

## EPFSF Briefing: Solvency II

**Summary:** *There is wide consensus across industry about the need to upgrade Solvency I, which is the current prudential framework for insurance supervision in the EU and has been in place since the 1970s. The European Commission is expected to publish a draft Solvency II directive in July 2007. It will be a Lamfalussy Directive.*

*Industry has already played an integral role in the development of the Solvency II principles working closely with the European Commission, CEIOPS and the European Parliament. As the policy debate moves to draft proposals in the second half of 2007, the Parliament's role as co-legislator will be key.*

### 1. Introduction

This briefing provides an update about progress on Solvency II. It follows a previous briefing that covered the rationale for Solvency II, the main features of Solvency II and industry views about principles and objectives. It therefore provides a slightly more detailed overview of the Solvency II requirements, focusing on some specific issues rather than attempting to cover the full spectrum.

### 2. An overview of Solvency II

The main aims of Solvency II are to protect policyholders and improve the competitiveness and the allocation of capital resources of EU insurers.<sup>1</sup> It plans to achieve this by establishing an integrated approach to supervision that reflects the risks to which insurers are exposed.

Solvency II also aims to provide a consistent regulatory approach across financial sectors in the EU. The design will be based on the concept of three pillars used in the EU's Capital Requirements Directive: valuations and capital requirements (Pillar 1), supervisory review process (Pillar 2) and public disclosures (Pillar 3). Solvency II will also address the definition of available capital. Unlike Basel II, where policymakers aimed to maintain a similar overall level of capital requirements for the industry as before, there are no such assurances for Solvency II.

Market-consistent approaches will be used to value assets and liabilities in Pillar 1. For liabilities, this means a best-estimate plus a market value margin (MVM) to reflect the uncertainties in the measurement of (certain) insurance liabilities – known as technical provisions. The key solvency control level (**Solvency Capital Requirement, SCR**) will be risk-based and will enable an institution to absorb significant unforeseen losses. The latter has been defined as covering losses with 99.5% probability over a one-year horizon. It will also reflect risk management and diversification benefits at legal entities (solo level). There will be a “standardised approach” for calculating the SCR using mainly stressed scenarios. Subject to regulatory approval, institutions will also be allowed to use their own internal models to calculate the SCR.

In addition, there will be another control level below the SCR, the **Minimum Capital Requirement (MCR)** the level of capital below which triggers ultimate supervisory intervention. Figure 1 shows the various components of Pillar 1.

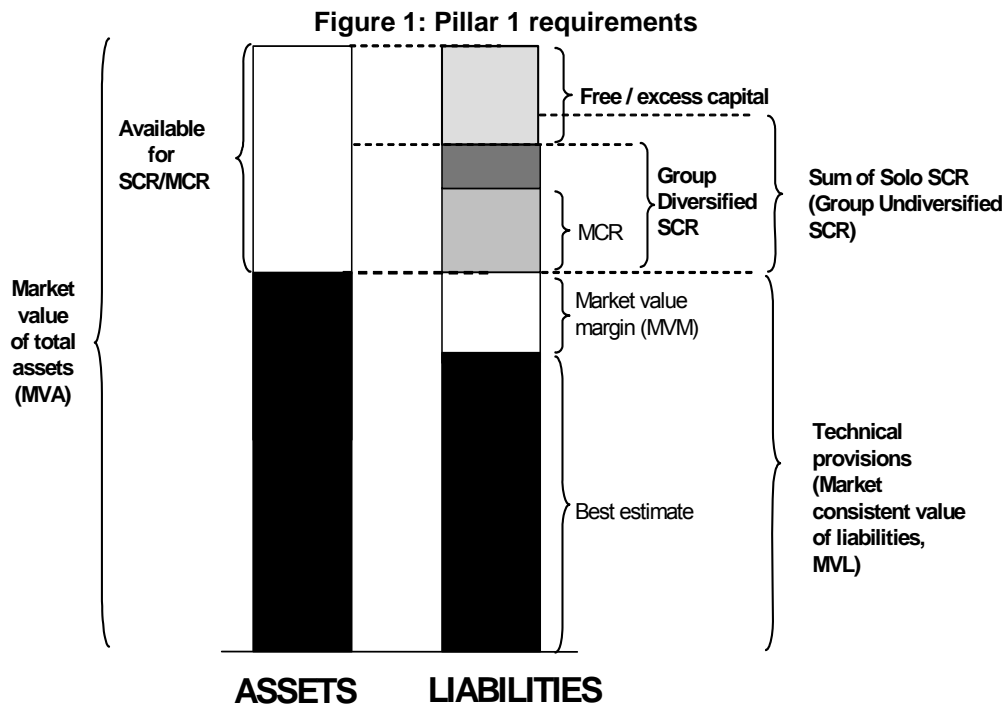
For Pillar 2, a structured supervisory review process is envisaged to encourage stronger risk management. The regulator will review insurers' assessments and may require improvements to risk management practices or increase the SCR. Pillar 3 disclosures introduce market discipline reinforcing the first two Pillars. CEIOPS has advised the Commission that disclosures should combine quantitative and qualitative elements about risk management and controls.<sup>2</sup>

