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Study of Insurance Economics

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Layout & Distribution: Valéria Kozakova

The Roadmap to Solvency II

Evelyne Massé

Need for a new supervisory framework for the insurance industry

- Find a balance between policyholders' protection (higher capital requirements to face new risks) and competitivity (limit cost of capital) ⇒ a more risk-sensitive framework
- Promote sound risk management, give more flexibility but push back the responsibility to the company's management ⇒ new dialogue between supervisors and insurance companies
- European level-playing field ⇒ harmonize supervisory standards and practices throughout Europe and across financial sectors.

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The Solvency II project: objectives and process

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Solvency in Europe

- 1970s: first EU non-life and life directives on solvency margins (= extra capital as a buffer against unforeseen events such as higher than expected claims levels or unfavourable investment results)
- 1997: Müller Report ("Solvency of insurance undertakings")
  - ➔ review of solvency rules
  - ➔ Solvency I project initiated
- 2001: Solvency II initiated ➔ Sharma Report
- 2002: Solvency I completed (in force by 2004)

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Objectives of Solvency II Directive
• Deepen integration of the EU insurance market
• Improve protection of policyholders and beneficiaries
• Improve international competitiveness of EU insurers
• Promote better regulation
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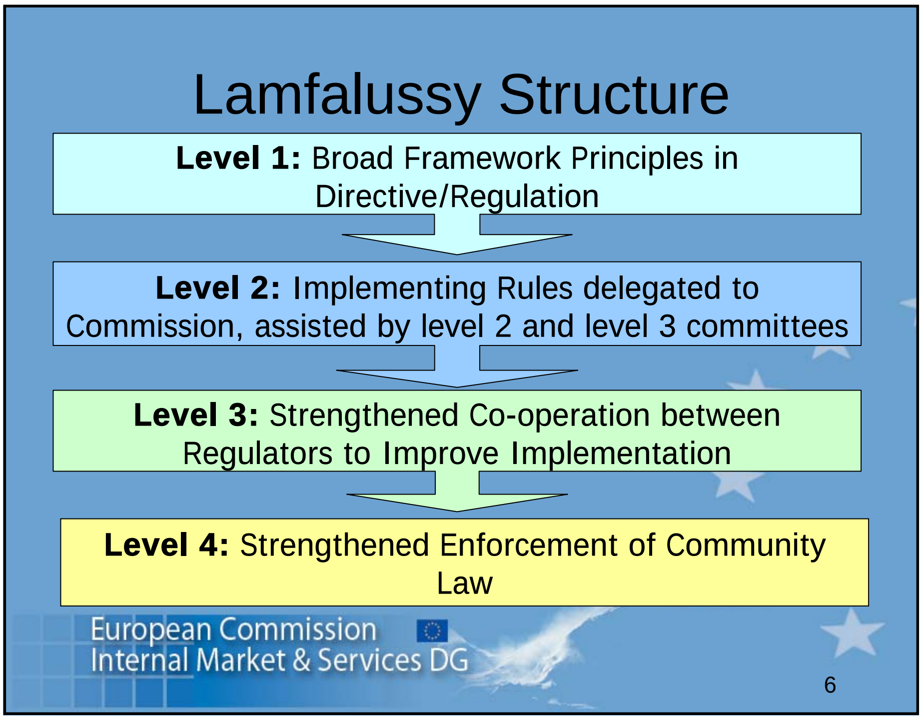
Lamfalussy Structure
Level 1: Broad Framework Principles in Directive/Regulation
Level 2: Implementing Rules delegated to Commission, assisted by level 2 and level 3 committees
Level 3: Strengthened Co-operation between Regulators to Improve Implementation
Level 4: Strengthened Enforcement of Community Law
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Solvency II Directive

- As part of the Solvency II project existing Insurance Directives (except for Motor Insurance) will be codified
- New Solvency II Level 1 framework legislation will be introduced into the codified version of the existing directives
- After adoption of the codified directive including Solvency II framework legislation, work on Level 2 implementing measures will begin

