

Solvency II regime: A revolution underway for European (re) insurance companies

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Outline for a CEPS Task Force

Over the past few years, the European (re)insurance industry has been undergoing fundamental changes. The difficult conditions experienced by the industry and the shortcomings of the current regulatory and supervisory framework (known as ‘Solvency I’) have forced regulators to change the way in which they regulate insurance companies’ solvency. In 2000, European regulators began a far-reaching review of the current solvency rules for (re)insurance companies. Unlike the new capital requirement rules for banks, which originated from the Basel II framework produced by the Basel Committee, the new solvency framework (‘Solvency II’) is a purely European creation. European regulators are indeed leading the field since the International Association of Insurance Supervisors (IAIS), which is the sister committee for insurance supervision of the Basel Committee for banking supervision, is catching-up in producing a global solvency framework for insurance companies.

Solvency II the new European framework for regulating the solvency of insurers (life and non-life) and re-insurers¹ mainly aims at ensuring adequate policyholder protection.

The new regime whose financial requirements are based on an economic total balance sheet approach, addresses the valuation of liabilities, including technical provisions and their margins; the quality, liquidity and valuation of assets; the matching of assets and liabilities; suitable forms of capital; and capital adequacy requirements.

The legislation was unveiled by the European Commission in **July 2007**² and is likely to be adopted by the European Parliament and the Council in **autumn 2008** and implemented in the 27 EU member states by **2011/2012**.

The new regime will drive a revolution in insurance and reinsurance companies’ solvency regulation. Indeed, starting from the three mutually-interactive pillar structure of Basel II – financial requirements, supervisory assessment and supervisory reporting and public disclosure – Solvency II is expected to emphasise the importance of realistic balance sheet valuation as the foundation for the

¹ Insurance companies whose annual premium income does not exceed €5 million and pensions funds covered by Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision are not under its scope.

² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0361:FIN:EN:PDF>

development of a risk-based capital regulatory framework together with a realistic liability valuation.

The process is ongoing and therefore many issues are yet to be fine-tuned and worked-out in the implementing measures.

Having already contributed to the debate since July 2003 through its first Task Force on “the future of insurance regulation and supervision in the EU: New developments, new challenges”³, a follow-up CEPS taskforce is set-up to examine:

- the fine-tuning of the directive and the design of the implementing measures in light of the results of quantitative impact studies and the application of the proportionality principle; and
- the future of group versus solo supervision and in particular the group support; and
- the international developments (IAIS and IASB) with a particular focus on the debate on mutual recognition

while contributing to the policy debate during the Directive adoption process by the Parliament and the Council.

1- The devil is in the details

The quantitative requirements under pillar 1 are laid down in six sections in the directive:

- **Valuation of assets and liabilities;** The valuation standards for all assets and liabilities will be based upon the current IFRS definition of fair value (*Article 73*). Implementing measures will be developed setting out how the fair value of specific balance-sheet items should be calculated, in order to ensure that these items are valued consistently across all Member States.
- **Technical provisions;** The calculation of technical provisions will be based on their current exit value (*Articles 74 to 84*). They will be established as best estimate liabilities plus a risk margin, except in the case of hedgeable risks arising from (re)insurance obligations. With respect to hedgeable risks, the value of technical provisions is calculated directly, as a whole, and derived using the values of those financial instruments. With respect to non-hedgeable risks, the risk margin is calculated using the so-called cost-of capital method. In this case, the cost-of-capital rate used is the same for all undertakings (e.g. fixed percentage) and corresponds to the spread above the risk-free interest rate that a BBB-rated (re)insurance undertaking would be charged to raise eligible own funds.
- **Own funds;** The calculation of technical provisions will be based on their current exit value (*Articles 74 to 84*). They will be established as best estimate liabilities plus a risk margin, except in the case of hedgeable risks arising from (re)insurance obligations. With respect to hedgeable risks, the value of technical provisions is calculated directly, as a whole, and derived using the values of those financial instruments. With respect to non-hedgeable risks, the risk margin is calculated using the so-called cost-of capital method. In this case, the cost-of-capital rate used is the same for all undertakings (e.g. fixed percentage) and corresponds to the spread above the risk-free interest rate that a BBB-rated (re)insurance undertaking would be charged to raise eligible own funds.
- **Solvency capital requirements;** The Solvency Capital Requirement is divided in three parts: the general presentation of that capital requirement, the Solvency Capital Requirement standard formula, and the use of internal models for solvency purposes (*Articles 99 to 124*). Many details of the contents of these parts will be adopted through implementing measures.
- **Minimum capital requirements;** The *minimum capital requirements* represent a level of capital below which policyholders' interests would be seriously endangered if the undertaking were allowed to continue to operate (*Articles 99 to 124*). The Minimum Capital Requirement

³ Taskforce report published in November 2006 available at:
http://shop.ceps.eu/BookDetail.php?item_id=1400

needs to be calculated quarterly, in accordance with a **simple and robust formula**, on the basis of auditable data. However, no final decision has been reached yet. Moreover the link between MCR and SCR should be examined.

