NOTE TO THE IC REINSURANCE SUBCOMMITTEE

Subject: Fast-track reinsurance supervision project
– Tentative staff recommendations for quantitative parameters and related issues

Purpose of this document

This document contains – for discussion purposes - tentative staff recommendations on certain quantitative parameters and related issues to be included in a fast-track reinsurance supervision directive. The tentative recommendations concern the following items:

- Solvency margins as a percentage of claims and premiums
- The application of different non-life and life reinsurance solvency margin requirements
- Size of the minimum guarantee fund
- Size of the reinsurance reduction factor
- The application of reinsurance solvency margins (and minimum guarantee fund requirements) for the inward reinsurance business of direct insurance undertakings
- Asset coverage of the whole solvency margin
- Use of amounts set aside to equalisation reserves to cover the solvency margin

This document will be discussed with Member States in a meeting of the IC Reinsurance Subcommittee on 11 June 2003.

The Commission Services also invite interested parties to comment on the document.
This note should be read together with the Commission staff’s draft for a reinsurance supervision directive (MARKT/2531/02 Rev. 2) and the cover note (MARKT/2524/03), both available at the Commission website.

I Introduction

Background

1. In 2000, Member States and the Commission Services agreed to start a project in order to assess the possibility of establishing a harmonised framework for reinsurance supervision in the EU. After discussions and hearings in 2000-2002, it was decided that a focus should be given to a “fast-track” approach. This approach will necessarily to a large extent have to be based on current direct insurance supervision rules. It should lead to EU legislation in a reasonably short period of time, which would benefit supervisors and companies as well as enhance the EU position in future mutual recognition negotiations with non-EU countries. A fast-track approach would also be in line with initiatives from the G7 group, the World Bank and IAIS. It is worth noticing that all major jurisdictions, which supervise reinsurance, do so on the basis of the rules for direct insurance.

2. After an orientation debate in the Insurance Committee in April 2002, the Commission Services started preparing detailed proposals for the reinsurance project. A first legal draft text was discussed during the autumn of 2002, and this work is currently ongoing. Until now, the legal work has concentrated on the non-quantitative parts of the directive text.

3. The Commission Services together with Member States have performed simulations to analyse the impact of certain combinations of solvency requirements and minimum guarantee funds. The impact of an increased reinsurance reduction factor has also been covered. Summary comments on certain simulations will be included in the "extended impact assessment" that will accompany the Commission proposal for a reinsurance directive.

Quantitative parameters and related issues for an EU reinsurance supervision regime

4. This note contains Commission staff recommendations to the IC Reinsurance Subcommittee on possible quantitative parameters to be used in a future EU reinsurance supervisory system. It also includes proposals for certain related issues. These recommendations are presented for discussion purposes, and are subject to change in the light of the discussions in the Insurance Committee, the IC Reinsurance Subcommittee and with interested parties.

5. The note takes account of earlier discussions with Member States and interested parties on the subjects, as well as of written submissions to the Commission Services.

1 Documents available at the Commission insurance website:
http://europa.eu.int/comm/internal_market/insurance/index_en.htm
6. The tentative recommendations concern the following items:

- Solvency margin requirements for non-life reinsurance
- Solvency margin for life reinsurance – The application of different non-life and life reinsurance solvency margin requirements
- Size of the minimum guarantee fund
- Size of the reinsurance reduction factor
- The application of reinsurance solvency margins (and minimum guarantee fund requirements) for the inward reinsurance business of direct insurance undertakings
- Asset coverage of the whole solvency margin
- Use of amounts set aside as equalisation reserves to cover the solvency margin

Next steps

7. The fast-track reinsurance supervision project will be discussed at the meeting of the IC Reinsurance Subcommittee on 11 June 2003.

8. On the quantitative parameters and related issues, the Services will have contacts with the insurance industry and other interested parties as part of our regular exchange of views.

9. The Insurance Committee is scheduled to have an orientation debate on the reinsurance project at its meeting on 2 July 2003.

10. The Commission Services aim at providing Member States with a draft directive text including quantitative rules towards the end of July for subsequent discussion in the IC Reinsurance Subcommittee in September (tentative meeting date 9 September 2003). A further subcommittee meeting could take place in early October.

