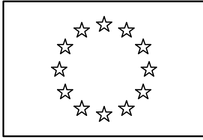

EUROPEAN COMMISSION
Internal Market DG

FINANCIAL INSTITUTIONS
Insurance

ANNEX 2 (sequel) to MARKT/2506/04–EN
Orig.
Brussels, 15 November 2004

SPECIFIC CALLS FOR ADVICE FROM CEIOPS

(SECOND WAVE)

Purpose of this document

The purpose of this paper is to consult the Insurance Committee on a proposed second set of Specific Calls for advice from the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in connection with the development of a new solvency system (Solvency II) for life and non-life insurance undertakings and reinsurance undertakings.

Subsequently this document will be updated to include further specific calls for advice and amendments.

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SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 7

1. TECHNICAL PROVISIONS IN LIFE ASSURANCE

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those on capital requirements, asset-liability management, quantitative Pillar II measures and non-life technical provisions.

1.1. Introduction

Solvency II will lead to major changes to the current EU life assurance provisioning rules in order to have IASB compatible technical provisions with greater harmonisation and transparency. Moreover, as these rules are of technical nature, in a new ("Lamfalussy") regulatory regime the detailed technical rules could most effectively be given in implementing measures and by supervisory guidance.

1.2. References

- International Association of Insurance Supervisors (IAIS)[1]:
  - Insurance Core Principles (number 20 in particular)
  - Quantifying and Assessing Insurance Liabilities Discussion Paper
  - Stress testing Guidance Paper
  - Current working documents of the IAIS Accounting Subcommittee
- European Commission[2]:
  - Report of the Working Group on life technical provisions to the IC Solvency subcommittee (MARKT/2528/02)
  - Discussion papers MARKT/2539/03, MARKT/2543/03, MARKT/2502/04, MARKT/2506/04 (Annexes)
  - Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision, KPMG, May 2002[3]

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1 See http://www.iaisweb.org/

2 See http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-workpapers_en.htm

3 http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-study_en.htm

- IASB documents:
  - DSOP, IAS 37, 39 and other relevant standards and drafts
- Member States' solvency projects, as well international projects such as the Swiss and the Singaporean projects, should be consulted. See for example:
  - The United Kingdom's enhanced capital requirements and individual capital assessments for life insurers[4].
  - The Netherlands' new Financial Assessment Framework[5]
- Relevant standards and publications by actuarial organisations worldwide, i.e. the International Association of Actuaries (IAA)[6] and the Groupe Consultatif[7] as well as their member societies such as Australia[8], Canada[9] and New Zealand[10].
- Moreover, the recent Embedded Value standard of the European insurance industry ("European Embedded Value Principles" by the CFO Forum 2004) should be analysed from IASB compatibility and practical points of view.

1.3. Background: preliminary proposal for principles for draft Directive

Article 20 of the Recast Life Directive 2002/83/EC has to be amended in the light of the new accounting and solvency requirements under the new regulatory regime.

For indicative purposes the first tentative analysis is provided in Appendix I, but it should be underlined that the intention of the Services is solely to initiate discussion and to consult on substantive points. While it seems practical to make direct references to the current article, which is attached as Appendix II, the tentative ideas and wordings below are not to be understood as a proposal of draft legal text. The Services will provide such a draft after consultation and receiving advice from CEIOPS.

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4 See PS04/16 at: www.fsa.gov.uk

5 See the papers for consultation at: www.dnb.nl

6 E.g. discussion papers and Preliminary Exposure Drafts for Potential IAA Standards regarding IFRS (http://www.actuaries.org/public/en/index.cfm) and A Global Framework For Insurer Solvency Assessment by the IAA Insurer Solvency Assessment Working Party 2004 (http://www.actuaries.org/public/en/documents/papers.cfm).

7 See http://www.gcactuaries.org/

8 See the actuarial standards available at the APRA website: www.apra.gov.au.

9 E.g. the practice specific and stand-alone standards and papers regarding valuation, see http://www.actuaries.ca/

10 Guidance notes and standards on prudential reserving and determination of policy liabilities, see http://www.actuaries.org.nz/

1.4. Specific Call for Advice

The Commission Services would like CEIOPS to advise on the issues identified below and in Appendix I. The provisioning standards to be included in the implementing measures could be supplemented by actuarial guidance and thus close co-operation with actuarial profession is necessary. The following aspects should be taken into account in the analysis.

Expected present value or "best estimate"[11] provisions should be unambiguously defined in a way that is IASB compatible and takes international developments into account (in particular the work underway in the IAIS and the Groupe Consultatif/IAA).

To take into account the uncertainty of valuation, and to protect policyholders (e.g. when the solvency margin has disappeared, the portfolio must be transferred or put into run-off), risk margins must be set in addition to expected values. Relevant factors (insurance risks, lapses, expenses etc) and methods for establishing risk margins as well as the appropriate level of aggregation should be addressed. The methods should be, to the greatest extent possible, compatible with IASB developments and the solvency capital requirement (SCR) calculation methodology in order to minimise additional workload and costs for insurance companies. However, non-IFRS companies and SMEs require specific consideration, and actuarial rules should allow, where feasible, different approaches and approximations ranging from traditional deterministic methods to sophisticated stochastic modelling. After an appropriate technical structure for risk margins has been found, an analysis of the goals of provisioning from the points of view of solvency, supervision, accounting and feasibility, is needed. Finally, a proposal regarding the possible benchmark level of prudence of the technical provisions with field-testing results should be communicated to the Services (see also request n° 13).

CEIOPS is requested to provide advice on how to precisely define the risk-free market interest rate for discounting the estimated future cash-flows applicable both inside and outside of the Euro zone. In addition, methods to establish (under this new kind of approach) technical provisions for the investment related parts of life assurance contracts, i.e. interest rate guarantees, bonuses, embedded options, should be developed. Ultimately valuation methods of profit-sharing policies should be explicit and promote fairness and transparency to clients and other stakeholders. However, proper recognition should be given to national differences in insurance products. CEIOPS should also address the new prudential aspects that arise when the guaranteed interest rate differs from the discount rate. Moreover, valuation techniques of mathematical finance should be investigated and their use encouraged particularly when assessing risks and prices of certain options embedded in life assurance contracts (both Pillar I and II measures should be considered). Insurance contracts, including unit-linked contracts, as well as investment contracts should be studied.

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[11] For a discussion on terminology, see the IAA Exposure Draft on current estimates mentioned in footnote 6.

Further analysis and development of open issues, e.g. the use of retrospective methods (if any), the definition of book of contracts (unit of calculation), the surrender value floor, and the provisioning for expenses, should be carried out in the light of international accounting and actuarial developments.

Finally, it is imperative for supervision to ensure that any changes in provisioning methods (both in national and company levels) do not lead to unfair sharing of profits or distortion of the distribution of bonuses. This applies to existing portfolios as well as between different generations of policyholders. CEIOPS's advice should include analysis if certain transitory measures (e.g. regarding provisioning rules for certain "old" contracts) are considered necessary.

1.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

1.6. Appendix I: tentative analysis of Article 20 of the Recast Life Directive 2002/83/EC

Headings below refer directly to the current Article 20 (see Appendix II) for convenience. However, at this stage tentative ideas are presented only in the form of brief comments as deeper technical analysis is necessary before final detailed conclusions can be made.

Point 1 A:

(i) could be *compressed* as follows: "the amount of the technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing contract. More detailed guidelines are given in implementing measures";

(ii) rules on *retrospective methods*, if any, could be given in the implementing measures;

(iii) this provision could be *extended* as follows: "a sufficiently prudent valuation is not a "best estimate" valuation, that is expected present value[12], but shall include an appropriate explicit risk margin for adverse deviation of the relevant factors as defined in implementing measures";

(iv) this provision would be included under point 1 B a);

(v) rules regarding *the unit of calculation* (e.g. individual/books of contracts) could be given in implementing measures. Accounting developments may necessitate changes to the current rules[13];

(vi) the rules regarding *the surrender value floor* have to be analysed in the light of accounting and solvency regime developments taking also into account traditional prudential practices and asset-liability mismatch issues. These rules could be given in implementing measures.

Point 1 B:

a) Here we would give *a valuation principle*, the most general approach being such as: "The rate of interest shall be chosen according to the nature of insurance contracts and the valuation method used for liabilities and assets", and refer to level 2 for details. Sub-points (i) and (ii) would be changed towards a system where interest rate guarantees are valued explicitly and a market interest rate yield curve is used for discounting. The possibility of adverse developments would be taken into account in risk margins and capital requirements. All these rules should be established in the future at the EU instead of the national level.

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[12] In the future, it would be useful to have precise technical definitions in implementing measures.

[13] E.g. certain risk margins may need to be established first at book of contracts level before making calculations at individual level.

Points c) and d) could be addressed in the implementing measures while b) and e) do not seem relevant in the future system.

Points 1 C and E:

General rules regarding *expenses* should be included in the general definition such as 1 A iii), and details could be given in implementing measures.

Point 1 D:

Provisions for guarantees and bonuses should be explicit and transparent: “in the case of participating contracts, the method of calculation for technical provisions shall explicitly take into account guarantees and future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the ~~current~~ published method of distribution of bonuses.” Details could be given in implementing measures when the analysis and development work is clearer;

Point 1 F:

This could be included in implementing measures.

