

EPFSF Briefing: Solvency II

Summary: *The Solvency II project has the wide and ambitious scope to build a new comprehensive framework for the insurance supervision. Following Basel II, it proposes a similar structure. It is essentially a European initiative and will be the first Lamfalussy Directive in Insurance. Solvency II is an opportunity not to be missed for an improvement of European leadership in insurance regulation. Altogether, it is a timely initiative to improve and streamline European insurance regulation.*

Solvency II has five objectives:

- 1. to review the current insurance directives.*
- 2. to review the overall financial position of insurance not just limited to the Solvency margin requirement.*
- 3. to protect policyholders in all EU members States.*
- 4. to take account of recent developments in insurance activities, risk management, financial methods and reporting, etc.*
- 5. to increase the supervisory process and to review the level of harmonization including supervisory powers and methods.*

THE LIMITS OF SOLVENCY I

The prudential rules in Insurance are currently defined by the Life and non-Life directives adapted from 1973 to 2002. They are based on three main elements:

- the requirement to hold "sufficient" provisions for insurance risks
- the definition of a Solvency margin: the minimal amount of regulatory capital an insurance company is obliged to hold against unforeseen events (increase of claims, bad return on assets...), in excess of technical provisions, in order to be able to pay its policy-holders.
- Admissibility and quantitative rules on limits to assets eligible to cover technical provisions

Solvency I does not establish at the EU level an appropriate harmonized definition of financial requirements, capital and provisions. Therefore in many countries, national regulators have set additional rules beyond the Solvency I minimal requirements which take account of the advances in risk management. This has led to:

- a divergence of regulatory provisions and capital held by insurance companies in the different member states
- a level of provisions or of capital requirement well beyond the Solvency I level.

Furthermore, Solvency I does not take into account group diversification. It also does not facilitate advances in risk-management techniques and practices, which have made impressive progress in the market: sophisticated models are now widely used within insurance companies and are considered key inputs for capital management, product pricing, risk mitigation, and market mechanisms such as credit ratings. Some supervisors have already implemented part of these techniques in their national jurisdictions.

For these reasons, there is a need for an evolution in the insurance regulatory framework.

MAIN ASPECTS OF SOLVENCY II

Preparations for the Solvency II project started in May 2001 and the policy approach has been endorsed by the EIOPC (European Insurance and Occupational Pensions Committee), the relevant Level 2 committee. Like Basel II, this regime is based on a three pillar approach:

Pillar 1 - Quantitative requirements (i.e. setting of minimum capital requirements)

Pillar 2 - Supervisory review (i.e. insurers to assess their own capital needs and manage that capital subject to supervisory review)

Pillar 3 - Reporting and disclosure (i.e. public disclosure of key information relevant to the market).

Aside from these similarities, the design of Solvency II must reflect the fundamental different nature of insurance and banks. For banks, most risks are on the asset side, e.g. market, credit or liquidity risks. Whereas insurers, also have to take into account the nature of insurance liabilities: liabilities risks (e.g. mortality risk, reserve risk, premium risk, catastrophe risk...) and asset-liabilities management risks. Moreover, banks tend to develop cross-border activities mainly through branches; while, conversely, Insurance groups are typically organized by subsidiaries rather than branches. Cross-border groups hold a large part of the European market. Therefore, local entities are subject to prudential requirements at national level.

The Solvency II directive will contain elements of the current regulatory framework within a single codification of 14 existing texts (Life & Non Life insurance; reinsurance; insurance groups and winding-up directive; while motor insurance directives are excluded). Solvency II will be the first Lamfalussy Directive in Insurance, hence, the Commission benefits from cooperation with CEIOPS (Committee of European Insurance and Occupational Pensions), Finance Ministries and other stakeholders, including industry and consumer representatives. Three separate "waves" of calls for advice have been sent to CEIOPS to provide technical input on various mandates for advice. The first two waves were submitted to the Commission in June and November 2005, while CEIOPS published their responses to the third wave in May 2006.¹

In addition to the Lamfalussy transparency and consultation principles, the Solvency II directive will be accompanied by an impact assessment report. Key input to this report will be sourced from the Quantitative Impact Studies (QIS) undertaken by CEIOPS. Results of QIS-1 were published in March 2006, while a more comprehensive QIS-2 covering the capital requirements was launched in May 2006. In addition, the European Central Bank will measure the effects of the new architecture on financial stability.

A public hearing on Solvency II was held by the Commission on 21 June 2006. The results of this hearing will also be fed into the impact assessment work and drafting of the Solvency II Directive.

