



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 21.4.2004
SEC(2004) 443

COMMISSION STAFF WORKING PAPER

**Proposal for a Directive of the European Parliament and of the Council
on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC and
Directives 98/78/EC and 2002/83/EC**

Extended Impact Assessment

{COM(2004) 273 final}

The structure of this document

This extended impact assessment consists of the following parts:

1. A general introduction to reinsurance, insurance/reinsurance markets and reinsurance supervision
2. Problems affecting the EU reinsurance market
3. Stakeholders for a reinsurance supervision directive
4. The main objectives for the reinsurance supervision project
5. Main policy decisions to reach the objectives
6. Expected impacts from the different options identified
7. How to monitor and evaluate the results and impacts of the proposal after implementation?
8. Results from stakeholder consultations
9. Justification for the Commission proposal

1. Introduction to reinsurance, insurance/reinsurance markets and reinsurance supervision

Introduction to reinsurance

Reinsurance is a structured risk transfer between an insurance undertaking (often called the "cedant") and a reinsurer. Reinsurance fulfils the following functions for an insurance undertaking¹:

¹ See also an Issues Paper prepared by IAIS Working Group on Reinsurance, "Reinsurance and reinsurers: relevant issues for establishing general supervisory principles standards and practices", Amsterdam 2000, p. 20 ff. Website: <http://www.iaisweb.org/>.

- Reduction of technical risks
- Permanent transfer of technical risks to the reinsurer
- Increase of homogeneity of insurance portfolio
- Reduction of volatility of technical results
- Substitute for capital/own funds
- Supply of funds for financing purposes
- Supply of service provision

In spite of its obvious connection to direct insurance business, there are some characteristics of reinsurance that may be important to highlight:

- There is no direct contractual relationship between the reinsurer and the original insured, and the policyholders have normally no priority to the assets of the reinsurer to cover their claims.
- Reinsurance is a business activity between professional parties.
- Reinsurers largely depend on information from the direct insurers to establish claims reserves. There are furthermore significant delays in receiving claims information.
- Reinsurance business has higher degrees of diversity in respect of geography and combinations of insured lines than direct insurance business.
- Reinsurers have significant catastrophe exposure, and special retrocession and pooling techniques to cope with those.

The role of the insurance and reinsurance sectors in the economy

The ***insurance sector*** plays a primary role in the economy by allowing businesses and households to buy protection from the risk of adverse events. By facilitating a wider distribution of risk, the insurance sector facilitates investment and consumption thereby contributing to a higher rate and a more sustainable pattern of economic growth. The importance of the insurance sector as a provider of risk protection within the EU economy has been increasing steadily, as indicated by a rise in the penetration level (i.e. the ratio of the value of insurance premiums to GDP) from 6.76% in 1993 to 9.22% in 2000². More recently, the role of the insurance sector has expanded to include the provision of a wide range of financial services, notably vehicles for investment and saving (e.g. in relation to house purchase, retirement etc.). This broader role in channelling savings into investment has also increased, as reflected in the substantial securities holdings of insurance companies, e.g. 39% of GDP in Germany in 2000, 72% of GDP in France and 110% of GDP in the United Kingdom in 1999).³ In consequence, the insurance sector has emerged as a major non-bank provider of financial services, often in direct competition with the depository institutions.

There is no experience of widespread failures in the insurance sector and, until recently, episodes of financial stress within the sector were not seen as having systemic implications. This view was based (a) on the fact that insurance companies are not deposit-taking institutions and do not perform payment and settlement functions and (b) on the assumption that insurance companies in financial difficulty would face only "slow-moving" liquidity shocks in light of their relatively long-term liabilities. In consequence, it was considered unlikely that insurers under financial strain would need to resort to rapid and large-scale asset sales to raise liquidity. However, the assessment of systemic risk associated with the insurance sector has been modified somewhat as the sector has intensified its financial market activities, building up considerable counterparty relationships with banks and becoming a major player in securities markets. While the risk is still less than that associated with the banking sector, there is increasing concern that widespread failures among insurance companies could affect the economic performance (i) directly by creating a shortage of insurance coverage causing disruption in businesses activities, (ii) indirectly via the impact on financial markets (e.g. the risk of fire sales in securities markets) and/or via links to the banking sector.

The ***reinsurance sector*** plays an equally key role in the economy by providing wholesale cover for the risks assumed by insurance companies on behalf of their clients. The transfer of risks to reinsurers reduces the fluctuations in the business performance of the primary insurers and also reduces their capital costs. While the average cession level in the EU is rather low (i.e. some 10% of all insurance premiums are reinsured), the cession level is relatively high for certain activities (i.e. 18% of non-life insurance premiums are reinsured, compared to 3% for life insurance premiums⁴ on average). Reinsurers may also serve the primary insurers as an equity substitute, provide additional underwriting capacity and are often part (or even the dominant business) of financial conglomerates. Besides insuring insurers, reinsurers are also major financial intermediaries and institutional investors and reinsurers' financial assets represented 1% of the global

² Source: OECD.

³ idem.

⁴ The low cession rate for life insurance is due to the fact that only the risk component of it, not the larger savings component, that is reinsured.

securities market in 2001.⁵ Accordingly, the stability of the reinsurance sector is not only vital to the stability of the insurance sector generally but also has important implications for the financial system as a whole.

Recent evidence of financial strain among reinsurers has focused the attention on the level and nature of risk assumed within the sector. Reinsurers face two risks in addition to those faced by primary insurers. First, they are exposed to greater volatility in their financial results because they protect the primary market against peak exposures. In consequence of this risk, they need to maintain relatively high levels of capitalisation. Second, they may be called upon to support ailing subsidiaries, as they are often the top trading company in a group structure. Despite these additional risks, reinsurers operate in a global market where their activities are often not subject to prudential oversight or to a lighter regime than that applying to primary insurers. Moreover, there is no global framework for reinsurance supervision. This situation has raised concern about potential risks in the reinsurance industry. On the other hand, reinsurers can benefit from significant geographical and sectoral diversification effects to a greater extent than direct companies.

Reinsurance is a highly international industry with a limited number of large companies. In 2002, the total reinsurance premium of the 40 largest reinsurance groups amounted to USD 138 601 200 000, whereof USD 58 544 000 000 stemmed from EU reinsurers⁶. In the EU, Germany has a dominant position with companies as Munich Re, Hannover Re and Allianz Re. Lloyd's is the largest UK writer of reinsurance, and SCOR together with Axa Re are the largest French reinsurers.

Supervision of reinsurance in the EU

Direct insurance activities in the EU are regulated and supervised in accordance with directives. These have been in force for 10-25 years and have been successful in assuring harmonised establishment and supervision rules, being the absolute prerequisites for the creation of a single market in insurance.

There are currently no prudential directives dealing with reinsurance. The only directive directly dealing with reinsurance is 64/225/EEC⁷ on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession. The directive does not deal with prudential issues but merely removes restrictions and discriminations on grounds of nationality or residence. The issue of creating a single licence or a passport for reinsurers is not dealt with in this Directive.

Concerning the actual supervision of reinsurers, a Commission questionnaire⁸ showed that all but one Member State supervise reinsurers either directly or indirectly⁹. There appears to be a movement towards direct supervision. However, direct supervision does

⁵ Source: "Reinsurance – a systemic risk?"; Sigma 5/2003, Swiss Re.

⁶ Standard & Poor's, Global Reinsurance Highlights 2003 Edition, London/New York 2003.

⁷ Council Directive of 25 February 1964 on the abolition of restrictions of establishment and freedom to provide services in respect of reinsurance and retrocession (64/225/EEC), O.J. S64 of 4.4.64.

⁸ "Report: results of questionnaire on the supervision of reinsurance undertakings", European Commission, doc XV/2040/99 + annex, 1999.

⁹ Directly means that any reinsurer conducting business in the Member State is required to be authorised in some way by the supervisor. Indirectly means that the supervisor only examines a reinsurer when it examines the adequacy of a reinsurance contract taken out by a primary insurer with that reinsurer. (Commission questionnaire, see footnote 6).

not exclude indirect supervision and it may be difficult to draw a sharp boundary between the two.

