areas of preparatory work, as well as elements of the framework directive, will be discussed.
43. At the 30 June 2004 IC meeting, the Services intend to discuss the results of the current consultation. The first set of requests for preparatory work on pillar II issues could be finalized before the pillar I issues. The timing will depend on the result of the consultation.
44. Finally, the Commission Services want to stress the importance of quantitative impact assessments and their contribution to the success of the Solvency II project (cf. MARKT/2539/03, e.g. chapter 3.4.2.). It will be necessary to have several rounds of quantitative analysis during the project.

3. GENERAL OVERARCHING ISSUES

45. Before entering into the detailed questions, there are horizontal themes that affect the framework of the Solvency II project to be made explicit. These are the accounting environment, the degree of incorporation of the IAIS standards, the notions concerned by the prudence level and the type of harmonization wished. Although they are more a matter for policy decision than a technical one, interested parties are invited to express their opinions on the choices suggested by the Commission.

3.1. Accounting environment

46. The underlying accounting environment is crucial to the Solvency II project. In earlier discussions, it has been agreed that the Solvency II project should be IASB compatible in order to reach a greater level of harmonisation. However, the IASB rules on insurance are still incomplete and may suffer further delays that will impact the timing of Solvency II. This incompleteness means that certain concepts have not been yet developed (for example, the market value margin), which adds uncertainty to the Solvency II project.

47. Several ongoing solvency projects (Australia, Finland, Netherlands, Sweden, United Kingdom) have faced this accounting challenge. In principle these projects have opted for a solution in which they define their own valuation rules for insurance assets and liabilities, taking the likely IASB developments into account. Furthermore, they have expressed the intention to adapt their approaches once the IASB solutions are adopted. The approach chosen by these countries seems to be in line with that outlined for Solvency II in the document MARKT/2514/02.

48. This would mean that

- IASB phase 2 rather than the interim phase 1 would be the reference point for the Solvency II project
- we should aim at implementing rules which are compatible with the likely outcome of the IASB project
- we can introduce adjustments or additions for supervisory purpose, but there is a clear aim for not creating specific supervisory accounting solutions
- current accounting rules can only be used for Solvency II as long as they are in conformity with foreseen IASB developments

49. The IAIS Accounting Subcommittee is also continuously following and contributing to the IASB developments in order to obtain accounting solutions that are suitable for supervisory purposes.

50. **Issue 1: What are your views on the proposed way of integrating IASB insurance phase 2 accounting into the Solvency II project?**

3.2. IAIS standards

51. We propose to incorporate the IAIS papers, and particularly the Insurance Core Principles, as far as possible in the future directive. The general wording of the articles in the directives could be directly inspired by the Core Principles. The requests for preparatory work would ask CEIOPS to look into each of the relevant IAIS principles, standards and guidance papers to make them operational, and translate them into implementing measures or guidance.
52. **Issue 2: What are your views on the integration of IAIS principles, standards and guidance papers into the Solvency II project?**

3.3. Elements related to a prudence level

53. The proposed architecture for the solvency system aims at increasing harmonization through setting a uniform level of prudence throughout the EU. Two notions are concerned by a prudence level: technical provisions and the target capital requirement, be it calculated in a standardized way or through an internal model (MARKT/2509/03). The level of prudence in the target capital requirement refers to all the components of the balance sheet and not only the own funds.
54. The IAA suggests adopting a "total balance sheet approach" to look at the overall solvency situation by requiring that the fair value of assets must be sufficient to cover a "realistic value" of insurance liabilities with given time and probability assumptions. This solvency assessment method can be applied internationally despite differences in accounting systems. The Commission Services see benefits in international comparability but believe that a more ambitious approach in which both the technical provisions and the solvency margin requirement are harmonised through explicitly defined levels of prudence is preferable for the Solvency II project.
55. The two characteristics of insurance, that is a long term activity with an inversed production cycle (policyholders pay their premiums up front, and sometimes long before, given the case, receiving the claim), entails that it is overall more important in insurance than in any other activity that the undertaking does not go bankrupt. Because of this, the current general principle of prudence regarding insurance operations must remain.
56. **Issue 3: What are your views on the choice of two elements, technical provisions and target capital requirement, concerned by a prudence level?**

3.4. Type of harmonization

57. The solvency directives have up to now ensured a so-called minimum harmonization, where Member States could set up stricter rules than the ones expressed in the directives. With Solvency II, the intention of the Commission is to move to a higher degree of harmonization. Maximum harmonization signifies that rules are set at such a level that Member States should feel no need to fix additional requirements.

58. In the context of Solvency II, this would mean that the general requirements would be set in the same way for all. Maximum harmonization would not prevent supervisors from, given the case, setting additional requirements in individual cases in the context of pillar II (see introduction of chapter 7).
59. Generally, the type of harmonization has implications on the level of detail of the rules. The greater the harmonization, the more detailed the rules. However, the new committee architecture gives margin for manoeuvre since these rules can be either in a directive or in implementing measures, both binding, and even in non-binding supervisory guidance.
60. Maximum harmonization would be an important challenge for all parties involved. The Commission services are aware that it is an ambitious goal that needs to be supported by strong political motivation.
61. **Issue 4: What are your views on maximum harmonization?**

4. TECHNICAL PROVISIONS IN LIFE ASSURANCE

4.1. Terminology

62. Increasing harmonization of technical provisions will be done through setting an explicit level of prudence. This implies, on the one hand, taking a policy decision on the level of prudence desired, and on the other, setting a method allowing to measure the level of prudence in technical provisions (choice of a risk measure and guidelines on how to use it).
63. Before entering into a technical discussion it is useful to review some of the main definitions. It is necessary to keep in mind that several fundamental issues will have to be looked at from a different angle when taking an IASB compatible point of view instead of the current practices.
- Technical provisions can be defined in an IASB compatible way as a risk-adjusted estimate of the present value of all future cash-flows arising from the commitments under examination. This estimate can be split further into two parts: expected present values (which relate to the mid-points of probability distributions) and risk margins (which relate to more prudent points of probability distributions, defined for example by standard deviations or percentiles¹⁰. Furthermore IASB proposes risk margins to be market based, see chapter 4.2. below).

The current definition in article 20 of the codified life directive (2002/83/EC) states that the calculation of technical provisions is a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing contract, and taking credit for future premiums due.

One main difference between these two definitions is that the IASB definition requires an explicit level of prudence.

A third definition of technical provisions can be found in the IAIS glossary as presented in the context of non-life insurance (see point 74).

- Present value is the sum of the estimated future cash-flows discounted at a specified interest rate. We refer to this rate as a discount rate or a technical interest rate. Risk-free market interest rate means the market yield of government bonds which have similar duration and currency to the estimated liability cash-flows. An IASB type of approach implies the use of an interest rate curve.

