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DRAFT SPECIFIC CALLS FOR ADVICE FROM CEIOPS

(THIRD WAVE)

Purpose of this document

This document includes a third set of draft 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 and reinsurance undertakings.

Table of contents

1.	ELIGIBLE ELEMENTS TO COVER THE CAPITAL REQUIREMENTS.....	3
1.1.	Introduction	3
1.2.	References	3
1.3.	Background.....	4
1.4.	Specific Call for Advice	5
1.5.	Reporting modalities	6
2.	COOPERATION BETWEEN SUPERVISORY AUTHORITIES	7
2.1.	Introduction	7
2.2.	References	8
2.3.	Background: situation in current directives and preliminary proposal for principles in the draft directive	9
2.4.	Specific Call for advice	11
2.5.	Reporting modalities	12
3.	SUPERVISORY REPORTING AND PUBLIC DISCLOSURE.....	13
3.1.	Introduction	13
3.2.	References	14
3.3.	Background: rules set in the current Directives	15
3.4.	Specific Call for Advice	16
3.5.	Reporting modalities	18
4.	PROCYCLICALITY.....	19
4.1.	Introduction	19
4.2.	References	19
4.3.	Background.....	20
4.4.	Specific Call for Advice	21
4.5.	Reporting modalities	21
5.	SMALL UNDERTAKINGS	22
5.1.	Introduction	22
5.2.	References	23
5.3.	Background: exceptions for small undertakings in the current Directives.....	23
5.4.	Specific Call for advice	24
5.5.	Reporting modalities	25

1. ELIGIBLE ELEMENTS TO COVER THE CAPITAL REQUIREMENTS

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 Safety measures (n° 9), the SCR standard formula (n° 10) and Group and cross-sectoral issues (n° 18).

1.1. Introduction

During the preparation of the Solvency I amendments the list of elements eligible for the solvency margin was discussed intensely. However, these rules should now be modified to take into account the new prudential levels of the solvency system (Minimum Capital Requirement and Solvency Capital Requirement), compatibility with international developments (IASB, IAIS, IAA and banking), and financial market developments.

1.2. References

- International Association of Insurance Supervisors (IAIS)¹:

For several years now the IAIS has been working in its Solvency Subcommittee on a Standard on Suitable Forms of Capital². The paper is currently being redrafted and is at present not publicly available. The ongoing discussion in the Solvency Subcommittee on this issue should be considered an important reference point for CEIOPS' analysis.

- European Commission³

Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, Articles 34-39.

- Basel Committee on Banking Supervision⁴

Section I of the 1988 Capital Accord, as amended, lists the elements eligible to cover the capital requirements for banks⁵.

¹ <http://www.iaisweb.org/>

² The latest version that was sent out for consultation is dated 12-3-2004

³ http://europa.eu.int/eur-lex/en/archive/2000/1_12620000526en.html

⁴ Basel Committee publications relating to the existing Capital Accord:
http://www.bis.org/bcbs/publ_02.htm

⁵ <http://www.bis.org/publ/bcbsc111.pdf> and <http://www.bis.org/publ/bcbs24.pdf>

1.3. Background

The Life⁶ and Non-life⁷ Directives include provisions on eligible elements for the available solvency margin, split up in three categories: 1) definition based elements, 2) elements not included in that definition, but which are considered to be eligible, 3) elements that need prior approval of the supervisory authority before they can be included in the available solvency margin. The Financial Conglomerates Directive introduced additional deductions of some participations in order to avoid regulatory arbitrage between the sectoral rules and those for financial conglomerates.

Some of the elements in the current Directives will already become obsolete over time (e.g. future profits are allowed until 31 December 2009). Other elements may no longer be applicable when using IASB compatible accounts (e.g. hidden reserves). However, without amendments to the present rules, IASB compatible accounts may also lead to more deductions of capital by the difference between undiscounted and discounted provisions. In addition, it is questionable whether the difference between non-Zillmerised and Zillmerised provisions should be admissible in the future, as this may not be compatible with a harmonised approach towards the calculation of technical provisions.

At present, the eligible elements for the Guarantee Fund (GF) and the available solvency margin differ. The requirements for the GF are stricter, as the elements that need prior approval (except for hidden reserves) cannot be included⁸. This difference is believed to be justified as the GF is the last line of defence. Therefore it should be covered by directly realisable elements.

It should be pointed out that the eligibility of some elements depends on the legal form of the undertaking, e.g. share capital, initial fund, members' accounts, supplementary contributions.

The development of new financial instruments needs to be looked at carefully. Although both the Life⁹ and Non-life¹⁰ Directives provide the option for the Commission to make technical adjustments using the Comitology procedure in order to clarify the items constituting the available solvency margin to take account of the creation of new financial instruments, this option has never been used.

In banking, capital is currently split into 3 tiers: shareholder capital and retained earnings (tier 1), supplementary capital (tier 2) and short-term subordinated debt (tier 3). A review of eligible capital elements has not been undertaken in the framework of Basel II, but is expected to start shortly.