Point 2:

No changes seem necessary.

Points 3-4:

These items should be addressed when the details of the new solvency requirements are better known.

1.7. Appendix II: for reference only, Article 20 of the Recast Life Directive 2002/83/EC

Article 20: Establishment of technical provisions

1. The home Member State shall require every assurance undertaking to establish sufficient technical provisions, including mathematical provisions, in respect of its entire business.

The amount of such technical provisions shall be determined according to the following principles.

A. (i) the amount of the technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing contract, including:

- all guaranteed benefits, including guaranteed surrender values,

- bonuses to which policy holders are already either collectively or individually entitled, however those bonuses are described - vested, declared or allotted,

- all options available to the policy holder under the terms of the contract,

- expenses, including commissions,

taking credit for future premiums due;

(ii) the use of a retrospective method is allowed, if it can be shown that the resulting technical provisions are not lower than would be required under a sufficiently prudent prospective calculation or if a prospective method cannot be used for the type of contract involved;

(iii) a prudent valuation is not a "best estimate" valuation, but shall include an appropriate margin for adverse deviation of the relevant factors;

(iv) the method of valuation for the technical provisions must not only be prudent in itself, but must also be so having regard to the method of valuation for the assets covering those provisions;

(v) technical provisions shall be calculated separately for each contract. The use of appropriate approximations or generalisations is allowed, however, where they are likely to give approximately the same result as individual calculations. The principle of separate calculation shall in no way prevent the establishment of additional provisions for general risks which are not individualised;

(vi) where the surrender value of a contract is guaranteed, the amount of the mathematical provisions for the contract at any time shall be at least as great as the value guaranteed at that time;

B. the rate of interest used shall be chosen prudently. It shall be determined in accordance with the rules of the competent authority in the home Member State, applying the following principles:

(a) for all contracts, the competent authority of the assurance undertaking's home Member State shall fix one or more maximum rates of interest, in particular in accordance with the following rules:

(i) when contracts contain an interest rate guarantee, the competent authority in the home Member State shall set a single maximum rate of interest. It may differ according to the currency in which the contract is denominated, provided that it is not more than 60 % of the rate on bond issues by the State in whose currency the contract is denominated.

If a Member State decides, pursuant to the second sentence of the first subparagraph, to set a maximum rate of interest for contracts denominated in another Member State's currency, it shall first consult the competent authority of the Member State in whose currency the contract is denominated;

(ii) however, when the assets of the assurance undertaking are not valued at their purchase price, a Member State may stipulate that one or more maximum rates may be calculated taking into account the yield on the corresponding assets currently held, minus a prudential margin and, in particular for contracts with periodic premiums, furthermore taking into account the anticipated yield on future assets. The prudential margin and the maximum rate or rates of interest applied to the anticipated yield on future assets shall be fixed by the competent authority of the home Member State;

(b) the establishment of a maximum rate of interest shall not imply that the assurance undertaking is bound to use a rate as high as that;

(c) the home Member State may decide not to apply paragraph (a) to the following categories of contracts:

- unit-linked contracts,

- single-premium contracts for a period of up to eight years,

- without-profits contracts, and annuity contracts with no surrender value.

In the cases referred to in the second and third indents of the first subparagraph, in choosing a prudent rate of interest, account may be taken of the currency in which the contract is denominated and corresponding assets currently held and where the undertaking's assets are valued at their current value, the anticipated yield on future assets.

Under no circumstances may the rate of interest used be higher than the yield on assets as calculated in accordance with the accounting rules in the home Member State, less an appropriate deduction;

(d) the Member State shall require an assurance undertaking to set aside in its accounts a provision to meet interest-rate commitments vis-à-vis policy holders if the present or foreseeable yield on the undertaking's assets is insufficient to cover those commitments;

(e) the Commission and the competent authorities of the Member States which so request shall be notified of the maximum rates of interest set under (a);

C. the statistical elements of the valuation and the allowance for expenses used shall be chosen prudently, having regard to the State of the commitment, the type of policy and the administrative costs and commissions expected to be incurred;

D. in the case of participating contracts, the method of calculation for technical provisions may take into account, either implicitly or explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonuses;

E. allowance for future expenses may be made implicitly, for instance by the use of future premiums net of management charges. However, the overall allowance, implicit or explicit, shall be not less than a prudent estimate of the relevant future expenses;

F. the method of calculation of technical provisions shall not be subject to discontinuities from year to year arising from arbitrary changes to the method or the bases of calculation and shall be such as to recognise the distribution of profits in an appropriate way over the duration of each policy.

2. Assurance undertakings shall make available to the public the bases and methods used in the calculation of the technical provisions, including provisions for bonuses.

3. The home Member State shall require every assurance undertaking to cover the technical provisions in respect of its entire business by matching assets, in accordance with Article 26. In respect of business written in the Community, these assets must be localised within the Community. Member States shall not require assurance undertakings to localise their assets in a particular Member State. The home Member State may, however, permit relaxations in the rules on the localisation of assets.

4. If the home Member State allows any technical provisions to be covered by claims against reassurers, it shall fix the percentage so allowed. In such case, it may not require the localisation of the assets representing such claims.

2. TECHNICAL PROVISIONS IN NON LIFE INSURANCE

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those on internal control and risk management (namely, the claims' management process) and capital requirements. In particular, in an economic capital approach, the evaluation of the capital requirements is largely dependent on the rules that will be fixed for technical provisions.

2.1. Introduction

Provisioning is one of the major risks faced by insurance companies identified by the KPMG report (see references below under European Commission). The Commission Working group on non-life technical provisions pointed to disparities in the provisioning practices not only between EU Member States but also inside each national market. In order to reach greater harmonization, it is necessary to develop more detailed EU rules on the calculation of the non-life insurance technical provisions, in particular by establishing a common explicit benchmark. This task is rendered even more challenging by the developing accounting framework (in insurance, IASB phase II insurance accounting standards still have to be adopted).

2.2. References

- International Association of Insurance Supervisors (IAIS)[14]:
  - Insurance Core Principle 20
  - Quantifying and Assessing Insurance Liabilities Discussion Paper
  - Stress testing Guidance Paper
  - Current working papers of the Accounting Subcommittee
- European Commission[15]:
  - Report of the Working Group on non-life technical provisions to the IC Solvency subcommittee (MARKT/2529/02, September 2002)
  - Discussion papers MARKT/2539/03, MARKT/2543/03, MARKT/2502/04, MARKT/2506/04 (Annexes)

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14 http://www.iaisweb.org/

15 http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-workpapers_en.htm

– Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision, KPMG, May 2002[16]

- IASB documents:

  – DSOP, IAS 37, 39 and other relevant standards and drafts

- Member States' solvency projects[17], for example, the UK PS04/16: Integrated Prudential sourcebook for insurers [18] or the Netherlands' new Financial Assessment Framework[19], as well as international projects such as the Australian Prudential standard GPS 210[20] and the Swiss solvency test project[21], should be consulted.

- Relevant standards and publications by actuarial organisations worldwide, i.e. the International Association of Actuaries (IAA)[22] and the Groupe Consultatif[23] as well as their member societies such as the USA Casualty Actuarial Society[24], the Australian Institute of Actuaries[25], the Canadian Institute of Actuaries [26] and New Zealand's Society of Actuaries[27].

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16 http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-study_en.htm

17 Weblinks to the Member States insurance authorities' websites can be found at http://europa.eu.int/comm/internal_market/insurance/links_fr.htm

18 http://www.fsa.gov.uk/pubs/policy/04_16/

19 See the papers for consultation at: www.dnb.nl

20 http://www.apra.gov.au/Policy/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=3831

21 http://www.bpv.admin.ch/en/pdf/SST_181204_en.pdf

22 http://www.actuaries.org/ and see especially Preliminary Exposure Drafts for Potential IAA Standards regarding IFRS (http://www.actuaries.org/public/en/index.cfm).

23 See http://www.gcactuaries.org/

24 Fair value of P&C liabilities: practical implications, 2004, see http://www.casact.org/pubs/fairvalue/

25 Professional Standard 300 on "Actuarial reports and advice on general insurance technical liabilities", see http://www.actuaries.asn.au/MembersContent/pdf/ps300_0204.pdf, and the related Guidance Note 353 on "Evaluation of general insurance technical liabilities", see http://www.actuaries.asn.au/PublicSite/pdf/GN353-200212.pdf

26 Standards 2100 and 2200 for insurers, December 2002, see http://www.actuaries.ca/publications/2002/202069e.pdf

27 Professional Standard n°4 on General Business, 1999, see http://www.actuaries.org.nz/publications.htm

2.3. Background: rules set in the current directives

The third non-life Directive 92/49/EEC (Article 17) amending Article 15 of Directive 73/239/EEC sets that "The home member state shall require every assurance undertaking to establish adequate technical provisions in respect of its entire business. The amount of such technical provisions shall be determined in accordance with the rules laid down in Directive 91/674/EEC."

The accounting Directive 91/674/EEC defines the provision for claims outstanding as “the total estimated ultimate cost to an insurance undertaking of settling all claims arising from events which have occurred up to the end of the financial year, whether reported or not, less amounts already paid in respect of such claims” (Article 28).