¹⁰ The mid-point of the probability distribution can be defined in several ways. For our purposes two measures are sufficient: a) a 50 percentile (median) is a point where 50% of the observations are below it, b) expected value (mean) is a probability-weighted average of the distribution. In case of skew distributions these measures differ: if the distribution is skew to the right, mean > median and vice versa. Three measures of spread that could be used for risk margins are: a) percentile higher than 50% or median, b) standard deviation, c) coefficient of variation or standard deviation divided by the mean. In case of symmetrical, bell-shaped normal distribution 75%/99%/99.5% of outcomes are below mean plus 0.67/2.33/2.58 times standard deviation.

Article 20 of the codified life directive (2002/83/EC) also states that the rate of interest used shall be chosen prudently. It shall be determined in accordance with the rules of the competent authority in the home Member State, applying the following principles:

- (i) when contracts contain an interest rate guarantee, a single maximum rate of interest shall be fixed and it may not be more than 60% of the rate on government bonds.
 - (ii) however, when the assets of the assurance undertaking are not valued at their purchase price, maximum rate(s) may be calculated taking into account the yield on the corresponding assets currently held, minus a prudential margin and, furthermore taking into account the anticipated yield on future assets.
- A "best estimate" liability is a policy liability which is evaluated at the mid-point of its probability distribution. However, the exact definition may vary: sometimes best estimates are used in the meaning of expected value and sometimes as a 50 percentile. IASB uses the former definition.

4.2. Life technical provisions: major issues for discussion

64. The following three main issues concentrate on the level of prudence in technical provisions.

65. **Issue 5: How should the explicit level of prudence in life technical provisions be addressed?**

Alternatives:

- Establish expected values (or so called "best estimates") of future cash-flows and add explicit risk margins on the relevant risk factors to calculate the technical provisions. (This approach seems to be compatible with the IAA and IASB proposals, however note that the IASB risk margin definition may be based on "book of contracts" and not on each contract separately.)
- Define the prudential target at an aggregated level and set explicit methods for evaluating the level of prudence, given the case, per portfolio or sub-portfolio (e.g. per business lines or "book of contracts"). (This aggregated approach could be IAA and IASB compatible too if applied appropriately, i.e. using "best estimates" as basis etc.)
- Calculate technical provisions with a prudent interest rate and appropriate mortality tables, contract per contract, but increasing harmonisation through more detailed rules. (This approach is based on the current EU system.)

Proposal: The Services prefer the first alternative as it seems reasonably well to take into account current practices and IASB proposals.

Questions:

- Is the proposed method suitable for all relevant risk factors, e.g. for investment related parts of the life assurance contracts (see the questions below)?
- At what level of aggregate should the book of contracts be defined?¹¹
- Should the method for calculating risk margins be similar for technical provisions and target capital? (This is the IAA's proposal)

66. **Issue 6: Should risk margins be taken into account in cash-flows or in the discount rate? How should they be determined concretely?**

Alternatives:

- Take uncertainty into account by adjusting the cash-flow estimates or their probabilities. (This is the IAA's approach and is likely to be the IASB preferred approach.)
- Adjust the discount interest rate to take into account the risk margins.
- Is some other available methodology better and why?

Note: IASB proposals as outlined in their discussion papers would allow the first two options above: to the "best estimate" liabilities (as defined above) a market value margin (MVM)¹² would be added.

Proposal: At this stage, the Services want to have further discussion and analysis before making a proposal.

Questions:

- In addition to insurance risk intensities (e.g. mortality, morbidity), can lapses (surrenders), expenses and other relevant factors be addressed in a similar way?
- Should a scenario-based approach be allowed in addition to probability distributions?

¹¹ Expected values are additive but standard deviations are not because they depend on correlation assumptions. Consequently this question is relevant for risk margin definition.

¹² Under fair value approach MVM for risk and uncertainty should reflect market prices (or market averages) for each assumption. Under entity-specific valuation assumptions that are not readily available in market can be deduced from insurer's own experience (e.g. expenses). MVM should be calculated separately for each similar book of contracts (correlations included) and then aggregated (without correlation benefits). MVM includes both diversifiable and non-diversifiable part of risk. Note however that MVM is not yet defined in detail in the DSOP. See also non-life technical provisions and the Australian references therein.

67. **Issue 7: What level of prudence should be set for technical provisions?**

Alternatives:

- Define a percentile: e.g. 75% (Australia non-life) or 90% or fix it by a corresponding formula based on the mean and the standard deviation (or the coefficient of variation).
- Best estimate + market value margin approach of the IASB.
- Is some other approach better and why?

Proposal: at this stage the Services want to have further discussion and analysis before making a proposal.

Questions:

- Should the approach and the level of prudence for risk margins be similar or different in life and in non-life insurance? Why?

68. **Issue 8: how should the technical interest rate for future commitments be defined? How should financial guarantees and options embedded in policies be valued?**

Alternatives:

- Use a relevant risk-free market interest rate. Take interest rate guarantees, surrender values and other embedded options into account explicitly and use traditional methods such as adjusting the commitments' cash-flow estimates or the discount technical interest rate. (This method is IASB compatible).

More advanced IASB compatible valuation method for with-profit liabilities would be to use financial valuation techniques such as option pricing, replicating portfolios, stochastic discounting and deflators to reflect the appropriate risk free discount rate and the risks associated with the income and capital streams from the assets. These more complex methods that are suggested by the IASB and the IAA may be especially beneficial or even necessary when valuing certain options embedded in life assurance contracts and these should be addressed in the first place.

- Use a prudent harmonised interest rate, also linked to the risk free market rate, such as the current option of a maximum of 60% of the bond rate, to allow for unexpected evolutions in interest rates.
- Is some other approach better and why?

Proposal: the Services believe that the first approach should be preferred as it would be IASB compatible. However, the more advanced option may not be well-known and established enough for EU-wide use at the moment. Furthermore, the linkage to bonuses needs to be taken into account (see the next point).

Questions:

- Can risks related to asset-liability mismatch and interest rate curve changes be addressed solely in the target capital requirement?
- How easily could the whole interest rate curve be used instead of a single point (or flat curve) when discounting future cash-flows in technical provisions?

69. **Issue 9: how to define and value bonuses more explicitly while taking into account different bonus policies in national and company levels?**

At the moment there are no harmonised EU rules for bonus provisioning. If market interest rates are used for discounting, it is essential that an explicit method for bonus provisioning be set. However, a lot of further work and analysis is needed: first of all the bonus rules must be clear enough for customers and for valuation purposes, policyholders reasonable expectations and fair treatment must be taken into account, calculation methods have to be developed and so forth. One major problem is that at the moment there are not much references available or guidelines given by the IASB.