⁶ Article 27 of Directive 2002/83/EC as amended by Article 23(2) of Directive 2002/87/EC

⁷ Article 16 of Directive 73/239/EEC as amended by Article 1 of Directive 2002/13/EC and Article 22(2) of Directive 2002/87/EC

⁸ Article 29(1) of the Life Directive 2002/83/EC and Article 17(1) of the First Non-life Directive as amended by Directive 2002/13/EC (Solvency I Non-life)

⁹ Article 64 of Directive 2002/83/EC

¹⁰ Article 51 of Directive 92/49/EC (Third Non-life Directive)

1.4. Specific Call for Advice

The Commission Services request CEIOPS to advise on the elements eligible to cover the SCR and MCR. In its advice, at least the following areas should be addressed:

- The use of IASB compatible accounts in the future has major implications for some elements that are now considered to be eligible. Elements should be identified that do not fit with the IASB concept and solutions proposed.
- Can new elements be identified that are the result of developments in financial instruments that would be suitable to cover the solvency requirements? Should there be any condition as to their admissibility?
- In Solvency II the (Minimum) Guarantee Fund does not exist. It can be argued that the role of the Guarantee Fund as last line of defence has therefore been taken over by the MCR. Should all elements that would be eligible in Solvency II for the SCR also be eligible for the MCR? Which elements should be eligible to cover the MCR? In this context it is also important to note the eligibility of assets covering Technical Provisions (see Call for Advice nr. 9 on Safety measures).
- The Financial Conglomerates Directive has introduced some amendments to the Non-life and Life Directives in order to inter alia automatically deduct participations in financial services undertakings¹¹. Will additional adjustments have to be made to take account of groups? What should these adjustments be?
- At present, the difference in approach between the insurance and banking rules may be foremost a presentational matter. In both sectors shareholder capital/initial fund plus (under conditions) members' accounts are considered to be core. Supplementary capital is also allowed, but only under fixed conditions and as a certain proportion of core capital. Differences in accounting principles are taken into account.

The present categorisation of the elements eligible for the solvency margin (definition, non-definition, supervisory approval) could be amended and brought into line with banking. Does the present categorisation lead to problems? In particular for those insurers that are part of a group. Would there be an advantage to use the banking 3-tier system?

¹¹ Articles 22-23 of Directive 2002/87/EC

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 30th June 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 28th February 2006.

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 potential mandates for these implementing measures, as well as to keep the Insurance Committee (EIOPC) informed 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.

2. COOPERATION BETWEEN 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 relating to SCR internal models (n° 11), Supervisory review process (n° 2), Peer reviews (n° 17) and Supervisory reporting and public disclosure (n° 21).

2.1. Introduction

The development of the single internal market for people and services, the current trends towards concentration and internationalisation in insurance, together with mutual recognition of prudential supervisory systems, call for a deepening of the cooperation between supervisors of the Member States. Existing Protocols and Directives organize cooperation between supervisors to some extent. The expert group on the state of financial integration following the Financial Services Action Plan in the insurance sector called for an increasingly convergent implementation and effective enforcement of the rules. In an unstable economic environment, where an undertaking's financial situation may evolve more rapidly than in the past and in a new solvency framework that relies more heavily on the assessment by the companies of their own risks, the complexity of supervisors' work will increase. It is essential that the procedures of cooperation be more detailed (frequency, type of information or triggering events, for example) and more wide-ranging (in times of crisis for example). Cooperation can take different forms, in particular exchange of information. The focus of this Call for Advice is on cooperation between supervisors of Member States. However, cooperation with third countries' supervisors¹ may have to be touched upon at a later stage.

¹ Currently, Directive 2000/64/EC provides a framework for exchange of information with third countries: "Member States may conclude cooperation agreements providing for exchange of information with the competent authorities of third countries or with authorities or bodies of third countries as defined in paragraphs 5 and 6 only if the information disclosed is subject to guarantees of professional secrecy at least equivalent to those referred to in this Article. Such exchange of information must be intended for the performance of the supervisory task of the authorities or bodies mentioned.

Where the information originates in another Member State, it may not be disclosed without the express agreement of the competent authorities which have disclosed it and, where appropriate, solely for the purposes for which those authorities gave their agreement. (Article 2 amending the third generation Directives):

2.2. References

- Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS²) (ex- Conference of European Insurance Supervisory Authorities) Siena Protocol (1997) and Helsinki Protocol (2000)³
- International Association of Insurance Supervisors (IAIS)⁴
ICP 5 Supervisory cooperation and information sharing, October 2003
Supervisory Standard on the Exchange of Information, January 2002
Supervisory Standard on group coordination, October 2000
- European Commission
Proposal for a Capital Requirements Directive (CRD), 14 July 2004, Articles 126-134, 25-34 and 40-52⁵.
Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, Article 21⁶.
Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, Articles 11 and 12⁷.
Directive 98/78/EC on the supplementary supervision of insurance undertakings in an insurance group, Article 7⁸.
Directive 2000/64/EC as regards exchange of information with third countries, Article 2 amending Articles 16(3) and 15(3) of the third non-life and life Directives respectively.

