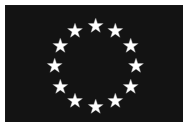


# EUROPEAN PARLIAMENT

2004



2009

---

*Committee on Economic and Monetary Affairs*

27.9.2007

## **WORKING DOCUMENT**

on Insurance and Reinsurance - Solvency II

Committee on Economic and Monetary Affairs

Rapporteur: Peter Skinner

## 1) Background: is there a need for a new legislative framework and why?

The present solvency framework for insurance and reinsurance undertakings needs updating due to its rules based approach, creating a wide range of possibilities for different national rules and thus presenting an obstacle for a fully functioning internal market. Due to this lack of harmonisation and especially due to completely different accounting principles, Solvency I gives different results in different Member States. It has therefore failed to provide a level playing field for companies and to ensure a similar level of protection for policy holders and beneficiaries.

The Commission's proposal for a new solvency framework, called Solvency II, published in July 2007 is introducing a **risk sensitive approach** with incentives for risk management, with a better (optimal) allocation of capital, taking into account market consistent valuation of assets and liabilities (with a view to developing a "fair value" concept) in accordance with the international accounting standards (IAS) and with timely calculations and more transparency.

It is structured **in the form of three pillars**, similar to Basel II capital requirements package for the banking sector; i.e. Pillar I is defining quantitative requirements, Pillar II qualitative requirements and Pillar III is dealing with rules on supervisory and public disclosure and reporting.

On the **supervision side**, it encourages supervisory cooperation and convergence, enhances the role of CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors), introduces an early warning mechanism and outlines a framework for a more **effective Group supervision**. It aims to change supervisory authorities' working methods from "ticking the box" to really understanding the risks to which the supervised entity is exposed; as for example the prudent person approach for the investment policy. It gives responsibility back to the company management and strives to elevate professional standards in the industry. Although innovative and modern in its overall approach, the proposal fails to improve the rules on **information given to the policy holder**.

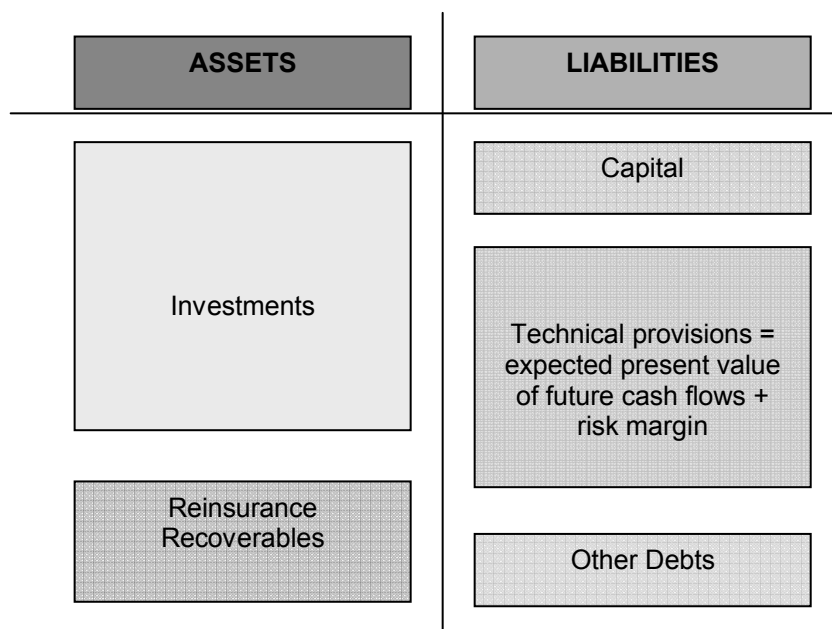
The legal form is one of the **re-cast and codification** with 80% of the old text being subject to a re-cast into the "new" language (subject to the review of the Legal Affairs Committee) and the rest being the new text, introducing the new Solvency II rules. The new text is **principles-based and Lamfalussy compliant** providing the basis for adoption of implementing measures at Level 2 and with instructions for supervisory convergence at Level 3 of the Lamfalussy legislative process. The Commission has also provided for an impact assessment as an annex to the proposal for a directive.

The foreseen **timetable** for the Report in the Economic and Monetary Affairs Committee is to present the draft in February 2008, with examination of amendments in May 2008 and the Committee vote in either June or July 2008.

