



MARKT/2516/07
October 2007

Draft outline of the Impact Assessment for level 2 implementing measures of Solvency II

Purpose of this note

The Solvency II Framework Directive Proposal was adopted by the Commission on 10 July 2007, as planned.

Following publication of the proposal, a work plan has been agreed with EIOPC and CEIOPS covering the development and adoption of level 2 implementing measures as well as level 3 guidance.

As part of the work on the development of level 2 implementing measures, the Commission plans to conduct a full Impact Assessment, similar to the exercise performed for the level 1 Framework Directive, and produce an Impact Assessment report to accompany the Commission proposal for the level 2 implementing measures (foreseen for the 1st semester 2010).

The purpose of this note is to present a proposed outline for the Solvency II Impact Assessment work on level 2 measures and to obtain feedback and suggestions from Member States on this exercise.

Question 1: Do Member States agree with the general approach set out for the development of the level 2 Impact Assessment?

Question 2: Do Member States agree that the problem definition and objectives for the Level 1 Impact Assessment should be retained for the Level 2 Impact Assessment, subject to elaboration of the existing operational objectives where necessary?

Question 3: Do Member States agree with the policy issues proposed to be analysed as part of the Impact Assessment of level 2 implementing measures?

Question 4: Do Member States agree with the areas identified for further analysis to be conducted by different stakeholders?

1. BACKGROUND: SOLVENCY II ROADMAP

The Solvency II Framework Directive Proposal was adopted by the Commission on 10 July 2007, as planned. The level 1 Framework Directive Proposal was accompanied by an Impact Assessment Report¹.

Following the publication of the proposal, a work plan has been agreed with EIOPC and CEIOPS covering the development and adoption of level 2 implementing measures as well as level 3 guidance. The work plan also covers the transposition of the Directive into national law by Member States and allows time for the industry and supervisors to update their systems, processes and procedures. The work plan envisages that the new regime will become fully operational in 2012².

As part of the work on the development of level 2 implementing measures, the Commission plans to conduct a full Impact Assessment, similar to the exercise performed for the level 1 Framework Directive, and produce an Impact Assessment report to accompany the Commission's proposal for the level 2 implementing measures (foreseen for the 1st semester 2010).

The purpose of this note is to present a proposed outline for the Solvency II Impact Assessment work on level 2 measures and to obtain feedback and suggestions from Member States on this exercise.

2. IMPACT ASSESSMENT (IA) OF THE SOLVENCY II PROJECT

The Commission's White paper on Financial Services Policy 2005–2010 requires all new directive proposals to be subject to an IA.

The work conducted on the Solvency II IA report accompanying the level 1 Directive Proposal was both time-consuming and difficult. In total, including all the annexes, the IA report runs to almost 1500 pages and includes contributions from industry trade associations, supervisors, consumer representatives, the European Central Bank and DG ECFIN.

The Solvency II Directive Proposal was the first Directive of DG MARKT whose IA Report was submitted to the examination of the IA Board, a newly constituted internal Commission committee. The main IA report includes a summary of the recommendations made by the IA Board and the changes made to the report itself in response to them.

As far as implementing measures are concerned, it should be noted that in theory not all the Lamfalussy level 2 measures require a mandatory Impact Assessment: an *ad hoc* procedure applies to all Comitology measures, including Lamfalussy level 2 measures. According to the White Paper on the Financial Services Policy 2005-2010, "*the Commission will also assess – on a case by case basis – whether technical implementation (level 2) measures also require impact assessment*".

But in the case of Solvency II, given the complexity of the project and that a considerable amount of work remains to be done at levels 2 and 3, the Commission believes that it would be appropriate to subject the level 2 implementing measures to a full IA. The IA Board has expressed its support for additional work to be carried out in order to enable further quantitative analysis of the costs and benefits to be conducted once the technical details have been drafted.

¹ http://ec.europa.eu/internal_market/insurance/solvency_en.htm

² See Commission's letter to CEIOPS, 19.07.2007, Annex I – List of Implementing measures in the Proposal for a Directive, and Annex II – Solvency II Roadmap.

In line with this approach, the (draft) Council conclusions on the 2007 Lamfalussy Review invite the development of ex ante impact assessment for level 2 measures.

2.1 Level 1 Impact Assessment

2.1.1 Structure of the Impact Assessment report

For the level 1 Impact Assessment Report, the Commission adopted the following structure:

- Executive summary;
- Main report;
- 13 "B Annexes" (detailed policy options analysis);
- and 18 "C Annexes" (external contributions on specific areas, issues or topics).