Three alternative development ideas have been suggested by the life working group and a fourth is being currently studied by some Member States:

- Require the definition of a profit-sharing policy and simulate this policy in ALM requirement (pillar II obligation)
- Define transparency rules on effective guarantees and profit-sharing mechanisms so as not to create undue expectations.
- Introduce an EU principle of "fair-sharing" the profits.
- Realistic provisioning is currently being explored in the UK for example.

Proposal: the Services do not have a view at the moment because further analysis seems necessary.

Questions:

- Is it necessary to require explicit profit-sharing rules in order to be able to appropriately value future cash-flows of bonuses?
- Can similar methods as for interest rate guarantees be used when estimating bonus cash-flows?
- How can flexibilities in bonuses be taken into account in solvency calculations? Can the bonus provision function as a buffer to smooth volatility?
- What alternative above do you prefer or do you have other suggestions?

70. **Issue 10: Profits may be recognized at the inception of the policy in IASB. Should this recognition be limited? If so, how?**

The IASB is currently discussing the issue of profit at inception for life and non-life insurance contracts. Significant hesitation about such up-front profits has been stated by supervisors and also by most IASB Board members. IASB may propose the same model as for core deposits in banks, i.e. the valuation of outstanding liabilities cannot be less than the current surrender value (which means in a way 100% surrender rate assumption). The issue creates problems for certain life insurance products where companies have significant acquisition costs that in the new accounting framework should be booked as costs. If these costs cannot be compensated by future gains, these traditionally profitable products would be booked at a loss in the year of inception. Even bigger problems may arise from asset-liability matching point of view because asset values would move freely according to market prices but liabilities' movement would be restricted.

- Do you have comments on the profit at inception issue?
- Should the issue be addressed in two parts: a) valuation of assets and liabilities should be coherent to avoid mismatch problems, b) profit restriction could be addressed by unrealised gain type of element which could be taken into account in solvency calculation?

If you support a solution where the profit at inception is limited, how should this limit be defined:

- Linked to the market value of liabilities.
- Some other figure, based on the bond rate for example.
- Different levels according to the horizon of the business lines.
- Linked in some way to the solvency situation of the company.
- Some other approach.

Proposal: the Services do not have a view at the moment because further analysis seems necessary.

Note: this issue is also valid in non-life insurance.

71. **Issue 11: Do we need actuarial standards recognized internationally in order to reach the goals relating to issues above?**

As the discussion above clearly indicates, the goal of a more harmonised, transparent and market-based valuation system for life technical provisions cannot be achieved easily. The Services believe that an agreement on common EU actuarial standards, agreed upon by a European actuarial association such as the Groupe Consultatif, might be a prior requisite. In fact the same argumentation could apply also when it comes to harmonisation at an international level (i.e. IAA standards may be necessary).

Note: This issue is also valid in non-life insurance.

72. References

The Services have gathered the following tentative list of references as an example. Consequently, any comments and additions are welcomed as they would be helpful in the further technical work.

IAIS documents:

- ICP 20
- Quantifying and Assessing Insurance Liabilities Discussion Paper
- Stress testing Guidance Paper

Commission papers:

- Report of the Working Group on life technical provisions to the IC Solvency subcommittee (MARKT/2528/02)
- Discussion paper MARKT/2539/03

IASB documents:

- DSOP, IAS 37, 39 and other relevant standards and drafts

Member States' solvency projects are described on their websites. See for example:

- United Kingdom: www.fsa.gov.uk

Consultation Paper CP 190: Enhanced capital requirements and individual capital assessments for non-life insurers (July 2003)

Consultation Paper CP 195: Enhanced capital requirements and individual capital assessments for life insurers (August 2003)

- Netherlands: www.pvk.nl

Standards¹³ and publications¹⁴ by the actuarial organisations worldwide, i.e. the members of the Groupe Consultatif in Europe as well as other IAA members such as the actuarial societies of Australia and Canada should be consulted. Useful inspiration could be found for example in the following documents:

¹³ IAA's publications as well as national actuarial standards and links to the member associations' websites can be found from the IAA website: www.actuaries.org.

¹⁴ For example the Staple Inn Actuarial Society's website includes several papers on Fair Value provisioning: www.sias.org.uk. The Society of Actuaries' website: www.soa.org contains several useful documents, see for example North American Actuarial Journal Vol. 6, No 1, January 2002, and their new ALM standard.

IAA documents:

- Discussion papers on IASB fair value
- A Global Framework For Insurer Solvency Assessment, by the IAA Insurer Solvency Assessment Working Party, draft report, October 1, 2003¹⁵

Australian standards:

- standards on valuation (e.g. 1.01, 1.02, 4.01, 5.01)
- related guidance notes (e.g. 252, 258, 259)

The standards above are also part of the Australian APRA standards¹⁶.

Canadian standards:

- practice specific standards for insurers, draft (e.g. chapters 2100, 2300, 2500)
- stand-alone standards of practice for the valuation of policy liabilities of life insurers
- valuation technique paper 11 on the valuation of universal life policy liabilities

New Zealand's standards:

- guidance note for life insurance company prudential reserving
- professional standard on determination of life insurance policy liabilities.

¹⁵ The report of the working party is available at the IAA website: www.actuaries.org.

¹⁶ See the website: www.apra.gov.au.

5. TECHNICAL PROVISIONS IN NON-LIFE INSURANCE

5.1. Terminology

73. As in life issues, the accounting environment chosen will contribute to shape the Solvency II project.

74. Consequently, it is necessary first to clarify the terminology used in order to show the main differences that accounting approaches imply and where further work will be needed.

- The current definition results from the 1991 Insurance Accounts Directive: "The provision for claims outstanding shall be the total estimated ultimate cost to an insurance undertaking of settling all claims arising from events which have occurred up to the end of the financial year, whether reported or not, less amounts already paid in respect of such claims" (article 28, Directive 91/674/EEC). Article 60 indicates that the criterion of ultimate cost for the valuation of the provisions for claims outstanding is to be applied prudently.
- However, technical provisions can be defined in an IASB compatible way in a similar fashion as in life insurance, as a risk-adjusted estimate of the present value of all future cash-flows arising from the commitments under examination. This can be split further in two parts: expected present values and risk margins (see chapter 4.1. on life technical provisions).
- The IAIS Glossary defines technical provision as the "amount set aside on the balance sheet to meet liabilities arising out of insurance contracts, including claims provision (whether reported or not), provision for unearned premiums, provision for unexpired risks, life assurance provision and other liabilities related to life insurance contracts (e.g. premium deposits, savings accumulated over the term of with-profit policies)".
- According to the OECD ("Assessing the solvency of insurance companies" – Policy issues in insurance – n°4, July 2003, page 60), "the provision for claims outstanding (PCO) measures the estimated total cost of ultimate settlement of all claims incurred before the date of record, whether reported or not, less any amounts already paid out in respect thereof". The paper indicates that the PCO aggregates three different types of claims presenting varying degrees of uncertainty (information on the claim, incremental cost factors): claims for an amount known precisely but not yet paid to the beneficiaries, claims reported, and thus known, but for an as yet indeterminate amount; and claims incurred but not yet reported as of the date of the balance sheet (IBNR). The PCO also includes a management provision intended to cover all expenses arising from the processing of claims and is reduced by recoverable amounts.

