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Subject: Design of a future prudential supervisory system in the EU – Recommendations by the Commission Services

I Introduction

Background

1. The Solvency II project was initiated in order to investigate the need for a revision of the current EU solvency system. The project has been divided into two phases, the first of which is now drawing to a close. In this first phase, Member States and the Commission Services have studied a number of areas (such as use of risk-based capital systems, lessons to draw from the bankers' Basle process, use of internal models, Lamfalussy developments, links between financial reporting and supervisory accounts etc[1]) in order to discuss the general design of a future EU solvency system.

2. In the document MARKT/2535/02 "Considerations on the design of a future prudential supervisory system", the Commission Services summarised the work in phase 1 as well as presented an overview of possible alternatives for a Solvency II system. This paper has been discussed at meetings of the IC Solvency Subcommittee on 7 and 14 February 2003. The Services have also received a number of written comments from Member States, industry and other interested parties. Presentations and discussions at the "Solvency Market Day" have also provided useful insights.

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1 All documents relating to the Solvency II project can be downloaded from the Commission insurance web-site: http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-workpapers_en.htm

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Purpose of this paper

3. The purpose of this paper is to prepare the Insurance Committee’s orientation debate on 9 April on the direction of the Solvency II project.

4. Following-up on the document MARKT/2535/02 (with its questionnaire MARKT/2500/03), this paper sets out the Commission Services’ tentative views on the overall design of a future EU solvency system. The recommendations are, however, subject to change in the light of the IC orientation debate.

5. Towards the end of the paper, the Commission Services comment on future work to be undertaken in phase 2 of the Solvency II project.

II General considerations for a new EU prudential supervisory system

General starting points

6. The new system should provide supervisors with the appropriate tools to assess the "overall solvency" of an insurance undertaking. This means that the system should not only consist of a number of quantitative ratios and indicators, but also cover qualitative aspects that influence the risk-standing of an undertaking (management, internal risk control, competitive situation etc.).

7. A solvency system defined in this broader sense could usefully take its starting point in a Basle-type three-pillar structure, but adapted to the needs of insurance supervision. Adopting such a structure would imply that special considerations are made concerning the interaction between the different pillars of quantitative and qualitative supervision, as well as to the role of disclosure. The importance of the supervisory review process in pillar II would be highlighted. The tentative Services recommendations below are organised around a three-pillar structure.

8. The solvency system should encourage and give an incentive to insurance undertakings to measure and manage their risks. In this regard, there is a clear need for developing common EU principles on risk management and supervisory review. Furthermore the quantitative solvency requirements should cover the most significant risks to which an insurance undertaking is exposed. This risk-oriented approach would lead to the recognition of internal models (either partial or full) provided these improve the undertaking's risk management and better reflect its true risk profile than a standard formula.

9. In order to clarify the different roles of capital requirements in the solvency system, the Commission Services would see benefits in distinguishing between a "target" requirement based on the need for economic capital at a certain ruin probability, and a more easily calculated lower, absolute minimum level. Such a two-level approach to capital requirements would have the advantage of giving supervisory authorities and insurance undertakings the time to take appropriate corrective action.

10. In order to ensure consistency across financial sectors, the general layout of a Solvency II system should, to the extent necessary, 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 be subject to the same capital adequacy or solvency requirements.

11. A new solvency system should aim at more efficient supervision of insurance groups and financial conglomerates. Whilst building primarily on a "solo" supervisor concept, forms of co-operation and co-ordination between supervisors could be further developed. The Commission Services will elaborate further on the distribution of supervisory tasks between entity and group levels. Furthermore, the Conference of EU supervisors should be asked to intensify their efforts to make group supervision more efficient. The possible introduction of internal models at group level also raises the issue of increased co-operation between supervisors.

12. The future system should lead to increased harmonisation of quantitative and qualitative supervisory methods and thereby contribute to the creation of a level playing field within the insurance industry, as well as between financial sectors. Therefore a new system should, to the extent possible, build on the principle of maximum harmonisation. This view has clearly been supported by industry, the European Parliament and the Economic and Social Committee.

13. The future regulatory and supervisory framework should be as efficient and flexible as possible. It should be adaptable to the changing nature of insurance business and to the rapid development of products, methods and models. Lamfalussy or comitology techniques should therefore be used in order to construct a supervisory framework that could allow for the use of more complex methods whilst remaining flexible. The Insurance Committee or its successor body will retain a pivotal role in guiding future Solvency II work in a Lamfalussy system. Close co-ordination between the reformed Insurance Committee and Conference of EU Insurance Supervisors will be necessary. The Conference as a future Lamfalussy level 3 body will become increasingly important in providing technical advice to the Commission.