2.4. Specific Call for Advice

The Commission Services would like CEIOPS to advise on rules to value non-life technical provisions, with the aim of establishing technical provisions that are sufficient to cover the liabilities with a quantified level of confidence. Given the diversity of non-life business lines and the many factors impacting on ultimate claims settlement, the Commission is aware of the methodological difficulties involved with this approach. To take into account the uncertainty of the valuation and to protect policyholders (e.g. when the solvency margin has disappeared and the portfolio must be transferred or put into run-off), risk margins must be set in addition to the expected present value or “best estimate” provisions. The following aspects should be taken into account in the analysis.

– required quantitative prudence level: how should it be fixed, to what amounts exactly should it be applied;

– actual quantitative prudence level: how should it be evaluated, at what level of aggregation, etc.

– obligation to use several appropriate actuarial methods amongst the generally accepted methods – some or all of these methods may have to be defined;

– if considered appropriate, criteria to decide on final amount of technical provisions when methods give differing results (for example, the criteria could be to choose the amount that is given by several methods). These criteria must not be so strict that it prevents the exercise of actuarial judgement and discretion.

– introduction of a detailed annual report on the valuation of technical liabilities making explicit the actuarial and economic assumptions made, their evolution over time and the reasons for the benefits or losses of liquidation. This report should also disclose the risk margins above the expected value included in the technical provisions and the justification of the discount rate used.

– appropriateness of introducing guidelines on reserving (levels of aggregation, allowance for risk interdependency, etc.).

– harmonization of the data collected (implying a prior definition of the terms used), including run-off triangles of undiscounted technical provisions used to assess provisioning adequacy and claims paid triangles.

– adaptation of the estimates of the technical provisions (whenever there is significant information and at least at periodic intervals) and mechanisms to ensure estimates of technical provisions are responsive to major external events (e.g. rapid inflation or catastrophic events).

– Treatment of non-IFRS companies and SMEs, avoiding undue complexity.

– To promote solvency on a long term basis, should a compulsory equalization mechanism be maintained regardless of the taxation and accounting regimes (this could, for example, be incorporated in the Solvency Capital Requirement calculation)?

CEIOPS is invited to advise on how best to develop common EU actuarial standards to achieve greater consistency in provisioning practices.

As stated in the Framework for consultation, CEIOPS is asked to work with actuarial bodies, in particular the Groupe Consultatif. The advice must be compatible with the likely accounting developments, unless duly justified. The advice must take into account insurance-specific standards and recommendations adopted in other international fora (namely, IAIS and OECD).

2.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 9

3. SAFETY MEASURES

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, including those relating to Investment management (request n° 5) and Quantitative impact study (request n° 13).

3.1. Introduction

According to the analysis provided in the Services' earlier papers, there are several articles in the current Directives that have to be reviewed and possibly amended in the light of Solvency II developments that could be called "safety measures". These safety measures help establish a minimum, robust level of solvency that is easy to apply. As such, these measures ensure a smooth transition between the current and the new Solvency II regime. This Call for Advice concerns the Minimum Capital Requirement or MCR (Article 28 in Directive 2002/83/EC), authorised asset classes (Article 23) and diversification and matching rules for assets (Articles 24 and 26).

The requirement to cover technical provisions and solvency requirements with appropriate assets (Article 22) has already been addressed in a Specific Call for Advice (request n° 5) and the rules regarding the eligible items for the available solvency margin (Article 27) will be addressed later in a Specific Call for Advice.

3.2. References

See the relevant references and the Commission papers mentioned in the context of solvency capital requirement and technical provisions.

For the "prudent person" approach, the main reference is the recent EU Directive for occupational pension funds (Directive 2003/41/EC, Article 18).

3.3. Background

This Specific Call for Advice concerns Articles 23-24 and 26-31 in the Recast Life Directive 2002/83/EC and equivalent articles in the Non-life Directives. At this stage no draft wording is presented as the Services wish to first receive the advice from CEIOPS.

3.4. Specific Call for Advice

The Commission Services seek CEIOPS' advice on the safety measures that would be appropriate in the new solvency framework. The goal is a simple and consistent framework where the main focus is on effective risk management instead of great number of prescriptive limits. The analysis and proposals should include:

- Review of the MCR (Article 28). Its calculation should be as straight-forward as the current one and its calibration broadly the same as the current required solvency margin (Solvency I). Changes will include field-testing of alternatives (see request n° 13). Moreover, the MCR will have an absolute floor expressed in euros that is equal to the current minimum of guarantee fund (Article 29). IASB developments, including the definitions of technical provisions and insurance contracts, as well as other international developments, have to be taken into account. (See also requests n° 10, 12, 15 and 18).

- Authorised categories of assets covering technical provisions (Article 23) have to be revised in line with the new solvency methodology while also taking into account financial market developments. CEIOPS should analyse whether additional classes should be authorised (e.g. certain derivatives and alternative investments) when their risks are taken into account in the SCR calculation. Furthermore, as the list should be easy to apply and to update, the use of implementing measures should be considered where appropriate. Asset classification for different purposes (covering of technical provisions/MCR/SCR, asset risk calculation for the SCR) should aim at simple, coherent and universal rules without overlap.

- Some quantitative limits for asset diversification for supervisory purposes with a view of maximum harmonisation (Article 24). However, the prudent man approach and the asset-liability requirement will lead to more stringent limits than those safety measures, in most cases. In addition, the proposals should take into account the following aspects:

  – investment risk (including currency risk, Article 26) should be mainly addressed in the SCR calculation;

  – some classes of authorised assets should be subject to restrictions (e.g. real estate, unsecured loans, unquoted securities).

Moreover the available solvency margin (Article 27) should be modified to take into account the new prudential levels of the solvency system and international compatibility (IASB rules and IAIS, IAA and Basle II developments), and where appropriate, financial market developments (e.g. new innovative forms of capital or capital substitute). This area of work will be addressed later in more detail in a Specific Call for Advice.

3.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 10

4. SOLVENCY CAPITAL REQUIREMENT: STANDARD FORMULA (LIFE AND NON-LIFE)

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those relating to technical provisions, Pillar II quantitative measures, minimum capital requirement, safety measures (on assets), ALM, internal models and their validation, group and cross-sectoral issues, and quantitative impact studies.

4.1. Introduction

Solvency capital requirement (SCR)[28] is an innovation in European solvency regulation. It should be set above the Minimum Capital Requirement (MCR) and at a level that gives high-level protection to policyholders across the EU. This can be done by developing a mathematical model of major risks that an insurance company is exposed to, and calibrating the model appropriately. The main parameters to be chosen in the calibration are the risk measure (the probability of ruin) and the time horizon, which must be harmonised at EU level. Other specific parameters that relate to different risk situations and products may reflect national market specificities, if justified in order to better respect the general European prudential requirement.

4.2. References

- IAIS documents:

  – Insurance Core Principles 15d, 23

  – Guidance Paper Solvency control levels

  – Guidance Paper Use of actuaries

  – IAIS Solvency Subcommittee's work

- Ongoing work in the IAA/Groupe Consultatif (especially the reports of the IAA Insurer Solvency Assessment Working Party and the IAA Solvency Working Party[29]), Comité Européen des Assurances, EU Member States[30] and other jurisdictions[31]

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[28] Solvency capital requirement is the new term replacing “target capital” in earlier MARKT documents.

[29] Both reports are available at: http://www.actuaries.org/public/en/documents/papers.cfm

[30] See the references mentioned in the Calls for Advice regarding technical provisions

[31] E.g. the Swiss and the Singaporean solvency projects, and Australian actuarial standards and practice specific standards.

- Economic capital models of insurance companies as well as those used by rating agencies or associations could provide further inspiration.

4.3. Background: preliminary proposal for principles for draft Directive

An article for the definition of the SCR (N9 for "target capital" in document MARKT/2539/03) has to be developed. The following example outlines some possibilities for illustration and discussion purposes. It is tentative by nature and particularly the issues in square brackets require further analysis and consideration.

> "To be able to absorb significant unforeseen losses and to give [reasonable] assurance to policyholders, an insurance undertaking shall hold at all times solvency capital which is adequate having regard to its overall risk profile. Solvency capital requirement shall cover the relevant [underwriting, credit, market, liquidity, operational and other] risks. It shall be calibrated so that the probability of failure of an undertaking within [one] year is sufficiently low ["1/200" or "as defined in implementing measures"].

4.4. Specific Call for Advice

The Commission Services would invite CEIOPS to give technical advice on the issues mentioned above and on appropriate EU standards for calculating the SCR. The advice should involve the following areas:

- formulation of a detailed risk classification building on the work of the IAA;

- operational risks should be analysed and included in the SCR calculation to the extent feasible. Close attention should be given to the international developments in this field (Basle II, IAA, IAIS);

- the most relevant modelling approaches for different risks in the standard formula should be analysed (probability distributions, scenarios, factors etc). The proposed modelling approach should take into account the possibility of partial internal models;

- when aggregating different risks, their dependencies should be carefully analysed to decide how, and to what extent, correlation effects should be taken into account. A starting point of analysis could be prudently chosen correlation coefficients in the standard formula at an entity level (because the nature of certain dependencies is non-linear and non-stationary and consequently difficult to model and estimate reliably);

- estimation of other parameters should also be analysed in detail:

  – which benchmarks and indexes could be used to define the parameters

  – which estimation periods should be chosen

– how to address time-varying aspects (volatility clustering and “jumps”, trend/regime changes etc) and to which extent these could be taken into account in Pillar II (through stress-testing scenarios for example)

– should expert judgement be used when setting the parameters or should they be solely based on statistical inference

– in which areas and to what extent would parameters need to be calibrated to national markets in order to respect the targeted European level of prudence[32]

– how often should the parameters be updated and how

- risk measure and calibration:

– probability of ruin (in other words a percentile or Value at Risk), with suitable skewness adjustments where necessary, may be preferred in the standard formula[33].