5.2. Non-life technical provisions: major issues for discussion

75. The Working Group on non-life technical provisions (whose conclusions were published in the document referenced MARKT/2529/02) has indicated that the current principle of prudence is applied very differently between European countries and even, in some cases, between undertakings on the same domestic market.
76. If IASB accounting is to be the strict framework, non-life technical provisions will cover mainly the provision for outstanding claims. The provision for unearned premium and the provision for unexpired risks will probably not be shown as separate items (as well as the provision for deferred acquisition costs, currently recognized by certain local GAAPs) and equalisation provisions will no longer form part of the technical provisions. The exact outcome is not totally certain at this stage.
77. One of the objectives of the Solvency II is to establish a harmonised framework for the calculation of technical provisions in non-life insurance through an explicit prudence margin. Establishing precise and binding claims management guidelines will also mark a step towards greater harmonization. This will favour equal competition between EU undertakings and more homogeneous practices.
78. **Issue 12: How should the explicit level of prudence in provisions for claims outstanding be measured?**

Alternatives:

- Establish expected values for each component of the provision for outstanding claims (outstanding claims, IBNR, management expenses and recoverable amounts, for example) and add suitable risk margins to obtain the target level of prudence. Make the calculations per books of contract (see separate issue below).
- Define an overall prudential target for the provision for outstanding claims, as a general guideline.
- Define different targets of prudence per lines of business, as the degree of uncertainty varies strongly according to the horizon (long-tail / short-tail lines).

Proposal: The Commission services suggest the first alternative because it is IASB compatible.

Questions:

- Is the proposed method suitable for all relevant risk factors?

79. **Issue 13: At what level should the level of prudence in technical provisions be set?**

Alternatives:

- A fixed figure: the ultimate cost of the claims of an occurrence year should have a 75% (or 90% for example) probability of being covered by the amount set in the provision (75% is the current Australian non-life benchmark).
- Best estimate + a coefficient linked to the volatility of the line of business. This would allow to have different levels according to the lines of business (short-tail lines usually have a lower volatility than long-tail lines).
- IASB approach of "best estimate + market value margin". However, note that there is no clear method of calculating the market value margin to this day.
- Some other approach.

Note that the Australian approach is a mix of the two first alternatives since the rule is to apply the maximum between 75% and a formula based on "mean + coefficient of variation".

Proposal: At this stage, the Commission Services prefer to have further exchanges of views before making a proposal.

80. **Issue 14: If technical provisions are discounted, how should the discount rate be defined?**

The current approach does not allow discounting except as a derogation. In the few national insurance legislations which allow this derogation, it is seldom used in practice. However, in the IASB accounting environment, discounting technical provisions will be the norm.

Alternatives:

- One (very low, to allow for a Japanese-style scenario, or higher, near the 10-year bond rate) or several (different rates according to the horizon of the business lines) prudently set maximum interest rates at European level.
- Adopt the IASB's proposal, which will most likely be a relevant risk-free market interest rate that corresponds to the duration of liabilities.
- Some other approach.

Proposal: The Commission Services favour the second alternative.

81. **Issue 15: Definition of book of contracts.**

IASB technical provisions may be calculated by establishing expected values and risk margins per book of contracts.

Question:

How should this book of contract be defined in non-life insurance? Particularly, how should low frequency, high severity risks (e.g. aviation, major industrial risks, energy) be addressed from a prudential point of view?

82. **Issue 16: Harmonization of technical provisions implies claims management rules are explicit and harmonized. How detailed should claims management rules be?**

Alternatives:

- Very detailed.
- More general, following, for example, the OECD suggestions (see reference below).
- Is some other approach better and why?

Proposal: The Commission services suggest the second approach because it is the first time explicit requirements will be set on insurance companies and it is pragmatic to start with principles based requirements.

Questions:

- Should these rules be non-binding supervisory guidance or rather implementing measures?

83. **Issue 17: Treatment of equalization provisions?**

Currently equalization provisions¹⁷ are only required at EU level for credit insurance, and facultative for other insurance lines. Many Member States require them more widely. The use of equalisation provisions may change, as it is likely that these will be classified as own funds by the IASB. In earlier discussions, Member States and the Commission Services have expressed the view that insurance companies still should have the possibility to build up untaxed reserves as restricted solvency capital in a future EU solvency system to allow for unforeseen fluctuations.

¹⁷ Although equalisation provisions also exist in life (e.g. mortality risk for a group), they are treated in the non-life insurance chapter because they are especially wide-spread in this latter domain.

Proposal: The Commission Services believe that the issue of equalisation reserves should be addressed at a later stage of the project when the general structure of the capital requirements and the links to financial reporting have been laid down. The calculation of such statutory reserves need to be harmonised, transparent and linked to the target capital calculation.

Question: Do you agree with this proposal?

84. **Issue 18: Treatment of the provision for unexpired risks**

Currently, the provision for unexpired risks is compulsory in case premiums are insufficient to cover claims and management expenses. IASB accounting sets up a profit/loss recognition at inception of the policy and in consequence may not necessarily maintain that provision. One of the main risks faced by an insurance company is selling a new contract because the price (premium) is set before the cost (claim) is known. Experience has shown that companies have sometimes underestimated the value of certain options in the contract unknowingly. The general principle of prudence would tend to argue that this risk should be taken into account in technical provisions.

Proposal: The Services believe that this issue needs to be addressed but further discussion and analysis is necessary before a proposal can be made.

85. **References**

European Commission:

Report of the Working Group on non-life technical provisions to the IC Solvency subcommittee (September 2002) MARKT/2529/02

CEIOPS:

Report on prudential supervision of insurance undertakings (December 2002), under the chairmanship of Paul Sharma

Report on Technical provisions in non-life insurance (October 2002), under the chairmanship of Giovanni Manghetti

OECD:

Good practices for insurance claim management (November 2003)

Assessing the solvency of insurance companies (Policy issues in insurance, n°4, July 2003)

IAIS and IASB: see the references of life technical provisions.