II Tentative staff recommendations for quantitative parameters and related issues

Summary of tentative staff recommendations

| Solvency margin for non-life reinsurance: | 1) Alternatives based on a multiple of the current non-life regime:  
| | a. 20% of premiums  
| | 30% of paid claims  
| | ("125% alternative", higher when Solvency I class enhancement applies), or  
| | b. 25% of premiums  
| | 35% of paid claims  
| | ("150% alternative"), or  
| | 2) Use direct non-life solvency requirements (Solvency I) until the CEIOPS has pronounced on possible enhanced requirements as a function of class of reinsurance business or type of reinsurance contract.  
| Solvency margin for life reinsurance: | Use non-life reinsurance requirements for the whole reinsurance company generally. Insurance supervisors may require or allow use of direct life rules for a reinsurance undertaking’s life reinsurance portfolio.  
| Minimum guarantee fund: | 1m EUR (reinsurance captive of industrial or commercial group)  
| | 3m EUR (reinsurance undertakings)  
| Reinsurance reduction factor: | 75% of ceded reinsurance  
| Application to direct insurance undertakings: | Yes, if one of the following criteria is fulfilled:  
| | - the reinsurance premium exceeds 10% of the total premium  
| | - the reinsurance premium exceeds EUR 500m  
| | - the technical provisions resulting from inwards reinsurance exceed 10% of total technical provisions  
| Asset coverage: | The whole solvency margin – not only the technical provisions - should be covered by quality assets.  
| Amounts set aside to equalisation reserves: | Amounts set aside to equalisation reserves could be used to cover the solvency margin. |
12. The starting point for the Services' recommendations is that a fast-track reinsurance regime must to a large extent depend on direct insurance solvency rules (Solvency I). There are consequently limits for how much adaptation that can be made to the direct rules. Many interesting proposals have been raised during the project, and many are in fact under considerations in the Solvency II project. There is however a limit on how much inspiration the reinsurance supervision project can draw from the Solvency II project. When the Solvency II project is finalised, an alignment of the insurance and reinsurance solvency rules will take place.

13. The Services have also considered possibly different characteristics of the insurance and reinsurance markets that could have an impact on the level of solvency requirements. In discussions in Brussels and in the IAIS Reinsurance Subcommittee, actuaries and industry normally express that the insurance and reinsurance business is similar and that requirements should reflect this. Supervisors however often maintain that certain features make reinsurance activity more difficult to supervise, and that this calls for higher solvency requirements than in insurance. The Services believe that reinsurance should be considered as a specialised line of insurance, rather than a separate activity. This implies that the future reinsurance solvency requirements should be broadly in line with those of direct insurers, but that supervisors’ needs may call for a certain enhancement of some reinsurance parameters.

14. In formulating the recommendations, the Services have aimed at a supervisory system that would be workable and robust. The proposals are intended to be broadly in line with current thinking in the IAIS Reinsurance Subcommittee. Some elements of the IAIS reinsurance thinking are also well integrated into the Solvency II working schedule.

15. Most proposals have been included in the Services draft for a reinsurance directive (MARKT/2531/02 Rev. 2).

**Solvency margin requirements for non-life reinsurance**

16. In line with the above reasoning, the Services propose that reinsurance undertakings doing non-life reinsurance business should fulfil slightly higher solvency requirements than direct non-life insurance undertakings. This can be achieved in different ways. The Services ask for comments on the different alternatives presented below.

17. The first two alternatives are based on multiples of the current direct non-life regime. Having considered discussions with supervisors and industry, the Services believe that two levels of solvency requirements can be discussed: 125% and 150% of the current direct non-life rules. These requirements would be applicable to reinsurance undertakings as well as reinsurance captives (and for inward reinsurance business of direct insurance undertakings – see below).
18. In the first alternative the solvency requirement would amount to 20% of premium or 30% of paid claims. For reinsurance undertakings underwriting business in classes 11-13 according to directive 73/239/EEC, the Solvency I class enhancement at 150% level would apply. 

19. The second alternative proposes solvency requirement amounting to 25% of premium or 35% of paid claims. In this alternative solvency requirements are enhanced along the lines of Solvency I for all classes of reinsurance business.

20. A system based on the current non-life regime cannot catch all particularities of reinsurance business. In addition to the risk level inherent in different reinsurance classes, there are also different risks contained in different types of reinsurance contracts. Non-proportional business is for example often believed to be riskier than pro-rata and facultative business. Certain Member States have asked for certain of these elements to be reflected already in a fast-track regime.