With regard to direct supervision, domestic reinsurers are supervised more stringently than non-domestic reinsurers. This may appear paradoxical but it also perhaps reflects the greater difficulty of supervising effectively non-domestic reinsurers. For domestic reinsurers, all Member States require the submission of annual accounts and have the power to carry out on-site inspections. Other important supervisory powers are the ability to: impose fines, examine the sufficiency of technical provisions and require managers to be fit and proper.

With regard to indirect supervision, domestic reinsurers are again more strictly supervised than non-domestic reinsurers. Important supervisory functions are to examine: the financial solidity of the reinsurer, the spread of reinsurance business and assessments carried out by rating agencies.

2. *Problems affecting the EU reinsurance market*

The need for EU harmonised reinsurance supervision

There are currently no harmonised reinsurance supervision rules in the EU. The lack of an EU regulatory framework for reinsurance has resulted in significant differences in the level of supervision of reinsurance undertakings in the EU. The different national rules have created uncertainty for direct insurance companies (and their policyholders), barriers to trade within the internal market, administrative burden and costs as well as weakening the EU position in international trade negotiations:

- **1. *Uncertainty for direct insurance undertakings (and their policyholders):*** The different reinsurance supervision regimes in the EU have resulted in increased difficulties for direct insurance undertakings to choose their reinsurers in a prudent and cost-efficient way. The selection of reinsurers is of decisive importance for an insurance company, and could also affect the company's ability to pay claims towards policyholders.
- **2. *Barriers to trade:*** Certain EU countries use systems where assets of the reinsurer must be pledged (collateralised) in order to cover outstanding claims provisions. This makes optimal investment management more difficult and thus results in higher operational costs for reinsurance undertakings. This could in fact increase the price the reinsurer charges for taking over risks from direct insurance companies, and this pattern has been seen in certain Member States. Reinsurance companies may also decide not to be active in markets where the posting of collaterals is required, and consequently the availability of reinsurance protection will be more restricted.
- **3. *Administrative burden:*** In the EU, the CEA¹⁰ and the OECD¹¹ have identified administrative impediments for cross-border reinsurance services. The lack of mutual recognition between EU supervisory authorities in reinsurance in certain cases means that reinsurance undertakings are subject to different supervisory rules in several Member States. For reinsurance companies this could lead to significant double work and increased administrative burdens. Examples of burdensome administrative

¹⁰ See <http://www.cea.assur.org>.

¹¹ See <http://www.oecd.org/home/>.

measures are the multiple fit and proper checks of the group's highest management, double requirement for auditors' confirmation of balances as well as the obligation for branches to issue financial statements according to local GAAP (generally accepted accounting principles) for the whole group.

- **4. International trade negotiations:** It is argued that the lack of a harmonised EU system makes international mutual recognition agreements more difficult. The absence of such agreements means that European reinsurers are confronted with important barriers to entry into foreign markets, such as the requirement of posting collateral for the value of their commitments in the foreign market where the reinsurer intends to conduct business.

If no actions are taken at EU level, there is a risk that the internal market for reinsurance services would continue to work in a suboptimal way, which would harm the EU reinsurance industry. Negotiations with third markets on mutual recognition agreements could be significantly more difficult.

Underlying drivers internationally to the process

There are several underlying international drivers to this process:

- **G7** and the **IMF** have expressed concern that lack of reinsurance regulation could impede international financial stability. In fact, at recent Financial Sector Assessment Programme (FSAP) reviews in Member States, IMF has reiterated the need for legislation in this field.
- The **FSF** (Financial Stability Forum) has repeatedly expressed concerns about the transparency of the reinsurance market and has therefore created a task force to address the issue¹².
- The **OECD** has ongoing work in the reinsurance field, particularly as concerns exchange of reinsurance company information between supervisors.
- The **IAIS** (International Association of Insurance Supervisors) reinsurance work is closely coordinated with the EU fast-track project. A set of principles for minimum requirements for supervision of reinsurers as well as a standard on reinsurance supervision have been adopted.

Regulatory assessment – subsidiarity and proportionality

Before the formal initiation of the reinsurance supervision project, the Commission Services ordered a large study on general background issues¹³. One specific part of the study related to arguments for and against reinsurance supervision in general, and in the EU in particular.

The consultant identified the following arguments in favour of reinsurance supervision in the EU:

¹² See <http://www.fsforum.org/home/home.html>.

¹³ The study – prepared by the KPMG – is available at the Commission website: http://europa.eu.int/comm/internal_market/insurance/reinsurance_en.htm.

- Harmonised reinsurance supervision would contribute to financial stability through more transparent supervision and reduced regulatory arbitrage. This fact has been highlighted by several international organisations (see above).
- Streamlining of supervisory requirements that today vary substantially between Member States would reduce internationally active companies' compliance costs and reduce their administrative burden.
- Through the removal of barriers to entry, harmonised reinsurance supervision will lead to a more efficient internal market for reinsurance services.
- Reduced costs to market participants due to the disappearance of market barriers.
- Indirect additional protection for policyholders as insurance companies would be more able to make a prudent and cost-efficient choice of reinsurers.
- Improved transparency of the European reinsurance market as EU reinsurers will be subject to a harmonised supervisory framework.
- A supervisory system could give a quality mark to the EU reinsurance sector and increase its competitive situation world-wide. This is particularly important as the EU is the world's largest provider of reinsurance services.
- Reduction in insolvency risk for EU reinsurance companies due to the introduction of harmonised quantitative and qualitative solvency requirements.
- Increased bargaining power in trade negotiations with non-EU countries. The lack of a harmonised EU reinsurance framework has been an issue in recent discussions with US regulators and the US insurance/reinsurance industry.
- Cost savings for supervisors as duplication of work between control authorities in different countries can be avoided. This is important also for the insurance industry that directly or indirectly normally finances the supervisory authorities.

The consultant found the following arguments against reinsurance supervision in the EU:

- Reinsurance is an activity between professional buyers and sellers. As there is normally no direct link between the reinsurer and the policyholders, the need for supervision is less than in direct insurance. In addition strong market practice has been developed over many years.
- The global nature of reinsurance makes it less suitable to national supervision schemes, which could in fact become barriers to trade. Many direct supervisory schemes tend to have a domestic focus that is less relevant to reinsurance.
- The wide range of activities and business lines of a reinsurer may be difficult to capture in a supervisory system. It is a tall order for a national supervisor to be knowledgeable in such a wide field.

- A more severe EU reinsurance supervision system could disadvantage EU reinsurance companies, and some may leave the EU for an off-shore location.
- Reinsurance solvency requirements could increase reinsurance undertakings cost of capital. Particularly after the 9/11 terrorist attacks, the cost of capital for reinsurance undertakings has increased. The introduction of high solvency margin requirements would increase the capital costs further.
- Additional cost for supervisors as well as difficulties to find experienced reinsurance staff. Already today it is difficult for supervisory authorities to find and keep experienced reinsurance staff.
- Reinsurance is an insurance activity and therefore direct insurance rules should apply, and not specific reinsurance regulations. Different rules between insurance and reinsurance could make it increasingly difficult to create a level playing-field.