² <http://www.ceiops.org>

³ Available at the CEIOPS website at: [http://www.ceiops.org/cgi-bin/ceiops.pl?sprache=1&verz=05a_\\$P\\$ublications*02a_\\$P\\$rotocols&cm=nm](http://www.ceiops.org/cgi-bin/ceiops.pl?sprache=1&verz=05a_Publications*02a_Protocols&cm=nm)

⁴ <http://www.iaisweb.org/>

⁵ http://europa.eu.int/comm/internal_market/regcapital/index_en.htm#capitalrequire

⁶ http://europa.eu.int/comm/internal_market/pensions/legislation_en.htm

⁷ http://europa.eu.int/comm/internal_market/insurance/legis-inforce_en.htm#conglomerates

⁸ http://europa.eu.int/comm/internal_market/insurance/legis-inforce_en.htm#groups

- Council of the European Commission
‘Brouwer’ Report on Financial Crisis Management (adopted at the ECOFIN Council in April 2001)⁹
- Organisation for Economic Co-operation and Development
Decision of the Council on the Exchange of Information on Reinsurers, adopted by the Council on 25 July 2002¹⁰.

2.3. Background: situation in current directives and preliminary proposal for principles in the draft directive

Current directives

For insurance groups and financial conglomerates, a thorough exchange of information is organized by Article 7 of the insurance groups Directive 98/78/EC¹¹ and by Articles 11 (tasks of the coordinator) and 12 (cooperation and exchange of information between supervisors) of the financial conglomerates Directive 2002/87/EC.

For companies that do not belong to a group, one article, identical in the life and non-life directives, deals with cooperation between the Member States and the Commission (Article 62 of the Life Recast Directive¹² and Article 28 of the second

⁹ <http://ue.eu.int/uedocs/cmsUpload/Brouwer%20Report%20on%20Financial%20Crisis%20Management.pdf>

¹⁰ <http://www.oecd.org/dataoecd/49/43/1961202.pdf>

¹¹ Insurance groups Directive: Article 7 - Cooperation between competent authorities
1. “Where insurance undertakings established in different Member States are directly or indirectly related or have a common participating undertaking, the competent authorities of each Member State shall communicate to one another on request all relevant information which may allow or facilitate the exercise of supervision pursuant to this Directive and shall communicate on their own initiative any information which appears to them to be essential for the other competent authorities.
2. Where an insurance undertaking and either a credit institution as defined in Directive 77/780/EEC or an investment firm as defined in Directive 93/22/EEC, or both, are directly or indirectly related or have a common participating undertaking, the competent authorities and the authorities with public responsibility for the supervision of those other undertakings shall cooperate closely. Without prejudice to their respective responsibilities, those authorities shall provide one another with any information likely to simplify their task, in particular within the framework of this Directive.
3. Information received pursuant to this Directive and, in particular, any exchange of information between competent authorities which is provided for in this Directive shall be subject to the obligation of professional secrecy defined in Article 16 of Directive 92/49/EEC and Article 15 of Directive 92/96/EEC.

¹² Life recast Directive: Article 62 - Cooperation between the Member States and the Commission
“The Commission and the competent authorities of the Member States shall collaborate closely with a view to facilitating the supervision of the kinds of insurance and the operations referred to in this Directive within the Community.
Each Member State shall inform the Commission of any major difficulties to which application of this Directive gives rise, inter alia, any arising if a Member State becomes aware of an abnormal transfer of business referred to in this Directive to the detriment of undertakings established in its territory and to the advantage of agencies and branches located just beyond its borders.
The Commission and the competent authorities of the Member States concerned shall examine such difficulties as quickly as possible in order to find an appropriate solution.
Where necessary, the Commission shall submit appropriate proposals to the Council.”

non-life Directive, expanding Article 33 of the first non-life Directive). Although this Call for Advice does not address cooperation between Member States and the Commission but limits its object to cooperation between supervisory authorities, this Article can nevertheless provide inspiration.

In addition to these general rules, specific articles organise the cooperation between the home and the host Member States in the case of cross-border business: notification requirements to set up a branch, possible application of conditions in the interest of the general good by the host authority, possible adoption of appropriate measures in case of breaches of obligations by the host authority and statistical information (Articles 40-42, 46 and 49 of the Recast Life Directive).

Although it was decided that occupational pensions would be addressed at a later stage, it may be useful to point out that Directive 2003/41/EC on pension funds organizes cooperation between the Member States and the Commission (same comment as above – the Article’s scope includes more than supervisory authorities) in its Article 21, points 1 to 3¹³. In particular, cooperation in case of difficulties is explicitly mentioned.