21. The Commission Services believe that a full analysis and comparison of risk levels in reinsurance classes and reinsurance contract types goes beyond the scope of a fast-track reinsurance project. These issues will however be part of the Solvency II work.

22. The Services could however see a possibility for another alternative in which the CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) could be asked to perform an analysis of need for class enhancement related to different reinsurance classes or reinsurance contract types. Until such proposals would be adopted through comitology, direct Solvency I requirements should apply also for reinsurance undertakings. This approach could deal with concerns by certain Member States, for example the treatment of facultative reinsurance.

Solvency margin requirements for life reinsurance – Differentiation between non-life reinsurance/life reinsurance solvency requirements

23. In earlier documents, the Commission Services have suggested that due to the nature of life reinsurance business an approximation using non-life reinsurance solvency requirements may be reasonable for the fast-track project. This view is in fact supported by the CEA and several large reinsurance companies. Other commentators – mainly from the UK and Ireland – argue for specific life reinsurance rules based on the current direct life rules. Such an approach – however with different ratios – is currently used in the UK.

24. It can be argued that due to the lesser importance of life reinsurance business there is no need for establishing specific solvency requirement. On the other hand, some reinsurance undertakings may be specialised in quota share treaties or other constructions where they face similar or the same risks as direct life insurance.

---


3 This alternative has not been reflected in the draft directive text.
25. The Services still believe that the basis for a fast-track system should be approximation with non-life reinsurance solvency rules also for life reinsurance. We are however conscious that there may be cases where this will not lead to a solvency margin requirement that reflects the nature of the company’s overall business. Therefore the Services would like Member States' and commentators' views on a model where the national supervisors could in fact allow or require reinsurers to use existing direct life rules for their life reinsurance portfolio. 

26. In principle, the Services do not believe that specific life reinsurance ratios should be developed in a fast-track approach. This issue will be addressed as a part of Solvency II. However, as this issue is of relevance to certain markets (like the UK), the Services would appreciate comments on the applicability of the direct life ratios also to life reinsurance business.

27. In this case there are certain consequential issues to consider concerning the reinsurance (retrocession) factor in the case of use of direct life insurance rules, and consequential use also for life reinsurance business of direct undertakings.

28. For consistency reasons, the Services believe that reinsurance companies that apply direct life rules for their life reinsurance business should use the direct reinsurance (retrocession) factor as direct life companies (i.e. 15%) without increase. (See below)

29. The Services are of the opinion that the same permission or requirement to use direct life rules to life reinsurance business should apply also to direct undertakings underwriting life reinsurance (issue raised under the later subheading).

**Minimum guarantee fund**

30. The Services believe that the differentiation made in Solvency I concerning the minimum guarantee fund (MGF) provides an interesting starting point for a reinsurance requirement. According to the Solvency I Directive, the basic requirement is EUR 2m, but insurance undertakings underwriting business in classes 10-15 should have a minimum guarantee fund of EUR 3m.

31. Following the reasoning in the previous paragraphs, it could be argued that as reinsurance supervision may be considered more complex, the slightly higher minimum guarantee fund requirement may be appropriate. The Services would therefore propose that reinsurance undertakings should have a minimum guarantee fund of EUR 3m. (See Article 23 of the draft Directive).

32. The MGF requirement for reinsurance captives requires special consideration. The Services are of the opinion that reinsurance captives provide useful services to industry, particularly in lines where normal insurance cover could be difficult to find. The draft Directive contains a definition according to which a “captive reinsurance undertaking shall mean a reinsurance undertaking created/owned by an industrial or commercial firm […] the purpose of which is to provide reinsurance cover exclusively to the risks of the firm […] to which it belongs.”

---

4 This solution has been included in the draft directive text for discussion purposes (Article 22).

5 Document MARKT/2531/02 Article 1, paragraphe 14.
33. The vast majority of reinsurance captives are small entities serving only their own group. The insurance expertise is in many cases provided by captive managers and by the fronting direct insurer(s). As many of these captives retain only a small part of the insured risk, they are often capitalised at a lower level. The performed simulations showed that reinsurance captives are particularly sensitive to the MGF requirement.

34. For the reasons stated in the previous paragraph, the Commission Services believe that there may be reasons to formulate another MGF requirement for reinsurance captives than for pure reinsurers. The Services would therefore suggest that a MGF requirement of EUR 1m is established for reinsurance captives only underwriting business emanating from group companies (i.e. including also third party liability covers when a group company is the buyer of the cover). If a reinsurance captive underwrites group external risks on the regular reinsurance market, a MGF of EUR 3m should be established.