3. *Stakeholders for a reinsurance supervision directive*

During the preparation of the draft directive the following stakeholders were identified:

- **Reinsurance undertakings:** It is evident that reinsurance companies (including reinsurance captives) are the most directly concerned by a supervision directive. They will be subjected to a new set of rules that may require some entities to change their procedures or raise more risk capital. However, the system will also give a quality mark to EU reinsurance entities which will be a distinct advantage on the international reinsurance market. The system proposed by the draft directive will provide better market access in the EU and reduce administrative barriers. The sector is very concentrated and the new reinsurance supervision rules will directly affect about 150 reinsurance undertakings and about 250 reinsurance captives in the EU.
- **Insurance undertakings:** A reinsurance supervision regime in the EU will make it easier for direct insurance undertakings to evaluate the standing of different reinsurers. The existence of a reinsurance supervision system gives direct insurance undertakings a higher level of assurance when choosing reinsurers to participate in their outwards reinsurance programs. Supervised reinsurers will contribute to more financial stability for direct insurers, which could have an overall positive impact on the financial markets. In principle all direct insurance companies have outwards reinsurance, and this means that the reinsurance directive will have large importance for the insurance market.
- **Policyholders:** Policyholders will benefit indirectly through their insurance companies. Supervised reinsurance will bring more stability to direct insurance companies, which will reduce the risk that policyholders will suffer financial losses or lack of insurance cover resulting from insolvencies of direct insurance companies.
- **Insurance supervisors:** Harmonised reinsurance supervision in the EU will have marked positive impacts on the insurance supervisors. It will give increased quality to the supervision process as the home supervisor, who has the greatest knowledge of the reinsurance company, will be responsible for the analysis. The directive will also reduce double work between different supervisors and facilitate change of information between supervisors. The directive will provide supervisors with a clearer legal

framework for their ongoing work as well as for sanctions and other types of interventions.

4. *The main objectives for the reinsurance supervision project*

Having considered the current problems affecting the EU reinsurance market (part 2 above) and after wide-ranging consultations with Member States and interested parties, the Commission Services decided to launch the work on a reinsurance supervision directive in 2001. Member States, the insurance industry and other specialists broadly supported the initiation of reinsurance supervision work at EU level.

Together with Member States, the Commission Services formulated three guiding objectives for the reinsurance supervision work:

Objective 1

- The system should establish a sound and prudent regime in the interest of policyholders. Strong and well-supervised reinsurers contribute to a stronger internal market and international financial stability.

Problem areas addressed by the formulated objective

The objective addresses problem areas 1 (uncertainty for insurance companies and their policyholders), 2 (barriers to trade), and 3 (administrative burdens) as identified in chapter 2 above.

Discussion

The first principle is straight-forward and there is general consensus between Member States as well as the insurance sector. The importance of the reinsurance sector for financial stability has been studied by the IAIS, the IMF, the Financial Stability Forum and the G7 (see chapter 2 above).

Objective 2

- The system should build on essential coordination of Member States' legislation and mutual recognition of the supervision in the Member State where the reinsurance undertaking is licensed. Once licensed a company should automatically be allowed to conduct reinsurance business all over the European Community under the freedom of establishment and the freedom to provide services. No additional supervision of or checks on the reinsurance undertaking should be performed by supervisors in host Member States. This approach has shown its suitability during many years in the direct insurance field.

Problem areas addressed by the formulated objective

The objective addresses problem areas 1 (uncertainty for insurance companies and their policyholders), 2 (barriers to trade), and 3 (administrative burdens) as identified in chapter 2 above. The existence of a reinsurance supervisory system based on this principle will also be beneficial for the EU position in international trade negotiations (problem area 4).

Discussion

This is a key paragraph outlining the strategic choice between:

1. Harmonisation and mutual recognition
2. Pure mutual recognition without harmonisation

Experience in the EU has shown that a certain harmonisation of supervisory practices can improve the functioning of mutual recognition. It is however important to highlight that harmonisation through Directives – contrary to unification – provides some latitude to Member States to implement EU rules in a way that best suits their national situation. Alternative 1 would furthermore seem to be more in line with international efforts. Member States, industry and the Commission have agreed on continuing the work based on alternative 1. In addition, mutual recognition and essential harmonisation of prudential rules is the approach followed by the EU in order to establish the internal market for financial services (banking, insurance, investment services). It seems therefore appropriate to follow the same approach when establishing a EU regulatory framework for reinsurance.

Objective 3

- The introduction of a harmonised system for reinsurance supervision should lead to the abolition of systems with pledging of assets to cover outstanding claims provisions.

Problem areas addressed by the formulated objective

The objective primarily addresses problem areas 2 (barriers to trade) and 4 (the EU position in international trade negotiations) as identified in chapter 2 above.

Discussion

The collateralisation issue could be dealt with in two ways:

1. Abolish collateralisation requirements within the EU
2. Maintain the possibility for collateralisation

One major driving force for the reinsurance work – in the EU as well as internationally – is to reduce trade barriers and make the market more efficient. In this light, the collateralisation requirements used by some Member States and other jurisdictions could be seen as an obstacle. Other commentators argue that it is a necessary tool for prudential supervision.

Abolishing the collateralisation requirement was a key element in the CEA passport proposal, and it is widely supported by the EU insurance sector. A clear majority of Member States do not use collaterals and consider them as obstacles to an efficient internal reinsurance market. Certain Member States argue that the situation concerning collaterals is different in life and non-life reinsurance. A new reinsurance supervision regime should provide clear and forceful rules that remove the need for collateral requirements. The EU reinsurance work should clearly build on alternative 1. Indeed, in a regime founded on harmonisation of prudential rules and mutual recognition of

regulatory/supervisory regimes by Member States, a requirement such as collateralisation of outstanding claims provisions is not longer necessary since the reinsurer is subject to specific supervision according to mutually agreed standards aimed at ensuring its financial position.

5. *Main policy decisions to reach the objectives*

In order to reach the above objectives, a number of strategic choices had to be made during the project. For these major issues the available alternatives are discussed below, followed by reasoning for the chosen solutions.

Issue 1: Overall approach

The objectives outlined in chapter 4 could be addressed in different ways:

Alternatives

1. Status quo – no changes necessary to the current situation
2. Market mechanism solution/voluntary disclosure of reinsurance related information, alternatively recommendation concerning indirect supervision practice
3. Supervisory solutions

Discussion and reasons for the Commission proposal

The Commission Services agree with most commentators that there are problems in the internal market for reinsurance that must be addressed. A status quo solution does therefore not seem applicable. Virtually no commentators have given their support for a "do-nothing" alternative.

Concerning the issue of market mechanism, voluntary approaches vs. supervisory solutions, the Services believe that a comparison with the direct insurance field is relevant and instructive. The Services believe that, as in the direct insurance field, reinsurance legislation at EU level would be necessary, as significant differences in approaches today between Member States is at the core of the problem. Insurance supervision is a public concern and requires public regulation. A voluntary, disclosure-based approach would not provide sufficient trust in the supervisory system. The lack of tangible sanctions in such a disclosure-based approach could make the system less efficient when addressing potential problems in reinsurance undertakings.

A majority of Member States and industry organisations believe that there is a need for supervisory action in the field. The Services therefore propose that such an approach is chosen for the EU reinsurance project.

The chosen alternative in the light of the objectives in chapter 4

The Services believe that only a supervisory solution could fulfil objectives 1 and 2 laid down in chapter 4. Self-regulation within the insurance industry would not suffice to meet the objectives as insurance supervision is a regulatory function in all jurisdictions world-wide. The Services also consider it difficult to address objectives 3 and 4 through voluntary measures as amendments to legislation would be needed in several Member States.

Issue 2: Fast-track solution or comprehensive, long-term project

Different models for reinsurance supervisory systems have been discussed and/or proposed by several organisations. The proposals differ particularly on the comprehensiveness of the proposed systems and on the applicable time frame. Two broad approaches can be identified:

Alternatives

- | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ol style="list-style-type: none">1. Fast-track solution for a reinsurance supervision framework2. Long-term comprehensive project for a reinsurance supervision framework |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

Discussion and reasons for the Commission proposal

A majority of Member States and industry organisations believe that there is a need for expedient action to achieve tangible results in a short to medium-term perspective. Such a "fast-track" solution would take its starting point in current direct supervision rules and business practice, when appropriate with adjustments. A long-term project, linked to Solvency II, could to a fairly large extent build on the achievements in a fast-track project, but such a project will also have to take other long-term developments into account (such as profound changes in insurance accounting or in solvency rules). Against this background, the Commission Services have proposed that the reinsurance work should be based on a "fast-track" approach.

