

## EPFSF Briefing

### “Solvency II: outstanding issues”

#### Introduction

The second half of 2008 will be crucial for the Solvency II project. The European Parliament and the Council are expected to reach agreement on the Level 1 framework Directive, and CEIOPS will process and publish the results of the fourth Quantitative Impact Study (QIS 4). In the process, key decisions will have to be taken, decisions that will shape the European regulatory environment for insurance companies for the years to come.

There is agreement among stakeholders on both the objectives and the key risk-based principles of the Solvency II framework. Several key issues however remain to be solved. It is a challenging task to find suitable satisfactory solutions to these issues that will meet stakeholders' concerns while strengthening and completing the framework and enabling Solvency II to reach its objectives. Moreover, with Parliament elections and a new Commission in 2009, time is becoming a factor, and delay cannot be an option.

#### General support

**Objectives:** The press release that accompanied the publication of the draft Directive called Solvency II a ‘*ground-breaking revision of EU insurance law designed to improve consumer protection, modernise supervision, deepen market integration and increase the international competitiveness of European insurers*’. This is a clear statement on objectives, and one that has been endorsed by market participants, consumer representatives, supervisors and representatives of the European institutions and Member States alike.

**Risk-based principles:** Furthermore, there is also widespread - if not unanimous - agreement on the foundations of the Solvency II framework, as the draft Directive:

- introduces a total balance sheet approach; assets and liabilities are valued using a market consistent approach, consistent with IFRS.
- adopts an economic risk-based approach where supervisory tools and interventions will depend on the risk profile of the company.
- distinguishes two solvency requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The SCR covers all quantifiable risks and will function as a day-to-day target solvency level based on a 99,5% confidence level over a one year period. In the calculation of the SCR both diversification across risks as well as risk mitigation are taken into account. The MCR is a threshold below which policyholders are exposed to an unacceptable degree of risks.
- allows the SCR to be calculated by using either a standard formula or an internal model. Use of the latter is subject to supervisory approval.
- introduces more efficient supervision of groups, as important as solo supervision.
- introduces a supervisory review process that entails the review and evaluation of strategies, processes and reporting procedures, as well as the risks a company is taking on and the ability of a company to assess and manage those risks. The supervisor will use a company's mandatory Own Risk and Solvency Assessment (ORSA) as a basis for this process.

**Key issues remaining:** With agreement on key foundations in place, 5 issues in particular are still under debate in order to seek a solution that will be satisfactory to all involved *and* that will strengthen and complete the Solvency II framework.

- i.) Group support regime: In the context of group supervision regulation, the provisions of the draft Directive on group support are much welcomed by industry as they aim to make supervision more efficient, bringing it more in line with economic reality. The insurance industry supports the group support procedure as it allows for group diversification as well as (a degree of) capital mobility within a group. While sharing this assessment, the mutual insurance sector admonishes that to achieve this aim the group definition should be flexibilised/adapted/amended. To other stakeholders however, group support is a source for concern as they suspect a mismatch in supervisors' restricted role and limited powers in the supervision of cross-border groups on the one hand, and their responsibility for the local consumer and full (political) accountability on the other hand. Moreover, some stakeholders are concerned about the legal enforceability of the group support instrument as they are not convinced it provides sufficient guarantees.
- ii.) MCR structure and calibration: For the calibration of the MCR, three different approaches have been put forward so far:
- Modular approach: calculates the MCR as an aggregate of capital charges for different risks. This approach was tested in QIS 2 and 3, and did not fully meet expectations.
  - Linear approach: calculates the MCR as a fixed percentage of the technical provisions. This approach (and the related corridor approach) is being tested in QIS 4. Some stakeholders support it for its simplicity, while others point to the fact that this approach is not risk sensitive.
  - Compact approach: calculates the MCR as a percentage of the SCR. Widely supported by industry as it is the only risk sensitive approach that allows for a useful ladder of intervention, and therewith, allows for diversification. Opponents want the highest possible MCR due to its political nature.
- iii.) Surplus funds: Surplus funds are widely used in a number of European countries and these countries aim to have these funds recognized as own funds. This topic also raises a level playing field debate. Stakeholders question the extent to which recognition is consistent with the economic principles of the calculation of technical provisions, and the potential distorting impact for groups.
- iv.) Treatment of equity risk: The draft Directive's statement on equity risk is questioned by stakeholders. Supporters of the current wording argue that equity risk declines over time and that capital requirements should reflect that rather than a 1-year horizon. Others disagree, questioning this assumption and fearing a departure from the solvency framework of the directive and from the principle of market consistent valuation.
- v.) Pension funds: In some national markets occupational pension funds and life insurers offer similar products/services within the second pillar pension provision. So far according to the IORP Directive (IORP = Institutions of Occupational Retirement Provision) Solvency I rules apply to a number of pension funds whereas all the life insurers offering pension products/services will come under the Solvency II regime. The question could be raised whether Solvency II should be made applicable also to those IORPs that are currently under the Solvency I solvency margin rule. Even if it is difficult to establish which solvency regime could do justice to pension funds' singularities, the Commission review of the IORP Directive will aim at addressing this issue. Some stakeholders would like to address the question of a level-playing field between pension funds and life insurers offering similar occupational pension services. However, other stakeholders hold that more in depth research and fact finding has to be done to establish the respective playing fields in private pensions while taking into account Member States' competence in devising pensions policy.

## **Conclusion**

Many of the bricks of the Solvency II structure are already in place. Several difficult tasks still lie ahead however for the structure to become a building. Beams will have to be put in their place, and a firm roof needs to be constructed. Fulfilling these tasks, making the Solvency II building an acceptable place for all to live in, while adhering to the original floor plan and timetable, is what is at stake. The building must be finished for all to take benefit from.

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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