International developments

14. A future system should also take international developments into account with the aim of promoting further convergence in prudential standard setting. Work in organisations like the International Association of Insurance Supervisors (IAIS), the International Association of Actuaries (IAA) and the International Accounting Standards Board (IASB) should be considered. A significant EU input to these projects is essential to ensure a two-way exchange of ideas.

15. IAIS solvency principles, standards and guidance should be considered in the second phase of Solvency II. Considering the substantial European involvement in the IAIS solvency work, the Commission Services believe that co-ordination between the two projects would be possible and mutually beneficial. The timing of future IAIS work seems to be well in line with that for similar EU work.

16. The Commission Services believe that work within, and involvement by, the actuarial profession - IAA/Groupe Consultatif Actuariel Européen – will prove important for the continuation of the Solvency II project. The Groupe Consultatif will continue to play an important role in participating in technical working groups. The IAA Risk-Based Solvency Capital Structure Working Party Report will be presented in May 2003. This report, as well as the involvement of IAA/Groupe Consultatif specialists, could be helpful within the framework of defining a system for the target capital level, as well as for developing validation criteria for internal models.

17. As concluded in the report of the Forum Group on Reporting Requirements[2], accounting rules prepared by the IASB will be crucial to convergence in financial and regulatory reporting. The insurance accounting project of the IASB will have a clear impact on the Solvency II project. The IASB insurance project has been divided into a first phase with temporary solutions in place from 2005, and a second phase with a complete insurance standard to be applied as from 2007-2008. The second phase standard will be an important reference point for the Solvency II work.

18. The Commission Services believe that the IASB developments should be reflected when formulating the Solvency II reporting requirements. The intention should be to implement accounting rules, which are compatible with the likely outcome of IASB work. In areas where the supervisors' need for information is not fulfilled by IASB financial statements, adjustments or additions may be necessary. Current accounting rules could be used as a basis for quantitative work in Solvency II insofar they are in line with foreseen IASB developments.

[2] This report can be downloaded from the Commission financial services' web-site: http://europa.eu.int/comm/internal_market/en/finances/cross-sector/index.htm

III Tentative recommendations for a future EU prudential supervisory system

The recommendations follow the order of presentation in the annex to paper MARKT/2500/03.

Recommendations for the first pillar

Non-life technical provisions

19. Increased harmonisation of provisions for outstanding claims is a cornerstone of a new solvency regime in the EU. The Services would recommend that a quantitative benchmark for the prudence level in technical provisions be set, and that a technical provision standard with both first and second pillar elements be elaborated. The Services acknowledge the difficulties in establishing the relevant probability distributions, but believe that such an approach would be useful as a stimulus to a structured provisioning process, to the supervisory review process as well as to encouraging the development of internal models. The question of what benchmark level that should be chosen will have to be discussed further. Techniques and methods to be used according to the standard should be compatible with those used to prepare IASB accounts.

20. The current use of equalisation provisions may change, as it is likely that these will be classified as own capital by the IASB. The Commission Services however believe that insurance companies still should have the possibility to build up untaxed reserves as restricted capital in a future EU solvency system, and that such statutory reserves could be counted against the solvency capital requirements. The Commission Services believe that this issue should be addressed at a later stage of the project when the general structure of the capital requirements and the links to financial reporting have been laid down.

Life technical provisions

21. The current rules for establishing life technical provisions would have to be screened in the light of a new two-level solvency system and the advent of IASB accounting solutions. IASB is likely to use a risk-free market rate for discounting of future cash flows, and to establish valuation rules for embedded options and guarantees given in life assurance products. In this light there may be a need for a future prudential standard for life technical provisions to include requirements on a prudential margin and a resilience reserve. Detailed work would have to be performed in the second phase of the Solvency II project.

Investment issues

22. It has been argued that asset risk is not sufficiently well covered in the current EU solvency rules. This is especially the case for non-life insurance. The Commission Services therefore recommend that asset risk be captured in a more explicit way in the calculation of the target capital level. It can be discussed whether the new system should contain a limited number of quantitative limits or “safety nets” to reduce the risk related to very unbalanced portfolios. The issue whether such quantitative limits should be of minimum or maximum harmonisation nature must also be addressed.