Preliminary idea for a draft article in the future Directive (wording inspired by insurance groups Directive)

“The competent authorities of the Member States shall communicate to one another on request all relevant information which may allow or facilitate the exercise of supervision and shall communicate on their own initiative any information which appears to them to be essential for other competent authorities. Competent authorities must ensure sufficient cooperation in particular, when an insurance undertaking encounters financial difficulties.

Information received pursuant to this directive shall be subject to the obligation of professional secrecy.”

¹³ Occupational Pensions Directive: Article 21 - Cooperation between Member States and the Commission

“1. Member States shall ensure, in an appropriate manner, the uniform application of this Directive through regular exchanges of information and experience with a view to developing best practices in this sphere and closer cooperation, and by so doing, preventing distortions of competition and creating the conditions required for unproblematic cross-border membership.

2. The Commission and the competent authorities of the Member States shall collaborate closely with a view to facilitating supervision of the operations of institutions for occupational retirement provision.

3. Each Member State shall inform the Commission of any major difficulties to which the application of this Directive gives rise.

The Commission and the competent authorities of the Member States concerned shall examine such difficulties as quickly as possible in order to find an appropriate solution.”

2.4. Specific Call for advice

The Commission Services request CEIOPS to advise on the means to increase cooperation and exchange of information between Member States supervisors. In its advice, CEIOPS should consider at least the following issues:

- in order to be able to ask for relevant information, supervisors should be aware of the type of information available (public information and supervisory returns) in the other Member States;
- on internal models, supervisors should exchange information, namely on the assumptions underlying internal models used to calculate the SCR – this exchange should not be limited to supervisors of companies of the same group but should be conducted on a wider basis to allow harmonization and understanding by supervisors of acceptable differences of assumptions.
- cooperation in particular through exchange of information in times of financial crisis (Brouwer report)
- it may be interesting to set up a shared data base to be used by supervisors, if the security and confidentiality of the data can be ensured.
- means to ensure sufficient cooperation with supervisors of other financial sectors in the same Member State and with other Member States should be organised.
- minimum exchange of information between supervisors on the basis of an “objective” early-warning system

CEIOPS’ advice may differ according to whether these recommendations apply to all supervisors in general, solely to supervisors supervising a company doing cross-border business (through freedom to provide services or branches) and/or only to supervisors of companies that belong to the same group.

More specifically, as concerns insurance groups, the relevant Directive may need to be updated to include the following areas (see also request n°18 on Group and cross-sectoral issues):

- role of the lead supervisor (the Helsinki Protocol loosely defines this figure as the supervisor of the Member State where the dominant insurance undertaking of the group is established) in the decision-making process and working procedures to be followed among national supervisors of companies of the same group (in particular, in connection to internal models).
- exchange of information on the internal model(s) used by the companies of the group: detailed assumptions, calculations, results and, depending on the case, adaptations to the national market’s characteristics.

- detailed description of minimum compulsory exchange of information - possible compulsory regular exchange of standardized information between national supervisors and in particular, early-warning exchange of information when one of the companies in the group encounters difficulties.

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 30th June 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 28th February 2006.

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 potential mandates for these implementing measures, as well as to keep the Insurance Committee (EIOPC) informed 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.

3. SUPERVISORY REPORTING AND PUBLIC DISCLOSURE

This Specific Call for Advice should be examined in conjunction with the Framework for Consultation and other Specific Calls for Advice relating to the pillar 1 and 2 requirements. Transparency by supervisory authorities has been dealt with in Call for Advice n° 4. Issues relating to the exchange of information between supervisors are covered by Call n° 20 Cooperation between supervisors.

3.1. Introduction

“Supervisory reporting” and “public disclosure”

Closely related notions such as “reporting requirements”, “supervisory information”, “transparency”, “disclosure” and “public disclosure” are often used in a non-harmonised way between different sectors and different regulatory frameworks. For the purpose of this Call for Advice, we will make a distinction between “supervisory reporting” and “public disclosure”.

Harmonised reporting from insurance undertakings to their supervisors (*“supervisory reporting”*) will be an important part of the future regulatory architecture in the EU. Supervisory reporting goes beyond the notion of financial reporting rules, and includes different types of information that a supervisor needs to perform his/her functions. This information is normally not in the public domain. It is worth highlighting that such reporting requirements are only harmonised to a certain extent in the banking field¹.

In addition, transparency and disclosure of information by undertakings to the public could serve to reinforce market mechanisms and discipline (*“public disclosure”*). In the Basel II/CRD framework, pillar III requirements were created in order to collect selected supervisory information that could facilitate market participants’ assessment of banks and thereby reinforce the I and II pillar requirements.

Consequently this Specific Call for Advice covers a wider field than the pillar III requirements in the banking field. Supervisory reporting may be considered as a part of pillar II, but as the issues are clearly related we have chosen to deal with the issues in a single call.

¹ Cf. e.g. Article 75:2 of the CRD proposal COM (2004) 486, 14.7.2004.