Actuarial documents:

Clark, Hinton, Nicholson, Storey, Wells and White: The implication of fair value accounting for general insurance companies (presented to the Institute of Actuaries in March 2003)

Australian APRA standards and two reports on Australian risk margins:

- The Institute of Actuaries in Australia: Research and data analysis relevant to the development of standards and guidelines on liability valuation for general insurance, 20 November 2001, by R. Bateup, I. Reed (Tillinghast-Towers Perrin)
- APRA Risk margin analysis, prepared by S. Collins and G. White (Trowbridge Consulting) for the Institute of actuaries of Australia on 25-28 November 2001.

Actuarial standards globally, for example the Canadian P&C standard 1993. For a more detailed listing of sources and links, see life technical provisions references.

Furthermore, some of the US standards may provide inspiration (e.g. cash-flow testing, interest rate models) as well as actuarial publications by the Casualty Actuarial Society¹⁸.

¹⁸

See the website: www.casact.org.

6. TARGET CAPITAL

86. Introduction

The target capital together with technical provisions should ensure that the probability of failure of an insurance undertaking within a given period is very low (e.g. x % in y years). In this respect target capital has some things in common with the concept of economic capital (which is currently being applied by many of the largest insurance companies and groups) as well as with the capital required by rating agencies. This target capital will be calculated by a formula quantifying the major risks undertaken by this specific company with its whole activity.

In non-life insurance usually underwriting risk is dominating and investment risk is less important than in life assurance. The liability is usually of a shorter duration. Probability distribution and standard deviation based methods, including correlation structures, are easier to implement although skew distributions require special attention. However, at this stage, life and non-life will be treated together.¹⁹

The Commission services suggest that a whole spectrum of approaches should be available:

- a European standard approach,
- a national standard approach that would result from the European one with calibration of parameters to adapt it to the national market,
- an internal model that would wholly or partly substitute the standard national formula.

These approaches would have in common to be calibrated to the same risk level. The standard approach will have to be formulated in such a way that it is not too complicated to calculate. This is of particular importance to smaller insurance undertakings. The internal model will be elaborated by the company, and approved by the supervisory authority. It is clear that an internal "tailor-made" model can give more accurate results than the EU standard formula. Consequently, one way to motivate companies to develop internal models is that the resulting target capital may be lower in the internal model than in the standard approach.²⁰

¹⁹ For a more comprehensive analysis of life and non-life insurance specificities see the IAA draft report, chapters 6.2.3. and 6.6.9.

²⁰ The EU level ruin probability assumptions must be respected in the internal model approach as well as in the national standard approaches.

As with the technical provisions, some terms and approaches should be clarified first. As IASB compatibility is one goal in the new solvency regime, the solvency assessment should follow this line of thinking. Therefore the solvency assessment should be based on the cash-flow estimates of assets and liabilities and address the risks involved. In practice the following steps are required:

- (1) The insurance company must assess the “expected value” and the “uncertainty” of the future “cash flows” related to its policies in force.
- (2) The insurance company must assess the “expected value” and the “uncertainty” of the future “cash flows” related to the assets held by the company.
- (3) The insurance company must assess the “expected value” and the “uncertainty” of the “cash flows” related to policies to be written or renewed in the following year (going-concern).
- (4) In these assessments the company must take into account relevant risks.
- (5) The company shall organise its activities and maintain high enough amount of assets so that the “cash flows” generated by them with “a high probability” exceed the “cash flows” considered in points (1) and (4) above.

87. However, before going into the above mentioned technical matters, it is necessary to point out that although developing of target capital formula is a focus area in the Solvency II project, it should not get an exaggerated importance from stakeholders. The perfect model does not exist: every modelling approach is a simplified reflection of reality – the quality of the model depends on how well it meets the set goals and balances of the different competing requests (accurate and sophisticated vs. simple and user friendly, modular vs. integrated etc.). Furthermore, many important factors cannot be reliably measured and modelled although they certainly have significant implications for the insurer's solvency position (for example, the corrective actions taken by the company management and supervisors). The Services believe that these realities highlight the importance of pillar II supervisory review process in the solvency assessment and the possibility for insurance companies to develop and use their own (partial or full) risk models for risk measurement. Indeed, it is the sum of all pillars I, II and III measures that gives the overall protection to policyholders.

88. **Issue 19: Do you agree with the structure of a spectrum of approaches, from a standard European model approach to an internal model?**

Alternatives:

- Agree to have a whole spectrum of approaches: a European standard formula, a national standard formula that would result from the European formula with calibration of parameters to adapt it to the national market where necessary, an internal model that would wholly or partly substitute the standard national formula.
- First alternative except that no national calibration is allowed (only the European standard formula and internal models).

- First alternative except that no partial implementation of internal models (only a complete internal model can substitute the standard formula).
- Allow solely a European standard formula.
- First alternative except that on the European level, set a criteria (for example, the probability of ruin must be 1/200) but not a detailed European formula.

Proposal: The last option would be the most flexible but would not favour increased harmonization. The Services see benefits in the first option which appears to be both flexible – and thus is the most coherent with the overall objective of Solvency II which is to approximate as much as possible the real risks that a company meets – and significantly increase harmonisation.

89. **Issue 20: Which is the most suitable risk measure for the target capital?**

In the field of actuarial and financial research lot of effort has been made in order to find the best possible risk measures. Several alternatives have been suggested and the discussion is on-going²¹.

In the Solvency II project theoretical arguments must be balanced with practical ones and furthermore it is necessary that the risk measure have a good track-record and be familiar to the insurance industry.

Alternatives:

- Ruin probability (a percentile or probability of default or Value at Risk, VaR, to use a banking term), which gives the probability for the case that an insurance company will have not enough assets to cover its liabilities at the end of the observation period. (This is at the moment the more commonly used approach.)
- IAA proposes conditional tail expectation. This TailVaR risk measure quantifies the extreme tail of a claim distribution more prudently especially in skew or "fat-tail" cases (catastrophes etc.).
- A combination of different measures: VaR could be used as a general rule except for low frequency, high severity risks which would be measured with TailVaR or other measure that takes skewness into account appropriately. This is possible only if the sum of risks measured in different ways remains coherent.
- Is some other risk measure(s) better and why?

²¹

See for example the following references: IAA (2003): A global framework for insurer solvency assessment (draft); Dhaene, Goovaerts & Kaas (2003): Economic capital allocation derived from risk measures, North American actuarial journal, vol. 7, no. 2, April 2003; Landsman & Valdez (2003): Tail conditional expectations for elliptical distributions, North American actuarial journal, vol. 7, no. 4, October 2003; Panjer (2002): Measurement of risk, solvency requirements and allocation of capital within financial conglomerates, AFIR/ICA, Cancun 2002; Wirth & Hardy (1999): A synthesis of risk measures for capital adequacy, Insurance mathematics and economics, vol. 25.

