Kapittel 5

KAREL VAN HULLE[1]

Aims and General Outlines of Solvency II

Karel Van Hulle is Head of Unit for Insurance and Pensions in the DG Internal Market and Services in the European Commission.

1. Introduction

Insurance was one of the first economic sectors to be subject to control by the State. It is subject to close scrutiny by public authorities throughout the world. The State's long involvement in insurance is a consequence of the sector's economic and social importance.

A particular characteristic of insurance is that the production cycle is inverted, i.e. insurers receive a premium up-front, but are only obliged to pay-out if the risk materialises at some future date. This is the main reason why States control insurance, because it exposes policyholders and beneficiaries of insurance contracts to loss in the event that an insurance company goes bankrupt. As a consequence, State intervention has tended to focus on introducing measures that guarantee the solvency of insurance undertakings.

The present EU solvency rules go back to 1973 (non-life insurance) and 1979 (life insurance). They were last updated in 2002. The calculation of the capital requirement under Solvency I is relatively simple: a percentage of premiums and claims in non-life insurance and reinsurance and a percentage of technical provisions and of capital at risk in life insurance. The rules under Solvency I have worked well and the relatively few failures which have occurred under Solvency I were more due to management failure than to a lack of capital or technical provisions. However, a study conducted by the Committee of European Pensions and Insurance Supervisors (CEIOPS) has shown that in most cases of actual failure, the current solvency margin rules did not provide a significantly early warning that

[1] The opinions expressed in this article are only attributable to the author.

intervention was required and of forthcoming problems, presumably precluding supervisory authorities from intervening in a timely manner.[2]

There are therefore serious doubts whether Solvency I can remain the regulatory basis for insurance supervision in the years to come. The system is clearly outdated. It is retrospective and not prospective. It does not require management of insurance companies and insurance supervisors to look at the individual risk position of each insurer. It does not take account of a number of important risks, such as the asset/liability management risk, credit risk or market risk. Furthermore, it fails to provide insurance companies with the necessary tools to cope with increased international competition, with the emergence of new risks and with the growing pressure of capital markets. From an internal market perspective, it does not allow a real comparison between the financial position of insurance companies from different Member States, as the system fails to harmonise the most important element of an insurer's balance sheet, i.e. the technical provisions. Finally, the development of new techniques, particularly in actuarial science, allow for a more accurate analysis of risks.

Since the foundations of the current EU solvency regime were laid in the 1970's, the landscape surrounding solvency, including the insurance sector itself, financial markets, the approach to prudential regulation, techniques for risk management, actuarial methods and accounting standards have changed dramatically. The current solvency regime has been left behind and one of the most important consequences is a dislocation between regulatory capital and insurance companies' own assessment of the capital they need given the nature of their business.

Work has therefore started on the development of Solvency II, a new solvency regime that is better adapted to the present economic climate. It will be the subject of a new Commission proposal to be introduced in 2007.

Solvency II is a huge project that will deal comprehensively with insurance supervision preparing the industry for the important challenges that it will face in the future.

2. General outline of Solvency II

2.1 Objectives of Solvency II

The main objectives of Solvency II are laid down in the Framework for Consultation on Solvency II that the Commission published after consultation with Member States in the European Insurance and Occupational Pensions Committee (EIOPC).

Solvency II aims first of all at the protection of policyholders and beneficiaries. Although Solvency I also guarantees a degree of policyholder protection, it fails to provide supervisors an early warning so that they can intervene promptly if capital falls below the required level. Under the present regime, Member States can supplement the minimum standards set out in the current Insurance Directives with additional rules. Solvency II aims at a higher level of

[2] Answers to the European Commission on the Second Wave of Calls for Advice, October 2005

harmonisation in terms of the protection of policyholders and beneficiaries so that Member States will no longer need to introduce additional requirements. It will particularly strengthen policyholder protection through capital requirements which can provide early warning of deterioration in solvency levels.

Solvency II should also improve the competitiveness of EU insurers, both within the EU insurance market and internationally, by deepening the integration of the EU insurance market through a higher level of harmonisation of the rules applied to insurance undertakings in different Member States and through the convergence of supervisory methods, powers and tools. Solvency II will provide insurance companies freedom to choose their own risk profile, as long as they hold commensurate risk capital.

Solvency II should in addition provide for a better allocation of capital resources, without causing significant market distortions and impeding innovation in the insurance industry. The lack of risk sensitivity of the current regime and its failure to keep pace with industry and international developments in accounting, supervision and actuarial science distorts allocation of capital resources. It also impacts the investment strategies of EU insurers, which in turn has implications for EU capital markets and the wider economy.