– the principle could be to use a 1 year observation period although longer alternatives should also be studied (cf. also solvency control levels)

– different ruin probabilities should be tested, relevant alternatives presented and the preferred option mentioned

– going-concern aspects of business should be analysed and incorporated into the model where feasible (e.g. profit and loss forecasts and risk-sharing features of products), or taken into account through Pillar II measures

– whenever possible, appropriate simulations and field-testing should be performed to support the EU decision making process. As background information for the calibration, time series on actual available capital and prudence levels in relation to the EU minimum requirement should be set up in the Member States (e.g. before and during economic downturns)

The main concern regarding the implementation of Solvency II regime for SMEs is the potential complexity. This aspect has to be taken into account both when developing quantitative measures and when formulating supervisory requirements for insurance companies. While rather simple and crude approximations may be needed in the beginning for certain players in the EU insurance market, a new solvency regime should foster the development of quantitative risk management methods towards higher sophistication. Moreover, potential problems relating to procyclicality should be prevented to the extent possible in order to avoid “herd-behaviour” and pressure to change the SCR calculation parameters (when not based on objectively justified reasons). Consequently, the measures for improving

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[32] A balance must be found between “harmonising the formula” and “harmonising the probability of failure” of individual companies as both aspects are relevant in Solvency II.

[33] Note that in case of internal models the use of conditional tail-expectation (TailVaR) should also be considered, see a separate Call for Advice.

the solvency position of an undertaking should make effective use of time and tools available (i.e. corrective actions should start early enough and allow wide range of risk management and management tools be used). These issues will be addressed in more detail in separate Calls for Advice.

Lastly, there may be situations where the prescribed European confidence level ("ruin probability") might imply a higher capital requirement than the amount resulting from the standard formula; this issue could be addressed with a partial or full internal model, or a pillar II capital add-on (see separate Calls for Advice).

4.5. Life and non-life insurance specific issues

As the goal is to apply a uniform general approach and principles to the SCR and because the Calls for Advice are at a general level, the Services do not intend to prepare separate Calls for Advice for life and non-life insurance. However, in its response to this Call for Advice, CEIOPS will probably wish to make the distinction between life and non-life. It is unlikely that the standard formula used to calculate the SCR will be the same in life and non-life because of differences in risk profiles (product features, horizons, claim distributions - skewness, extreme events - actuarial methods). While reinsurance companies will be addressed later in a specific Call for Advice, it would be beneficial for future work if this aspect could be already taken into account.

4.6. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

5. SOLVENCY CAPITAL REQUIREMENT: INTERNAL MODELS (LIFE AND NON-LIFE) AND THEIR VALIDATION

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those relating to solvency capital requirement, technical provisions, ALM, supervisory review, internal controls and risk management, and group and cross-sectoral issues.

5.1. Introduction

The solvency capital requirement (SCR) can be calculated in two alternative ways, by the standard formula or by using an internal model. Internal models are an innovation in the European solvency regulation and there are many issues that need to be addressed before this option can be applied in practice. It is crucial that sound European standards for internal models and their validation and approval processes[34] are first put in place. However, in order to encourage companies to continuously focus on risk management (both at entity and group levels) it is desirable that internal models be developed and used in the EU. One way to facilitate the move towards internal models would be through partial models. Although it is possible that an internal model approach would give a lower SCR than the standard formula, the overall protection of policyholders (in terms of confidence level and time horizon) must always fulfil the agreed harmonised criteria given in the EU regulations, irrespective of the calculation method.

5.2. References

- The Commission Solvency II working documents, in particular MARKT/2515/02
- IAA report: A Global Framework for Insurer Solvency Assessment (chapter 7), and the references given therein[35]

Economic capital models of insurance companies as well as those used by rating agencies could provide useful further experience (see for example the study for the Commission prepared by KMPG[36]). Moreover, in the banking field there is extensive literature and experience on VaR model implementation.

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34 this wording denotes all the necessary steps and formalities that an insurance undertaking has to comply with in order to use its internal model for the SCR calculation

35 i.e. relevant Australian, Canadian, Basle I and II (i.e. CAD 3) standards

36 Online at: http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-study_en.htm

5.3. Background: preliminary proposal for the draft Directive

An article on internal models and their approval (N10-N11 in document MARKT/2539/03) could be developed along the following lines:

> "The solvency capital requirement may be calculated by an undertaking's own internal model after validation and approval by the competent authorities. The risk measure, the time horizon and the scope of risks covered must not be less prudent than in the standard approach. Detailed compliance criteria for undertakings wishing to use internal models will be established in implementing measures."

5.4. Specific Call for Advice

The scope of this Call for Advice is broad. The issues can be classified in three different areas (with different expertise requirements) as follows:

1. From a management point of view: integration of the internal model and internal processes, including management, business planning, investment, actuarial, underwriting, risk management, etc., processes, as well as the inter-linkage and communication between these processes

2. From an information technology point of view: the use of sound methods (e.g. project management), technical platform (e.g. software, interfaces), databases, documentation, testing etc

3. From an actuarial point of view: mathematical modelling of risks and parameter estimation, including

   - appropriate, documented and tested mathematical, statistical, financial, economics and simulation models and methods

   - statistically tested parameters and analysis of data (including robustness and sensitivity analysis)

   - in a going-concern approach assumptions (balance sheet and profit and loss items including risk-sharing features for the next year) should be in-line with the forecasts used internally in the company (budget etc)

To guarantee a high level of harmonisation and policyholder protection, an internal model, be it full or partial, must be consistent with the standard formula framework[37]. This requirement is especially important for partial models and should be addressed carefully in order to avoid "cherry-picking" and regulatory arbitrage. All the above issues require adequate resources and control functions at the appropriate level in the company. Internal models, if they are accepted for

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[37] Internal models must be documented clearly and based on the same explicit general principles as the standard formula. However, certain differences may well be justified if they give more accurate results. For full internal models more complex modelling techniques, e.g. the TailVaR risk measure and copula-based dependence modelling, could be preferable. On the other hand partial models should be closely linked to the standard formula as they are replacing only certain parts of it.

regulatory capital calculation purposes, cannot be "black boxes". It is not sufficient to merely set criteria for model input, processing and output requirements. A formalised, disciplined and comprehensive risk and capital adequacy assessment procedure must be put in place which covers both strategy-making and day-to-day operations of the company. Taking into account the nature of insurance business, it is clear that the risk and capital adequacy assessment/planning processes cannot be separated from the business planning and management processes. The management body of the company is responsible for the whole capital adequacy process (initiation, design - including comprehensive coverage of risks and their appropriate modelling, testing, documentation, monitoring, controlling, reviewing/updating, reporting, using results in decision-making). The fact that the supervisor has approved the model to be used for the SCR calculation does not diminish this management responsibility in any way.

The Commission Services would like CEIOPS to give technical advice on appropriate EU standards for calculating the SCR by an internal model and on the compliance criteria for model validation and approval by the supervisor.

The advice should involve the afore-mentioned aspects as well as more detailed areas pointed out by the IAA (prudential requirements, comparability and consistency requirements as well as specific modelling requirements concerning key risk factors, dependence modelling, testing etc).

Approval procedures should be harmonised to the extent possible in the EU while also taking into account national specific features and resource issues (including the use of external model audits). In particular prudential aspects regarding the transition from the standard formula to the internal model approach and the risk of modelling errors should be addressed: for example whether internal models should first be used in parallel with the standard formula for a certain period before they are approved by the supervisor to replace the standard formula, and whether certain "floors" based on the standard formula should be considered for a transitional period or permanently. Moreover, CEIOPS should consider how partial models could be used to encourage incremental development of internal models (cf. request n° 10).

Internal models, be they a re-parameterized standard formula or a partial or a full internal model, should be used where the standard formula does not give accurate enough results from a prudential point of view (see requests on risk management and on the supervisory review process)[38].

Group level models should be dealt with in relation to the Directives on insurance groups and financial conglomerates (a separate Call for Advice is given on group and cross-sectoral issues).

[38] The documentation of the standard formula should indicate its applicability limits, namely concerning the underlying risk profile assumed.

5.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. The first piece of technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

6. REINSURANCE (AND OTHER RISK MITIGATION TECHNIQUES)

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those relating to capital requirements, internal models, technical provisions, supervisory review, internal controls and risk management.

6.1. Introduction

Reinsurance is the key risk management tool in insurance, notably in non-life insurance, but also in life assurance, and is used in particular to mitigate certain volatile or extreme insurance risks. Other general risk mitigation methods include for example alternative risk transfer (ART). On the financial side, the hedging of investment risks through derivatives is becoming an increasingly important risk mitigation tool, notably in life assurance. The new solvency regime will be more tailored to the true risk-profile of an insurance company which implies that the effects of risk mitigation should be more accurately reflected. This aspect has to be taken into account in the development of the solvency capital requirement SCR (both in the standard formula and in the internal model approach). Subsequently also the current fixed ratio-based rules regarding the minimum solvency margin (future minimum capital requirement, MCR) reduction factor for reinsurance may have to be reviewed.