General introduction

Important work on supervisory reporting and public disclosure requirements is currently under way at national and international levels. The Commission Services believe – in the spirit of the recommendations of the Forum Group on Reporting Requirements – that it is important to closely monitor these developments in order not to overburden insurance undertakings with reporting/disclosure requirements. Special attention should be paid to the cost of gathering information.

The increased use of prospective methods, advanced risk management and full or partial internal models clearly calls for improved reporting/disclosure of the assumptions and scenarios used. In the Basel II/CRD Framework the institutions that use the advanced approaches must present special disclosures.

As supervisory reporting and public disclosure requirements will depend on the methods and measures adopted for pillar 1 and pillar 2, it is only possible to define the final, detailed requirements at a later stage of the project. It is however important that reporting and disclosure issues are integrated at an early stage in the development process of future Solvency II legislation, regulations and guidance.

3.2. References

- International Association of Insurance Supervisors (IAIS)²:
 - Insurance Core Principle 26
 - Guidance Paper on Public Disclosure (January 2002)
 - Standard on Disclosures concerning Technical Performance and Risks for Non-life Insurers and Reinsurers (October 2004)³
 - Standard for Disclosures concerning Investment Performance and Risks for Insurers and Reinsurers (public draft).
 - Furthermore the Reinsurance Transparency Subgroup has proposed reporting requirements for large, globally active reinsurance companies.
- International Accounting Standards Board (IASB)⁴:
 - IFRS 4 “Insurance Contracts”, IAS 39 “Financial Instruments: Recognition and Measurement and IAS 32 “Financial Instruments: Disclosure and Presentation” (incl. Exposure Draft ED 7⁵), including Basis for Conclusions, as well as elements of other standards, would constitute important reference material.

² <http://www.iaisweb.org/>

³ A corresponding standard for life assurance is scheduled for 2006/2007.

⁴ <http://www.iasb.org/>

⁵ A standard based on ED 7 would replace IAS 30 completely and lead to revisions of IAS 32 and IFRS 4.

- European Commission/proposed legislation:
 - Proposal for a Capital Requirements Directive, 14 July 2004, Articles 144-149 and Annex XII⁶.
- European Commission/Forum Group on Reporting Requirements⁷:
 - The Report prepared by the Forum Group on Reporting Requirements gives useful background on a general, cross-sector approach to coordinate regulatory reporting requirements in order to reduce the burden on financial institutions in the EU.
- Joint Forum⁸:
 - Report of the Multidisciplinary Working Group on Enhanced Disclosure chaired by Mr Fischer (2001)
 - Report “Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis” (May 2004)
- Basel Committee on Banking Supervision⁹:
 - Part 4 of the Basel II Accord (“The Third Pillar - Market Discipline”)

3.3. Background: rules set in the current Directives

The Third Generation Directives include a large number of different types of disclosure requirements. There is a general requirement for insurance undertakings to produce annual accounts covering their operations¹⁰. Furthermore there are specific disclosure requirements throughout the Directives on particular issues.

It is important to note that the general disclosure requirements in the 4th¹¹ and the 7th¹² Accounting Directives as well as in the Insurance Accounts Directive¹³ are normally also highly relevant for supervisory purposes, sometimes with certain additions or adjustments.

⁶ http://europa.eu.int/comm/internal_market/regcapital/index_en.htm#capitalrequire
⁷ http://europa.eu.int/comm/internal_market/finances/cross-sector/index_en.htm#reporting
⁸ <http://www.bis.org/bcbs/jfpubl.htm>
⁹ <http://www.bis.org/publ/bcbs107c.pdf>

¹⁰ Directive (2002/83/EEC) concerning life assurance, Article 13(1); Directive 73/239/EEC Article 19 (as amended by 84/641/EEC Article 11)

¹¹ Fourth Directive (78/660/EEC) on the annual accounts of certain types of companies, in particular Article 43.

¹² Seventh Directive (83/349/EEC) on consolidated accounts, in particular Article 34.

¹³ Directive (91/674/EEC) on the annual accounts and consolidated accounts of insurance undertakings, in particular Articles 63 and 64.

3.4. Specific Call for Advice

The Framework for Consultation contains the following statement concerning supervisory reporting and public disclosure requirements:

“Disclosure requirements enhance market discipline and complement requirements under Pillars I and II. The disclosure requirements should be in line with those elaborated by the IAIS and IASB in order to reduce the administrative burden for supervised institutions. They should also be compatible with disclosure requirements in the banking sector. Additions and adjustments could be proposed provided specific reasons for such exceptions are given. Confidentiality aspects linked to disclosure requirements need careful consideration.”

Supervisory reporting and public disclosure requirements are integral parts of the structure for the Solvency II regime. The specific issues under this call for advice must therefore be seen in the light of the specific calls for advice relating to pillars 1 and 2.

As reporting and disclosure requirements tend to be defined at a later stage in the elaboration process, the initial work on Solvency II requirements may have to concentrate on a general analysis of supervisors’ information needs as well as on issues relating to the coordination of requirements (between different areas of insurance supervision, between different financial sectors, as well as with financial reporting), consistency as well as the efficient collection and use of information.