Whilst insurers which manage their risks well should be able to benefit from lower capital requirements, appropriate attention will be paid to the important role of small insurance undertakings, which should not be unduly burdened if they effectively take on simpler risks. Nor should capital requirements be set at levels which make it difficult for the industry to take on new risks.

2.2 Structure of Solvency II

The new solvency system should provide supervisors with the appropriate tools and powers to assess the “overall solvency” of all insurance and reinsurance undertakings based on a prospective and risk-oriented approach. It will consist of quantitative elements but will also cover qualitative aspects that influence the risk-standing of the undertaking, such as the managerial capacity, internal risk control and risk monitoring processes.

Solvency II takes as its starting point the three-pillar structure inspired by Basel II, as introduced in the banking sector through the Capital Requirements Directive (CRD): quantitative requirements (Pillar 1), supervisory activities (Pillar 2) and supervisory reporting and public disclosure (Pillar 3). The three pillars should however not be looked at independently because there is a clear interaction between the three pillars.

In Pillar 1, the new solvency system contains two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR).

The SCR reflects a level of capital that enables an institution to absorb significant unforeseen losses. It will be set at a level that leaves less than a 1 in 200 chance that capital will prove inadequate over the next 12 months. The SCR is the risk-based capital requirement and the key solvency control level. It will be calculated on the basis of a standard formula.

Companies may however use an internal model to calculate the SCR, to the extent that such a model has been approved by the supervisory authorities. Criteria will have to be agreed for the validation of internal models. Although the responsibility for the development and use of an internal model will remain with the insurance company, supervisors will want to make sure that the model provides an accurate picture of the undertaking's risks.

The SCR may not be lower that the MCR, which reflects a level of capital below which ultimate supervisory action will be triggered. An insurance undertaking that breaches its MCR and cannot restore its capital position quickly, will be closed to new business. As the MCR represents an important trigger point, it must be objective and relatively simple to calculate.

An increased level of harmonisation for technical provisions is a cornerstone of the new solvency system. Technical provisions must be established in order for an insurance undertaking to fulfil its insurance obligations towards policyholders and beneficiaries, taking account of expenses. Harmonisation of the technical provisions should allow a better comparison between insurers. Their measurement should be based upon information provided by the financial markets and generally available data on insurance technical risks. Their amount will be the sum of a best estimate and a risk margin. An attempt will be made to align the calculation of the technical provisions with that used for financial reporting purposes (to be elaborated by the International Accounting Standards Board).

Because of the high degree of uncertainty as to their value and the time at which they materialise, the calculation of insurance liabilities has always been the subject of much debate. The current EU Directives require a prudent valuation but provide limited guidance on how this should be arrived at or the degree of protection that should result. Because insurance companies will be required to meet both technical provisions and solvency capital requirements, a key issue for the Solvency II framework will be to establish consistency between the two. Each must serve a specific and separate purpose so that there is no overlapping capital requirement.

Pillar 2 comprises a number of qualitative requirements. The starting point is that all insurance undertakings must have in place sound and effective strategies and processes to assess the risks to which they are exposed and to assess and maintain their capital needs. Those strategies and processes will be subject to review by the supervisory authorities. If, as a result of the supervisory review, the supervisor concludes that the insurance undertaking should hold more or a higher quality of capital, an add-on of capital can be imposed. If the problem identified by the supervisor is more related to inadequate risk management, the undertaking may be required to improve its management rather than to increase its capital.

The purpose of Pillar 3 is to enhance market discipline by requiring insurance undertakings to disclose publicly key information that is relevant to market participants. Supervisory reporting and disclosure requirements should be in line with those elaborated by the International Association of Insurance Supervisors (IAIS) and the IASB in order to reduce the administrative burden for companies.

In the elaboration of Solvency II, account is taken of the developments at international level, particularly within the IAIS (which is in the process of developing new solvency rules and principles), the IASB (which is in the process of developing new financial reporting standards for insurance undertakings) and the International Association of Actuaries (which has elaborated a classification of risks and is developing methods to calculate the best estimate).

Although the main focus of Solvency II is on capital requirements and supervisory review at the level of the individual legal entity, issues related to insurance groups and financial conglomerates also have to be addressed. The application of internal models in a group or conglomerate context is a key issue in this regard, as well as possible diversification benefits/costs and how to allocate these.

