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FRAMEWORK FOR CONSULTATION ON SOLVENCY II

Purpose of this document

This paper provides a framework for the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and other stakeholders in connection with the development of a new solvency system (Solvency II) for life insurance, non-life insurance and reinsurance undertakings.

The Framework for Consultation covers the totality of the Solvency II project. It sets out the policy principles and guidelines within which CEIOPS should develop its advice for the Solvency II project. In addition to the framework for consultation, CEIOPS will be requested to provide advice on detailed aspects of the new solvency system through “specific calls for advice”, which will be annexed to this framework for consultation.

Pending the preparation of specific calls for advice and consultation of the Insurance Committee (IC), CEIOPS should also be invited to develop work on Solvency II topics, on its own initiative, in accordance with these policy principles and guidelines, and seeking inspiration from prior Commission Services’ papers.

Other stakeholders are also invited to contribute to the development of a new solvency system within this framework. Their input will be fed back into the CEIOPS work. Consequently, interested parties are invited to address themselves to CEIOPS directly, with to copy to the Commission Services.

The framework for consultation may be revised and updated in the future after IC consultation.

FRAMEWORK FOR CONSULTATION ON SOLVENCY II

The European Commission, having consulted the Insurance Committee, requests CEIOPS and other stakeholders to advise on the development of a new solvency system to be applied to life insurance, non-life insurance and reinsurance undertakings, which Member States and supervised institutions are able to apply in a robust, consistent and harmonised way, without causing significant market disruption,

SUBJECT to the following conditions:

General features

– The new solvency system should provide supervisors with the appropriate tools and powers to assess the "overall solvency" of an institution[1] based on a risk-oriented approach. It should not only consist of quantitative elements, but also cover qualitative aspects that influence the risk-standing of the undertaking (managerial capacity, internal risk control and risk monitoring processes, etc.).

– This solvency system defined in a broader sense should take its starting point in a three-pillar structure: quantitative capital requirements, a supervisory review process and disclosure requirements. This implies that special considerations are made concerning the interaction between the different pillars of quantitative and qualitative supervision, as well as to the role of disclosure. The importance of the supervisory review process in pillar 2 is to be highlighted.

– In Pillar 1 the new solvency system contains two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR).

– The solvency system should be designed in such a way that it encourages and gives an incentive to the supervised institutions to measure and properly manage their risks. In this regard, common EU principles on risk management and supervisory review should be developed. Furthermore the solvency requirements should cover the quantifiable risks to which a supervised institution is exposed. This risk-oriented approach implies the recognition of internal models (either partial or full) provided these improve the institution's risk management, better reflect its true risk profile than under the standard approach and can be appropriately validated.

– The main focus of the Solvency II project is on capital requirements and supervisory review at the level of the individual legal entity. However, issues related to insurance groups and financial conglomerates also have to be addressed, including the implications for existing legislation (e.g. the Insurance Groups Directive (98/97/EC) and the Financial Conglomerates Directive (2002/87/EC)) and the application of internal models in a group or conglomerate context.

– In order to ensure convergence in financial and regulatory reporting, as well as to limit the administrative burden for supervised institutions, supervisory reporting should be compatible with accounting rules elaborated by the International

[1] i.e. life insurance, non-life insurance and reinsurance undertakings

Accounting Standards Board (IASB). This applies in particular to the techniques and methods used to calculate technical provisions (under phase II of the IASB insurance project). Where IASB developments may influence the new system, the likely outcome of IASB work will be taken into account. Additions and adjustments to IASB accounting rules may be proposed, provided specific reasons for such exceptions are given.

– The aim to attain ‘maximum harmonisation’ should be reflected by solvency rules which do not need additional requirements. The new solvency system should provide for uniform application.

– The solvency system should set a uniform level of prudence, both for technical provisions and for the Solvency Capital Requirement.

– In order to ensure consistency across financial sectors, the general layout of the solvency system should, to the extent necessary and possible, be compatible with the approach and rules used in the banking field. Products containing similar risks should, in principle, be supervised in the same way and should be subject to the same capital adequacy or solvency requirements. The new solvency system should be constructed in a way that facilitates efficient supervision of insurance groups and financial conglomerates and avoids regulatory arbitrage between and within financial sectors.