2.1.2 Main report

The analysis and conclusions contained in the IA main report (and executive summary) are based on the material contained in the C annexes and the analysis of the impact of policy options on different stakeholders in the B annexes.

The main report follows the standard structure for an IA report as set out in the Commission's IA Guidelines: identification of the problem, definition of the objectives, identification of alternative policy options likely to achieve those objectives, analysis of the impacts of the various policy options on different groups, comparison of the options considering all the relevant positive and negative impacts, and assessment of the overall impact of the approach ultimately retained, plus future monitoring and evaluation.

- ***Problem definition***

The problem definition, underpinning the need for action with Solvency II, shows how, although Solvency I updated the EU regime in 2002, a number of structural weaknesses remained. In particular, the regime is not risk sensitive; it has not ensured the removal of all restrictions preventing the proper functioning of the single market; it does not properly deal with group supervision; and it has been superseded by industry, international and cross-sectoral developments (See Annex 1 "Solvency II Problem Tree" and IA report Section 2.3).

- ***Objectives of the Solvency II project***

Given the weaknesses of the current EU regime, the following general objectives were agreed for the Solvency II project:

- Deepen the integration of the EU insurance market;
- Enhance the protection of policyholders and beneficiaries;
- Improve the international competitiveness of EU insurers and reinsurers;
- Promote Better Regulation.

In order to assess the effectiveness and efficiency of various policy options with respect to these general objectives, a number of specific and operational objectives were identified (See Annex 2 "Solvency II Objectives" and IA report Section 3).

For the purposes of the level 2 IA, the Commission intends to maintain the same problem definition and objectives as for the level 1 IA as the level 2 measures should be aligned with the principles agreed at level 1 and thus by definition should be addressing the same problem and trying to achieve the same objectives. That said, the Commission envisages that it may be helpful to introduce a fourth level of objectives (or sub-operational objectives) to analyse some of the very detailed options that will need to be examined at level 2. The extent to which it is necessary to elaborate on the existing operational objectives will become clearer during the process, in particular, once a definitive list of policy issues and options have been developed.

2.1.3 B Annexes: policy issues and policy options

In the level 1 IA Report, thirteen key issues were identified and various policy options analysed and compared for each one. The issues were split into high level policy options, relating to the overall design of the new regime, and lower level policy options.

The high level policy options dealt with the following issues: 1) whether a change is needed, 2) what legislative procedure should be followed, 3) what level of consistency with prudential supervision in the banking sector should be aimed for, 4) how insurance groups should be supervised, 5) how small and medium sized insurers should be treated, 6) whether the calculation of technical provisions should be harmonized for accounting and supervisory purposes, and 7) what approach should be taken with respect to the calculation of capital requirements.

The lower level policy options related to the following issues: 8) methods for the calculation of the technical provisions, 9) level of calibration of the SCR, 10) the choice of the risk measure for the SCR, 11) the design of the SCR standard formula, 12) the calculation of the MCR, 13) investment rules.

The detailed analysis and comparison of each option and in particular the impact on different stakeholder groups of each option is presented in Annexes B.1 – B.13 of the IA Report.

2.1.4 C Annexes: external and internal contributions

For the purposes of the level 1 Impact Assessment, several reports were prepared by external and internal contributors: KPMG, the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), the CEA, AISAM & ACME, the European Central Bank, FIN-USE and the Commission's Directorate General of Economic and Financial Affairs. In addition, CEIOPS carried out two Quantitative Impact Studies (QIS), and a public hearing was held by the Commission in 2006. All the reports have been published along with the IA Report.

2.2 Level 2 Impact Assessment

2.2.1 Suggested general approach

The Commission proposes to use the same structure for the level 2 Impact Assessment as that used for the level 1 Impact Assessment i.e.:

- Executive summary;
- Main report;
- B Annexes (setting out analysis and comparison of the impact on stakeholder groups of the various options identified for each issue);
- and C Annexes (external contributions on specific areas, issues or topics).

The Commission in its letter on further work for Solvency II has asked CEIOPS to contribute to the preparation of the IA in particular with respect to the analysis and comparison of the policy options (as contained in the B annexes). CEIOPS' technical advice will be the primary input for the drafting of the implementing measures proposal by the Commission. CEIOPS' involvement in the IA³ should help structure the advice, rationalizing the process of the problem examination, and making sure that the policy development process and IA process are closely aligned and that the decision making process followed for key issues regarding level 2 implementing measures is as transparent as possible.

Consequently, the Commission proposes to ask CEIOPS to provide a contribution along the lines of the B Annexes for the level 2 IA. This contribution would need to be provided together with the final advice on the implementing measures in October 2009.