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Framework for Consultation

CEIOPS
Committee of European Insurance and Occupational Pensions Supervisors

EIOPC

- To help **CEIOPS** and other stakeholders in the development of the new solvency regime
- The Commission, in consultation with **EIOPC**, has developed a Framework for Consultation
- The Framework for Consultation
  - Covers the totality of the Solvency II project
  - Sets out policy principles and guidelines
  - Includes "Specific Calls for Advice" sent to CEIOPS

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Framework for Consultation

- The new solvency system should provide for uniform application and sufficient consumer protection whilst supporting fair competition
- The new solvency system should focus on the overall solvency of institutions looking at both quantitative and qualitative aspects

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Framework for Consultation

- The new solvency system should be risk-oriented, prospective and robust as well as provide incentives for insurance undertakings to improve risk management
- The new solvency system should improve cross-sectoral consistency and promote international convergence

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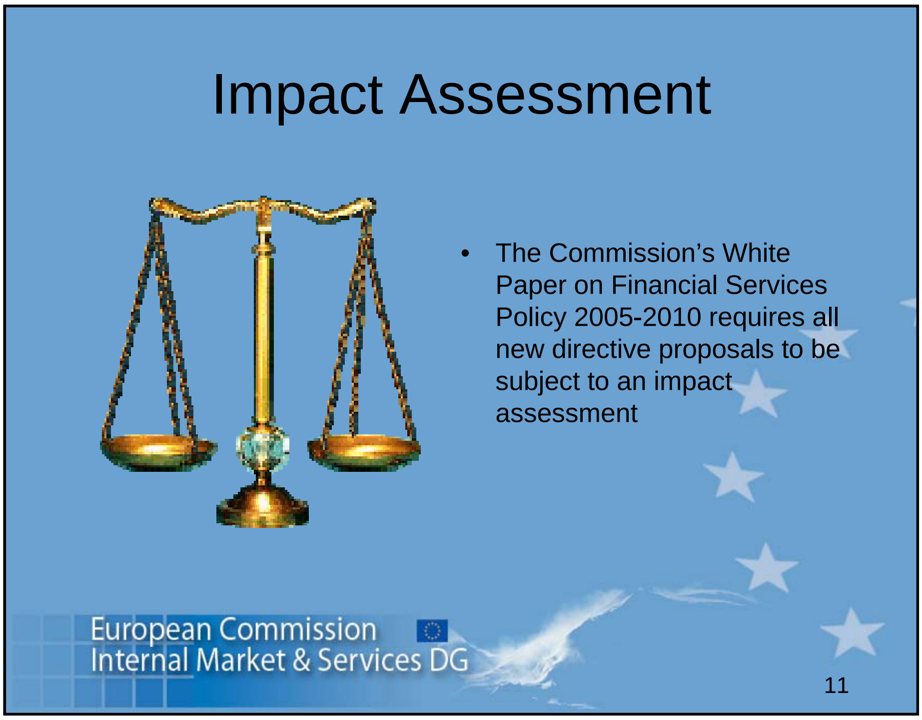
Impact Assessment
• The Commission's White Paper on Financial Services Policy 2005-2010 requires all new directive proposals to be subject to an impact assessment
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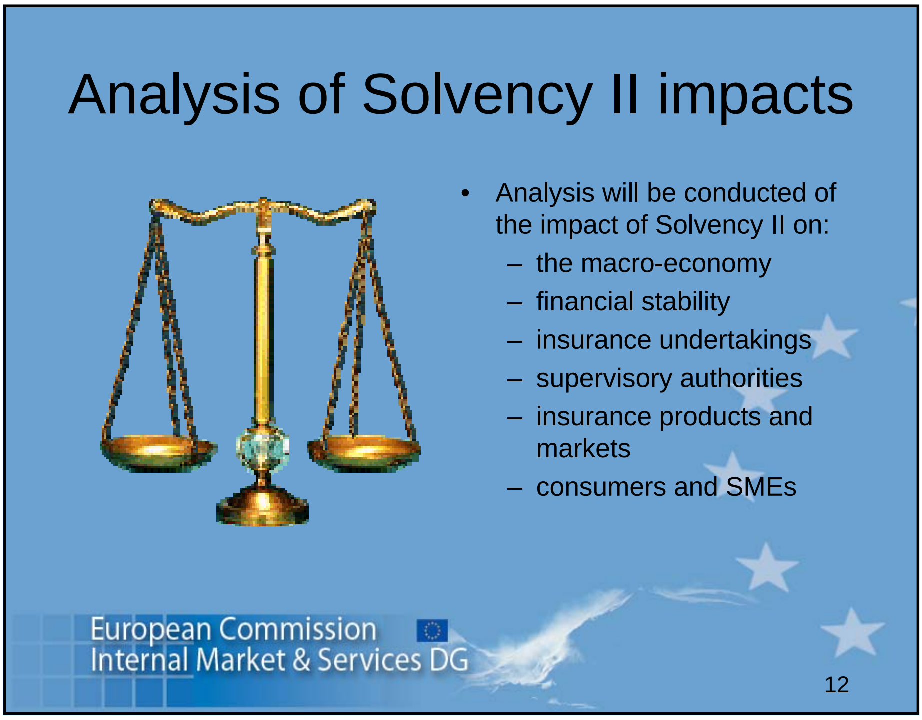
Analysis of Solvency II impacts
• Analysis will be conducted of the impact of Solvency II on:
– the macro-economy
– financial stability
– insurance undertakings
– supervisory authorities
– insurance products and markets
– consumers and SMEs
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Benefits must outweigh costs