23. The Commission Services tend to believe that not only the technical provisions, but also <u>the capital requirement (i.e. the target level) should be covered by safe, diversified and adequately spread assets</u>. A transitory period may be needed for the introduction of such a requirement.

Capital rules

24. The Commission proposes to introduce <u>two levels of regulatory capital requirements:</u> a target capital level as well as a minimum capital level. Both of these levels will be binding for companies, and the regulatory system should identify the <u>supervisory actions and sanctions</u> that are related to non-fulfilment of the two different levels. It may furthermore be necessary to define a scale of supervisory action when an insurance undertaking's capital lies between the target and the minimum (i.e. safety net) level (cf pillar II).

25. The <u>target capital level</u> should in principle reflect the economic capital that a company would need to operate with a quantified low probability of failure. The calculation of the target capital requirement should aim at reflecting and quantifying most risks that an insurance undertaking is exposed to. The Commission Services believe that the target level should be the main supervisory tool for companies operating under normal circumstances. A standardised framework should be elaborated at EU level, possibly with assistance from the IAA/Groupe Consultatif. A European set of standard coefficients could be elaborated, but jurisdictions with sufficient statistics may prefer to derive their own coefficients. The model could be constructed in a modular fashion. The standardised approach should take reinsurance cover into account, and address the issue of large severity, low frequency losses. Time horizon and confidence level should also be discussed.

26. The new EU system should allow companies to <u>use internal risk models for the calculation of their target capital level</u>. This facility will be conditional upon the internal model having been validated by the supervisory authority. Validation criteria should be developed at EU level, possibly in co-operation with IAA/Groupe Consultatif, IAIS and taking experience from the banking sector into account. Partial models could be accepted in order to facilitate the introduction of internal models.

27. A <u>minimum capital level or "safety net</u>" should be established to act as a trigger level for ultimate supervisory action. It should be calculated in a simple and objective way, as supervisory actions at this level may need court decisions in certain jurisdictions. It could be calculated independently, or could be a fraction of the target capital level. However, the Commission Services see advantage in having an independently-calculated minimum level. The minimum capital could be calculated in a manner similar to the current solvency margin requirement, but certain features could also be introduced to make the requirement more efficient. One idea could be to express the requirement as a percentage of the technical provisions (calculated in a more harmonised way). The absolute level could be set at about the same level as the current non-life system. Further consideration may be needed for the safety net level in life insurance. The Commission Services do not foresee that internal models could replace the minimum capital level.

Recommendations for the second pillar

Internal control and risk management

28. Principles for the internal control of insurance undertakings should be developed in accordance with future recommendations from the Conference's "Madrid" group (see part IV below).

29. Insurance undertakings should be required to follow principles for sound risk management. Such principles could be developed following the general outline prepared by the Conference's "London" (or "Sharma") group[3] (see part IV below). Inspiration can also be taken from the work in the banking sector. The rules should include principles concerning the underwriting of business, as well as general instructions for the management of policies, claims and technical provisions.

30. Companies should furthermore be required to strengthen their financial management by presenting an investment policy plan.

31. Special importance should be attached to asset-liability matching/management and to the structure of the reinsurance programme of an insurance undertaking.

32. In addition, the insurance undertaking may be required to have a "fair attitude" towards policyholders as regards for example its profit sharing policy and the information given to policyholders (see also pillar III).

Supervisory review process

33. The supervisory review process is essential for the functioning of a new EU solvency system. Several important aspects of the supervisory review process could usefully be harmonised at EU level, keeping in mind the need for supervision tailored to the needs of individual companies.

34. Supervisory authorities need a common framework for assessing corporate governance. Early-warning indicators and reference scenarios for stress tests could also be harmonised at European level, with possible adaptation reflecting the specific characteristics of markets. The supervisory review process should also include an analysis of an insurance undertaking's longer term development, with the view to assessing its financial position on an ongoing basis.

35. A harmonised minimum set of common statistics would furthermore facilitate communication between supervisors and promote supervisory convergence.

36. Minimum criteria for on-site inspections could be set. Such visits are likely to be a mandatory element of the validation process of internal models.

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3 This report can be downloaded from the Commission insurance web-site (ibid footnote 1).

Co-ordination of supervisory action in times of crisis

37. The new solvency regime should address the need for co-ordinated supervisory action where one or several undertakings, or an entire sector, face problems to fulfil prudential requirements. In addition, the system should aim at avoiding pro-cyclical requirements that could aggravate an already difficult situation.