Proposal: Tentatively the Services see some benefits in the third alternative. This kind of system could capture best the reality without being too complicated to implement. However further discussion and analysis is necessary before a proposal can be made.

90. **Issue 21: which is the most suitable time horizon for the target capital definition?**

Alternatives:

- Is the adoption of a single time horizon appropriate for all risks when supplemented with appropriate pillar II measures²²? What is the suitable horizon in that case: 1 year or longer?
- Would a more suitable approach be to have different time horizons according to the term of the risks involved? The IAA suggests adopting a one-year time horizon as a rule except for some complex and long-term risks (e.g. those for which there is not a replication portfolio available in market, i.e. "type B risks") for which the term of the contract and risks (both systematic and non-systematic) are to be taken into account. How should risks be divided for the setting of the horizon? What is the appropriate number of years for these horizons?

Proposal: the Services believe that the first option could be more practical and that a one-year time horizon could be prudent enough when the new solvency system is wholly in place (longer term elements would be taken into account in pillar II). However, the second option has its merits from a theoretical point of view. Note however that in the solvency assessment the full term of the cash-flows has to be taken into account (see the relevant definitions in section 4.5 of the IAA draft report).

91. **Issue 22: which is the most suitable confidence level assumption if a) ruin probability (VaR) is chosen or b) if TailVaR is chosen?**

Note that the definition of the risk measure is linked to the prudence assumption: if the risk measure is more prudent, the confidence level can be lower and vice versa. (As mentioned above, TailVar is a more prudent measure than VaR especially in "fat tail" cases.) Note also that technical solutions (i.e. probability distributions vs. scenarios etc.) are addressed in a separate point below.

²² E.g. rules on risk management, continuity testing, early warning indicators, and revised supervisory powers including additional capital charges.

Alternatives:

- If VaR is chosen, the following options should be discussed and analysed: 1/100, 1/200, 1/500, 1/1000.
- For b) IAA proposes a TailVar risk measure and the confidence level of 99%. When addressing longer time horizon (see above) a lower level such as 90%–95% is suggested.
- Is some other assumption better and why?

Proposal: as this is the major policy issue, the Services believe that wide and in-depth discussion and analysis is necessary before a proposal can be made. However, in some jurisdictions such as the Netherlands, the UK and Australia, VaR and 99.5 % probability (i.e. the ruin probability of 1/200) has been applied. Broadly speaking this implies that insurance companies must be at least of investment grade quality ("BBB") in terms of ratings. The Services lean towards this view.

Note: this is a work area where feedback and iteration is necessary, i.e. calculations for calibration and field-testing purposes need to be made at several stages of the project. The first indicative case studies may be needed even before a formal request for preparatory work can be formulated.

92. **Issue 23: Should target capital measurement be done on a going-concern assumption or on a run-off or a winding-up basis?**

This issue concerns uncertain costs specifically linked to the winding-up or run-off (for example, investments, personnel). Technical provisions inherently take into account run-off costs.

Alternatives:

- The solvency assessment takes into account the run-off risk of the existing portfolio but not the new business over the solvency assessment time horizon.
- As above but the new business over the solvency assessment time horizon is taken into account.
- Strictly on a going-concern basis which means that the run-off risk is not taken into account.
- Is some other approach more suitable?

Proposal: the Services want to have further discussion before making a proposal. The IAA solvency report highlights the need to have a balanced approach. Furthermore, some supervisors believe it appropriate to shift to a full run-off approach when the solvency of an insurance undertaking reaches a level that is considered too low.

93. **Issue 24: how to address operational risks?**

Alternatives:

- Address operational risks both in Pillar I and II.
- For the time being deal with operational risks in Pillar II. If the wording in the directive is broad enough, operational risks can be added to Pillar I formula if and when appropriate methodology is available.
- Is some other approach more suitable?

Proposal: the Services want to have further discussion before considering a proposal.

94. **Issue 25: a) What classification of risk factors should be adopted? b) Which risk factors should necessarily be included in the standard and the internal models?**

Alternatives:

- Regarding a), use the IAA risk classification (see their specific report on this subject: "Report of Solvency Working Party for IAA Regulatory Committee"). Regarding b), use their standard approach for the target capital, i.e. Pillar I should include underwriting, credit, market and (later) operational risks and Pillar II should include liquidity and other relevant risks not included in Pillar I.
- Is some other risk classification better for point a) and why?
- Is some other model for point b) better (description) and why?

Proposal: the Services believe that the first alternative would be a suitable starting point. However, the modelling approach for the chosen risks must be carefully studied and also other models may provide inspiration and practical experiences.

Questions:

- How can the benefits of different RBC formulas, such as those of rating agencies or national supervisors or industry, be considered in the EU work?

95. **Issue 26: how should the structure of the standard model be formed? Should life and non-life insurance have a different approach?**

Alternatives:

- Model is based on probability distributions. This would mean that the whole spectrum of possible outcomes of each risk factor in question is taken into account. (This is the IAA's approach).

- Model is based on scenarios²³. This would mean that only some specific points of the probability distributions are used when calculating the target capital requirement. (Generally speaking scenario-based models are easy to understand and to implement but on the other hand a balance between accuracy and practicality may be difficult to find and there may also be other side-effects regarding correlations etc.)
- Is some other model better and why?

Proposal: the Services believe that the main decision-making criterion culminates in finding a good balance of accuracy and practicality of the method. The IAA's model is based on probability distributions as are those used in Australia and Finland. In the recent projects in the Netherlands, Switzerland and the United Kingdom, a scenario based approach has been chosen. In conclusion, at this stage the Services want to consult the stakeholders before making a proposal.

96. **Issue 27: how should risk dependencies and correlations be taken into account?**

Alternatives:

- Take correlations into account in the calculation of the target capital, both when it results from the standard formula (this would probably result in some kind of "square root formula") and from internal models. (IAA is in favour of this approach.)
- Do not assume correlation benefits and just add up the capital requirements for different risks to get the total number. (Basle II standard approach for credit risk is an example of this approach.)
- Do not assume correlation benefits in the standard approach but allow them in internal models.
- Is some other model better and why?

Proposal: the Services tentatively see benefits in the third option (from incentive point of view) but the other alternatives must also be analysed before making a decision.

Questions:

- Is the correlation coefficient an appropriate measure for dependencies?
- Can the correlation benefits be adequately measured (especially in exceptional circumstances or in the tails of the distributions)?
- What alternative do you favour?

²³

In this context only Pillar I requirements are being discussed. Scenario techniques related to stress testing and other Pillar II measures are addressed elsewhere in this document.