The Commission Services would like CEIOPS to advise on the issues identified below.

- Analyse supervisors’ overall need for supervisory information, and how well existing (or coming) reporting standards (IAIS, IASB, Basel II/CRD pillar III requirements, CEBS work on reporting standards etc) would serve this purpose. The analysis must include life assurance, non-life insurance and reinsurance. The analysis should address the need for entity-specific information used for solvency calculation purposes.
- Formulation of a general supervisory reporting approach for Solvency II, including how reporting requirements under different pillar I and II issues should be aligned. Similarities and possible divergences with the Basel II/CRD regime should be analysed.

- Formulation of a general concept for public disclosure for the Solvency II system, including possible elements of market transparency and market discipline¹⁴. Consideration should be given to examining possible incentives to undertakings to provide public disclosure. Similarities and possible divergences with the Basel II/CRD regime should be analysed. Special consideration should be given to identifying information that enhances a policyholder's understanding of the solvency standing of the insurance undertaking and its possibilities to honour its commitments. Issues related to confidentiality and the disclosure of proprietary information should be analysed¹⁵.
- Links to financial reporting; the possibility of using a set of financial data that, with certain adjustments, could be used for financial reporting as well as for supervisory returns. CEIOPS should furthermore consider the need and formulation of "prudential filters", as well as the possible use of specific reporting formats for prudential purposes.
- The possible use of the materiality principle when undertakings fulfil the supervisory reporting/disclosure requirements¹⁶. This principle is used in the Basel II/CRD framework and in "principle-based" financial reporting frameworks, and may be important in a future supervisory system with increased information requirements, in combination with the reporting of entity-specific information.
- CEIOPS should analyse the need for special disclosure requirements for small insurance undertakings. Consideration should be given to identifying the reporting/disclosure requirements for "non-IFRS" companies.
- Consideration should be given to the efficient gathering of supervisory information. CEIOPS should elaborate on what information should be gathered and provided automatically (for example via Internet) to other supervisors, and what information should be available upon request (see Call for Advice n° 20). The possible need for harmonised information technology systems and an EU supervisory data base may have to be addressed at a later stage of the Solvency II project.

¹⁴ On this issue see Archon Fung/Mary Graham/David Weill (2002): The Political Economy of Transparency: What makes Disclosure Policies Sustainable, <http://www.ashinstitute.harvard.edu/Ash>

¹⁵ For the issues raised under this point, CEBS work may provide a useful starting point for CEIOPS' deliberations.

¹⁶ One formulation of this principle can be found in the IASB Framework for the Preparation and Presentation of Financial Statements, paragraph 30: "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful".

- Coordination of reporting/disclosure requirements at insurance entity level, group level as well as conglomerate level. The need for cooperation between supervisors involved and the possible attribution of tasks between them should be analysed.
- The issue of the frequency of reporting and disclosure should be analysed. In this regard, the disclosure requirements in Basel II/CRD are worth analysing¹⁷.
- Due to differences between national markets or companies, there may be a need for additional supervisory information at national or company level (as part of the supervisory review process in pillar 2 for example). CEIOPS should consider how such national adjustments could be made in a way that respects the general design of the system.

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 30th June 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 28th February 2006.

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 potential mandates for these implementing measures, as well as to keep the Insurance Committee (EIOPC) informed 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.

¹⁷ Basel II paragraph 818 and CRD Article 147.

4. PROCYCLICALITY

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 the SCR (n° 10), the QIS (n° 13) and solvency control levels (n° 15).

4.1. Introduction

Procyclicality as a concept depends on the context in which it is used and therefore needs to be defined. For Solvency II it can be understood to be the pressure on institutions to sell assets or raise capital at inopportune times, due to the risk sensitivity of the capital requirements. It therefore is not related to the underwriting cycle.

Procyclicality is assumed to be a feature of any risk-sensitive approach, but the effects may vary. As Solvency II will introduce a risk-sensitive capital requirement (SCR), there is a need to look at the potential procyclical effects and solutions to deal with them.

Procyclicality has been given a lot of attention in the framework of Basel II. Supervisors and academics have produced quantitative studies to analyse the impact of this effect. However, generally speaking, in the development of solvency systems throughout the world, this was never a major issue.

4.2. References

- PWC study for the Commission (MARKT/2003/02/F): Study on the financial and macroeconomic consequences of the draft proposed new capital requirements for banks and investment firms in the EU¹.
- The Portuguese supervisory authority has developed a tool that is based on a longer time horizon than 1 year and that assumes mean reversion (based on Wilkie models)².
- The Dutch supervisory authority has developed, as part of its financial assessment framework, a continuity analysis to explicitly include in supervision a long term perspective. The analysis assesses whether the financial risks of the undertaking are within acceptable limits in the long term and how the undertaking manages these risks. The analysis (“Pillar 2”) does not have a direct effect on the capital requirement³.