Concerning analytical work to be conducted on relevant areas, as for the level 1 IA, we propose to ask a number of different stakeholders to provide contributions on specific topics and papers for the development of level 2 measures along the lines of the C Annexes.

The Commission will then produce the main report based on the information provided in the B and C Annexes. The main report will contain: a review of the procedural issues and of the consultation of interested parties conducted for the level 2 measures (e.g. Public Hearing to be held in January 2008 on QIS4 specification); detailed discussion and comparison of the policy issues and options looked at with respect to the level 2 implementing measures and the rationale behind the choice of the preferred option, plus an update on future planned monitoring and evaluation of the proposal once it becomes fully operational. The report will also briefly recall the problem definition and objectives agreed for the Solvency II project at level 1 along with a description of any elaborations made to the operational objectives.

The main report along with the annexes will be circulated for comment to stakeholders before being finalized.

Question 1: Do Member States agree with the general approach set out above for the development of the level 2 Impact Assessment?

³ Following the reorganization of its Working Groups, CEIOPS has allocated to the Financial Stability Committee (FSC) the competencies for the IA analysis to be done for level 2 and level 3 measures. The FSC will act as a coordinator as far as the IA is concerned of the other working groups that deal with the individual issues.

Question 2: Do Member States agree that the problem definition and objectives for the Level 1 Impact Assessment should be retained for the Level 2 Impact Assessment, subject to elaboration of the existing operational objectives where necessary?

2.2.2 List of main policy issues to be analysed

The first step that needs to be taken in moving forward with the IA work at level 2 is the identification of the main policy issues that should be analysed as part of the level 2 Impact Assessment. Once the main issues have been determined then various different policy options will need to be identified for each issue. The Commission has identified the following main policy issues regarding level 2 implementing measures (see table below).

List of main policy issues	
Pillar I	1 Technical Provisions: Best estimate
	2 Technical Provisions: Risk margin
	3 SCR standard formula: Market risk
	4 SCR standard formula: Underwriting risk
	5 SCR standard formula: Profit sharing
	6 SCR standard formula: Solo and group diversification effects
	7 SCR internal models
	8 MCR: design
	9 MCR: calibration
	10 Own funds
Pillar II	11 Own Risk and Solvency Assessment
	12 Capital add-ons
Pillar III	13 Supervisory Reporting
	14 Public Disclosure
Groups	15 Group support regime
	16 Supervisory co-operation and co-ordination

Once a definitive list of main policy issues has been identified, then the Commission will work with CEIOPS in order to develop a number of different policy options for each policy issue.

Question 3: Do Member States agree with the policy issues proposed to be analysed as part of the Impact Assessment of level 2 implementing measures?

2.2.3 External work to be conducted on specific areas, topics or issues (C Annexes):

The Commission will invite a number of stakeholders to produce specific contributions and papers on relevant areas and topics. For the level 1 IA, the C Annexes were split broadly by stakeholder group (e.g. industry, consumers, supervisors, etc). For the level 2 IA we propose to theme the C Annexes by policyholder groups or alternatively by business line.

We have identified the following areas where a specific assessment of the impact of the level 2 measures would be desirable:

1. Mass risks (including motor and household insurance)
2. Health insurance
3. Long term saving products
4. Commercial insurance, reinsurance and risk mitigation techniques

In addition, the Commission has identified two issues where further analysis needs to be conducted. First, an assessment of administrative costs, including costs associated with reporting requirements. Second, a quantitative assessment of the impact on the economy as a whole, including the analysis of the impact of Solvency II on the investment policy of insurers.

- Mass risks (including motor and household insurance)

In line with the objectives and actions announced in the Green Paper on Retail Financial Services in the Single Market, we have started examining the issue of fragmentation of retail insurance markets. Given the leading position of motor insurance in the retail insurance sector, representing one third of the non-life business in Europe, we selected this insurance branch to be analyzed first.

Following this preliminary analysis, the Commission intends to commission a thorough external market study examining and explaining price divergences of several important retail insurance lines of business between the EU 27 Member States. This study will include analysis of the factors having the most influence on the final price of insurance in each Member State.

As part of this study, the Commission also proposes to look at the potential impact of the introduction of Solvency II on pricing, competition and integration of EU retail insurance markets, e.g. motor and household insurance. One of the conclusions of the level 1 IA Report is that it is anticipated that Solvency II will increase competition, especially for mass retail lines of business, such as motor and household insurance, put downward pressure on many insurance prices, and increase choice by encouraging product innovation. However, without conducting a thorough study at level 2, it is difficult to establish what the likely size of these effects will be.