97. **References**

Comments and additions to the following list of references are welcomed.

IAIS documents:

- Insurance Core Principles 15d, 23
- Guidance Paper Solvency control levels
- Guidance Paper Use of actuaries
- IAIS Solvency Subcommittee's work

Ongoing work in the IAA (especially the draft report of the IAA Insurer Solvency Assessment Working Party), Comité Européen des Assurances, EU Member States and other jurisdictions (e.g. APRA actuarial standards numbers 2-3, practice specific standards for insurers/chapter 2500).

Economic capital models as well as those used by rating agencies could provide inspiration.

7. SUPERVISORY ISSUES – SUGGESTIONS FOR REQUESTS FOR PREPARATORY WORK BY CEIOPS

98. Making explicit and harmonizing supervisory powers and responsibilities is one of the innovations of the Solvency II project. While we are not dealing with supervisory powers in this paper (it will be dealt with in a forthcoming paper), it is necessary to keep them in mind as the result of the supervisory review might be the necessity to exercise them.
99. The Commission Services tentatively suggest that the directive explicitly recognizes that supervisory authorities can add on specific capital requirements to those calculated in pillar I, under certain conditions to be further specified.
100. The paragraphs below deal with the following five areas of work linked to pillar II issues:
- the objective of supervision,
 - review of the requirements on companies' management,
 - supervisory review process
 - quantitative elements in the supervisory review process (continuity testing, stress testing and early warning ratios), and
 - transparency of the supervisory authorities.

The first area concerns a proposal for an article in the directive. The four other areas include both suggestions for articles in the directive and draft requests for preparatory work (however, the supervisory review process, be it through its quantitative or non-quantitative aspects, is considered as a single article in the future directive).

101. In order to clarify the context of these draft requests for preparatory work, suggestions for the new articles in the future directive (articles N1 to N6 as identified in the previous paper MARKT/2539/03–EN, chapter 2) are made. However, the objective of this part of the paper is to consult to help the Commission Services write the requests for preparatory work. Although comments on the articles of the directive are welcomed, interested parties are asked to concentrate on the formalized suggestions for preparatory work.
102. Principles of the IAIS²⁴ and the draft capital adequacy directive for credit institutions and investment firms, stemming from Basle II²⁵, have been major sources of inspiration. The most relevant IAIS principles are annexed to this paper.

²⁴ See their website: <http://www.iaisweb.org/>.

²⁵ See the websites: www.bis.org and www.europa.eu.int/comm/internal_market/regcapital.

103. Although timing and the request for regular progress reports are not mentioned at this stage, these elements will be included in the requests for preparatory work.

7.1. Objective of supervision

104. A draft new article, to be included in the future directive, is given below.
105. Article 10 of the recast life directive 2002/83/EC is titled "Competent authorities and object of supervision". However, it does not define explicitly the overall objective of financial supervision but lists the areas concerned by financial supervision. In view of increasing transparency, the Commission services suggest including explicit objectives of supervision in the directive.
106. To write out this new article, inspiration has been drawn from the second IAIS Core Principle adopted in October 2003 at the General meeting in Singapore.
107. Proposal of article N1 in the directive

The objective of financial supervision is to act for the benefit and protection of policyholders. Supervision also promotes the maintenance of efficient, fair, safe and stable insurance markets.

108. Questions
- Do you agree a specific article on the objective of supervision would be useful?
 - Do you have any comments on the wording?

7.2. Requirements on companies' management

109. Introduction

Suggestions for preparatory work are made below (as well as proposals for draft articles in the Directive in three of the four cases).

This work area on requirements on companies' management differs from the others in that it is aimed at companies at least as much as to supervisors. In setting requirements to companies, it is understood that these requirements be reviewed by supervisors.

A system of internal control is critical to effective risk management and a foundation for the safe and sound operation of an insurer. It provides a systematic and disciplined approach to evaluating and improving the effectiveness of the operation and assuring compliance with laws and regulations. It is the responsibility of the board of directors to develop a strong internal control culture within its organisation, a central feature of which is the establishment of systems for adequate communication of information between levels of management (Explanatory note 10.2 of IAIS Insurance Core Principle 10). Once risk is assessed and management is informed of its existence, this risk needs to be managed, that is company rules and culture must exist on maximum sustainable amounts of risk, identification of the persons responsible for taking on the risk and how to deal with excessive risks.

In the course of its review, the supervisor has to assess how these requirements on risk management are fulfilled. While "supervisors play a critical role in the risk management process by reviewing the monitoring and controls exercised by the insurer ..., the ultimate responsibility for the development of best practices and the proper operation of the insurer must always rest with the board of directors" (explanatory note 18.3 of IAIS principle 18).

110. References

IAIS Core principles: 10, 18 and 19.

"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

111. Proposal for the directive

Proposal of structure: For efficiency and clarity reasons, it is suggested to split this work area in two articles (N2 and N3).

Proposal of wording

Article N2: Risk assessment and internal control

The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations (ICP 10).

The supervisory authority requires insurers to recognise the range of risks that they face and to assess them effectively (ICP 18).

Article N3: Risk management

The supervisory authority requires insurers to manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums (ICP 19).

The ICP 19 wording above may need to be amended in the directive to allow for broader risk classification and risk management techniques.

Question:

- Do you have any comments, both on the level of detail of the wording and on the wording itself?

112. Suggestion for a request for preparatory work

The Commission Services would like CEIOPS to advise on detailed rules by which supervisors can ensure that companies have proper risk assessment, internal control system and risk management procedures. CEIOPS should incorporate as far as possible the essential and advanced criterias of the Insurance Core Principles and make them operational. The Services are also seeking advice as to whether these suggested rules should be classified as binding implementing measures or as supervisory guidance (see paragraph 33). CEIOPS should address the following recommendations in the preparatory work.

Risk assessment and internal control

Ensure a company correctly assesses the risks incurred. This implies that:

- Major types of risks are identified, such as underwriting, asset, reinsurance and operational risks.
- Accounting and other records provide complete, accurate, verifiable and timely information
- A comprehensive internal control system is in place,
- Transactions are only entered into with appropriate authority
- Clear hierarchical lines, delegations and responsibilities have been defined
- An investment policy document 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

Risk management

Ensure a company correctly manages the risks incurred. This implies:

- Management is able to identify, assess, manage and control the risks of the business and hold sufficient capital for these risks
- Strict separation between risk management and risk controlling
- Clear guidelines are given, including limits to risk taking
- Internal audits are periodically performed and the report's recommendations are followed up.
- Management is able to promptly adapt the strategy to the circumstances.

- Rules do not encourage excessive financial commitments or risk-taking (for example, counter-signatures are compulsory from certain thresholds)
- Stress testing is regularly conducted, including both scenarios and sensitivity tests.