Furthermore, developments in the reinsurance industry during last years (post September 11, impact from declining stock markets, etc.) call for a rapid introduction of a harmonised supervisory system. A number of reinsurance companies have ceased writing new business, and a number of new entrants have appeared. The level of premium has increased with over 30% between 2001 and 2002 according to Standards & Poor's¹⁴.

The chosen alternative in the light of the objectives in chapter 4

The Services believe that both alternatives could fulfil the objectives identified in chapter 4. However, as there is a clear need for swift action, a preference is given to a fast-track solution. As stated above, a fast-track solution can be seen as a first block towards a comprehensive Solvency II solution.

¹⁴ *ibid.*

Issue 3: Voluntary passport or mandatory licensing system?

Alternatives

1.	A voluntary passport system for companies wanting to adhere to the system
2.	Mandatory licensing system giving Community reinsurers a passport for cross-border business in the EU

Discussion and reasons for the Commission proposal

This issue has been the subject of extensive discussions with Member States and interested parties. The below discussion is based on the document MARKT/2036/01 (available on the Commission website).

In order to structure the discussion, some key aspects of the systems are highlighted in the first box below. Thereafter pros and cons with the two systems are summarised.

<i>Aspect</i>	<i>Mandatory licensing system</i>	<i>Voluntary passport system</i>
<i>Scope of the regime</i>	All reinsurance companies	Reinsurance companies that want to enjoy some advantages linked to a voluntary passport system, or let their cedants enjoy certain benefits linked to the passported status of the reinsurer.
<i>Initiation of process to get licence/ passport (new entity)</i>	The planned entity wanting to do reinsurance business.	The entity wanting to enjoy advantages linked to the voluntary passport system.
<i>Initiation of process to get licence/ passport (existing entity)</i>	The existing entity must fulfil licensing requirements in order to continue making reinsurance business.	The existing entity must fulfil certain requirements to receive a single passport in order to receive some advantages linked to the system.
<i>If licence/passport is not given</i>	No reinsurance business can be made.	The entity can continue to do reinsurance business, but will not enjoy advantages linked to the system.
<i>If licence/passport revoked</i>	No reinsurance business can be made.	The entity can continue to do reinsurance business, but will not enjoy advantages linked to the system.

Pros and cons with a mandatory licensing system

The introduction of a licensing system would have the following general pros and cons. The table also indicates the stakeholders – see above chapter 3 – that are specifically concerned by the described advantages or disadvantages.

<i>Pros</i>	<i>Cons</i>
A mandatory licensing system would be the best suited to ensure a level-playing field in the EU for reinsurance services (<i>all stakeholders</i>).	To introduce a mandatory licensing system in a previously non-regulated sector could be perceived as being contrary to “deregulation” efforts currently à la mode (<i>reinsurance companies</i>).
The efficiency of a mandatory licensing system has been proven by its wide use in financial sector and insurance (<i>all stakeholders</i>). It gives a clear mandate to the insurance supervisor (<i>supervisors</i>).	Could create problems, as already active companies would have to pass a licensing or a registration procedure. It may be difficult in such a situation to request the company to cease activities if not fulfilling the criteria (<i>reinsurance companies</i>). Alternatively extensive transition periods may be needed.
In line with EU principles as it covers any undertaking and not only those having a European perspective. The system will ensure the financial soundness of all reinsurance undertakings (<i>all stakeholders</i>).	As certain companies could be removed from the market, the choice of reinsurers at different ratings could be limited. This may reduce cedants’ possibilities to entity-specific risk management and optimal allocation of capital. (<i>insurance undertakings, policyholders</i>)
A mandatory licensing system gives supervisors means to remove unsuited companies from the reinsurance market (<i>supervisors</i>).	A full, mandatory licensing system could be difficult to sell to the insurance industry which could perceive it as cumbersome and expensive (<i>reinsurance companies</i>).

Pros and cons with a voluntary passport system

The introduction of a voluntary passport system would have the following general pros and cons. The table also indicates the stakeholders – see above chapter 3 – that are specifically concerned by the described advantages or disadvantages.

<i>Pros</i>	<i>Cons</i>
Such a system could be based on “soft law” and thereby be comparatively easy to implement, and to maintain (<i>insurance companies, reinsurance companies, supervisors</i>). Believed to be less administratively burdensome. Could be more suitable to a B2B sector like reinsurance.	A voluntary passport system could be perceived as provide weaker assurance than a licensing system as only some companies would be supervised (<i>all stakeholders</i>). Such a system would also lead to less transparency for buyers of reinsurance.
Leave companies the choice whether they would like to adhere to the system or not (<i>reinsurance companies</i>).	The position of the supervisor in such a system would be weaker than in mandatory licensing system. Supervisors do not have the possibility to remove unsuited companies from the reinsurance market (<i>supervisors</i>).
Easier to get acceptance from insurance industry (<i>reinsurance companies</i>).	If licensing systems for reinsurers are in place in certain countries, it would seem illogical to replace those with a voluntary passport system (<i>supervisors</i>).
A voluntary passport system may be easier to implement internationally (<i>insurance companies, reinsurance companies, supervisors</i>).	A voluntary passport system would introduce differences in treatment between direct insurers and reinsurers (<i>all stakeholders</i>).

Member States have expressed their support for a mandatory licensing system at several

occasions. The insurance industry has reiterated their preference for a voluntary passport solution.

After wide consultation with Member States, the insurance industry and other interested parties the Commission Services decided to propose a mandatory licensing system. Such a system would fit well to the current structure of EU insurance legislation and be similar to the “single EU passport” in direct insurance. The choice is also in line with the direction of the ongoing IAIS reinsurance supervision project.

The chosen alternative in the light of the objectives in chapter 4

The Services believe that a mandatory licensing system would be more likely to fulfil the set objectives of the EU reinsurance supervision project. Such a system would cover the whole market and thereby better serve financial stability and internal market concerns (objective 1). A mandatory licensing system would furthermore lead to more coordination between Member States' treatments of all reinsurers (objective 2). Concerning the objective to abolish collateralisation requirements (objective 3), the Services consider the mandatory licensing solution more efficient as it has the support of most supervisors in the EU and internationally.

Issue 4: Quantitative solvency requirements for non-life reinsurance

As in the direct insurance field, a legal proposal in the reinsurance field will consist of qualitative and quantitative rules. Qualitative rules for example relate to the quality of the management, risk management and internal control of the reinsurance undertakings. These areas are normally very similar to direct insurance, and in principle the same rules should be used. Quantitative rules relate to issues like the solvency margin requirement, the level of the minimum guarantee fund, reinsurance reduction factor and investment rules. In these fields other solutions may be needed than in direct insurance. In simulations and consultations we have considered different designs and levels for the solvency requirements:

Possible approaches

- Alternatives where the solvency requirements for reinsurance are close to those of direct non-life insurance, possibly combined with comitology powers to increase the requirements in particularly risky lines of insurance
- Alternatives where the solvency requirements for reinsurance are higher than those for direct non-life insurance, for example 50% or 100% higher

Discussion

In the Insurance Committee document MARKT/2513/03, the Commission Services presented three main alternatives for the quantitative solvency requirements (available on the Commission website).

Specific alternatives for quantitative solvency requirements for non-life reinsurance

Alternative 1 ("100% alternative") consisted of solvency requirements that were close to those of direct non-life insurance (including Solvency I amendments). In such an alternative the reinsurance reduction factor would remain at 50% and amounts set aside to equalisation reserves would not be part of the available solvency margin. The minimum guarantee fund would be EUR 3m for reinsurance undertakings and EUR 1m for reinsurance captives.

Arguments in favour of a 100% alternative:

- It is a solution inspired by the existing EU legislation for direct insurance and has a good track record.
- Member States that today supervise reinsurance mainly use direct non-life rules.
- It avoids distortions between direct insurers accepting reinsurance and pure reinsurers.
- It brings a common denominator to the reinsurance and insurance rules which would facilitate subsequent adaptations following the outcome of the Solvency II project.
- This solution is supported by the Member States which have the most important reinsurance sectors, i.e. the "exporters" of reinsurance (DE, IE, LU and UK).
- Industry broadly supports such a solution.