- Supervisors need to justify the measures they impose on insurance companies
- Solvency II must forster sound risk management practices and improve consumers' protection
- Solvency II must improve international competitiveness of EU insurers
- Solvency II must not become a compliance exercise. Pillar 3 is important in this regard.

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Quantitative Impact Studies (QIS)

- The Quantitative Impact Studies run by CEIOPS will be a key input in assessing the quantitative impact of the proposal
- QIS aim at:
  - assessing the workability of the different methodologies
  - identifying the design and calibration issues
  - assessing the possible impact of the different technical options
- Two QIS have been completed. A third QIS will be launched next Springtime (April 2007)
- If needed, more QIS exercises will be conducted to refine the new framework

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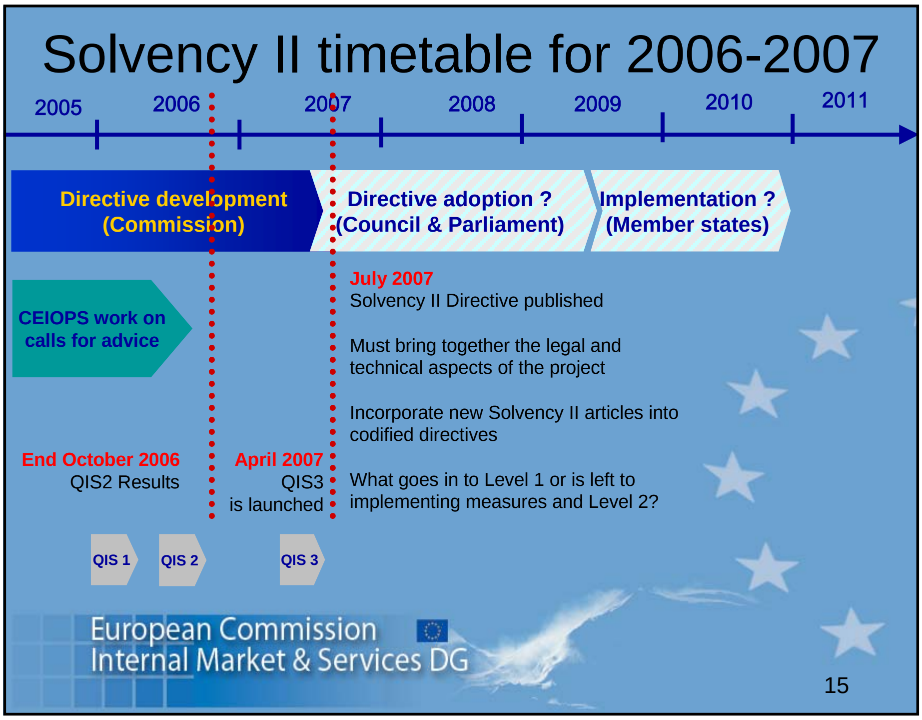
Solvency II timetable for 2006-2007
2005
2006
2007
2008
2009
2010
2011
Directive development (Commission)
Directive adoption ? (Council & Parliament)
Implementation ? (Member states)
CEIOPS work on calls for advice
July 2007
Solvency II Directive published
Must bring together the legal and technical aspects of the project
Incorporate new Solvency II articles into codified directives
What goes in to Level 1 or is left to implementing measures and Level 2?
End October 2006
QIS2 Results
April 2007
QIS3 is launched
QIS 1
QIS 2
QIS 3
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The Solvency II project:
key issues and stage report
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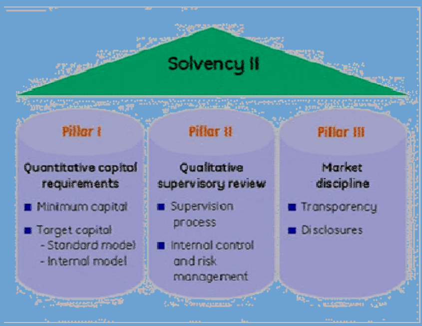
Outstanding Technical Issues



- In January 2006, the Commission wrote to CEIOPS identifying a number of areas where more detailed advice was required
- These areas included:
  - The valuation of technical provisions
  - The SCR standard formula
  - Pillar 2
  - Pillar 3
  - Group issues

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Technical Provisions

- Revised framework for consultation (June 2006)
- Valuation of technical provisions for solvency purposes on a market consistent basis

  = **best-estimate + risk-margin**
- QIS 2 results: respective merits of Cost of Capital vs. Percentile

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SCR Standard Formula

- QIS2 is just a test
- E.g. treatment of equity investments has been questioned
- What should the benchmark risk measure be? (Value-at-Risk or Tail Value-at-Risk)
- Industry need to be actively involved in design of QIS3
- QIS3 is more than a test: it should be a calibration exercise

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Pillar 2

- Commission's White Paper on Financial Services Policy 2005-2010 priorities include:
  - *Convergence of supervisory practices and standards across Europe*
- Solvency II must be accompanied by and deliver real convergence
- Commission does not want the same rules being implemented in 25 different ways across Europe