In order to ensure consistency across financial sectors, the general layout of the solvency system will, to the extent possible, be compatible with the approach and rules used in the banking field. Products containing similar risks should, in principle, be supervised in the same way and should be subject to the same capital adequacy or solvency requirements. The new solvency system will also be constructed in a way that facilitates efficient supervision of insurance groups and financial conglomerates and avoids regulatory arbitrage between and within financial sectors.

2.3 Procedure

A bottom-up approach has been chosen for the development of Solvency II, which is fully in line with the new Lamfalussy approach adopted in the context of the EU financial services' legislation and with the better regulation agenda, which is one of the priorities of the Commission's White Paper on financial services policy in the next five years. Much attention is paid to proper and timely consultation of all relevant stakeholders with full transparency about the process and the draft texts prepared at different levels.

Solvency II will be the first insurance project, whereby the Lamfalussy approach is used. The new solvency rules will be included in a Framework Directive which will comprise the basic principles of the new system (level 1). Where necessary, further implementing powers will be given to the Commission, which will elaborate the implementing measures (level 2) with the help of CEIOPS, with close cooperation with EIOPC and full information of the European Parliament. In order to make the system work in practice, CEIOPS will prepare joint interpretation recommendations, consistent guidelines and common standards. It will also compare regulatory practice to ensure consistent implementation and application (level 3). The Commission checks Member State compliance with EU legislation and may take legal action against Member States suspected of breaching EU law (level 4).

On the basis of the Framework for Consultation developed by the Commission in close consultation with Member States, a number of questions were sent to CEIOPS. These questions followed the broad structure of the Solvency II project and were included in three consecutive Waves of Calls for Advice. All EAA insurance supervisors were thus directly involved in the design of the new solvency system. This should ultimately contribute to a better convergence of supervisory practices in the EAA countries. CEIOPS provided

elaborate answers to each of these Calls for Advice. Stakeholders were asked for their advice on each of the draft answers developed by CEIOPS.

A large number of organisations and individuals are involved in the development of the project: the Commission, Member States through their participation in EIOPC, CEIOPS, the Groupe Consultatif Actuariel Européen, the Chief Risk Officers Forum (CRO Forum), the Chief Financial Officers Forum (CFO Forum), the European insurance industry (CEA, AISAM, ACME) and the consumers (Fin-Use). The European Parliament is also showing a great deal of interest and several information sessions have already been organised for members of the Economic and Monetary Committee. The involvement of so many people upstream should ultimately make it easier to agree the new solvency rules.

Two Qualitative Impact Studies (QIS) were conducted by CEIOPS. The results of QIS 1 were published in January 2006. QIS 2 was launched on 1 May 2006. The results will be made public in October 2006. More Qualitative Impact Studies will be necessary before the final decisions can be taken.

A public hearing was organised by the Commission on 21 June 2006 examining the project from different angles: the supervisors, policyholders and other stakeholders, insurance products and markets and international developments.

3. Outlook

The Commission intends to submit the new solvency rules for adoption to Council and Parliament in July 2007. These rules will be incorporated in a proposal for a Directive which will also include a recast of the existing Insurance Directives (Life, non-Life, Reinsurance, Winding-up, Insurance Groups). The proposal will be accompanied by an Impact Assessment, which will describe the impact of Solvency II on the industry, on products and markets and on supervisors.

Following the Lamfalussy approach, the solvency rules included in the Directive will be principle based, referring to the Commission for further implementing measures to be developed after adoption of the Directive. In order to assess the impact of the proposed rules, it will be necessary to include sufficient detail in the Directive and to already have a clear idea about the contents of the implementing measures that will have to be developed afterwards. Attention will also have to be paid to ensuring, through appropriate implementation deadlines, that the new solvency system can be introduced smoothly.

Although it is too early to put a fixed date on the introduction of Solvency II, it is not unreasonable to presume that the new solvency rules will apply from 2010 onwards. However, it is fair to say that many insurance companies are already now preparing themselves for the introduction of Solvency II by improving their risk management and by developing internal risk models.

The implementation of Solvency II will have important consequences for the way in which insurance companies and supervisory authorities will operate in the future.

Requiring all firms to conduct an individual risk and capital assessment will act as a powerful tool to encourage and reward better and more comprehensive risk management practices. This in turn will lead to a much better assessment and alignment of actual capital needed by an insurance company to meet its risks. The new solvency rules will change business attitude from a compliance based culture to a risk management culture.

Supervisory authorities will have to get more knowledgeable about risk management and internal models. As a consequence, they may need to attract people with different skills and acquire new resources. Cooperation in the development of further implementing measures and in the validation of group internal models, as well as peer reviews, will contribute to improving supervisory convergence, which should ultimately also be in the interest of the insurance industry and of policyholders.