6.2. References

- IAA report: A Global Framework for Insurer Solvency Assessment (e.g. chapters 5.4 and 8)
- IAIS: Relevant standards and the Reinsurance Subcommittee's working documents
- the Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision for the Commission prepared by KMPG[39] (chapters 6-7)
- European Commission ART Market Study Final Report, 2 October 2000
- relevant Basle I and II standards
- documents of Member States' supervisory authorities (e.g. a French reinsurance report and schedules[40])

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39 Online at: http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-study_en.htm

40 Available at http://www.ccamip.fr

Economic capital models of insurance companies could provide useful further experience.

6.3. Background

Reinsurance and risk mitigation is such a complex, technical and entity-specific topic that it might best be treated for the most part through implementing measures and supervisory guidance. Where addressed in the Framework Directive, the wordings will have to be relatively general. Consequently the Services do not consider appropriate to provide tentative legislative draft at this stage.

6.4. Specific Call for Advice

The scope of this Call for Advice is technically challenging. A starting point has to be a general assessment of company's reinsurance program (and other risk mitigation programs, where relevant) which constitute a major part of the risk management and internal control processes. Consequently, the supervisory review process is of fundamental importance when evaluating the credit that can be given for reinsurance with regard to solvency requirements (this point was also underlined in the IAA's report[41]).

At least the following areas should be addressed:

- the SCR standard formula should take into account insurance risk reduction effects brought about by reinsurance[42] to the extent they can be reliably quantified and addressed in a standardised way

- also the possibility to take into account financial hedging should be analysed[43]. Furthermore in order to avoid arbitrage opportunities, the capital requirements between different industries that provide products involving financial guarantees should not differ significantly.

- The internal model approach to SCR should allow for sound reinsurance, hedging and other risk mitigation techniques to the extent they can be reliably quantified for prudential supervision purposes

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[41] A quote from the IAA's report, p. 71: "The recognition of reinsurance for solvency purposes must be closely linked to the ability of the company, supervisor or both to assess the impact of the reinsurance program of the risk profile. Given the diversity and complexity of reinsurance contracts, it is apparent that a simple factor-based approach is likely to be too crude to reflect the effect of reinsurance accurately. Therefore standardized (e.g. factor-based) approaches should be used with caution since the proper treatment of reinsurance really requires a modelling approach. Similarly, if the gross risk profile is not, or is very vaguely described, the proper recognition of reinsurance in terms of risk reduction is not possible"

[42] Respective merits and demerits of both gross and net of reinsurance approaches should be considered.

[43] Applicability may also depend on the model structure, i.e. if a factor- or scenario-based system is chosen.

- current rules regarding the reinsurance reduction factor and the MCR should be reviewed in the light of SCR developments. Furthermore, the possibility to take into account financial hedging should be analysed in order to avoid regulatory arbitrage possibilities and to have consistency between the SRC and MCR[44].

The Commission Services request CEIOPS to take into account reinsurance and other relevant risk mitigation techniques in its response to other Specific Calls for Advice of the Commission. This advice should involve the afore-mentioned general areas as well as more detailed topics identified by the IAA, i.e. credit rating of reinsurer, type of reinsurance, tail behaviour, non-linearity and correlation effects etc.

6.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

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[44] In most cases the current “4 % rule” of life assurance (future MCR) is probably lower than what would be needed to respect the low probability of failure requirement of the future SCR. But at least in theory, if the balance sheet has been hedged perfectly, the situation may be different.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 13

7. QUANTITATIVE IMPACT STUDY AND DATA RELATED ISSUES

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those relating to capital requirements, technical provisions, group and cross-sectoral issues, and Pillar 2.

7.1. Introduction

Quantitative impact studies (QIS) are a highly important and challenging part of the Solvency II project as a new higher solvency capital requirement (SCR) based on more harmonised technical provisions and new accounting rules (IASB/Solvency II) will be introduced. A QIS will supply the necessary input for the extended impact assessment that the Commission has to provide when proposing the Framework Directive.

Nevertheless, several steps seem necessary: thus a first indicative simulation should be available when the Directive is proposed, while secondly more detailed studies will need to be carried out in the light of the further developments of CEIOPS' technical advice in relation to implementing measures.

As issues relating to small and medium sized companies (SMEs) and procyclicality are closely related to the impact analysis of the new solvency system, these work areas have been mentioned in this Call for Advice although more specific treatment is foreseen when development work is advanced enough.

7.2. References

- the Commission's Communication COM 2002/276 on Impact Assessment[45]
- IAA report: A Global Framework for Insurer Solvency Assessment (e.g. chapters 4.8, 6, appendices)
- For benchmarking purposes industry-level analyses already carried out in Member States, Comité Européen des Assurances/national industry associations and IAA/Groupe Consultatif should be useful.
- Economic capital models of insurance companies, consultants and rating agencies should provide further benchmarks and experience[46].
- On SME and procyclicality issues, analyses and solutions of Basle II should provide useful background.

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[45] Available online at: http://europa.eu.int/comm/environment/eia/2002276communication.pdf

[46] One recent contribution is the Mercer Oliver Wyman report, Life at the End of the Tunnel, 2004.

7.3. Background

Irrespective of how detailed the article concerning the SCR will be, approximate estimates of the resulting capital levels should be available before the Framework Directive is formally proposed by the Commission. Consequently, preparations should start in good time as requested in this Call for Advice. However, at later stages the calculations can be refined while also taking into account the results of discussions with the co-legislators[47].

SME and procyclicality aspects should be integrated in the future solvency framework. When the development work and impact analysis have been progressed further, it may prove necessary to address certain SME issues separately in the Directive and/or implementing measures.

7.4. Specific Call for Advice

This Call for Advice will require careful planning and effective execution as it is very challenging from technical, resource and timing point of views. The following issues have to be addressed while opting for the most appropriate solutions:

- Data definition
- Data requirements and collection (having regard to present differences in asset and liability valuation) and standardised reporting
- Comparability and quality of data – acceptable approximations
- Sample sizes
- Scenarios to be tested
- Organisation of work, co-operation issues
- Planning for progressively more sophisticated and comprehensive approaches to field-testing[48]
- Specific implementation issues concerning SMEs
- Analysis of possible procyclical effects and measures to reduce them (e.g. how to build buffers over and above the required amount SCR, cf. the solvency control levels Call for Advice)

The objective is to assess the economic consequences of the Solvency II project in the EU, including the impact on the insurance industry (cost of capital, cost-benefit analysis, international competitiveness), the financial markets (market efficiency, systemic risk etc) and the policyholders (cost-benefit analysis -

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[47] A figure for the ruin probability / confidence level has to be defined explicitly at the EU level to fix the calibration definitively and to enable the calibration of internal models in particular.

[48] This Call for Advice refers generally to all forms of quantitative studies that will be needed.

especially regarding different confidence levels and time horizon assumptions, implications on product availability and prices).

The Commission Services request CEIOPS to contribute to the organisation, coordination and performance of the simulations so that the set time goals can be respected. These quantitative impact studies should include analysis and guidance on SMEs and procyclicality issues (these areas will be addressed by separate Specific Calls for Advice still to be issued).

7.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. The first piece of advice explaining the preparations made and the plans for the execution of the first round of quantitative impact studies should be transmitted by 31 October 2005. The preliminary results of this first round should be available as soon as possible thereafter to enable the Commission to propose the Framework Directive.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N° 14

8. POWERS OF THE SUPERVISORY AUTHORITIES

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those on the supervisory review process, on independence and accountability of the supervisory review process and on group issues.

8.1. Introduction

The Sharma report indicated that it would be beneficial to the prudential supervision process to include some principles concerning supervisory authorities' powers in the Directive. A preliminary consultation (document MARKT/2502/04) showed that most Member States (as well as industry) were in favour of a more detailed description of these supervisory powers through a specific article in the Framework Directive. Some commentators mentioned the need to adjust powers to the new Solvency II framework by mentioning explicitly risk management, internal models and the possibility for the supervisor to add on supplementary capital requirements. However, the legal implications of drawing up a list of detailed supervisory powers remains an open question: while some Member States feel that it would help supervisors in court proceedings, others fear that increasing the level of detail may reduce their powers - because powers not explicitly detailed in the Directive may be considered as excluded. A possible solution could be to have, in addition to the articles of the Directive which make reference to specific powers, a general enabling article and include in implementing measures more detailed elements such as the conditions under which such powers can be exercised. These powers should be exercised transparently, within appropriate limits and subject to due process.

8.2. References

- **Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS[49])** (ex- Conference of European Insurance Supervisory Authorities)

  Report on prudential supervision of insurance undertakings (December 2002), under the chairmanship of Paul Sharma[50]

  Conclusions of the "Fit and Proper" Working Group DT/A/148/02Rev3**,** October 2002

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49 http://www.ceiops.org

50 http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-conference_fr.htm

- **International Association of Insurance Supervisors (IAIS):**

  Many of the IAIS documents[51] deal directly or indirectly with supervisory authorities' powers.