¹ http://europa.eu.int/comm/internal_market/regcapital/docs/studies/2004-04-basel-impact-study_en.pdf

² <http://www.isp.pt/NR/exeres/97C24D91-5FD7-4874-9D7D-FFE049D206D9.htm>

³ http://www.dnb.nl/dnb/bin/doc/FTK%20Consultation%20Document%20English%20translation_tcm13-47968.pdf, pages 44-49

- The French supervisory authority uses a solvency report that contains an analysis of the conditions under which the undertaking is able to fulfil all its liabilities in the medium and long term⁴.

4.3. Background

As stated above procyclicality as a concept depends on the context in which it is used and therefore needs to be defined. For Solvency II it can be understood to be the pressure on institutions to sell assets or raise capital at inopportune times, due to the risk sensitivity of the capital requirements⁵. The procyclicality effect occurs when the pressure to sell assets or to raise capital becomes so great that a large number of companies act in a similar way and in the same time period thereby intensifying the (financial) markets cycle as a result of which the initial pressure on these institutions is not alleviated and can even be reinforced.

In banking, procyclicality is the extent to which risk-sensitive capital requirements will exacerbate economic cycles by sharply increased capital requirements. It is assumed that as credit ratings of counterparties fall and the amount of regulatory capital increases, an economic downturn is exacerbated by creating credit crunches. Therefore the nature of the procyclicality effect in insurance and banking seems to be different.

Most research in this field has been undertaken during the development of Basel II. The study by PWC for the Commission indicates that a risk-sensitive system can result in less and less damaging, procyclicality and reduce herd behaviour. The greatest defence against procyclicality will be the risk awareness of undertakings which includes a more forward looking approach. Stress tests also encourage to mitigate the effects of procyclicality.

The procyclical effect can be alleviated by looking at solvency over a longer period. Some ratings are meant to look “through the cycle” aiming at some sort of stability of the rating. The approaches used by major rating agencies, as well as in several of the supervisory models quoted under 4.2, aim at reaching such a result. Through-the-cycle ratings are to a certain extent stable because they are intended to measure default risk over long investment horizons, and because they are changed only when rating agencies are confident that observed changes in a company's risk profile are likely to be permanent.

⁴ <http://www.legifrance.gouv.fr/WAspad/UnArticleDeCode?code=CASSURAL.rcv&art=L322-2-4>
⁵ <http://db.riskwaters.com/public/showPage.html?page=6288>

4.4. Specific Call for Advice

The Commission Services request CEIOPS to advise on the existence and impact of procyclicality in Solvency II and if the impact were to be significant, to suggest solutions to remedy the effect. In its advice, at least the following areas should be addressed:

- It is suggested that a working definition is developed for Solvency II purposes.
- In order to assess the potential for procyclical effects, it is necessary to identify the sources for procyclicality in Solvency II. In assessing the potential effects, it should be noted that positive/upwards effects may also occur as a result of procyclicality⁶.
- The potential impact of procyclicality should be analysed to assess the importance of this issue.
- Several possible solutions have been discussed to alleviate the effects, including longer time horizons, separate tools (stress testing) and adjustments within the Supervisory Review Process in Pillar II. CEIOPS is requested to elaborate on suitable solutions.

4.5. 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 30th June 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 28th February 2006.

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 potential mandates for these implementing measures, as well as to keep the Insurance Committee (EIOPC) informed 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 E.g. the increased equity investments by insurers and pension funds in the late 1990s also stimulated the booming of the equity prices, which in turn increased the available solvency margin.

5. SMALL UNDERTAKINGS

This Specific Call for Advice concerns most of the other Calls for Advice as it is a horizontal subject. It seeks to highlight the concern that Solvency II should not be overly costly for small undertakings but does not intend to have an entirely special treatment of them. Like the other Specific Calls for Advice, it must also be examined in conjunction with the Framework for Consultation.

5.1. Introduction

Solvency II is focused towards better managing and quantifying risks in order to better protect policyholders. This is not without a cost. Finding the right balance between quality and cost is particularly important in the case of small undertakings. However, if it is decided that certain adaptations must be made for them, these must not compromise the key underlying solvency principles. Well-functioning small undertakings have an essential role to play in the European insurance markets.

The definition of a small undertaking is a challenge. The obvious first idea is to define them through size; however, this raises the question both of the criteria chosen to measure size and the level of the threshold. The definition used in Directives¹ and the Commission Recommendation of 6 May 2003² of small and medium-sized enterprises are the undertakings that meet two out of three criteria amongst balance-sheet total, net turnover and number of employees.

However, between one small company (defined by size) underwriting only motor and homeowner insurance, and another, insuring medical liability or aviation insurance, there is not much in common. As Solvency II will be a risk-oriented system, it would seem necessary to take into consideration the types of risks underwritten when defining small undertakings.

This Call for Advice isolates small undertakings for two purposes. The first is to identify whether very small undertakings should be excluded from the scope of the Solvency II Directives. The second is to reflect on whether adaptations of the new solvency regime will be necessary for small undertakings and, if so, what type of adaptations.