Arguments against a 100% alternative:

- This option is perceived as too soft by Member States that primarily "import" reinsurance and by those requiring collaterals. An adoption of this alternative could increase the difficulty to abolish the collateral requirement within the EU.
- This alternative does not take the more risky nature of some reinsurance activities (long tail business, catastrophic covers etc) into account, which would require higher solvency requirements.
- The model may be seen by third countries as too soft and therefore be an insufficient basis for trade negotiations. These countries could therefore be less inclined to agree to abolish collaterals for EU reinsurers.

Alternative 2 ("150% alternative") would increase the direct solvency requirements by about 50%. The reinsurance reduction factor would be increased to 75% and amounts set aside to equalisation reserves could be part of the available solvency margin. Same minimum guarantee fund requirements as for alternative 1 above.

Arguments in favour of a 150% alternative:

- It reflects the more risky nature of reinsurance as it would require a higher solvency margin
- It could contribute to a generally higher solvency standing of the EU reinsurance industry and thereby positively affect its international business.
- It could facilitate the suppression of the collateral requirement in the EU
- It could enhance the EU position in trade negotiations
- It has support by most Member States that "import" reinsurance (for example EL, ES, FR, IT, FI).

Arguments against a 150% alternative:

- Based on data currently available to the Commission, it has not been proven that reinsurance has a systematically higher risk level than direct insurance. However, certain lines and individual portfolios may have a higher risk level. A risk-based approach is the object of Solvency II work, and the 150% alternative in fact pre-empts the outcome of this work.
- Industry has expressed its opposition to this alternative.
- The higher capital cost for reinsurers could reduce the reinsurance capacity in the EU, increase the price of reinsurance and could lead to relocation of companies to non-EU jurisdictions (especially reinsurance captives).
- It would create a distortion of competition between insurers and reinsurers.

Furthermore, the Services defined a ***third alternative (1b)*** that builds on alternative 1 above but includes elements of comitology for future amendments to the reinsurance regime. According to this alternative, solvency requirements could be enhanced by up to 50% for certain reinsurance business lines or types of reinsurance contracts. Until such comitology decisions have been taken, direct insurance solvency requirements should apply.

Arguments in favour of alternative 1b:

- It is consistent with a "fast-track" approach.
- It is broadly consistent with the Solvency I amendments implemented for direct insurance.
- The model would allow better fine tuning of the solvency requirements than the direct regime, and alternatives 1 and 2 above. It could therefore be considered a "bridge" to Solvency II.

- Several Member States with important reinsurance business (DE, LU, UK) are ready to consider it.
- The alternative builds on involvement of supervisors in the elaboration of the new rules. This is important as the solvency regime is one of supervisors' most important tools.

Arguments against alternative 1b:

- It will take a certain time before the new class enhancement rules have been adopted through comitology.
- Some Member States, mainly "importers" of reinsurance and France, consider this alternative less robust than alternative 2 above, and it may therefore be more difficult to achieve the suppression of the collateral requirement within the EU.
- Industry has expressed hesitation about this solution.

After consideration and discussions with Member States and the insurance industry, the Commission proposes to build on alternative 1b for the proposed reinsurance directive. The Commission Services are of the view that such a model would enable a better fine-tuning than for example the Solvency I solutions. It is for example likely that differentiated enhancements (i.e. somewhere in between "0%" or "50%") would be used. The solution also provides an efficient tool for reacting quickly to market developments. The specific considerations relating to the minimum guarantee fund requirement can be found in connection with the simulations in chapter 6 below.

The chosen alternative in the light of the objectives in chapter 4

The Services believe that several of the proposed solutions could in fact fulfil the objectives set in chapter 4. The quantitative requirements are only one part of the supervisory system and must be seen in the light also of other supervisory measures. As the proposed alternative 1b gives supervisors an important function in assessing the need for further capital for certain lines, it could be considered more adapted to reinsurance business than a general increase of the solvency requirement with a certain percentage. This is essential for objectives 1 and 2.

Certain commentators may argue that a higher solvency requirement for reinsurance would facilitate the abolishing of collaterals in the EU (objective 3). The Member States that currently use a collateralisation system have in fact asked for higher solvency requirements for reinsurance. Taking arguments and reactions from commentators into consideration, the Services believe that alternative 1b will be the most appropriate in addressing the objectives for the exercise, and that it will efficiently pave the way for the abolishing of the collaterals within the EU.

Issue 5: Quantitative solvency requirements for life reinsurance

For life reinsurance, certain other considerations than in non-life have to be made. Life reinsurance business is sometimes very similar to direct life business, but often it has another character as normally only risk-bearing elements (i.e. not the savings part) are reinsured. During the project two distinct solutions have been discussed for life reinsurance.

Alternatives

1. In principle use direct life rules for life reinsurance
2. Approximate through use of direct non-life rules also for life reinsurance

Both alternatives could include certain adjustments such as class enhancement.

Discussion and reasons for the Commission proposal

In initial discussions it was proposed that life reinsurance business in principle could be treated in a way similar to non-life reinsurance. This model is used in certain countries that today supervise reinsurance. One possible approach would be to use the current health rules in the non-life directive, which in principle would lead to a solvency requirement that is one third of the non-life requirement.

In discussions with Member States and the insurance industry, however some cases were highlighted where the nature of life reinsurance would be better reflected through the use of direct life rules. Member States also feared that approximation through non-life rules would lead to arbitrage between life insurance and life reinsurance. Considering the arguments, the Commission Services have decided to propose that life reinsurance should be subject to direct life rules.

The class enhancement discussion is also different for life reinsurance. There is generally perceived to be less need for enhancements in life business, and therefore Solvency I did only include such rules for non-life insurance. The Commission Services have not encountered arguments that call for class enhancement through comitology for life reinsurance. Certain commentators, particularly from the UK and Ireland, have however called for lower requirements in life reinsurance than direct life insurance due to the (perceived) lower risk level. The Commission Services however consider that due to level playing field reasons the same requirement should be applied in life insurance and life reinsurance. More detailed considerations on the risk inherent in different life products will be made in the Solvency II project.

The chosen alternative in the light of the objectives in chapter 4

The Services believe that both proposed solutions could in principle fulfil the objectives set in chapter 4. The quantitative requirements are only one part of the supervisory system and must be seen in the light also of other supervisory measures. The chosen alternative has the great advantage to ensure consistency between life insurance and life reinsurance, thereby reducing the risk of arbitrage.

6. *Expected impacts from the different options identified*

Introduction

In chapter 5, a number of alternative solutions to the five major issues were presented. One major function of this paper is to analyse the potential economic, social and environmental impacts on different stakeholders of the different alternatives.

In this chapter we will therefore address the impacts of the following issues from an economic and a social angle:

Issue 1: Overall approach
Issue 2: Fast-track solution or long-term, comprehensive project
Issue 3: Voluntary passport or mandatory licensing system
Issue 4: Quantitative solvency requirements for non-life reinsurance
Issue 5: Quantitative solvency requirements for life reinsurance

The reinsurance supervision project does not have any direct environmental impact.

The impact will be discussed from the perspectives of the different major stakeholders identified in chapter 3, i.e. reinsurance undertakings, insurance undertakings, policyholders and insurance supervisors.

Some of the issues involved are highly technical and for most stakeholders the impact will basically be the same for most alternatives. A qualitative analysis has been judged the most relevant for the issues. However, for issues 4 and 5 also certain quantitative simulations have been performed. The analysis is based on background studies, market material, quantitative analyses (when available) as well as material and comments from Member States and stakeholders. The Services have summarised the different impacts in order to facilitate the presentation of the results.

After the discussion on the different issues, certain general issues will be commented upon (impact over time, impact outside the EU or in accession countries).