⇒Pillar 2 draft texts well underway

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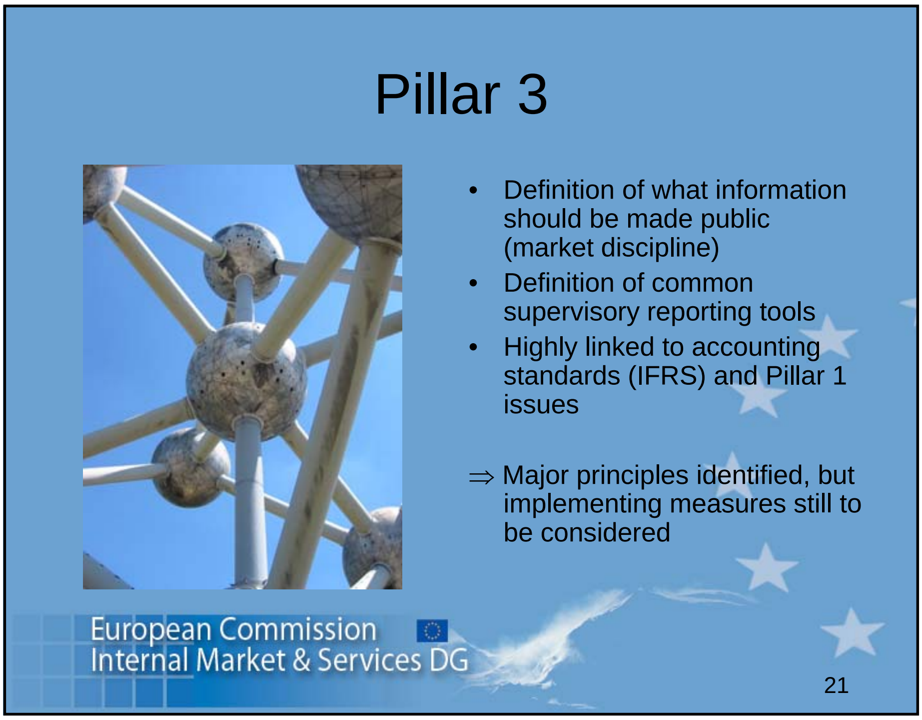
Pillar 3
• Definition of what information should be made public (market discipline)
• Definition of common supervisory reporting tools
• Highly linked to accounting standards (IFRS) and Pillar 1 issues
⇒ Major principles identified, but implementing measures still to be considered
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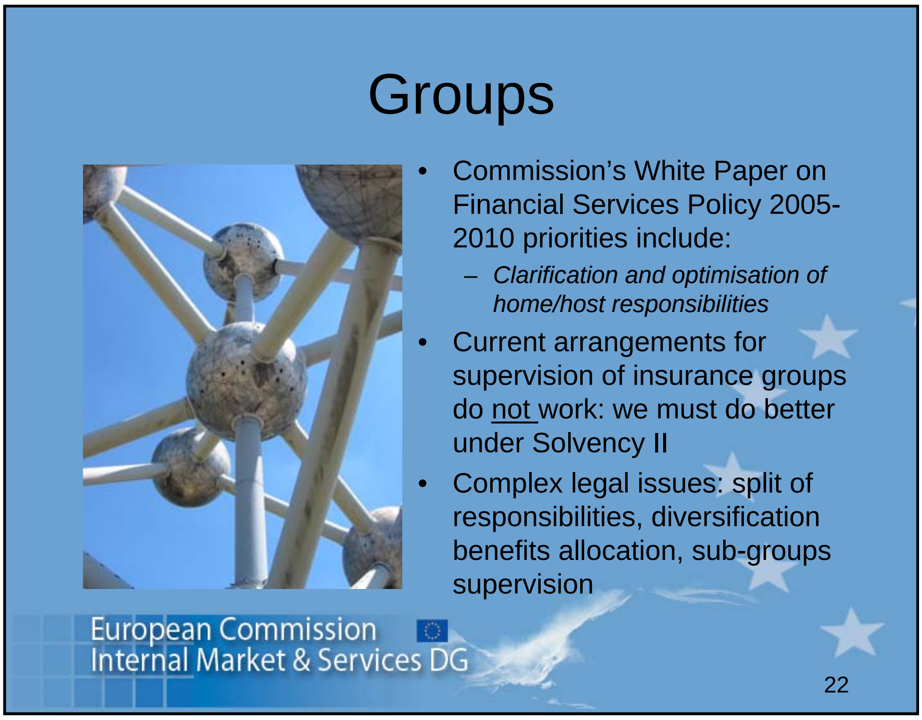
Groups
• Commission's White Paper on Financial Services Policy 2005-2010 priorities include:
– Clarification and optimisation of home/host responsibilities
• Current arrangements for supervision of insurance groups do not work: we must do better under Solvency II
• Complex legal issues: split of responsibilities, diversification benefits allocation, sub-groups supervision
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How to prepare and contribute to the project
(Solvency II in practice)
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How to prepare
Documentation / information:
• EC website (e.g. framework for consultation)
• CEIOPS Consultation Papers and Submissions to the European Commission
• National supervisors and ministries
• Industry trade bodies: Comité Européen des Assurances (CEA), AISAM and ACME (mutuals), local professional associations
• Auditors and actuaries
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How to contribute