– Further international convergence is promoted through compatibility of the new solvency system with work of the International Association of Insurance Supervisors (IAIS) and the Groupe Consultatif Actuariel Européen / International Association of Actuaries (IAA).

– In order to assess the new solvency system one or more quantitative impact studies (QIS) will have to be made. Coherent data is a fundamental requirement to perform such studies. The corresponding data collection requirements the methodology and timing for these QIS all need analysis.

Pillar 1 Features

– An increased level of harmonisation for technical provisions is a cornerstone of the new solvency system. To that effect it is recommended to set a quantitative benchmark for the prudence level in technical provisions. The relationship between technical provisions in the new solvency system and the future accounting regime and an appropriate level of prudence for technical provisions require analysis.

– The Solvency Capital Requirement (SCR) reflects a level of capital that enables an institution to absorb significant unforeseen losses and that gives reasonable assurance to policyholders. The SCR should be calculated in such a way that the quantifiable risks to which an institution is exposed are taken into account and based on the amount of economic capital corresponding to a specific ruin probability and time horizon. The appropriate ruin probability and time horizon to be used and the implications for the calculation of the SCR using a going-concern basis require analysis.

– The standard approach to calculate the Solvency Capital Requirement (SCR) can be based on a variety of methods, e.g. a factor-based formula, probability distribution-based formula, scenarios or combinations thereof. The most suitable standard approach taking into account the specificities of life, non-life and reinsurance business, which consequently vary according to the specific sector concerned, require analysis.

– The Minimum Capital Requirement (MCR) reflects a level of capital below which ultimate supervisory action would be triggered. It shall be calculated in a more simple and robust manner than the SCR as this kind of action may need authorisation by national courts. To facilitate and stabilise the transition to the new overall solvency system, the MCR should be constructed in a straightforward manner such as under the present "Solvency I Directives", while maintaining existing levels of prudence.

– The risks addressed in the capital requirements should be based on the IAA risk classification and include: underwriting risk, credit risk, market risk, operational risk and liquidity risk. Additions and adjustments to the IAA risk classification could be made provided specific reasons for such exceptions are given. To the extent these risks are not quantifiable they will be taken into account in Pillar 2.

– Institutions' internal models may be used to replace the standard approach to the SCR if the internal model has been validated for this purpose. The validation criteria and the validation process should be developed and harmonised. The possibility to extend this option to group-wide internal models requires analysis.

Pillar 2 Features

– The supervisory review process should increase the level of harmonisation of supervisory methods, tools and processes. In particular, it should aim to identify institutions with financial, organisational or other features susceptible to producing a higher risk profile. Such institutions require a higher solvency capital than under the SCR.

Pillar 3 Features

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

IN ADDITION,

Revision of Framework for consultation

– This Framework for consultation may be revised by the Commission, after consultation of the Insurance Committee. The Framework for consultation will therefore function as a dynamic reference document for the development criteria of the new solvency system.

– CEIOPS has a particularly important role to play in the development of the new Solvency system. If in its deliberations, CEIOPS takes the view that the reference terms set by this Framework for consultation require revision or that a choice should be made between several identified alternatives, it will inform the Commission analysing the advantages and disadvantages of the alternatives.

Pensions / IORPs

– Solvency requirements of institutions for occupational retirement provision (IORPs) are linked to those of life insurance undertakings by way of article 17 of Directive 2003/41/EC. However, solvency requirements for IORPs are an important and separate subject that should be addressed at a later stage.

Specific Calls for Advice

– This Framework for consultation will be supplemented by Specific Calls for advice from CEIOPS on individual topics of particular importance for the successful development of the new solvency system. The Commission will consult with the Insurance Committee before requesting a Specific Call for advice from CEIOPS.

– A Specific Call for advice will be considered as an integral part of this Framework for consultation and will be annexed to this Framework for consultation.

– A Specific Call for advice may be revised in the same way as the Framework for consultation.

Reporting Modalities

– CEIOPS should provide regular progress reports covering advice on the new solvency system to the Commission at four-monthly intervals, with the first report to be provided by 31st October 2004. Where warranted, reports should be provided more frequently, e.g. where policy decisions may be required.

– A Specific Call for advice may provide for different reporting requirements.

Publication

– In the interests of transparency, after consultation of the Insurance Committee, the Commission will publish on its insurance web-site this Framework for consultation and Specific Calls for advice.