Impacts of the alternatives for the overall approach (issue 1)

The grid outlines the main expected impacts of the proposals on the different stakeholders:

	<i>Status quo alternative</i>	<i>Market mechanism/ voluntary measures</i>	<i>Supervisory alternative</i>
<i>Reinsurance undertakings</i>	None	Slight increase in disclosure requirements. Marginal extra costs.	Subjected to mandatory supervision and solvency requirements, but <i>only</i> in the home Member State. Certain compliance costs, but the latter are likely to be outweighed by benefits resulting from Single European licence.
<i>Insurance undertakings</i>	None	Slightly better information about available reinsurers.	Facilitated choice of reinsurer could make a prudent and cost-effective choice easier.
<i>Policyholders</i>	None	None	A derived benefit due to direct insurers facilitated choice of reinsurers, and potentially better monitoring of the solvency situation.
<i>Insurance supervisors</i>	None	Slightly better information about reinsurers.	Substantial benefits from harmonised supervision and the introduction of solvency requirements. Benefits also from increased cooperation between supervisors. Certain implementation costs, which could however be partly reduced thanks to the increased cooperation.

The grid clearly demonstrates that the most positive market and economic impacts (reduced administrative burden, single European licence, facilitated market access, etc.) will come from the supervisory alternative. The additional costs related to the supervisory alternative would be outweighed by the significant advantages of a single European licence system. A supervisory alternative will bring certain compliance costs for reinsurance companies. For certain reinsurance companies, capital increases may be needed. Social impacts, i.e. primarily the interests of the policyholders, would be best served by a supervisory alternative. A reinsurance supervision system is unlikely to have

any material impact on the employment situation in the insurance/reinsurance sector. The analysis has not led the Services to believe that the introduction of reinsurance supervision would materially increase the premium level of policyholders.

As indicated above in chapter 5, both the status quo and the voluntary disclosure alternatives fail to meet the objectives of this exercise.

Impacts of a fast-track vs. a long-term comprehensive project (issue 2)

As outlined in the previous chapter, the differences between the alternatives mainly relates to the timing and the measures possible to introduce in a short to medium-term perspective. In a fast-track project the perceived benefits as well as certain implementation costs will come earlier. As outlined above, many elements of the two approaches are in fact similar and the fast-track approach prepares the introduction of Solvency II.

Reinsurance undertakings may argue that an alignment to the long-term Solvency II project would give them more time to implement necessary changes. An introduction of a fast-track system followed by changes due to Solvency II, could force companies to change their systems twice. On the other hand, a swift introduction of a reinsurance supervisory scheme will give advantages to EU reinsurers, and particularly this argument has been highlighted in the consultations.

For the same reasons as outlined under issue 1, insurance undertakings and their policyholders would benefit from a swift introduction of reinsurance supervision.

Insurance supervisors are obviously benefiting from a swift fast-track system as well as from the introduction of a more thorough Solvency II project. Most supervisors have clearly expressed the need for a fast-track approach, but at the same time they are committing very important resources to work related to the Solvency II project.

Impacts of a passport vs. a licensing system (issue 3)

The impacts on different stakeholders of the introduction of a passport or a licensing have been discussed in detail in chapter 5. The two grids on pros and cons with a licensing respective a passport system highlight the impact on different stakeholders.

Impacts of alternatives for the non-life solvency requirements (issue 4)

This section contains a general discussion on how the different stakeholders are affected by the choice of the solvency alternative. The aim of this section is to give a qualitative overview of some results from the more technical simulations. The second section contains summary results of the simulations performed during the reinsurance supervision project.

General discussion on the impacts of different solvency alternatives

The different solvency alternatives outlined in chapter 5 in fact represent a continuum between basically identical requirements as in direct insurance to alternatives with higher requirements, both in terms of solvency and size of the guarantee fund.

The reinsurance companies are directly concerned by the requirements under the different alternatives, and the impact on them are outlined in the sub-chapter below containing the summary results from the simulations.

As discussed above, the Services believe that all the outlined solvency alternatives would bring advantages to insurance companies and their policyholders. High requirements could be said to lead to stronger, more solvent reinsurance undertakings, which would be in the interest of direct companies. However, if the requirements are set too high, the price of reinsurance cover may increase, which would affect direct insurance companies. It is important to remember that many direct insurance companies also accept inwards reinsurance business, and may therefore be subject to some of the new reinsurance rules. This issue is analysed below in connection with the fourth simulation.

Insurance supervisors have different views on the impact of the different solvency alternatives. Some supervisors believe that higher solvency requirements are motivated from a prudential point of view, whereas others stress the importance of similar requirements between insurance and reinsurance.

Results from simulations

A number of the most important alternatives outlined above have been the subject of three simulation exercises performed between August 2002 and October 2003. The simulations performed related to the following quantitative parameters in different combinations:

- Solvency margin requirements as percentages of claims and premiums
- 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

The parameters were combined into scenarios which were subsequently simulated using data available at national insurance supervisors. The samples used differ somewhat between the simulations. For certain computations life reinsurance business have been included in the samples, and simulations been done according to the non-life requirements. The extent of life reinsurance business is normally small in reinsurance companies.

The first set of simulations related to combinations of *different solvency margin and minimum guarantee fund levels*. Around 400 reinsurers from 11 Member States were included in the sample and the simulation period was 1999-2001/2002. The simulated solvency margin requirement ranged from 16% of premiums/23% of claims to 35% of premiums/50% of claims. The minimum guarantee fund sizes ranged from 3-10m EUR for reinsurers and 1-10m EUR for reinsurance captives.

The results showed that a number of smaller reinsurance undertakings would suffer due to the minimum guarantee fund requirements. Some companies showed solvency deficits because they were part of a group and only capitalised to a certain extent, although the group as such was solvent. The results showed in particular that many reinsurance captives were only capitalised to a minimum extent, and that an increase in the minimum

guarantee fund requirement could directly hurt their solvency position. The Commission Services believe that the new solvency system must be robust and sufficiently prudent, but at the same time the requirements on EU reinsurers cannot be significantly higher than their international competitors. Commentators argue that high solvency requirements could hurt the captive reinsurance industry severely and there could be a risk that these companies will move to a non-EU jurisdiction if the solvency requirements are deemed to be excessive. This would in fact lead to a situation with less supervisory control. For larger companies in particular, the simulations showed the clear impact of losses in 2001 and 2002 on the available solvency margin. In conclusion, the Commission Services conclude that the results call for a solvency margin for reinsurance that is not too different from that of that of direct insurance companies, and that special considerations for captive reinsurers should be made.

The second set of simulations related to a possible *increase in the reinsurance reduction factor*. Today a direct insurance undertaking that reinsures a portfolio of risks can only get solvency requirement relief up to a cession of 50% regardless how large the reinsured part is. A quality supervision framework could however enable this level to be raised. A simulation to analyse the impact of an increase of the reinsurance reduction factor to 75% and 90% was therefore made. Around 1 500 direct insurance undertakings from 10 countries totalling a premium volume of about EUR 270 000m were included in a simulation for the year 2001.

The simulations showed that roughly one fifth of the companies in the sample did in fact reinsure to an extent of more than 50%, and therefore would profit from an increased reduction factor. Some market segments seem to profit more than others. This was for example the case for smaller life insurers and larger composite insurance undertakings. On a market level the relative decrease in the solvency requirement would be small (less than 5%) in both simulated alternatives.

The purpose of the ***third set of simulations*** was to test a number of combinations of solvency requirements and minimum guarantee funds from the perspective of small reinsurers and reinsurance captives. 145 pure reinsurance undertakings from 8 Member States and 275 reinsurance captives from 6 Member States were included in the simulations for the period 1999-2001. The simulated solvency margin requirements ranged from 16% of premiums/23% of claims to 35% of premiums/50% of claims. The minimum guarantee fund sizes ranged from 1-3m EUR.