Reinsurance reduction factor

35. In earlier documents, the Commission Services have tentatively supported the idea that direct insurance undertakings using EU licensed reinsurers should be able to benefit from a reinsurance reduction factor higher than the current 50%. This view is also supported by the insurance industry and the actuarial community. On the other hand, supervisors have expressed significant hesitation to increasing the reduction factor for ceded reinsurance.

36. Simulations performed showed that a reduction factor of 75% or 90% would generally have only a small impact on the required solvency level for the EU reinsurance market. However, the simulations also demonstrated that certain market segment would benefit more from such changes requirements. An increased reduction factor would also have a clear impact on smaller direct insurers and or entrants to the insurance market.

37. Considering the different arguments, the Commission Services would propose a reinsurance reduction factor of 75%. The same percentage should apply for retrocession.

Application to direct insurance undertakings

38. At several occasions during the reinsurance project there have been discussions on whether inward reinsurance business underwritten by direct insurance undertakings should be subject to the reinsurance solvency requirements. Proponents of this idea argue that this would create a level playing field and reduce the risk for arbitrage. Other commentators are of the opinion there is no apparent problem as the nature of the reinsurance business is normally different (insurers exchanging reciprocity contracts, lower layers, quota shares etc). Another argument is that it would be difficult to single out the reinsurance part of the business; for example how should facultative reinsurance be treated.
39. The Services tend to believe that the same solvency margin requirements should apply for reinsurance business regardless of what type of company that does the underwriting. In fact, the proposed solvency levels for reinsurance would work well in the class enhancement system introduced by the Solvency I directive. The Services do however believe that it is important to introduce a threshold value (for example 10% of total premium) in order to limit the number of direct undertakings that would have to apply the two set of rules. An absolute threshold of for example EUR 500m of inward reinsurance premium could also be introduced. The Services are also considering to have a third criterion linked to the proportion that the technical provisions in inwards reinsurance represents as a part of total technical provisions (for example 10%).

40. Such application would however give rise to number of consequential issues, particularly as regards the minimum guarantee fund, the asset rules and life reinsurance.

41. Concerning the minimum guarantee fund, the Services believe that the reinsurance requirements should be used for the whole direct insurance undertaking. Under our proposal, the MGF would in most cases be the same (i.e. EUR 3m).

42. On the issue of asset rules, the Services have in earlier documents proposed that reinsurers should follow a “prudent person” approach for their investments. Direct insurers do however follow more detailed quantitative placement rules. The fact that the reinsurance activities are performed in the same entity as direct insurance may trigger specific considerations. The Services therefore suggest that direct insurance undertakings should follow the direct non-life placement rules also for assets related to the reinsurance part of their activities. Consequently these companies do not need to have assets covering the full solvency margin, as Article 19 of the draft reinsurance directive is linked to the introduction of a "prudent person" approach.

**Asset cover of the whole solvency margin**

43. The current direct insurance regimes require technical provisions to be covered by diversified and sufficiently spread assets.

44. The Commission Services have proposed that a “prudent person” approach should be used for investments in a fast-track reinsurance supervision regime. Such an approach necessarily depend on a broader look on the reinsurance undertakings' assets, and therefore it may be less suitable to limit the asset coverage rules to only be applied to the amount of the technical provisions. The Commission Services therefore propose that the whole (minimum) solvency margin should be covered by quality assets (see Article 19 of the draft directive).

45. This recommendation is in line with recent discussions on the Solvency II project.

---

6 This solution has been included in the draft directive text for discussion purposes (Articles 36 and 38).

7 See staff paper MARKT/2509/03 "Design of a future prudential supervisory system in the EU – Recommendations by the Commission Services".
*Amounts set aside to equalisation reserves*

46. The current direct insurance supervision regime only requires equalisation reserves/provisions in credit insurance. Member States are however allowed to establish such reserves/provisions also for other lines of insurance business.

47. Simulations performed showed that many reinsurance undertakings have significant amounts set aside to equalisation reserves. In the current direct supervision directives these amounts are not allowed to cover the solvency margin.

48. It could be argued that especially reinsurance entities could benefit from the establishment of such reserves, and that consequently these amounts should be classified as "available solvency margin". To this end the Commission Services propose to include a provision in Article 20 stating that the available solvency margin may also consist of equalisation reserves established in accordance with Article 18.