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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

concerning life assurance on the taking-up and pursuit of the business of Insurance and Reinsurance

SOLVENCY II

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

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SOLVENCY II IMPACT ASSESSMENT REPORT

EXECUTIVE SUMMARY

The Solvency II project has been developed in full transparency and in collaboration with all stakeholders and interested parties. For the impact assessment, several reports were prepared by: the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), the CEA, AISAM & ACME[1], the European Central Bank, FIN-USE[2] and the Commission's Directorate General of Economic and Financial Affairs. In addition, CEIOPS has carried out two Quantitative Impact Studies (QIS), and a public hearing was held by the Commission in 2006.

1. PROBLEM DEFINITION

The economic and social importance of insurance is such that intervention by public authorities, in the form of prudential supervision, is generally accepted to be necessary. Not only do insurers provide protection against future events that may result in a loss, they also channel household savings into the financial markets and into the real economy. Intervention by public authorities has tended to focus on introducing measures that seek to guarantee the solvency of undertakings, or minimise the disruption and loss caused by insolvency.

1.1. Current EU regime

The rationale for EU insurance legislation is to facilitate the development of a Single Market in insurance services, whilst at the same time securing an adequate level of consumer protection. The development of the necessary legislative framework began in the 1970s with the first generation Insurance Directives[3], but was only completed in the early 1990's with the third generation Insurance Directives. The third generation Insurance Directives established an “EU passport system” (single licence) for insurers based on the concept of minimum harmonisation and mutual recognition.

1.2. Weaknesses of the current EU regime

The Directives required the Commission to conduct a review of the solvency requirements. A limited but expedited reform[4] - Solvency I - was agreed in 2002, following that review. However, it became clear during the Solvency I process that some weaknesses remained:

- <u>Lack of risk sensitivity:</u> A number of key risks, including market, credit and operational risk, are not properly captured under the current EU regime. Moreover, the regime is not forward-looking, contains very few qualitative requirements regarding risk management and governance, and does not require supervisors to conduct regular reviews of these qualitative aspects. The lack of risk sensitivity does not incentivise insurers to manage their risks adequately, nor to improve and invest in risk management. The present regime does not ensure accurate and timely intervention by supervisors, nor does it facilitate optimal

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1 Comité européen des assurances (CEA), Association Internationale des Sociétés d'Assurance Mutuelle (AISAM) and Association of European Cooperative and Mutual Insurers (ACME).

2 FIN-USE is a forum of user experts in the area of financial services established by the Commission in 2004.

3 Directive 79/267/EEC; Directive 73/239/EEC; and Directive 73/240/EEC.

4 Directives 2002/12/EC and 2002/13/EC.

allocation of capital. As a result, the current EU regime does not protect policyholders as well as it might.

- Restrictions on the proper functioning of the Single Market: The present EU framework sets out minimum standards that can be supplemented by additional rules at national level. These additional rules distort and undermine the proper functioning of the Single Market in insurance. This increases costs for EU insurers (and policyholders) and hinders competition within the EU. Significant differences in the way in which supervision is conducted also remain, which further undermines the Single Market.

- Sub-optimal arrangements for the supervision of groups: The current approach to the supervision of groups has increasingly become detached from the reality of how groups are actually structured and organised, as it focuses on legal entities. The organisation of groups has become increasingly centralised as enterprise-wide risk management systems have been introduced and key functions have been consolidated. The gap between the way groups are managed and supervised not only increases costs for insurance groups, but also increases the danger that some key group-wide risks will be overlooked.

- Lack of international and cross-sectoral convergence: The work of the International Association of Insurance Supervisors and the International Accounting Standard Board on the development of new solvency standards and on the valuation of technical provisions is moving towards an economic risk based approach, which is radically different from the philosophy underlying the current EU regime. Meanwhile, a risk-based solvency regime has been introduced for banks via the Capital Requirements Directive[5]. A lack of international and cross-sectoral convergence undermines the competitiveness of EU insurers. Lack of cross-sectoral consistency also increases the possibility of regulatory arbitrage.

1.3. Is action necessary at EU level?

Although in theory it is possible for Member States to introduce similar regulatory regimes, addressing the weaknesses of the current system, and for supervisory authorities to better coordinate their supervisory activities, thus removing the obstacles to the proper functioning of the Single Market, there is little evidence of this occurring in practice. Current experience would even suggest that the opposite is the case. Action needs to be taken in order to facilitate such a change, and this action needs to be taken at EU level in order to increase harmonisation.