- **European Commission:**

  Proposal for new capital requirements regime for credit institutions and investment firms re-casting Directive 2000/12/EC and Directive 93/6/EEC (Basel II or CAD III Directive), Article 136 (14 July 2004)[52]

8.3. Background: supervisory powers in the current Directives

Today, the insurance Directives confer powers on supervisory authorities. These powers can be classified into four categories: specific powers related to specific procedures in the lifespan of an insurance company, general powers, powers linked to the main objects of supervision and intervention powers (when policyholders' rights are threatened or when an undertaking fails to comply with its obligations).

Specific procedures:

- Licensing (fit and proper, structure of group, scheme of operations; share holders, Articles 4–9[53])
- Authorisation of transfer of portfolio (Article 14)
- Qualifying holdings (Article 15)

General supervisory process:

- Access to information (Article 13)
- Investigation (Articles 10 and 13)

Concerning the main objects of supervision:

- Sound administrative and accounting procedures and adequate internal control mechanisms (Article 10)
- Calculation and cover of technical provisions (Articles 10 and 20)
- Verification of assets (Articles 10, 22–25)

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51 http://www.iaisweb.org/

52 http://europa.eu.int/comm/internal_market/regcapital/docs/com-2004-486/act1_en.pdf

53 The articles all refer to the Recast Life Directive 2002/83/EC. Non life Directives contain similar rules.

Intervention powers (Articles 37–39 and 46):

- Limits to the free disposal of assets
- Financial recovery plan
- Plan for the restoration of a sound financial position
- Short-term finance scheme
- Higher required solvency margin or downward revaluation of the available solvency margin
- Withdrawal of authorisation
- Refusal of authorisation and prohibition to conclude new contracts in case of non compliance with right of establishment or freedom to provide services provisions

8.4. Specific Call for Advice

By putting more onus on the undertakings to know and manage their risks, the new risk-based solvency system will increase the complexity of supervision. In this context, CEIOPS is invited to advise on a new definition of supervisors' powers. The decision on the precise scope of the supervisors' powers is a political one. However, CEIOPS is asked to give technical advice that will provide input and help take such a decision. Keeping in mind that one of the objectives is to increase harmonization; this advice should at least take into account the following elements:

- Powers that may need to be made explicit:

  - General power to obtain all relevant information from the insurance company, in particular concerning risk management and internal models, including third parties to whom an insurance undertaking has outsourced key activities.
  - General power to investigate, including third parties to whom an insurance undertaking has outsourced key activities.
  - Powers to increase capital requirements and to require a company to use an internal model, under certain circumstances to be determined.

- If supervisors decide to outsource certain supervisory functions to outside parties, they must ensure that these outside parties receive adequate information. It must remain clear that ultimate responsibility rests with the supervisor.

- Circumstances in which these powers can be used (in this respect, there is a link with the Solvency control levels).

- The application of these elements at group level may require specific consideration.

Based on the advice provided by CEIOPS, the Commission will decide on the proposed division of requirements between the Framework Directive, subsequent implementing measures and aspects which are best addressed by supervisory guidance.

8.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 15

9. SOLVENCY CONTROL LEVELS

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with those on the supervisory review process and on the powers of supervisors.

9.1. Introduction

In Solvency II, solvency is viewed in the widest sense, including not only the available capital but also the coverage of liabilities by admissible assets and off-balance sheet items. In short, solvency concerns the whole financial position and is not merely restricted to the available capital. The supervisor safeguards the interests of the policyholder and must therefore be aware when there is a growing threat to the insurer's solvency. Effective and harmonised supervisory action is enhanced by the establishment of solvency control levels.

9.2. Definition

Although previous papers had referred to "target level intervention", the terminology used is the IAIS "solvency control levels". Solvency control levels are limits that, when breached, trigger supervisory action. The strength of the ensuing action is adjusted to the type of control level (early warning or ultimate levels). Together the solvency control levels form a coherent and explicit framework for minimum supervisory action ensuring that gradual action is applied to a gradually deteriorating financial situation. Solvency control levels concern not specific aspects of the solvency regime but solvency as a whole. They are publicly disclosed.

The IAIS Guidance paper points out that "The control level should be set high enough to allow intervention at a sufficiently early stage in an insurer's difficulties so that there would be a realistic prospect for the situation to be rectified" (paragraph 9). This implies that the time horizons involved in defining the control levels should be consistent with the time horizons of the financial recovery plans. The objective of these control levels is to reinforce risk-based supervision to "safeguard policyholders from excessive loss due to an insurer's inability to meet its obligations" (IAIS Guidance paper paragraph 7).

9.3. Reference

- International Association of Insurance Supervisors (IAIS)[54]:
  - Draft Standard on Capital Adequacy Requirements, February 2004 (not publicly available to date)
  - Solvency Control Levels Guidance Paper, October 2003
  - Insurance Core Principle 23, October 2003
  - Principles on capital adequacy and solvency, January 2002

9.4. Background: current situation

Currently, there are two explicit solvency control levels (though the Directives do not use this terminology):

- minimum required solvency margin
- guarantee fund

The consequences of reaching these control levels are stated in Article 37 of the Recast Life Directive 2002/83/EC (and in Article 20 of the first Non-life Directive 73/239/EEC) :

- for breaching the minimum required solvency margin: plan for the restoration of a sound financial position
- for breaching the guarantee fund: short-term finance scheme and, dependent upon the case, license withdrawal

In addition, there is an implicit control level which is the coverage of technical provisions by admissible assets. If this control level is breached, the competent authority may limit the free disposal of assets. In some Member States, the supervisor can also require a financial recovery plan.

9.5. Specific Call for Advice

A crucial element in fixing the number and level of the control levels will be the actions taken when they are breached. The consequences of breaching a control level will differ according to the gravity and speed of deterioration. Breaching the highest capital control level could entail actions which are widely left to the judgement of the supervisor (principles-based approach) while breaching the MCR or the coverage control level should bring about prompt and severe sanctions (rules-based approach). Note that the minimum guarantee fund will be replaced by an absolute minimum requirement (i.e. the MCR will be calculated according to a formula, with an absolute floor).

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[54] http://www.iaisweb.org/

The goal is to have a simple yet effective system in place. Tentatively, control levels could be set along the following lines.

The coverage of technical provisions (and the SCR in the future) by admissible assets will constitute a first control level. Changes in valuation and safety measures may necessitate additional solvency control levels.

On the available capital itself, there could be at least three solvency control levels. Two of them are already known, namely the minimum solvency requirement (MCR), and the solvency capital requirement (SCR) - which will necessarily be higher than the previous one since the MCR is a floor to the SCR. However, in situations where the SCR is very close to the MCR, the higher solvency control level will not be effective. CEIOPS is asked to advise on such a case. One solution may be to set a floor to the SCR in percentage of the MCR.

The Commission Services suggest considering additional control levels, playing different roles:

- an early warning indication of the deterioration of the insurer's financial situation: it should then logically be set at a higher level than the SCR. However, if the SCR has been calibrated at a sufficiently high level, this third level may not be necessary.

- a level calibrated on a longer time horizon than the one assumed in the SCR calculation: its level would then depend on a long-term plan and long-term evaluations of the technical provisions.

- a countercyclical tool: it would be set at a variable level, higher when companies make profits and lower in bad times. This would limit the procyclicality inherent to risk-based systems. A separate Call for Advice on procyclicality will be issued at a later stage.

The consequences attached to each of the suggested control levels need also to be discussed.

The control levels are minimum compulsory harmonized tools. They do not exclude additional action by the supervisor if the situation of the undertaking justifies it (for example, the speed of the deterioration).

For insurance groups, a specific additional control level may be required to determine the overall position.

CEIOPS is asked to advise on the solvency control levels taking into account at least the previous elements. This advice should cover the number and definition of the control levels as well as the consequences (actions and/or sanctions) to be attached to each level.

To the extent possible, CEIOPS should support its advice with a field test on companies that have failed, looking at both qualitative elements (reasons of failure) and quantitative (evolution of the ratio of available solvency margin to the required solvency margin, for example). This field test may help to define risk areas and consequently, would assist in setting adequate control levels.

9.6. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 16

10. FIT AND PROPER CRITERIA

Fit and proper requirements are one of the key aspects of corporate governance and of particular importance in financial services. In insurance, customer confidence in the undertaking is essential as the premium is paid sometimes long before the claim is received. This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, namely on the supervisory review process and on group issues.

10.1. Introduction

By fit and proper, it is understood that the person must hold the necessary qualifications and/or experience (fit) and be of good repute (proper). The current Directives already contain the general principle that management and shareholders must be fit and proper (see detailed references to the current Directives below). The application of these requirements varies in the EU[55]. It seems necessary to define the scope of these criteria more precisely, and perhaps extend them, in order to increase the level of harmonization. This convergence can be reached by different means: either by introducing more detail in the Directive; by making a reference to implementing measures in the Directive (level 2); or by suggesting CEIOPS issue supervisory guidance on this subject. Although the Commission Services have no firm opinion yet on the form of these requirements, there is a need to harmonize the definition and application of these criteria to create a more level playing field and a safer insurance environment, as noted in the Sharma report.

10.2. References

- International Association of Insurance Supervisors (IAIS)[56]:
  - Insurance Core Principle 7 (Suitability of persons), October 2003
  - Guidance Paper for Fit and proper principles and their application, October 2000
  - Supervisory Standard on Licensing (points 37-44), September 1998

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55 For example, some Member States ask for very general information while one Member State requires individuals to complete a specific and detailed questionnaire including questions, e.g. on drug and alcohol habits.