Question:

- Do you have any comments on the above?

7.3. Supervisory review process

113. 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. Harmonizing the supervisory process between Member States at an enhanced level to reach best practice quality is consequently essential. However, this subject is new in EU regulation. The Commission Services are very much dependent on the extensive practice in Member States on this subject. As a starting point to EU regulation, it would be useful to set at least the agreed good 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, focused both towards specific undertakings and the whole market.

This work area is subdivided to allow for a separate treatment of the quantitative tools.

114. References

IAIS Insurance Core Principles 4, 11, 12, 13, 14, 15 and relevant elements of ICP 17 to 28.

"Review of capital requirements for banks and investment firms", Commission Services Third Consultation Paper, Working Document, 1 July 2003: articles 116 and 117 and annex I, sections 1 and 11-14

115. Proposal of an article N4 in the directive

In order to achieve its objectives, the supervisory authority supervises the financial soundness of individual insurers. This requires an analysis of individual insurers and insurance groups as well as the market and the environment in which they operate (ICP 11²⁶). The analysis of individual insurers is both off-site and on-site.

²⁶ Explanatory note 11.1 to IAIS Insurance Core Principle 11.

The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market (ICP 12). The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements (ICP 13).

The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision (ICP 14). Where needed, the supervisory authority imposes sanctions based on clear and objective criteria that are publicly disclosed (ICP 15).

Questions

- Do you have any comments?

116. Suggestion for a request for preparatory work

Note: This suggestion concerns the supervisory process which is the core activity of the supervisor, and does not deal with all the other activities a supervisor carries out (authorising an undertaking to carry out business in a new branch, checking the effectiveness of the business plans, etc.). It concerns the framework and not the detailed checks.

Proposal of a wording :

Internal Market DG requests CEIOPS to provide technical advice on agreed good standards for harmonizing 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). CEIOPS must incorporate as far as possible the essential and advanced 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 the management and 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 or an evaluation 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 companies in the same group
- assessment of the insurer's financial strength, notably the technical provisions
- evaluation of compliance with corporate governance requirements.²⁷
- non-quantitative supervisory tools, both retrospective and prospective (e.g. "rapport de solvabilité" in French regulation²⁸, "continuity testing" in future Dutch regulation²⁹).
- exchanges with third parties (auditors, independent actuaries, entities to which the undertaking has outsourced some of its functions, etc.)

Question:

- Do you have any comments on this?

7.4. Supervisory review process: quantitative tools

117. Introduction

Although quantitative tools are part of the supervisory review process (at this stage, there is no proposition of a separate article in the directive on this subject; however, the question remains open), it will here be treated separately because of their potential crucial role in an increased harmonization of the supervisory process. National supervisors each use their own early-warning indicators, even if they are not always formalized and named in this way, or their own market references, sometimes implicit, to evaluate potential problems in an insurance company.

118. References: IAIS Insurance Core Principles

ICP 11 and particularly, explanatory note 11.4: "A quantitative analysis of the market could include, for example, developments in the financial markets generally; the number of insurers and reinsurers subdivided by ownership structure whether a branch, domestic or foreign; the number of insurers and reinsurers entering and exiting the market; market indicators such as premiums, balance sheet totals and profitability; investment structure; new product developments and market share; distribution channels; and use of reinsurance."

ICP 13, explanatory note 13.1 "On-site inspection ... needs the support of market information and statistics derived from the analysis of the annual accounts and returns".

²⁷ Explanatory note 13.5 to IAIS Insurance Core Principle 13.

²⁸ Rapport d'activité 2000-2001, page 42, Commission de Contrôle des Assurances (French Insurance Supervisory Authority), website http://www.cca.gouv.fr/fichiers/rapp2002_14.pdf

²⁹ White paper on the continuity test, September 2003, Pensioen- en Verzekeringkamer (Dutch Financial Services Authority), website http://www.pvk.nl/download/Wp_eng_con.pdf.

119. Suggestion for a request for preparatory work

The Internal Market DG seeks CEIOPS's advice on a detailed description of the essential tools necessary for the supervisory process to be efficient. These tools may include:

- market statistics that would be comparable between countries (priority pointed out by the working group on non-life technical provisions – IC Solvency subcommittee).
- early-warning indicators to alert the supervisory authority on the situation of certain undertakings (such as the German set of ratios),
- stress testing, sensitivity testing and scenarios analysis, and
- projections to evaluate the long-term resilience of the undertaking (future "continuity testing" in the Dutch regulation).

Internal Market DG also seeks CEIOPS's advice on the quantitative references these tools should have and whether these references should be harmonized at EU level. Finally, the Commission Services would also like to have advice on whether the rules suggested by CEIOPS should be binding implementing measures or supervisory guidance.

Question: Do you have any comments on this suggestion for preparatory work?

7.5. Transparency of the supervisory authorities

120. Introduction

Increased transparency will help harmonizing supervisory practices. It is also the counterparty of the proposal to recognize, in the directive, explicit powers to increase the required capital. These explicit powers will be treated in a further paper (see §4).

121. References

IAIS Insurance Core Principles 2d, 4

"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

Article 129 Transparency and accountability

- (1) The general criteria and methodologies used by the competent authorities in the evaluation process referred to under Article 126 shall be publicly available.
- (2) At a minimum, the analysis and results of the evaluation process shall be communicated by the competent authorities to the institutions which are required to take prudential measures pursuant to Article 128.

- (3) Requirements to hold an amount of own funds higher than that prescribed in Article 3 shall not be published.

Annex J, section 3 Transparency and accountability

While communicating the results of the evaluation process pursuant to Article 129, paragraph 2 to the institutions the competent authorities shall:

- (a) explain in sufficient detail the factors which have led to the evaluation process' conclusions;
- (b) indicate areas of weakness identified, the prudential measures required and the timeframe for their implementation;
- (c) explain any major action planned by the competent authority.

122. Proposal of an article N5 in the directive

The supervisory authority conducts its functions in a transparent and accountable manner (ICP 4).

Question: Do you have any comments?

123. Suggestion for a request for preparatory work

The Commission Services require CEIOPS's advice on the nature and the level of transparency an insurance supervisory authority should show. CEIOPS must incorporate as far as possible the essential and advanced criterias of the Insurance Core Principles and make them operational. This transparency can concern different areas:

- objectives: the supervisory authority publishes its objectives and gives reasons for and explains any deviations from its objectives
- internal organization
- annual report
- elements of the work program (such as prioritisation criteria)
- analysis and results of the evaluation process

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

The advice should also include suggestions as to what rules should be considered as implementing measures rules and what should be treated as supervisory guidance.

Question: Do you have any comments on this suggestion?

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