



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS
Insurance and pensions

MARKT/2505/05-EN

NOTE TO THE MEMBERS OF THE IC

Subject: Policy issues for Solvency II
Possible amendments to the Framework for Consultation

1. INTRODUCTION

The Framework for Consultation was discussed in the Insurance Committee (IC) at the June 2004 meeting. It was envisaged that the document could function as a dynamic reference document for the development of the new insurance solvency system, Solvency II. If the document were to be revised, the Commission would consult the IC.

At the December 2004 meeting, the IC was informed of the Commission's intention to reflect on some issues that would require further policy guidance. CEIOPS in particular requested that the number of possible solutions to some of the Calls for Advice was narrowed down. The IC was also informed that the Commission would produce a new Roadmap. This note should be read in conjunction with the new Roadmap (MARKT/2502/05).

This note is for discussion in the IC on 8 April 2005. Annexed to this note is a draft amended Framework for Consultation. The purpose of this note is to identify the main changes and to structure the debate in the IC.

2. ISSUES ADDRESSED

The main proposed changes in the Framework for Consultation include:

- Objectives (paragraph 1): The amended framework clarifies the objective of solvency, i.e. to protect policyholders. This is the main objective but does not exclude that other objectives may be set. As can be seen from the draft outline Directive (MARKT/2507/05), many changes will have to be made to the present Directives, which may include changes to the Insurance Groups Directive and the Winding-up Directive. However, the precise impact on other Directives cannot be established yet.

- Scope of Pillars 1-2-3 (paragraphs 2 and 21): Although Solvency II uses the same Pillar terminology as Basel II/CRD (Capital Requirements Directive), this does not imply that the content is the same. Basel II/CRD is an important source of inspiration, but is not to be copied without further discussions. Some elements of Solvency II are not covered by Basel II. This is the case e.g. in Pillar 1, where Solvency II covers a wider range of risks than Basel II/CRD. In Solvency II, the scope of Pillar 2 not only relates to supervision of the undertaking's evaluation of its capital requirements, but also to all the risks that it faces. The scope of Pillar 2 also relates to the harmonisation of the supervisory activities. It therefore includes quantitative and qualitative aspects. Pillar 3 includes harmonisation of supervisory reporting. In addition, some Calls for Advice also relate to work not (or not yet) undertaken by the Basel Committee, including the revision of eligible capital.
- Relation between MCR and SCR (paragraph 3): The Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR) will be calculated for different purposes and using different methodologies. Although the result of the prospective and risk-oriented calculation of the SCR could be lower than the more simple calculation of the MCR, the MCR should act as a floor to the SCR.
- Internal Models (paragraphs 5 and 20): When the standard formula has been replaced by an internal model (partially or fully) the result of the SCR can be higher or lower than using the standard formula. However, even when an internal model is used, the result of the calculation should not be lower than the MCR. Supervisors may allow and, in certain cases, even require an institution to develop an internal model. Supervisors should be given the option to require an internal model in those cases where the activities of the undertaking deviate substantially from the assumptions underlying the standard formula.
- Group issues (paragraph 6): The supplementary supervision should reflect the developments in the organisation of financial groups. The relevant rules need to be set at the relevant level. The allocation of responsibilities of supervisors involved in group supervision needs to be reviewed, in particular in connection with the use of internal models. However, capital should be distributed adequately in the group to ensure that at solo level, sufficient capital is available.
- Valuation, reporting and disclosure (paragraphs 7 and 22-23): Valuation principles belong to the fundamentals on which Solvency II will be built. It is recognised that specific prudential valuation standards for assets and liabilities of insurance undertakings have to be developed, taking into account the objective of IASB compatibility. Supervisory reporting goes beyond the notion of financial reporting rules, and includes different types of information that supervisors need to perform their duties.
- International compatibility (paragraph 11): Since the July 2004 Framework and the February 2005 Cornerstones were issued, the IAIS has provided new relevant input for the Solvency II project.
- Impact assessment (paragraph 12): The Commission has to provide an Impact Assessment annexed to the Proposal for a Directive. In addition, full Quantitative Impact Studies will be carried out as part of the Solvency II project. The scope and detail of both exercises will be different.

- Guarantee schemes (paragraph 13): In developing Solvency II the existence of guarantee schemes should not be taken into consideration. The new solvency system should provide enough safety without relying on guarantee schemes. This however, does not imply that the Commission will not propose a Directive concerning guarantee schemes.
- Small undertakings (paragraph 14): Reference is made to small undertakings rather than SMEs, because it is felt that possible exemptions should only apply to insurance undertakings of a limited size. Small undertakings should respect the same basic principles as all other institutions, but at the same time the new regime should not be overly costly for these undertakings. It may be necessary to provide for some specific rules.
- Technical provisions (paragraph 15): In line with the Call for Advice concerning this issue (2nd wave), technical provisions consist of a best estimate plus a risk margin. The confidence level should be set at 75%. This is introduced as a working hypothesis, but the percentage may need to be adjusted based on future impact studies.
- SCR confidence level and time horizon (paragraph 16): The parameters in the SCR should be calibrated in such a way that the quantifiable risks to which an institution with a diversified portfolio of risks is exposed are taken into account and based on the amount of economic capital corresponding to a ruin probability of 0.5% (99.5% Value at Risk) and a one year time horizon. This is introduced as a working hypothesis, but the percentage may need to be adjusted based on future impact studies. When an undertaking does not fulfil the SCR, it shall re-establish the amount of capital covering the SCR in due time, based on a concrete and realisable plan submitted to the supervisor for approval.
- MCR level and action (paragraph 18): When an undertaking breaches the MCR, ultimate supervisory action is triggered, which is similar to the action taken currently when an undertaking has less capital than the guarantee fund. The exact level of the MCR will be set based on impact studies.
- Reporting modalities (paragraph 32): After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance. Consequently, CEIOPS should continue to develop and deepen its analysis.

3. OTHER ISSUES TO BE ADDRESSED

The draft amendments to the Framework for Consultation only include those on which policy guidance can be given at this stage of the process. The Services believe that these draft amendments satisfy the request by CEIOPS for limiting the options. This would give CEIOPS the opportunity to develop the new system in a more efficient way, without restricting important innovations. However, at the same time some issues remain outstanding:

- The effects of changing valuation principles and new solvency requirements make it difficult to express in advance a target as to the effects on the total available capital in the industry, because of the implications of the valuation principles on the measurement of capital.

- Solvency II should encourage innovation in the industry, provide opportunities to cover new risks and improve the global competitive edge of EU companies, whilst ensuring that politically important risks may continue to be covered.
- The precise design of supervisory competences in group and cross-sectoral issues also depends on the review of the Insurance Group Directive (due 1 January 2006) and the review of the Financial Conglomerates Directive, which is expected to be initiated in 2005.

These issues could be addressed at a later stage when more information is available on the design of the new system and on the impact of the valuation principles.

4. NEXT STEPS

After the meeting of the IC, this note and the Annex to this note (Framework for Consultation) will be further updated to reflect the results of the discussions and of comments received by stakeholders. After a final revision the Framework for Consultation will be sent to CEIOPS.