When analysing the results of these simulations, it is obvious that the lowered minimum guarantee fund requirement leave smaller reinsurers in a significantly better position than in the cases studied in the first set of simulations. However the number of deficits under certain of the above hypotheses is still noteworthy, particularly for reinsurance captives. It is important to note that these companies in many cases are well capitalised in relation to the solvency requirement, but hit by the minimum guarantee fund amount.

Also for this simulation it is important to note the very significant impact that accumulated equalisation provisions/reserves have in certain Member States.

The purpose of the ***fourth set of simulations*** was to analyse the impact of using the proposed reinsurance solvency margin requirements and sizes of guarantee funds to the inwards reinsurance business of direct insurance undertakings. If the solvency requirements for reinsurance business would be different from those of direct insurance, it may be necessary for level-playing field reasons to apply such requirements also to that

part of direct insurers' business that consists of inwards reinsurance. About 150 direct insurance undertakings from 10 Member States for which the inwards reinsurance business written surpassed 10 % of their total premium income or 500m EUR were included in the sample for the period 1999-2001. The simulated solvency margin requirement ranged from 16% of premiums/23% of claims to 35% of premiums/50% of claims. The minimum guarantee fund sizes ranged from 3-10m EUR.

Also in this context, it is important to see the simulations results in the light of the average figures and time period. On average the companies in the sample fulfil the different requirements more or less easily (depending on the hypotheses). When considering developments over time period 1999 to 2001, the trend has been slightly negative. In the higher hypothesis the number of negatively affected companies is elevated. The insolvency deficits affect above all small companies. The results are broadly in line with those of pure reinsurance companies.

The simulation convinced the Commission Services that – if different – reinsurance requirements should be used for reinsurance business regardless of the entity – reinsurance or insurance undertaking – that does the underwriting.

Impacts of alternatives for the life solvency requirements (issue 5)

As stated above, life reinsurance business has to a certain extent been included in the simulations under issue 4. These results consequently give a tentative indication on how the impact of a direct non-life approximation solution would impact reinsurance companies. One important outcome was that direct non-life did neither take the remaining saving element nor the different risk structure into account. In certain markets the application of non-life rules would lead to significant solvency requirements. The insurance industry suggested that a solution similar to the one used for health insurance practiced by non-life companies could be appropriate. Furthermore, the results indicated significant calculations difficulties.

The Commission Services asked Member States to perform simulations in which the life part of the reinsurance portfolio was separated and computed according to direct life insurance rules. However, in many Member States such information was not readily available. This solution was therefore studied based on material from a restricted number of Member States. The different calculation methodologies and the small sample make definite conclusions difficult. In subsequent discussions of the results with Member States, several concluded that a split solution with life rules for the life part, and non-life rules for the non-life part would be preferable.

The quantitative and qualitative analyses performed have not led the Commission Services to believe that the choice of solvency alternative for life reinsurance will have an impact on policyholders, neither as regards the level of premium nor the certainty of claims payments.

Insurance companies as well as reinsurance companies are affected by the different proposals, but the effects seem to be very linked to market conditions in different markets. Continental European reinsurers tend to accept a non-life approximation solution to a larger extent than reinsurers from the UK and Ireland. Different supervisory practices and requirements in EU Member States basically decide to what extent supervisors are affected by the alternatives. For example, a split solution is already practiced in countries like the UK and would lead to less supervisory implementation costs than in countries that already today use a non-life approximation solution.

Some general comments

Impact over time

The simulations have been made for the period 1999-2001, with completions for 2002 for certain options. This has been a difficult period for the insurance sector, and the simulated figures indicate deterioration of the solvency situation during this time. The weaker results are however more related to the difficult situation on the financial markets than to reinsurance claims following the 11 September event. We have had several discussions with Member States and insurance industry on the results of the simulation taking the cyclic situation into account.

Impact outside the European Union or in accession countries

Representatives for accession countries have participated in the working group during 2003. The reinsurance sector in the future Member States is very small, and representatives have stated that they assess the impact of the proposals to be very limited. Furthermore, the major reinsurance providers in the accession countries often are subsidiaries or affiliates from reinsurance companies established in the current EU-15.

As has been the case for the direct insurance directives, a future directive may be used as inspiration for legislation in certain third countries.

As the Commission has intended the proposal to be in line with current reinsurance work at the international level it is believed that the adoption of a harmonised EU regime will positively affect the standing of recently adopted IAIS reinsurance standards. It is furthermore believed that the reinsurance directive could be a positive element in the reinsurance part of the ongoing EU-US Regulatory Dialogue.

7. How to monitor and evaluate the results and impacts of the proposal after implementation?

The proposal is expected to follow normal implementation procedures, i.e. transposition in Member States within 18-24 months. As in other insurance fields, implementation may be facilitated through cooperation between Member States ministries' and supervisory authorities.

In addition to normal monitoring by Commission Services, the Insurance Committee will follow how the directive is implemented and used. The ongoing long-term project Solvency II will also at a later stage deal with reinsurance related issues, and to that end work in this project would need to take the working of this reinsurance directive into account. As the Solvency II system will come into place in the EU within a number of years, no formal evaluation clause has been included in the proposed fast-track reinsurance directive.

8. Results from stakeholder consultations

Introduction

Stakeholders have been consulted regularly during the project, and have provided the Commission Services with very important input. In the beginning of the project, a major hearing with over 100 participants was organised, and subsequently all participants (as well as other interested parties) were included in a sending-list that received all

documents produced under the project or a message stating that new documents have been posted on the website (see annex). The Commission reinsurance website is:

http://europa.eu.int/comm/internal_market/insurance/reinsurance_en.htm

The project has been followed by interested parties from a broad variety of sectors and professions. The sectors consulted are basically the following: insurance (commercial companies, mutuals, cooperatives etc), insurance associations (EU level as well as nationally), insurance intermediaries (brokers etc), accounting associations, actuarial associations, industry general (UNICE), analysts, risk/captive managers, SME-organisation (BEUC), consulting firms, banks, lawyer firms, rating agencies.

The Commission Services have benefited significantly from the input given by stakeholders and interested parties, particularly as the project has involved many very difficult technical matters. The documents sent out for comments dealt with policy issues as well as detailed matters. During 2002 and 2003 all policy decisions taken by the Commission Services were preceded by comments from stakeholders, in particular the insurance industry.

Comments received on the objectives of the reinsurance project (chapter 4)

The early consultations were taken into account when formulating the general approach and the objectives for the project. Commentators have generally been very supportive of all the three major objectives of the project. A few Member States have raised comments on the fact that objective 2 would prohibit additional checks or requirements by Host States. This objective has however been strongly supported by all other stakeholders, in particular the insurance industry. The Member States that currently use collateralisation have obviously expressed objections to objective 3, but all other stakeholders have unanimously supported the objective as formulated by the Commission Services. Certain Member States have commented on the difference in collaterals between the life and non-life insurance fields.

Comments received on the major policy issues (chapter 5)

Issue 1 – Overall approach: Most commentators have been in favour of a supervisory approach to reinsurance. Certain companies have argued in favour of voluntary solutions, but a greater number of companies and associations have stated that only a supervisory solution would give an additional quality mark to EU reinsurance. A status quo alternative has not been supported by any of the major stakeholders.

Issue 2 – Fast-track or comprehensive, long-term project: Most Member States have argued in favour of a fast-track approach, and this has also been the clear view of the Insurance Committee. Initially a number of Member States however supported an alignment to the long-term Solvency II project. Other stakeholders have been very supportive of a fast-track solution based on current direct supervision rules. Technical specialists (like actuaries and accountants) have however pointed out that the restricted time frame would limit the number of possible solutions, thereby postponing the introduction of certain methods until the Solvency II project is finalised.

Issue 3 – Voluntary passport or mandatory licensing system: A clear majority of Member States has expressed support for a mandatory licensing system similar to that of direct insurance. Most industry commentators, but not all, would however have preferred a

voluntary passport solution, but for reasons stated above the Commission has followed Member States' advice to propose a mandatory licensing system.