56 http://www.iaisweb.org/

- Organisation for Economic Co-operation and Development (OECD)[57]:

  Governance of Insurers - Revised guidelines (DAFFE/AS/WD(2003)1/REV3)

- Conference of European Insurance Supervisory Authorities:

  Conclusions of the "Fit and Proper" Working Group DT/A/148/02Rev3**,** October 2002

  Report on prudential supervision of insurance undertakings (December 2002), under the chairmanship of Paul Sharma[58]

- European Union

  Proposal for new capital requirements regime for credit institutions and investment firms re-casting Directive 2000/12/EC and Directive 93/6/EEC (Basel II or CAD III Directive), Articles 11 and 12 (14 July 2004)[59] Directive 2000/12/EC on credit institutions (codifying Directive 92/30/EC on consolidated banking supervision), Article 6 point 1, Article 7 point 2 and Article 16.

  "Shareholder Control by Competent Authorities under Articles 5 and 11 of the Second Banking Directive: Implementation by Member States", European Commission, XV/1079/99-EN, 28.7.1999

  Directive 95/26/EC with a view to reinforcing prudential supervision (post-BCCI Directive)

- Current rules in Member States (namely as gathered in the framework of the CEIOPS pillar II Working Group).

10.3. Background: fitness and propriety in the current Directives

The current Directives state that the persons that "effectively run" the insurance undertaking must be "of good repute with appropriate professional qualifications or experience" (Article 6 paragraph 1(e) of the Recast Life Directive 2002/83/EC and Article 5 of the third Non-life Directive 92/49/EEC modifying Article 8 of the Directive 73/239/EEC), and that shareholders and members with qualifying holdings must have the necessary qualifications "to ensure the sound and prudent management" of the undertaking (Articles 8 of the Recast Life Directive and of the third Non-life Directive).

The same fit and proper requirement applies to the management of branches of EU insurance undertakings (Article 40 paragraph 3 of the Recast Life Directive and Article 32 of the third Non-life Directive). The general representative of

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57 http://www.oecd.org/

58 http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-conference_fr.htm

59 http://europa.eu.int/comm/internal_market/regcapital/docs/com-2004-486/act1_en.pdf

branches of third-country undertakings must also be approved (Article 51 of the Recast Life Directive and Article 23 of the first Non-life Directive 73/239/EEC) and - although there is no explicit mention of the conditions of approval- fitness and propriety are surely part of these conditions.

A specific article aims at harmonizing throughout the EU the proof of good repute by defining it as an extract of the judicial record or an equivalent document (Article 61 of the Recast Life Directive and Article 3 of Directive 73/240/EEC abolishing restrictions on the freedom of establishment in non-life insurance).

The recent informal ECOFIN Council in Scheveningen discussed obstacles to mergers and acquisitions in the EU-banking sector. One of the main difficulties encountered was the role supervisory authorities could play in the acquisition of national banks through their application of the rules governing qualifying holdings. As a result, Commissioner Bolkestein agreed to review Article 16 of the consolidated banking Directive (2000/12/EC) on "Qualifying holdings in a credit institution". Since similar provisions exist under Article 15 of the Recast Life Directive (and correspondingly for non-life insurers), analogous scope for national supervisory action may also exist in the insurance sector. In the light of the recent ECOFIN discussion, consideration should be given to these issues.

10.4. Specific Call for Advice

The Commission Services would like CEIOPS to advise on whether it is necessary to change the current wording of the Directives and, if so, on the elements that could be considered in the new Directive. More generally, CEIOPS is invited to advise on an optimal level of harmonisation of the fit and proper criteria. The decision on the precise degree of harmonisation has still to be taken at political level. However, CEIOPS is asked to provide technical advice as input to help make such a decision.

As to substantive issues, CEIOPS is invited to provide advice on at least the following questions, taking into account international developments on the subject (see references).

- Scope: to whom should the fit and proper criteria be applied? The current Directives state that it applies to the persons that "effectively run" the insurance undertaking (should this be defined more precisely or at least for certain key posts?). Should it be extended to members of supervisory boards? Should the fitness criteria apply to the board as a whole or to each individual member separately? Should it apply to the actuaries employed by the insurance undertaking? Should it also apply to external parties such as auditors, actuaries and/or asset managers? Should these requirements be adapted for some types of companies?

- Definition: what does "fit and proper" embrace exactly – does it include compatibility of functions, conflicts of interest and conditions on residence where the undertaking or branch is set up, for example?

- When should fit and proper requirements be applied? Should they be applied differently at different times? Should the requirement apply in the same way when there is an acquisition, as when there is a change in the qualifying holding?

- What procedures and on-going controls should be set up by the supervisory authority to check the continued respect of fit and proper criteria?

- What powers should the supervisor exercise when fit and proper requirements are not fulfilled?

- The application of these elements at group level may require specific consideration.

In relation to the recent ECOFIN discussion on the role of national supervisors in relation to qualifying holdings, the following aspects should be examined:

One of the purposes of Art. 8 and Art 15 (Directive 2002/83/EC and Directive 92/49/EEC) is to establish a balance between an internal market, which cross-border or cross-sector mergers and acquisitions may help to achieve, and the necessary prudential powers of supervisory authorities.

These Articles enable the competent authorities to appraise the suitability of the shareholders and members and if necessary to reject any particular group structures as improper. The aim is to ensure that the prudent and sound management of an insurance undertaking is not called into question by the existence of major holdings. If the competent authorities consider that the influence exercised by shareholders or members works to the detriment of the prudent and sound management of the insurance undertaking the Members States may take a series of measures to put an end to that state.

The concept of sound and prudent management is not explicitly defined in the Directives. Nonetheless, it is obvious that only prudential reasons may be taken into account.[60] Hence, it does not give Member States the power to veto qualified participations with a view to protect national interests. Neither may economical interest or market related considerations be taken into account.

In this context, reference should further be made to Art. 6 par. 1(e) of Directive 2002/83/EC and Art. 8 par. 1(e) of Directive 73/239/EEC. These Articles lay down as a condition for authorisation that the assurance undertaking is effectively run by persons of good repute with appropriate professional qualifications or experience. However, no more detailed rules are contained in the EU-Directives clarifying what should be understood under this criterion. The Conference of European Insurance Supervisory Authorities made an inquiry on the application of the fit and proper requirements in the different Member States. The report showed that the application of the “fit and proper” requirements vary quite considerably between different Member States.

It appears that Member States seem to use the assessment related to Art. 6 par. 1(e) of Directive 2002/83/EC and Art. 8 par. 1(e) of Directive 73/239/EEC when they examine the sound and prudent management in case of an acquisition of a qualifying holding referred to in Article 8 and 15 of Directive 2002/83/EC of 5

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[60] See for example the Commission’s reasoning in IP/99/773 “Financial Services: Commission to send reasoned opinion to Portugal over veto against BSCH participation in Champalimaud group”

November 2002 concerning life assurance and Directive 92/49/EEC of 18 June 1992 (third non-life insurance Directive).

Issues to be considered:

- Should common criteria concerning the sound and prudent management referred to under Article 8 and Article 15 of the Insurance Directives be developed?

- It appears that supervisory authorities take the assessment under Art. 6 par. 1(e) of the recast life-Directive into account when examining the sound and prudent management under Articles 8 and 15. Would a more harmonised approach of the "fit and proper criteria" within the licensing process minimise the need for a separate control of "fit and proper" within the assessment of "sound and prudent management"?

- With a view to the increasing cooperation between financial sectors, would it be desirable to apply the same or similar criteria for "sound and prudent management" and for "fit and proper" standards to all financial sectors or is there a need for a certain differentiation between sectors. The advantage could be that cross sectoral acquisitions would be made easier.

- Should the existing thresholds in Articles 15 be revised in order to have a harmonized approach between Member States?

- Should there be a different approach to the vetting of qualifying holdings where the acquisition is made by a supervised entity as opposed to a non-supervised undertaking? As there are neither common licensing rules nor fit and proper standards for non-supervised undertakings there might be a need to apply a different approach to such entities.

10.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

SPECIFIC CALL FOR ADVICE FROM CEIOPS: REQUEST N• 17

11. PEER REVIEWS

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for Advice, in particular with the one on the supervisory review process.

11.1. Introduction

The insurance Directives (Article 10 point 1 of the Recast Life Directive 2002/83/EC and Article 9 of the third Non-life Directive 92/49/EC) specify that the "financial supervision of an insurance undertaking … shall be the sole responsibility of the home Member State". Nevertheless, while supervision of an individual insurance undertaking is clearly a national competence, for the proper functioning of a system of mutual recognition, as well as for general financial stability reasons, it is important that all Member States exercise high quality supervision in accordance with best practices.

Furthermore, supervisors can learn from each other on different aspects of supervision, thus improving the level and quality of overall EU supervision.

In addition, for a multinational group, it is important that supervisory practices do not differ excessively between Member States. The insurance expert group report on stock-taking of the Financial Services Action Plan stressed the importance on "convergent implementation", particularly in a group environment.

In this context, the Commission considers that peer reviews can play an important role in rapid and effective dissemination. This in turn will enhance supervisory convergence, as highlighted by the Brouwer Report.