### 3. The overall financial requirements

Solvency II will change insurers' financial position by changing capital requirements, valuations of assets and liabilities and what counts as eligible capital for solvency purposes.

<sup>1</sup> European Commission, “Amended framework for consultation on Solvency II”, April 2006.

<sup>2</sup> CEIOPS, “Advice to the European Commission on supervisory reporting and public disclosure in the framework of the Solvency II project”, March 2007



Source: Adapted from CEA and CRO Forum, "Solutions to major issues for Solvency II, February 2006.

Insurers usually hold assets in excess of what they need to cover capital requirements and technical provisions – "free/excess capital" in Figure 1. So, other things being equal, an increase in capital requirements reduces free/excess capital. However, insurers need a buffer of excess capital to ensure that regulatory requirements are not breached; for business and strategic reasons and to fulfil the requirements of shareholders and rating agencies. The change in excess capital is therefore key in understanding the overall balance sheet impact of Solvency II.<sup>3</sup>

Quantitative Impact Studies (QIS), coordinated by CEIOPS, including the current QIS3, aim to estimate the change in excess capital. CEIOPS QIS2 report<sup>4</sup> suggests that only insurers with no excess capital would need to raise additional capital. There were also a number of supervisors that reported an overall reduction in excess capital (eleven for life insurance and sixteen for non-life). However, it is important to note that reductions in excess capital as a result of regulatory changes could affect insurers even if there is no threat to insurers' solvency because of the wider purpose that they fulfil in the business. This is consistent with the evidence of UK banks which have substantive excess capital and yet they will only absorb a small part of increases in capital requirements (the remaining will lead to an increase in capital held).<sup>5</sup>

#### 4. Risk management and diversification benefits

Insurers are in the business of accepting and managing risks. A key feature of insurance businesses is diversification between risks and without it insurance business would not exist. Thus every insurer uses diversification to manage the portfolio of risks that arises in the business. Risk management and, in particular, diversification benefits The globalisation of insurance and the provision of insurance across borders within the EU mean that this diversification benefit can also extend across jurisdictions.

Solvency I does not take into account the practices insurers have implemented to manage risks. Nor does it recognise the diversification benefits available. A truly risk based Solvency II would fully recognise the differences in risk management and diversification benefits between insurers to create

<sup>3</sup> For more detail about the elements of free assets and how the requirements might change under Solvency II see CEA, "Assessing the impact of Solvency II on the average level of capital", November 2006.

<sup>4</sup> CEIOPS, "QIS2 summary report", 6 December 2006.

<sup>5</sup> Alfon, I., Argimon, I. and Bascunana-Ambros, P. "What determines how much capital is held by UK banks and building societies?", FSA Occasional Paper 22, July 2004.

a level playing field. It is important that risk management approaches and diversification benefits are not arbitrarily excluded which would lead to an uneven playing field.

#### **5. Effective supervision of insurance groups**

Insurance groups are a key part of the EU insurance market. Their determining feature is managing operations as integrated economic entities, with integrated management and group-wide risk management approaches. Solvency II must provide a proportionate and harmonised framework for supervising these groups.

Solvency II will need to strike the appropriate balance between the roles and responsibilities of the group supervisor and supervisors of other legal entities in the EU. This includes a clear allocation of responsibilities. Firstly, the scope of group diversification benefits should not be restricted arbitrarily. Secondly, an effective monitoring of groups' financial position requires clarity as to whether the binding SCR should be at group level. Thirdly, flexibility to allocate capital within a group is needed to strike the balance between local requirements and group requirements.