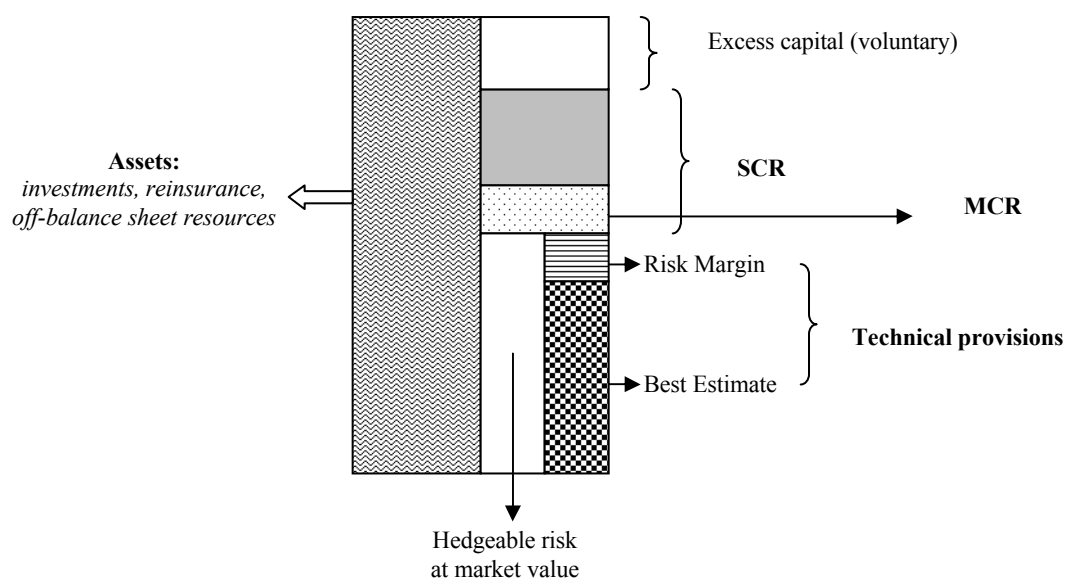
## 2) Quantitative requirements: Pillar I

The main objective of Pillar I requirements is to ensure that the insurance and reinsurance companies are able to meet their obligations when due, with a 0.5% probability of ruin (1 in 200 failure rate over one year). Therefore the Solvency II framework takes a **holistic "total**

**balance sheet approach"**, instead of targeting rules at the individual balance sheet items.



Companies thus need to hold enough assets to meet the following: solvency capital requirements (SCR), minimum capital requirements (MCR), technical provisions (best estimate of future cash flows plus a risk margin for risks that cannot be secured / assured (unhedgeable risks)).



One of the main issues on the quantitative side is **how to value these assets and liabilities**, especially technical provisions, own funds (i.e. market-consistent value of assets minus market-consistent value of liabilities) and investments for the purpose of calculating the

solvency capital.

For the SCR, calculations can be done by using the **standard formula** or by the use of an **internal model**, approved by the supervisory authority. However, many technical details are still being developed and are subject to the results of the third quantitative impact study (**QIS 3**) currently undertaken by CEIOPS. The latter is foreseen to be published in November 2007. It will give a more precise definition of the standard formula, i.e. calibration of its parts as well as the final proposal for the MCR. A discussion on whether to use a compact or modular approach for the MCR is still ongoing among the industry and the supervisory authorities. It is important for many other issues, including for Group supervision that a solution for the MCR is found.

Apart from all these, there are still **several open issues** including the geographical diversification effects for groups, and harmonisation of actuarial methodologies (also linked to the QIS 3). Moreover, issues such as securitisation in particular regarding credit default swaps need to be discussed.

The proposal touches also on several **sector specific issues** like the use of members' calls to cover capital requirements by mutual insurance companies. As to the health insurance providers, there are no changes proposed by the new solvency framework. As to the smaller and medium sized companies (SMEs), the directive includes some provisions to allow them a proportionate and manageable implementation. The results of the quantitative impact studies will contribute to this process.

### 3) Supervision and qualitative requirements: Pillar II

The proposal enhances tools for **supervisory activities**, including definition of supervisory powers, provisions for cooperation between supervisors as well as for supervisory convergence. Given the bulk of work foreseen for the supervisory level (Level 3), the accountability of supervisors and transparency of their way of work needs to be assured.

Pillar II also addresses **qualitative requirements on companies**, i.e. their system of governance, including an effective internal control system, risk management systems, actuarial function, internal audit and rules on outsourcing. These requirements are also linked to the approval of internal models, procedure of which should, if possible, be harmonised among supervisors.