- Health Insurance

Given the current demographic trends and the inflation of health care costs, the role of private insurance as a provider of protection against health risks is becoming more and more important. The area of health insurance is central for many stakeholders (consumers, policy makers, health insurers).

The issue of the possible social impact of Solvency II on areas such as health insurance was raised by the IA Board, as well as during inter-service consultation. In order to provide a first answer to this question, a specific box was inserted in the main IA report (See "Social Impact of Solvency II" - IA Report page 44). Nevertheless, the Commission believes that further work is required in this regard, particularly as coming up with an appropriate design and calibration of the Solvency Capital Requirement for health insurers is proving not to be an easy task, given national differences in this field (e.g. in terms of the products offered, as well as the existence in some Member States of specific equalization mechanisms). Following QIS2 and QIS3 results, concerns were expressed by participants in some Member States regarding the appropriateness of the SCR standard formula for their business.

The Commission proposes asking CEIOPS to look at this issue and in particular the impact that Solvency II will have on health insurance in different Member States, in order to ensure that Solvency II properly reflects the situation in each Member State and in particular takes proper account of relationships between private and public health insurance systems.

- Long-term saving products

The ageing of the population creates numerous financial challenges. Over the last few decades, public finances have come under increasing pressure and the current lack of sufficient pension provision is recognised as one of the main issues facing societies today.

The insurance sector is widely recognised as having a major role to play in this regard and the issue of the possible impact of Solvency II on the design and pricing of long-term savings and retirement products offered by insurers has been raised by the ECB, DG ECFIN and the IA Board. In particular, the question raised was whether Solvency II could result in a transfer of investment risk to households and if so what the consequences of such a shift would be.

The Commission believes that it would be valuable as part of the level 2 IA to analyse the potential impact on the design, pricing and availability of long-term savings products in order to ensure that Solvency II properly accounts for the wide diversity of long term savings products offered across the EU at present, as well as encouraging the creation of innovative new products by insurers.

- Commercial insurance, reinsurance and risk mitigation techniques

The insurance industry, by providing insurance coverage to companies both large and small, reduce the amount of capital they are required to hold, improve their financial soundness, promote innovation and help promote sensible risk-management measures.

It is important therefore that the impact of Solvency II on commercial insurance is examined carefully at level 2 in order to ensure that Solvency II properly accounts for commercial insurance lines of business and in particular low frequency, high severity lines of business where some increases in prices might be expected as result of the increased transparency arising from the introduction of the new regime, at least in the short term.

It is also important that the impact of Solvency II on reinsurance markets and other risk mitigation techniques is looked at in detail in the level 2 IA as greater allowance and recognition of risk mitigation techniques used by insurers under Solvency II is one of the innovations of the new regime that many stakeholders involved in the level 1 IA felt would bring considerable benefits. In particular, it is important that Solvency II properly reflects the economic substance of risk mitigation techniques.

- Administrative costs (including costs associated with reporting)

The Commission's IA guidelines prescribe that the administrative costs associated with the introduction of new legislation should be assessed using the EU Standard Cost Model.

For the level 1 IA, given the principle-based nature of the Framework Directive and the fact that detailed requirements will only be introduced at level 2, it was not possible to use the full model. However, the CEA made an assessment of the likely additional administrative burden of the introduction of Solvency II (See Annex C.8c of the IA Report). This data was then used by the Commission to populate the EU Standard Cost Model at a high level.

For the level 2 IA, the net administrative cost will need to be calculated in accordance with the EU Standard Cost Model in greater detail. In particular, detailed information will have to be collected to determine the net administrative cost of supervisory reporting and public disclosure requirements under the new system. The net administrative costs would have to be calculated for a number of different policy options – i.e. with respect to each of the different options identified for comparison regarding supervisory reporting and public disclosure.

- Macro-economy (and investment policy of insurers)

For the level 1 Impact Assessment, DG ECFIN produced a qualitative assessment of the impact of Solvency II on the macro-economy (See Annex C.6 of the IA Report). For the level 2 IA DG MARKT has asked the ESAF (Joint research Centre of the European Commission), in collaboration with DG ECFIN, to develop a quantitative model to assess the macroeconomic impact of Solvency II. This quantitative assessment will complement the qualitative assessment already performed.