In addition, many EU insurance groups have operations outside the EU that would be taken into account when assessing the overall group position. This raises fundamental questions about their treatment. In particular, how to strike the balance between applying Solvency II to assets and liabilities outside the EU to ensure a consistent assessment and recognising that the commitments to policyholders in third country subsidiaries are defined by the third country regime. This is a fundamental issue for the international competitiveness of EU insurance groups, which compete in most of these jurisdictions with non-EU insurance groups. Solvency II will not succeed if EU insurance groups are put at a competitive disadvantage in global markets.

CEIOPS has recommended peer reviews after Solvency II implementation. This would be useful for harmonising approaches for group supervision but there should also be measures to improve trust and cooperation between EU supervisors ahead of Solvency II.

#### **6. Global developments**

Solvency II sits at a junction of global developments in financial reporting and insurance supervision. At the moment, insurers may experience up to three different approaches for risk measurement: one used for internal purposes, another used for supervisory purposes and another one for ratings purposes. These approaches should converge, at least at a conceptual level, while retaining some differences that are consistent with the different purpose that they serve. This will be beneficial for industry. It will assist capital allocation decisions, group assessments and other strategic decisions.

In addition, the International Accounting Standards Board (IASB) is reviewing global accounting standards for insurance contracts valuation. Consistency is crucial for Pillar 1 valuations and industry supports it. A recent IASB project update with tentative conclusion suggests that there is some growing consistency although it appears that there is still some way to go.<sup>6</sup> An IASB discussion paper is expected in the second quarter of 2007 setting out their views on the future direction of accounting for insurance contract liabilities.

At the same time, the International Association of Insurance Supervisors (IAIS) is currently working on solvency related issues. This could set the foundations for long-term mutual recognition of insurance supervisors. It is aiming to adopt solvency standards covering valuation of assets and technical provisions, risk management and capital resources as well as adopting guidance on internal models during 2007.<sup>7</sup> EU policy makers are also in favour of convergence, which industry supports. This would be very valuable in the group's assessment mentioned earlier. This debate is ongoing and should be monitored closely as Solvency II develops.

#### **7. Conclusion**

<sup>6</sup> The IASB's tentative conclusions are summarised in a project update from December 2006 (<http://www.iasb.org/NR/ronlyres/A2458C14-C195-442B-B126-8CBF5DD28653/0/Insurance.pdf>). It refers to concepts that are in Solvency II such as best estimate and risk margins but it is not clear that in practice they will have the same meaning.

<sup>7</sup> IAIS, "Road map for a common structure and common standards for the assessment of insurer solvency" February 2006.

One of the aims of Solvency II is to protect policyholders. Solvency II should deliver consumer protection at an acceptable price. Hence it is imperative that the framework follows a true economic and risk-based approach without arbitrary additions of margins as this will increase the aggregate level of capital above what is actually required, and therefore increase the cost to consumers.

Insurance supervisors found that the main causes of financial failure or near failures were clustered around the broad themes of management quality and inappropriate risk decisions.<sup>8</sup> Emphasising the importance and recognition of risk management and introducing a more structured review of risk management through the Pillar 2 supervisory review process will therefore contribute to policyholders' protection.

To conclude, five key issues that are critical to the success of Solvency II:

- The impact of Solvency II should not be underestimated. Solvency II could affect insurers' financial position and could result in demands for extra capital even if there is no threat to solvency. As a result, capital which would otherwise be used to deliver current business strategy, could be diverted away. Solvency II should not become a measure that prevents insurers from using their capital in an efficient and risk-based way;
- Risk management and diversification are practised by all insurers. It is important that they are fully recognised in Solvency II and that they do not become the determining features of an uneven playing field between insurers;
- Effective group supervision will require striking the appropriate balance between the roles and responsibilities of the group supervisor and the supervisors of other legal entities in the EU. Care should also be taken to avoid putting EU insurance groups at a competitive disadvantage in global markets;
- Consistency with global accounting standards and insurance supervisory requirements will be hugely beneficial to EU insurers.
- Solvency II must strike the right balance between information that is commercially sensitive and encouraging market discipline.

If these five issues are pursued by the European Parliament, Solvency II has a good chance of becoming the global standard for insurance supervision.

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<sup>8</sup> Sharma, P., "Prudential supervision of insurance undertakings", December 2002.

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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