2. OBJECTIVES OF THE SOLVENCY II PROJECT

Given the weaknesses of the current EU regime, the following general objectives were agreed for the Solvency II project:

- Deepen the integration of the EU insurance market;

- Enhance the protection of policyholders and beneficiaries;

- Improve the international competitiveness of EU insurers and reinsurers;

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5 Directive 2006/48/EC and Directive 2006/49/EC.

- Promote Better Regulation.

In order to assess the effectiveness and efficiency of various policy options with respect to these general objectives, a number of specific and operational objectives were identified.

3. Policy options, Impact Analysis and Comparison

The various policy options were split into high level and low level policy options, for the purposes of the project:

- High Level Policy Options relate to the overall design of Solvency II, including whether a change is needed, and if so, what legislative procedure should be followed. Other key questions analysed were: the extent to which lessons could be learned from Basel II and the Capital Requirements Directive; how insurance groups should be supervised; how small and medium sized insurers should be treated; whether the calculation of technical provisions should be harmonised; and what approach should be taken regarding the calculation of capital requirements (See Table 1).

- Low Level Policy Options included: methods for the calculation of technical provisions; the level of calibration of the capital requirements; and how the capital requirements should be designed. In addition, various options regarding the treatment of investments were considered (See Table 2).

4. Overall expected impact of Solvency II

The analysis conducted and the feedback received from stakeholders and interested parties regarding the various policy options, indicate that the introduction of a new economic risk-based solvency regime, making full use of the Lamfalussy architecture, is the most effective and efficient means to meet the general objectives of the Solvency II project.

4.1. Retained approach for Solvency II: an economic risk based approach

A system based on sound economic valuation principles will reveal the true financial position of insurers, increasing transparency and confidence in the whole sector. Introducing risk-based regulatory requirements will ensure that a fair balance is struck between strong policyholder protection and reasonable costs for insurers.

In particular, capital requirements will reflect the specific risk-profile of each insurance company. Insurers that manage their risks well - because they have rigorous policies, use appropriate risk-mitigation techniques, or diversify their activities - will be rewarded and allowed to hold less capital. On the other hand, poorly managed insurers, or insurers with a larger risk appetite, will be asked to hold more capital in order to ensure that policyholder claims will be met when they fall due.

Solvency II will result in much greater emphasis being placed on sound risk management and robust internal controls. The responsibility for an insurers' financial soundness will be pushed back firmly to its management, where it belongs. Insurers will be given more freedom – i.e. they will be required to meet sound principles rather than arbitrary rules. Regulatory requirements and industry practice will be aligned and insurers will be rewarded for introducing risk and capital management systems that best fit their needs and overall risk profile. In return, they will be subject to strengthened supervisory review.

The new regime will also enhance transparency and public disclosure. Insurers applying best practice will be further rewarded by investors, market participants and consumers.

The new Lamfalussy architecture will enable the new regime to keep pace with future market and technological developments as well as international developments in accounting and insurance regulation. In addition, although the same high level principles will apply to all insurers, implementing measures will enable the rules to be adapted so that they are applied proportionately to the nature, scale and complexity of each insurer. The new Lamfalussy architecture by advancing supervisory convergence and co-operation will also result in a more harmonised treatment of insurers across Europe.

In addition, the codification of the *acquis* and integration of the new principles in one single document will make European law clearer and more accessible to all stakeholders, in line with the Better Regulation Agenda.

4.2. Benefits for stakeholders

Overall, considerable benefits are expected from the Solvency II project and the expected impact on all interested parties is positive.

- <u>Industry:</u> The direct beneficiaries of Solvency II will be insurers. In addition to promoting sound risk management, aligning supervisory requirements with market practices and rewarding well-managed companies, the new regime will also establish a true level playing field and will contribute to a further integration of the EU insurance market. The international competitiveness of EU insurers and reinsurers will be improved through the alignment of regulatory quantitative requirements with the true economic cost of the risks they run.

- <u>Supervisors:</u> Supervisors will obtain better supervisory tools, enabling more timely and effective action, as well as powers to conduct comprehensive reviews of all the risks insurers face. Sharing of tasks between solo and group supervisors will provide for a better understanding of entities forming part of an insurance group and will enhance supervisory cooperation and convergence.