Institutionalized European cooperation between insurance supervisors has already been set up under the aegis of CEIOPS. Peer reviews would further enhance this cooperation. The conduct of peer reviews would in principle fall under the responsibility of CEIOPS.

11.2. Tentative organisation of peer reviews

Based on the experience of Commission peer reviews in the acceding countries as well as practice under the joint IMF and World Bank Financial Sector Assessment Program (introduced in May 1999), the Commission Services suggest the following modalities to initiate discussion:

Peer reviews could consist of an extended visit during which interviews are conducted with key individuals in the relevant supervisory bodies and some market participants. The review would conclude by a presentation setting out the main conclusions and recommendations. The review should be seen as a positive and constructive means of improving the existing supervisory structures and systems.

Evaluation would be based on CEIOPS' supervisory guidance, against the backdrop of EU legislation. Where the peer review found a major weakness, the peer review participants should alert the Commission Services.

The country visited could send peer participants its self-assessment (to be developed by CEIOPS) one month before the peer review takes place, along with copies of relevant legislation. A draft report would be prepared very shortly after the peer review and submitted to the authorities reviewed for comment before the draft peer review report was finalised. Authorities would be able to submit written observations within a month of the final report and the assessors would then draw final conclusions.

The report itself could consist of two parts: one part devoted to a general assessment highlighting good practices and weaknesses requiring to be addressed. The second part would detail those good working methods and practices that could be considered as "European best practice". This second part of the report could be circulated within CEIOPS.

The first part of the report could remain confidential. However, there should be a structured follow-up. For example, where the next assessment report found that measures had not been taken to correct weaknesses detected in the previous report, those aspects would be gathered in a separate report and appropriately communicated to CEIOPS. CEIOPS should regularly inform the Commission Services of cases of possible infractions to EU legislation.

Periodicity: The reviews would be held every 3 to 5 years, or when there is a need. They could start with the country that has the least recent IMF report and finish with the country that has the most recent IMF report.

11.3. References

- EU peer review exercise in pre-accession countries
- Joint IMF and World Bank Financial Sector Assessment Program (FSAP)
- Report on financial stability (Brouwer report), April 2000[61]
- National Association of Insurance Commissioners (NAIC), Financial Regulation Standards and Accreditation Program (June 2004)[62]

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61 http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/misc/ACF16BD.htm

62 http://www.naic.org/frs/accreditation/docs/frsa_6-04.pdf

11.4. Specific Call for Advice

Although this subject has been discussed in the Insurance Committee, no political consensus has emerged as yet. To provide input for future discussions on this issue in the Insurance Committee, CEIOPS is asked to give technical advice on the procedure to follow for these peer reviews, if they were set up. Namely, the Commission would like CEIOPS to advise on the following elements:

- Basis of the assessment: Comments are requested on the suggested basis for peer review. Should this be based on CEIOPS supervisory guidance and EU legislation or should it introduce other elements, such as IAIS principles, and/or should a specific questionnaire be elaborated?

- Scope of the peer review: should this cover the overall activity of the supervisory authority visited or should reviews focus on certain aspects?

- Implications and follow-up action of peer reviews: both for the supervisory authorities visited (e.g. remedial action, statistics on supervisory activity, additional resources devoted ,…) and also for the supervisory authorities lending participants to the peer review process. In particular, the implications for smaller supervisory authorities should be considered.

- Practical modalities of the peer review: duration, choice of participants, organizations interviewed (e.g. should participants meet the insurance industry for example),…

- Peer review report: characteristics (form of the report, confidentiality requirements, etc.) and follow-up action triggered by the peer review report

- Strength of the recommendations

For background and reference purposes only, the legal text could be formulated along the following lines:

> "Supervisory authorities will aim for a convergence of their working methods through peer reviews to secure a high-level protection for policyholders."

11.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

12. GROUP AND CROSS-SECTORAL ISSUES

This Specific Call for Advice should be examined in conjunction with the Framework for consultation and other relevant Specific Calls for advice, in particular with those relating to capital requirements and Pillar 2.

12.1. Introduction

During the 1990's major changes have taken place in European insurance and financial markets as well as in the regulation and supervision of insurance and financial groups. At the same time, new risk management methods and risk transfer/arbitrage developments have been and are increasingly being employed in the market. Many of these issues are relevant for the Solvency II project and require analysis.

Consequently CEIOPS is invited to analyse whether the Insurance Groups Directive (IGD, 98/78/EC) requires to be amended in the context of Solvency II.

Later this Call for Advice may be amended in the light of CEIOPS's development work and – after consultation with the responsible Commission Services - may also take into account financial conglomerate related issues, where appropriate.

12.2. References

- Directive 98/78/EC on the supplementary supervision of insurance undertakings in an insurance group (IGD)

- Directive 2002/78/EC on the supplementary supervision of credit institutions, insurance undertakings and investments firms in a financial conglomerate (FGD)

- Directive 2000/12/EC on credit institutions (codifying i.a. Directive 92/30/EC on consolidated banking supervision)

- Proposal for a Directive on capital adequacy of investment firms and credit institutions (CAD III, COM(2004) 486 final)[63]

- Reports and other documents by industry and consultants may provide further inspiration, e.g. reports on financial conglomerate issues related to group diversification benefits[64] and legal firewalls[65].

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63 http://europa.eu.int/eur-lex/en/com/pdf/2004/com2004_0486en.html

64 http://www.dnb.nl/dnb/bin/doc/study_risk_profile_tcm7-13908.pdf

65 http://www.dnb.nl/dnb/bin/doc/Freshfields%20report_tcm7-28994.pdf

12.3. Background

The Insurance Group Directive's primary objective is to avoid double or multiple gearing of capital by requiring, where appropriate, an adjusted solvency calculation. In the framework of Solvency II it is necessary to analyse whether the current provisions can be applied as they are, or whether amendments are required.

It is not intended to start a debate on the principle of equivalence laid down in the Directive concerning the 3 methods to calculate an adjusted solvency requirement. This might be a particular issue for the general report to be submitted to the Insurance Committee by the Commission based on Article 11.5 of the IGD. This report on the application of the IGD and, if necessary, on the need for further harmonisation, must be submitted by 1 January 2006.

In connection with the presentation of the 2006 report, the Commission Services will initiate steps to elaborate on the future group and conglomerate supervision in the EU. This exercise may trigger amendments or additions to Calls for Advice from CEIOPS.

12.4. Specific Call for Advice

The Commission Services request CEIOPS to analyse what amendments, if any, to the IGD would be needed to make Solvency II workable for the supplementary supervision of insurance undertakings in an insurance group. This input is needed in order for the Commission Services to prepare the Solvency II Framework Directive on a timely basis.

This analysis should generally cover areas such as links with banking activities, cross-sectoral risks and capital arbitrage.

Specifically, this Call for Advice requests CEIOPS to analyse

(a) the scope for regulatory arbitrage in capital requirements between the same or similar financial products sold by insurance or by other financial institutions;

(b) whether, in the context of the Solvency II project, the Insurance Groups Directive (IGD, 98/78/EC) requires to be amended

If so,

- what amendments are required?
- why are these required?
- what alternatives exist?

In its reply, CEIOPS is requested to address at least the following issues:

- Should the IGD be applied both for the minimum capital requirement (MCR) and the solvency capital requirement (SCR) or only for the SCR? Should also any Pillar 2 individual capital increases be taken into account? A prerequisite for the proposal for a Directive is an analysis of how supervisory actions and respective solvency control levels are to be linked (i.e. what supervisory actions are needed at group level and how and when they should be triggered by the control levels). Consequently the work carried out by the Pillar I groups regarding the "solo requirements" should be taken as a starting point for analysis.

- Should the solo SCR requirements (both the standard formula and the internal model method) be amended to take into account group specificities and how? Are there important differences in risk profiles at solo and group levels (exposure to other/new risks which are not relevant on a solo basis, i.e. 'diversification costs')? (See also separate Call for advice on solvency control levels). Do 'diversification benefits' exist as a result of the fact that the insurer is part of an insurance group? Can these costs and benefits be quantified appropriately?

- Validation process for internal models (see also the separate Call for Advice on this topic): which supervisor(s) is/are responsible for the validation of the internal model, how to ensure efficient cooperation of supervisors, what additional requirements should be set for a group level model compared to a solo model etc

- The scope of an internal or partial model: is it possible to allow the use of an internal model for the SCR for only a limited number of insurers in a group (and the standard formula for the others), or should the internal model as a rule be required to be applied to all insurers in the same group? Could different (partial) internal models in the group be allowed (for practical reasons) provided they are calibrated prudently enough?

- Would a supervisory review process (SRP) for insurance groups need to be set up, in particular to take account of risks not existing on a solo level, but existing at a group level and that are not taken into account in Pillar I? (See also the Call for Advice on SRP)

- Should supervision be applied at group level and how? What would that exactly entail including advantages/disadvantages (cf. separate Calls for Advice on supervisory powers, solvency control levels, SRP)?

- Does the IGD need amending because of possible changes in the elements eligible for the solvency margin (this will be addressed in a separate Call for Advice)?

12.5. Reporting modalities

CEIOPS should provide regular progress reports under this Specific Call for Advice in accordance with the Framework for Consultation, i.e. at four-monthly intervals with the first report to be provided by 28th February 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 31 October 2005.

After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the formal mandates for these implementing measures, as well as to keep the Insurance Committee appraised of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of this Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

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