- Participate in QIS 3!
- Participate in the Commission's surveys:
  - A public hearing was held in June 2006
  - An online consultation was conducted (closed in September 2006)
  - Interviews with ~20 European companies organized in November and December 2006
- Participate in the studies conducted by professional trade bodies: e.g. CEA survey on change in products and markets

⇒ EC and CEIOPS' doors are open to all stakeholders

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QIS 3 schedule

- Pre-specification field study: end of February 2007
- Final QIS 3 questionnaire: April 2007
- Answers to be sent before end of June 2007
- Autumn 2007: analysis of the results

⇒New design and calibration for quantitative standards (e.g. SCR, MCR)

Large participation of the industry is crucial: various sizes, various businesses.

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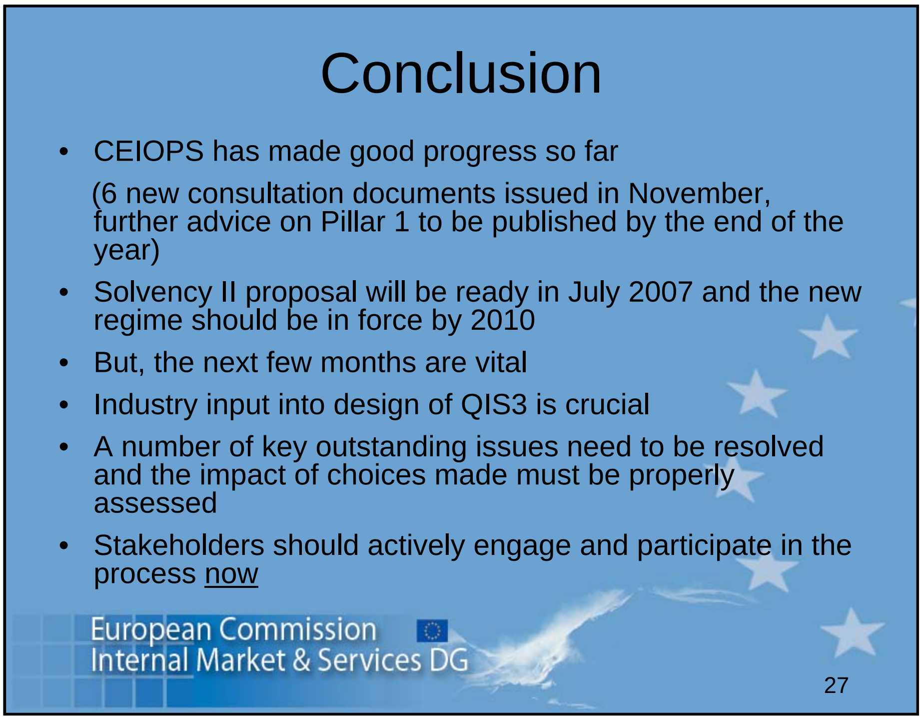
Conclusion
• CEIOPS has made good progress so far
(6 new consultation documents issued in November, further advice on Pillar 1 to be published by the end of the year)
• Solvency II proposal will be ready in July 2007 and the new regime should be in force by 2010
• But, the next few months are vital
• Industry input into design of QIS3 is crucial
• A number of key outstanding issues need to be resolved and the impact of choices made must be properly assessed
• Stakeholders should actively engage and participate in the process now
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