- **Investments.** All investments held by (re)insurance undertakings (i.e. assets covering technical provisions, plus assets covering Solvency Capital Requirement and free assets) must be invested, managed and monitored in accordance with the "prudent person" principle (According to Articles 129 to 132).

Substantial progress has been achieved in the principles of pillar I, but many details are still to be agreed upon before the adoption and the specification of the implementation measures. Amid important aspects addressed in the framework directive, the Task Force will examine thoroughly the proportionality principle in light of the ongoing work of the CEIOPS and the industry.

2- Group supervision

The new directive (Articles 219 to 277) introduces several improvements applicable to all (re) insurance groups, including the identification and the appointment of the group supervisor, its rights and duties, cooperation between supervisors, preference of a consolidated model for group solvency for groups to benefit from diversification effects, the group internal model, the supervision of sub-groups, convergence and group support. These improvements will be fine-tuned and agreed up on in the consultation process. The CEPS Task Force will contribute to the ongoing discussions in light of its previous work on the matters.

3- Links of Solvency II with the ongoing work of IAIS and IASB

With respect to capital adequacy and solvency requirements, the International Association of Insurance Supervisors (IAIS) has developed a wide range of principles, standards and guidelines that have proved to be effective. Despite progress achieved in recent years and its present far-reaching work plan, the IAIS has not yet produced a global framework to regulate insurance and re-insurance companies. In parallel, the International Accounting Standards Board (IASB) has been reflecting for the past few years on the main components of an accounting model for insurance contracts. The most recent discussion paper was published in May 2007 for public consultation until 16 November 2007. The CEPS Task Force will follow-up and comment the work in progress by the IAIS and IASB and will examine the links with Solvency II to ensure the convergence of rules worldwide.

4- Task Force programme

The Task Force will meet three times in 2008 to discuss relevant policy issues. The discussions will materialise in a CEPS Task Force report which will be written by the "rapporteur (s)" and published in autumn to reflect the consensus of its members.

Contributions from the participants and the speakers are also welcomed.

The first meeting will take place on **09 April 2008** at CEPS. The first meeting will examine group supervision issues in light of new specifications of the quantitative impact study 4 and the reports published by the CRO forum and CEA.

Invited speakers are:

- Dominique Thienpont; European Commission;
- Patrick Brady, Chairman of the CEIOPS WG on Insurance groups supervision committee;

- Alberto Corinti, CEA;
- Joachim Oechslin, CFO, Munich Re; and
- Yann Le Pallec, Standard and Poor's.

The second meeting in **July 2008** will look at the proportionality principle.

The third meeting in **September 2008** will look at international developments and mutual recognition and will discuss the first draft taskforce report.

The taskforce will also invite Peter Skinner the Rapporteur of Solvency II from the European Parliament (EP). The invitation will depend on the timetable of the finalisation of the EP report.

5- Fee Structure

CEPS taskforces are principally designed for CEPS corporate members but are open to non-members as well, at a higher cost. The participation fee is 1800 euros for corporate members or 5500 euros for non-members (VAT not included). This fee covers the participation of the registered person in the meetings, documentation, lunches and 3 copies of the final report. It is payable before the start of the first meeting.



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CEPS Task Force on

Solvency II regime: A revolution underway for European (re) insurance companies

Participation Form

The participation fee is €1,800 for CEPS Corporate Members and €5,500 for non-members.

I wish to participate in the CEPS working party on “Solvency II Regime: A Revolution underway for European (re) insurance companies”

Name:

Position:

Company:

Address:

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Telephone:

Fax:

Email:

- My company is a corporate member of CEPS and pays €1,800(+21% VAT).
- My company is not a corporate member of CEPS and pays €5,500 (+21% VAT).
- My company is interested in becoming a member of CEPS. Please send additional information.

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