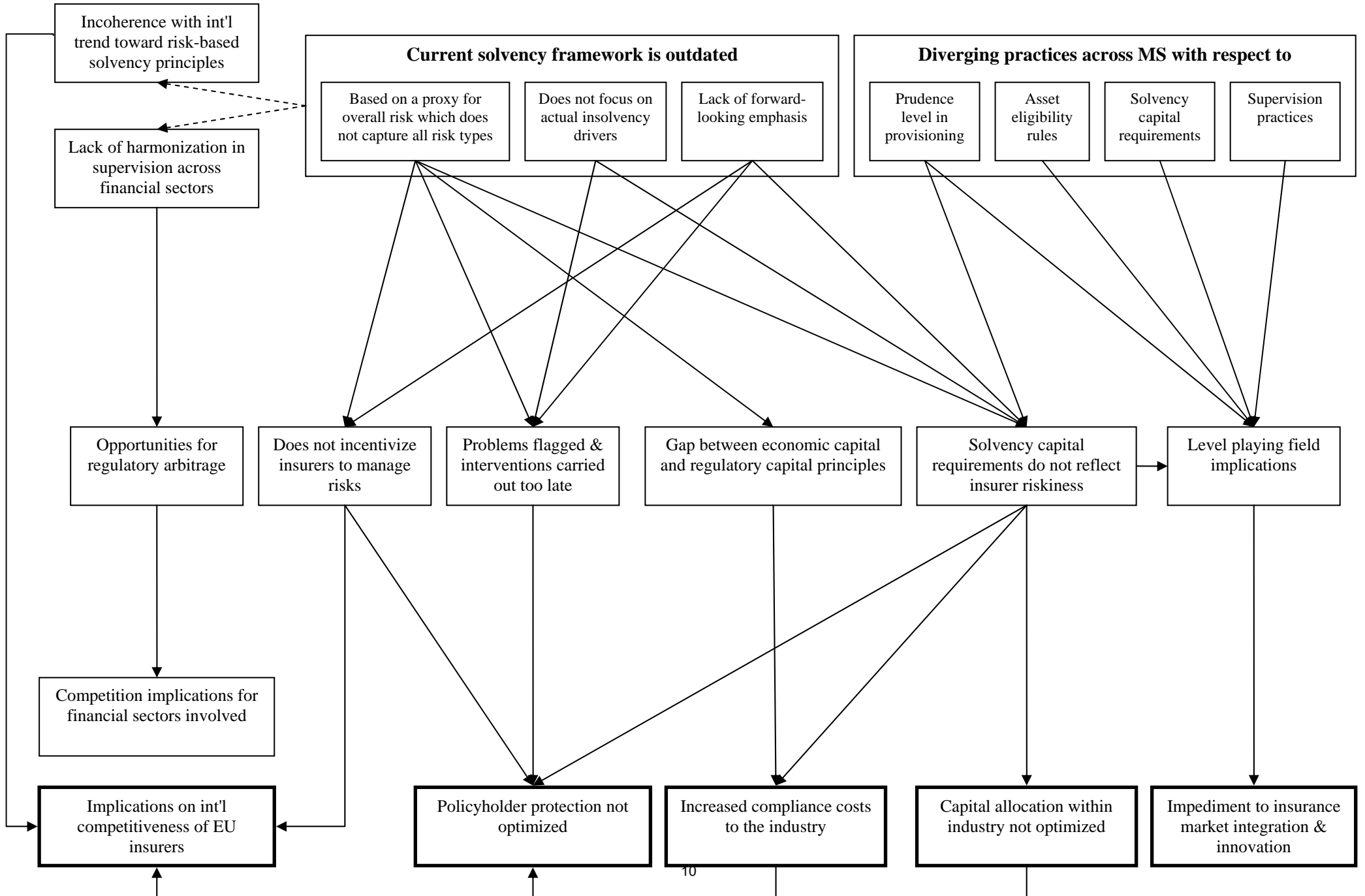
At the same time, the European Central Bank's (See Annex C.07 of IA Report) report dealing with the impact of Solvency II on Financial Stability included a quantitative assessment looking at whether insurers had changed their asset allocation in anticipation of the introduction of Solvency II. The Commission has asked ECB to periodically re-run the econometric analysis done for the level 1 IA, based on updated data, for the level 2 IA. This analysis will help the Commission to ensure that there is a smooth transition from the old to the new regime and consequently that the potential for any short-term negative impacts on financial stability arising from the introduction of Solvency II will be minimized.

Question 4: Do Member States agree with the areas identified for further analysis to be conducted by different stakeholders for the C annexes?

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ANNEX 1 - SOLVENCY II PROBLEM TREE



ANNEX 2 - SOLVENCY II OBJECTIVES

GENERAL
SPECIFIC
OPERATIONAL