- <u>Policyholders:</u> The main indirect beneficiaries of Solvency II will be policyholders. First, the new regime will ensure a uniform and enhanced level of policyholder protection across the EU, reducing the likelihood that policyholders lose out as a result of insurers getting into financial difficulty. Second, the introduction of an economic risk-based approach will give policyholders greater confidence in the products offered by insurers, as Solvency II will promote better risk management, sound pricing and strengthened supervision. Third, Solvency II will increase competition, especially for mass retail lines of business, such as motor and household insurance, putting downward pressure on many insurance prices, and will increase choice by encouraging product innovation.

- <u>Economy as a whole:</u> As well as increasing the international competitiveness of insurers, the alignment of regulatory requirements with economic reality will provide for a better allocation of capital at firm level, at industry level, and within the EU economy. This will result in a decrease in the cost of raising capital for the insurance sector, and possibly also for the EU economy as a whole, through the role of the insurance industry as an institutional investor. More efficient allocation of risk and capital within the economy will also promote financial stability in the medium to long term.

4.3. Potential short-term side-effects

Although the overall impact of Solvency II on all parties will be positive, the analytical work conducted has raised a number of potential short-term issues that need to be borne in mind. These issues relate primarily to existing features of insurance markets that will be highlighted by the introduction of an economic risk based solvency regime. Depending on the reaction of stakeholders, there may be some short-term negative impacts. In general, the greater the extent to which insurers anticipate the introduction of Solvency II, the less likely it is that these short-term negative impacts will occur.

- <u>Initial implementation costs:</u> Solvency II will spur significant up-front costs, both for the industry and supervisors, if they have not already introduced modern risk management systems or moved to a system of risk based supervision. The analytical work conducted in the preparation of this report anticipates that the initial net cost of implementing Solvency II for the whole EU insurance industry will be € 2-3billion. However, these costs will be outweighed in the long run by the expected benefits.

- <u>Insurability:</u> As risks will receive a regulatory treatment in line with their true economic cost, long-term/high-severity insurance lines will attract higher quantitative requirements. In the short-term, this may result in a reduction of coverage for some types of insurance, although, where the insurance activity is generally economically viable, insurers will in the long-term be able to continue to provide such coverage, through the use of risk mitigation techniques, the introduction of new innovative products and by adjusting prices.

- <u>Cross-subsidisation:</u> Transparent pricing will highlight possible present cross-subsidisation between high-frequency/low-severity business lines (e.g. motor insurance) and low-frequency/high-severity business lines (e.g. aviation insurance). It cannot be excluded that insurers will decide to limit cross-subsidisation, which might lead to an increase in prices in certain areas.

- <u>Equity investment:</u> Unlike under the current regime, market risks will be subject to capital requirements under Solvency II and the new framework may thus have an impact on the investment strategies of insurers. In particular, under Solvency II fixed-income assets will receive a lower capital charge than equities as they are less volatile. As a result, insurers could decide to rebalance their portfolios, in order to better match assets and liabilities, and purchase more bonds at the expense of equity, if they determine that the potential increased investment return on equities does not offset the cost of holding more capital. This might affect EU equity markets in the short term.

- <u>Consolidation:</u> The recognition of diversification effects implies that well diversified entities, or those which are part of an insurance group, will in practice face lower capital requirements than single solo entities which are less well diversified. Although this is fully in line with the economic principles underpinning the proposal, and does not entail lower protection for policyholders, it may nevertheless act as a catalyst to the already existing trend of consolidation in the EU insurance market and increase already existing competitive pressures on small and medium-sized insurers. However, many SMEs are specialised insurers that carefully monitor and manage their risks, and benefit greatly from being close to their customers. Where this is the case, these natural competitive advantages will be fully recognised and will result in lower capital requirements for these SMEs. In addition, very small insurers will continue to be exempted under Solvency II.

4.4. Dangers of not following an economic risk-based approach

If Solvency II does not result in insurers being required to hold capital in line with the economic cost of the risks they run, this could undermine the effectiveness and efficiency of Solvency II. In particular, it could increase the likelihood and severity of some of the potential short-term side effects described above.

5. DEVELOPMENT OF IMPLEMENTING MEASURES, MONITORING AND EVALUATION

The Solvency II Directive will set out the key principles underpinning the new solvency system. The overall architecture of the system, including the general design of the capital requirements, will be a key part of the Directive. Once the Directive has been adopted, implementing measures will be developed and introduced using comitology.