¹ Article 5 of the second non-life Directive 88/357/EEC defining large risks, and Article 11 (1) of the Fourth Accounting Directive 78/660/EEC giving the possibility to allow simplified reporting requirements for small undertakings.

² Annex of the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (2003/361/EC).

5.2. References

- European Commission:

Proposal for a Capital Requirements Directive (CRD)¹, 14 July 2004: standardized approach for credit risk and basic indicator approach for operational risk.
- Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) (ex- Conference of European Insurance Supervisory Authorities)

Report on Internal control for insurance undertakings (Madrid Working Group), chaired by Carlos Montalvo, December 2003², chapter 5 on small entities.

5.3. Background: exceptions for small undertakings in the current Directives

The current Directives make very limited exceptions for small undertakings through exclusion from the scope of the Directives or option for Member States to reduce their guarantee fund. The exceptions are for entities which are defined either by their size, their legal form or by the types of business they underwrite.

- Exclusion from the scope of the Directives

Article 1 of Directive 2002/13/EC (Solvency I directive) amending Article 3 of Directive 73/239/EEC (first non-life directive) and Article 3 of the Recast Life Directive 2002/83/EC exclude from their scope namely small mutuals, defined inter alia by premiums under 5 million euros. However, in non-life, if the undertaking underwrites liability insurance, it automatically falls within the scope of the Directive, whatever the amount of premiums collected. In addition, small companies (less than 200 000 euros) that underwrite assistance are excluded from the scope of the Directive. In life, whatever the premium collected, companies doing exclusively funeral insurance are excluded from the scope of the Directive. This description is an approximation (other conditions apply, see the exact text of the Directives) but overall, it is a combination of income size and types of risks underwritten that define a small undertaking, with types of risks overriding the size factor.

- Reduction of capital requirements

Article 1, point 4 of Directive 2002/13/EC (Solvency I Directive) amending Article 17 of Directive 73/239/EEC (first non-life Directive) and Article 29 of the Recast Life Directive 2002/83/EC have a specific provision for mutuals (possibility for Member States to provide a one-fourth reduction of the guarantee fund) under certain additional conditions. In practice, mutuals are often small undertakings and here, in a way, the legal form is an approximation of size.

¹ http://europa.eu.int/comm/internal_market/regcapital/index_en.htm#capitalrequireproposal

² [http://www.ceiops.org/cgi-bin/ceiops.pl?sprache=1&cm=nm&verz=05a_\\$P\\$ublications*03a_Rep\\$oS\\$rts&what=1&who=/texte/0312_madrid.pdf](http://www.ceiops.org/cgi-bin/ceiops.pl?sprache=1&cm=nm&verz=05a_Publications*03a_RepoSrts&what=1&who=/texte/0312_madrid.pdf)

It is worth noting however that the calculation of the solvency margin, the valuation of technical provisions and the current insurance accounting rules contain no specific provisions for small undertakings. The same is true of the supervisory review process, although it is clear that, in practice, the supervisor acts according to the scale, nature and complexity of the company.

5.4. Specific Call for advice

Current solvency or capital adequacy projects (concerning insurance in the EU or outside the EU, or related to banking) generally make allowance for small undertakings by accepting at least two methods as equivalent, a simplified or standard method, and a more complex one.

The Commission Services are of the view that small undertakings should respect the same basic principles as all other insurance undertakings. However, in certain areas, it may be necessary to make allowance for small undertakings, either through different requirements or by specifying “according to the scale and nature of the risks”. The Commission Services request CEIOPS to advise on whether a specific treatment of small undertakings is necessary and if so, in what areas precisely. In its answer, CEIOPS should address at least the following issues:

- What would be an appropriate definition of small undertakings that would take into account the risks they underwrite?
- Should very small undertakings be excluded from the scope of the directive?
- Should there be adaptations of the capital requirements for small undertakings (absolute floor of the MCR, calculation of the MCR, calculation of the SCR by the standard formula)?
- The standard formula of the SCR will apply to companies that do not have the resources to build an internal model. This will concern most, if not all, small undertakings. However, some small undertakings may wish to avail themselves of partial use of internal models. Should any specific consideration be made for those small undertakings?
- If a small undertaking has a very specific risk profile (because of the types of risks underwritten or the types of assets held), the supervisor may require that it builds an internal model. Should this possibility be limited? If so, under what conditions may a supervisor require an internal model? (see requests n°11 on internal models and n°14 on powers of the supervisor).
- Should reporting requirements for small undertakings be different? (see request n°21 on supervisory reporting and public disclosure).

Note that the quantitative impact study must explicitly include the impact of the new rules on small undertakings.

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 30th June 2005. Technical advice provided in relation to the Commission proposal for the Framework Directive should be transmitted by 28th February 2006.

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 potential mandates for these implementing measures, as well as to keep the Insurance Committee (EIOPC) informed 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.