Prudential powers and measures

38. As indicated in the discussion of the two regulatory capital levels, the intervention powers and responsibilities of the supervisory authorities should be closely defined.

39. The aim of strengthening the supervisory review process is to make the prudential system more sensitive to insurance undertakings' individual risk profiles. Supervisors may therefore in individual cases set requirements beyond the standard requirements or demand more detailed disclosures. General principles for departures from standardised rules should be elaborated.

Transparency and accountability of the supervisory authorities

40. Principles should be set to ensure the transparency of supervisory action vis-à-vis the market. The general criteria and evaluation methodology of the supervisory authorities must be publicly available.

Peer reviews

41. The increased complexity of the future solvency system in general, and the increased importance of second pillar supervisory work in particular, may call for a system strengthened by a peer review process of the working modalities of supervisory authorities. Such reviews could for example be organised by the Conference of EU supervisors. Although no detailed discussions have yet taken place at EU level on this issue, the Commission Services believe that this question would have to be addressed in the course of the Solvency II work.

Recommendations for the third pillar

42. Third pillar disclosures will be an important part of the future insurance supervisory architecture in the EU. Transparency and disclosure could serve to reinforce market mechanisms and risk-based supervision. As disclosure requirements will depend on the methods and measures adopted for pillar I and pillar II, it is only possible to define the pillar III reporting requirements in the course of the upcoming Solvency II work.

43. The Commission Services believe – in the spirit of the recommendations of the Forum Group on Reporting Requirements – that it is important to closely monitor developments in the IASB, the IAIS (in particular the Enhanced Disclosure Subcommittee) and the Basle II work so that reporting requirements could be co-ordinated in order to reduce the administrative burden on undertakings.

44. Careful consideration has to be made whether certain supervisory information should or should not be made public. This is particularly the case for companies confronted by regulatory compliance problems, where the mere publication of that information could seriously aggravate the situation.

IV Future Solvency II work

45. Provided that the Insurance Committee generally endorses the recommendations included in this paper, the Commission Services intend to prepare a project management paper outlining the organisation and tentative timing of future Solvency II work. Such a document will be discussed in the IC Solvency Subcommittee, and be subsequently presented to the IC (e.g. possibly at the July meeting) for debate and approval.

46. The Solvency II project covers a number of very complex and work intensive tasks. The project management paper will present proposals how these tasks could be structured and allocated to Commission working groups, and – in the spirit of Lamfalussy - to Conference working groups, or cases where outside parties should be asked to provide background material. The paper will furthermore identify reporting structures and the interrelationships between different working groups.

47. The organisation of the project is dependent on developments concerning the extension of the Lamfalussy approach to insurance. The Commission Services see clear advantages in using such a structure, and believe that the general concepts can be introduced also in the insurance supervision area. The Services will keep the IC informed on further developments concerning the Lamfalussy proposal.

48. The successful model used for the technical working groups on non-life technical provisions and life assurance may be used for groups led or facilitated by the Commission. The core of these groups will consist of specialists from Member States' supervisory authorities, and due to resource constraints at the Commission, it is also likely that the secretariats of certain groups may be provided by Member States. It is also envisaged that relevant external specialists (e.g. actuaries, accountants or specialists from companies) will be invited to participate in the work of certain groups.

49. As stated earlier in this paper, the Conference of EU supervisors will continue to play an important role in the Solvency II project. The output from its work will, however, change nature under the foreseen Lamfalussy approach. The London/Sharma report has provided high quality input to the phase I discussion, and much of the risk management work in phase II will be based on this work. The results of the Madrid group on internal risk control will be directly incorporated in the work under the second phase of the project. In accordance with the Lamfalussy approach, the Commission/level 2 will ask the Conference/level 3 to undertake further work.

50. The Commission Services may also ask outside parties (such as the CEA or the various mutual umbrella organisations) for background information and input to the working groups.

51. The Solvency II project will require sizeable staff resources at EU and Member State level. It is unlikely that the Commission insurance staff can be significantly increased. Therefore the bulk of the technical input must be provided by Member States specialists.

52. The Solvency II is furthermore a long-term project, and different modules of rules may be introduced at different times. For a certain time there will be a co-existence of old and new supervisory rules. This is believed necessary in order to calibrate the new rules and enhance the understanding of potential differences in the old and new approaches.