Issue 4 – Quantitative solvency requirements for non-life reinsurance: The reactions from stakeholders on the level of the solvency requirements have been many and strong. The Commission Services have had a large number of meetings with interested parties, particularly from the insurance industry, the captive reinsurance industry, risk managers, actuaries, consultants and accountants. Generally industry representatives and insurance consultants have argued that reinsurance is an activity that is close to direct insurance and therefore the same solvency requirements should apply. Some insurance supervisors have however strongly taken the view that reinsurance is more volatile and difficult to supervise and consequently a slightly higher requirement would be appropriate. The Commission Services have taken account of the views of both sides in the proposed option (see chapter 9 below). Technical comments from the actuarial and accounting professions have been taken into account when elaborating the solvency requirements.

Issue 5 – Quantitative solvency requirements for life reinsurance: This issue has also been the subject of much discussion, both as regards the actual requirements as the calculation methods. The Services have in fact consulted on different solutions, but both among insurance companies and Member States divergent views remain. Continental European companies have both expressed support for a non-life approximation method, but this has been rejected by several Member States. Furthermore industry has asked for adjustments in certain of the direct insurance values to be used for reinsurance. Ireland and the UK seem to have a specific situation as they today use adjusted direct life requirements to their reinsurance companies. These are in some cases significantly lower than the direct life rules. Considering these comments, the Services have concluded that a split solution (use direct life rules for life reinsurance, direct non-life rules for non-life reinsurance) would be preferable. The Commission proposal would consequently lead to higher requirements in life reinsurance than the current ones used in the UK and Ireland.

Comments received on the draft legal text

During 2003 the Commission Services have consulted at several occasions on issues concerning the draft legal text, and new versions have been prepared following comments from interested parties, in particular the insurance industry and the actuarial profession. Some of the submissions were very detailed and provided very useful input to the work of the Commission Services. Comments often related to possibilities of simplifying the legal text, and these have to a large extent been integrated. Technical comments from industry and actuaries have been important for the elaboration of the technical parts of the directive.

9. *Commission draft proposal and justification*

The chosen policy options

In accordance with the considerations presented in chapters 4 and 5, the Commission has chosen to present a proposal for a directive with the following features:

- An approach based on harmonisation and mutual recognition.
- A fast-track approach for a directive based primarily on current direct supervision rules.
- A mandatory licensing system.
- A system that would abolish collateralisation requirements in the EU.
- Solvency requirements in line with those of direct insurance, however with the possibility of class enhancement up to 50% through comitology for non-life reinsurance.

Particularly the issues of collateralisation and the level of the solvency requirements have been discussed by Member States and interested parties.

In the Commission Services' view, abolishing the collateralisation requirement is a key element improving the internal market for reinsurance services in the EU. It is widely supported by the EU insurance sector. A clear majority of Member States do not use collaterals and consider them as obstacles to an efficient internal reinsurance market. A new reinsurance supervision regime should provide clear and forceful rules that remove the need for collateral requirements. Furthermore, if Member States were allowed to maintain their collateral requirements vis-à-vis EU reinsurers, this would considerably weaken the EU's position in international negotiations aiming at abolishing such requirements.

Concerning the solvency requirements, the Commission Services believe that the chosen solution (direct solvency rules as the basis, complemented through comitology) would link this proposal in a logical way to the Solvency I and Solvency II exercises. This is also a logical step towards a more risk-based structure foreseen for Solvency II. The solution enables fine-tuning of the solvency requirement in reinsurance, using Solvency I techniques. The solution has the support by a number of Member States. The solvency requirement is an important supervisory tool, and it is therefore important that the supervisors advice the Commission before the presentation of a proposal for reinsurance class enhancement.

The insurance and reinsurance industries have expressed hesitation towards the use of comitology and class enhancement. The Commission Services believe that such a model would enable fine-tuning to a greater extent than for example the Solvency I solutions. It is for example likely that differentiated enhancements (not only "0%" or "50%") would be used. The solution also provides an efficient tool for reacting quickly to market developments. The Commission Services will ask CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) for advice on possible class enhancement, and substantive consultation with industry and specialists will be ensured. The Services see the clear role of the actuarial profession in this work.

The chosen option in the light of other solutions

As indicated in earlier chapter, technically there are both a less ambitious alternative (a disclosure model) and a more elaborated model (risk-based capital, Solvency II type solutions) for an EU reinsurance supervision approach. A more ambitious alternative going in the direction of risk-based capital requirement would not have fitted the time constraints for a fast-track project, and it would furthermore have clashed with Solvency II work. A pure disclosure model would not have fulfilled the objectives set for this exercise. Though the comitology element, some positive trade-off from a more advanced model has been included.

When discussing possible trade-off between the different solvency options, the Commission Services believe that the chosen alternative in a way could combine certain advantages of the 100% as well as of the 150% alternatives.

Available data for simulations of the alternatives

Member States have done great efforts to collect the data needed for the simulations. In some cases, information was not available and in others approximations have been made. The Services however believe that the results from the simulations give a sufficiently full picture to proceed with the presentation of a Commission proposal.

The experiences from this simulation exercise will serve as useful input for coming Solvency II simulations.

ANNEX: Consultative documents prepared during the project

See website: http://europa.eu.int/comm/internal_market/insurance/reinsurance_en.htm

17.09.2003	Fast-track reinsurance supervision project – General stakeholder consultation on the draft legal text including solvency parameters	MARKT/2522/03	
15.07.2003	Fast-track reinsurance supervision project – Commission Services working document for consultation	MARKT/2531/02 Rev. 3	
02.07.2003	Fast-track Reinsurance Supervision project	MARKT/2513/03	
May 2003	Note to the members of the IC Reinsurance Subcommittee for the meeting of 11 June 2003	MARKT/2524/03	
28.05.2003	Fast-track reinsurance supervision project – Tentative staff recommendations for quantitative parameters and related issues	MARKT/2523/03	
28.05.2003	Draft working document: Proposal for a Directive of the European Parliament and of the Council on reinsurance	MARKT/2531/02 Rev.2	
April 2003	Towards a fast-track EU reinsurance supervision regime – Preparation of a text of a draft proposal for a Directive of the European Parliament and of the Council on reinsurance	Note to IC subcommittee	  
4.3.2003	Draft working document: Proposal for a Directive concerning reinsurance	MARKT/2531/0 2 Rev. 1	
08.10.2002	Towards a fast-track EU reinsurance supervision regime 1) Status of the project and 2) Preparation of draft legal provisions – Discussion Paper	MARKT/2530/02	  
02.10.2002	Draft working document: Proposal for a Directive concerning reinsurance and retrocession	MARKT/2531/0 2	
02.05.2002	Fast-track Reinsurance Supervision project – Conclusion of discussions in		

the IC and future steps

01.02.2002	Considerations concerning the general form of a fast-track EU Reinsurance Supervision regime		da de el en fr it nl pt sv
19.11.2001	Investment rules for assets covering technical provisions in reinsurance in reinsurance undertakings	MARKT/2099/01	en
19.11.2001	The establishment of technical provisions in insurance and reinsurance – a comparative study	MARKT/2088/01	en fr
19.11.2001	Discussion based on the KPMG report chapter 6 "The rationale with regard to supervisory parameters" and chapter 7 "The arguments for and against reinsurance supervisions and a broad cost-benefit analysis"	MARKT/2087/01	de en fr
19.11.2001	Reinsurance Supervision project – Status of working programme and future steps, reactions and comments, tentative time schedule	MARKT/2086/01	en
05.06.2001	Approaches to Reinsurance Supervision – Follow-up and structure of Work Programme	MARKT/2042/01	de en fr
10.04.2001	Considerations concerning "licensing" and "passport" systems of reinsurance supervision	MARKT/2036/01	es de en fr it
14.02.2000	Approaches to Reinsurance Supervision Rev. 1	MARKT/2132/00	es de en fr it

Contact:

Ulf Linder, Telephone:(32-2) 299.22.76, ulf.linder@cec.eu.int