It is important for these provisions to be in line with the provisions in securities and banking sectors and hence to achieve the **cross-sectoral consistency** and convergence. Solvency II will be ahead of other sectors in terms of evolution.

As to the **winding-up provisions**, the question remains whether the proposal should be extended also to reinsurance companies in order to improve the financial stability of the whole value chain: from end-consumer via insurance to reinsurance company.

### 4) Supervisory reporting and public disclosure: Pillar III

There is a need to converge the rules on supervisory reporting in order to deliver a

**comparable format and content.** This is especially important when talking of Group supervision as well as reporting obligations via national authorities to CEIOPS. The proposal does not address this issue in detail and it remains to be seen whether sole guidance at Level 3 is a sufficient tool to guarantee such a convergence and even perhaps to lead to a common supervisory reporting data base.

As to the public disclosure of company's solvency and financial condition, the proposal foresees disclosure in the form of annual reports, with some discretion given to the Member States on the separate public **disclosure of capital add-on** (possibility of up to 5 years' transitional period).

As to **the information given to policy holders**, there is an important question as to if and how far the directive should go in updating these requirements as well as in harmonising provisions for life and non-life.

## 5) Group Supervision

In Europe, the market share of large insurance companies, most of them groups, is 85% in terms of premiums<sup>1</sup>. Encouraging cross-border activities of the groups also bears an important link to the completion of the internal market. Since many groups are financial conglomerates, there are also strategic issues to be considered in terms of cross-sectoral comparability, especially between life products and other savings products such as investment funds.

Under the current framework, groups can already benefit from diversification between jurisdictions and sectors if they combine all activities into one legal entity. Solvency II intends to introduce a system where groups can benefit from diversification also if they have decided to establish several limited liability companies as many of them have done, if the group is able to provide for **group support** (i.e. capital held at the group level to support subsidiaries in case of deficits).

For such a system to work the consequences for the local and group supervisor under the new system, if one of the limited liability companies of a group (i.e. subsidiary) goes bankrupt, need to be clarified. There must be no ambiguities regarding how the guarantee system will apply and what legally binding form it will take. The **liabilities of the local and the group supervisor** have to be defined, even to the extent as to which of the two will be called to account by national authorities and what will be their **obligations** at the European level. Therefore clear allocation of competences between group and local (solo) supervisor, and effective mechanisms for cooperation and information sharing need to be put in place. Powers of local supervisors in case of an SCR breach where the group supervisor does not react (in a fully satisfactory manner) should be defined. In connection with the latter, it is evident that the final proposal on the MCR has to be found and adopted at Level 1 for a complete agreement on the group support to be reached.

Group support provisions are also linked to the currently undergoing study on the **insurance guarantee schemes** and the possibility of a common EU level solution. Many Member States

---

<sup>1</sup> CEA (European Insurance and Reinsurance Federation), Briefing Note 2, "The Insurance Groups and Solvency II", p. 2

already have guarantee schemes, so it is important to establish whether or not an EU-wide scheme is feasible.

## 6) International Dimension and Third Countries

Since the new Solvency II framework will be setting **global standards** for a modern principle based regulation, it is important that the European Commission, as well as EU Member States, and their supervisory authorities and especially CEIOPS remain active at the international level; bilaterally i.e. with the U.S. National Association of Insurance Commissioners (NAIC), Swiss Federal Office of Private Insurance (FOPI) etc. as well as multilaterally, i.e. within the IAIS (International Association of Insurance Supervisors) and the Trans-Atlantic Legislators Dialogue (TLD). The proposal is in line with current thinking within the IAIS and IASB.

The proposal introduces rules on the **equivalence of third country** solvency regimes, which will have consequences for groups with subsidiaries also outside the EU.

## 7) Solvency II as a Lamfalussy directive

Provisions for a Solvency II regime are principle-based, thus foreseeing a bulk of work at Level 2 and Level 3. Although such an approach will enable the EU insurance market to changes in the markets, it is important to guarantee the oversight and the involvement of the European Parliament in the process, in particular when defining the rules at Level 2 and Level 3 for the first time. Therefore it is vital for the **new comitology procedure, i.e. regulatory procedure with scrutiny** to apply for all provisions foreseeing adoption of implementing measures, either in the form of an implementing directive or implementing regulation.

Although the Commission, in its letter to CEIOPS of 19 July 2007, outlined the subjects on which CEIOPS will be issuing its Level 2 advice and also listed the implementing measures foreseen for adoption in 2010, it may be requested to provide a more **extensive description** as to the content of each individual implementing act.