The Commission will ask CEIOPS to run further quantitative impact studies covering all aspects of the new regime. The results of the third quantitative impact study (QIS3) are due in the second half of 2007 and will come in time for negotiations in Parliament and Council. Depending on the outcome, it may result in amendments being made to the general design of the capital requirements set out in the proposed Solvency II Directive.

The results of the fourth quantitative impact study (QIS4) will be the main quantitative input into CEIOPS future advice on possible implementing measures. The Commission does not exclude the possibility, however, that a further quantitative impact study will be required after QIS4 to fine tune the calibration of the new solvency regime before it enters into force.

Table 1: Summary of High Level Policy Option Comparison						
Policy Option			Ranking of Policy Option Assessment against Relevant Objectives			
Set	No	Description	Effectiveness	Sustainability	Efficiency	Consistency
Status Quo vs. Change?	1.1	No change	3	3		
	1.2	Update existing directives	2	3		
	1.3	Wait for international solution	2	2		
	1.4	Develop new EU solvency system	1	1		
Legislative approach	2.1	Update existing directives with Level 1 legislation	4	2		
	2.2	Update existing directives with Level 1 & 2 legislation	2	1		
	2.3	Codify existing directives and update with only Level 1 legislation	3	2		
	2.4	Codify existing directives and update with Level 1 & 2 legislation	1	1		
Cross-sectoral consistency	3.1	Retain current quantitative approach	4		3	
	3.2	Adopt Basel pillars 1 and 2	3		1	
	3.3	Adopt Basel pillars 1, 2 & 3	2		2	
	3.4	Adopt Basel pillars 1, 2 & 3 but adjust for specificities of insurance	1		2	
Group supervision	4.1	Retain current solo plus approach	3		3	
	4.2	Assign responsibility to a single lead supervisor	2		2	
	4.3	Reallocate responsibilities of solo and group supervisors	1		1	
SMEs	5.1	Same regime for all insurers	1		3	
	5.2	Separate regimes for large and small insurers	2		2	
	5.3	Same principles for all insurers, but range of methods available to meet them	1		1	
Technical provision calculation	6.1	Retain current rules	3	3	3	
	6.2	Harmonize and align calculation for accounting and prudential purposes	1	1	2	
	6.3	Harmonize calculation for prudential purposes only	2	2	1	
Capital requirement calculation	7.1	Update current required solvency margin calculation	4	2		2
	7.2	Introduce a scenario-based approach	3	2		2
	7.3	Introduce European RBC system	2	1		2
	7.4	Introduce system based on the amount of economic capital	1	1		1

Table 2: Summary of Low Level Policy Option Comparison							
Policy Option			Ranking of Policy Option Assessment against Relevant Objectives				Coherence with Preferred High Level Options
Set	No	Description	Effectiveness	Efficiency	Consistency	Sustainability	
Provision Calculation Methods	8.1	Undiscounted best estimate with percentile risk margin calculation	3	3	2	2	3
	8.2	Discounted best estimate with percentile risk margin calculation	2	2	1	2	2
	8.3	Discounted best estimate and cost of capital risk margin calculation	1	1	1	1	1
SCR Calibration	9.1	0.5 % ruin probability over a 1 year horizon for SCR	1	1			1
	9.2	Lower ruin probability for SCR (higher capital requirement)	2	2			2
	9.3	Higher ruin probability for SCR (lower capital requirement)	3	2			2
Choice of Risk Measure	10.1	Use Value-at-Risk measure	1	2	2		2
	10.2	Use Tail Value-at-Risk measure	2	3	3		3
	10.3	Use Value-at-Risk measure with some exceptions	1	1	1		1
Design of SCR Formula	11.1	Use scenario based approach for all SCR risk modules	2	3			3
	11.2	Use mixed approach (scenarios and factor based approach)	2	2			2
	11.3	Use mixed approach (scenarios and factor based approach) providing for simplified factor based approaches in those modules where scenarios are used	1	1			1
	11.4	Use factor based approach for all risk modules	2	2			3
MCR Calculation	12.1	MCR calculated as % of SCR	1	1			1
	12.2	MCR calculated using simplified version of SCR	1	1			1
	12.3	MCR calculated as % of current solvency margin requirement	2	2			2
Investment Rules	13.1	Retain current investment rules and Member States options	4	3			3
	13.2	Introduce harmonized investment rules	3	2			2
	13.3	Abolish investment rules but retain the prudent person principle	1	1			1
	13.3	Abolish investment rules and the prudent person principle	2	1			2