PROJECT STAKES & INDUSTRY VIEWS

The industry and other stakeholders agree with the Commission on the fundamental need to modernize prudential supervision of insurance activities – it is therefore widely regarded as a policy priority. This trend towards risk sensitive supervision is fully supported by most supervisors (as a means of encouraging greater efficiency of supervision) and similarly by companies (capital requirements more adapted to the economics of products should lead to a decrease of capital).

In order to contribute to the competitiveness of the insurance industry within Europe and abroad and to improve consumer choice and protection, some principles should be at the forefront of the new approach. For an optimal implementation of these principles, the regulatory measures will require significant progress towards integrated European supervision.

The basic principles and objectives

1. A harmonization and common approach to quantitative (Pillar 1) and qualitative (Pillar 2) prudential requirements for the whole European Union. The aim is to establish a level playing field, without discrimination against new entrants and gold plating. It will be key to simplify legislative transposition at the national level, standardize filing requirements and avoid regulatory arbitrage made possible by the differences in today's prudential regulation.

¹ See <http://www.ceiops.org>

2. A recognition of internal models, as significant progress has been made these last few years, in terms of the nature and measurement of the risks or in the developments of stochastic models. These methods should be examined by CEIOPS to ensure that rules and conditions of supervision are equivalent and create a level playing field.
3. A recognition of risk diversification strategies at the subsidiary as well as the group level which protect both business and consumers. This should lead to a reduction of capital adequacy requirements.
4. The aggregated level of capital should not increase for the industry. The European insurance industry's ability to globally withstand both the last financial crisis and a series of major losses in recent years attests to its fundamental strength and the ability of insurers to adapt to change in the nature of risk while complying with existing regulation.

Supervisory and other challenges ahead

For policymakers, the primary role of supervision is to ensure that the solvency of insurance companies is preserved and that consumers are adequately protected.

In developing the new regime, there is a need for supervisors to ensure a balance between maintaining market confidence and the efficient allocation of capital. The main risk of Solvency II is not that of insolvency of companies, given the recent experience of the industry in very difficult times. Instead, it is that there would be insufficient capital available for the risks against which individuals or businesses need cover. Capital is a scarce and costly resource; excessively high capital requirements at the different levels of groups, sub groups and individual companies would lead to costlier products for consumers and capital inefficiency in the insurance market. As a consequence, insurers would cover fewer risks at a higher cost. The cost of supervision must therefore be proportionate to the expected benefits.

The current regulatory regime does not allow a consistent approach to the supervision of a group with local regulators assessing prudential requirements on a stand alone basis. As supervisors are getting more involved in the risk management organization and systems put in place by insurance groups, their requests for reporting are currently uncoordinated, generating a multiplication of regulatory reporting and compliance activities.

Therefore, the increasing pan-European or even global nature of many financial groups' calls for more integrated supervisory approaches. Internationally active insurance firms will not be able to reap the full benefits from Solvency II without a consolidated or lead supervisor in particular regarding the validation of internal risk models and the recognition of diversification benefits. The current debate in the EU on integrated supervision and supervisory convergence is therefore of vital importance to the insurance sector.

Tough political decisions may be ahead, as some European insurance supervisors have fundamentally different approaches to supervision of insurance companies, that may be difficult to resolve without political guidance.

As Solvency II will set a global benchmark, it will need to take account of insurance regulatory initiatives in third countries. CEIOPS is already exchanging information with the US and Swiss authorities, who are keen to ensure an internationally consistent approach. In addition, international supervisors are developing common principles in the IAIS (International Association of Insurance Supervisors).

However, the most difficult external challenge is probably posed by the uncertainty over the future insurance accounting framework. The timetable for Solvency II is not coordinated with the IASB's timetable for finalization of the insurance accounting framework, but the European insurance sector cannot afford to wait much longer for a new Directive. In any case, wide divergences between definitions for reporting purposes would increase the costs of Solvency II.

CONCLUSION

Solvency II is a very ambitious EU initiative which provides an opportunity to modernize and consolidate European insurance regulation. To ensure Member States' can meet their commitment to economic reform across Europe, Solvency II must recognize the important economic role played by the insurance market in terms of risk management and capital allocation. However, implementation of the Solvency II Directive is not expected until 2010, by which time the insurance sector will have made further advances in measuring risk and allocating capital. Therefore, it is vital that stakeholders develop a new framework now that will ensure better value for consumers and a more efficient allocation of capital across the EU in years to come.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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