

**Third Progress Report
to the European Commission
on
CEIOPS' work in the field of the Solvency II project
(June 2005)**

The European Commission has requested CEIOPS to advise on the development of a new solvency system to be applied to life, non-life and reinsurance undertakings in the European Union.

As a part of this, CEIOPS is requested to give regular Progress Reports to the Commission at four-monthly intervals, informing of the steps taken to advance technical work and respond to the Specific Calls for Advice, as well as draw attention to any further issues identified by CEIOPS' Working Groups. This is the Third Progress Report.

'First wave' of Calls for Advice

On 25 February 2005 CEIOPS issued its fourth consultation paper dealing with the Draft Answers to the EU Commission on the 'first wave' of Calls for Advice (Nos. 1-6) in the framework of the Solvency II project. Following public consultation until 25 May 2005, CEIOPS has considered the comments received.

The Answers to the European Commission's 'first wave' of Calls for Advice, were approved at the CEIOPS Members' Meeting 28 June 2005 in London. The Answers (CEIOPS-DOC-03/05) have subsequently been sent to the European Commission, as well as published at CEIOPS' website (www.ceiops.org – Consultations – Consultation Papers) together with the comments received and the resolution on the comments (CEIOPS-SEC-43/05).

'Second wave' of Calls for Advice

CEIOPS received the 'second wave' of Calls for Advice from the European Commission 23 December 2004, covering:

- Technical Provisions in Life Assurance (No.7);
- Technical Provisions in Non-Life Insurance (No. 8);
- Safety Measures (No. 9);
- Solvency Capital Requirement: Standard Formula, Life and Non-Life (No. 10);

- Solvency Capital Requirement: Internal Models, Life and Non-Life (No. 11);
- Reinsurance (and other risk mitigation techniques) (No.12);
- Quantitative Impact Study and Data Related Issues (No. 13);
- Powers of Supervisory Authorities (No. 14);
- Solvency Control Levels (No. 15);
- Fit and Proper Criteria (No. 16);
- Peer Reviews (No. 17); and
- Group and Cross-Sectoral Issues (No. 18).

CEIOPS assigned the task of drafting and coordinating each answer to specific Working Groups. In developing the Draft Answers, CEIOPS' Working Groups have received valuable contributions from industry, actuarial and audit groups.

The Draft Answers to the European Commission to the 'second wave' of Calls for Advice were approved at the CEIOPS' Members Meeting 28 June 2005 in London.

In line with the general approach to transparency set out in the Public Statement on Consultation Practices, CEIOPS will publish its Draft Answers to the 'second wave' in its Consultation Paper No. 7 on CEIOPS' website (www.ceiops.org – Consultations – Consultation Papers). CEIOPS will invite comments on the Draft Answers from stakeholders. CEIOPS will consider the comments from third parties before transmitting its final answers to the European Commission.

'Third wave' of Calls for Advice

On 29 April 2005 CEIOPS received the 'third wave' of Calls for Advice from the European Commission. These cover:

- Eligible Elements to Cover the Capital Requirements (No. 19);
- Cooperation between Supervisory Authorities (No. 20);
- Supervisory Reporting and Public Disclosure (No. 21);
- Procyclicality (No. 22); and
- Small Undertakings (No. 23).

Methodology for answering the 'third wave' of Calls for Advice

CEIOPS assigned the task of drafting and coordinating each answer to specific Working Groups. CEIOPS is planning to have four distinct phases before responding to the 'third wave':

- **Development:** until the end of September 2005, the Solvency II Working Groups and the Financial Stability Committee will develop the Draft Answers. The chairs of the Working Groups will have the overall responsibility for ensuring work is properly co-ordinated and that the Commission's questions are properly addressed.

- **Approval:** from the end of September 2005, the Secretariat will take ownership of the Draft Answers produced by the Working Groups and prepare them to be approved by CEIOPS' Members Meeting on 27 October 2005.
- **Consultation:** subject to approval at the Members Meeting on 27 October 2005, the Draft Answers will be released for a three-month public consultation period.
- **Review:** from the end of January 2006, CEIOPS will review the responses to the consultation and consider any necessary amendments.

Following possible revisions and final approval by CEIOPS' members, the final answers are expected to be transmitted to the European Commission by 28 February 2006.

Third Progress Report

In the following section, CEIOPS provides brief updates on each of the Calls for Advice in the 'third wave'. These updates summarise some of the technical issues identified by the Working Groups and describe how CEIOPS is planning to advance the work. In some cases, options under consideration in the Working Groups have been highlighted.

The contents of these progress reports do not have the status of advice, nor should they be taken as a definitive statement of the issues which CEIOPS considers most significant. Where appropriate, CEIOPS will also consider whether it is necessary to provide further advice that has not been specifically called for.

Eligible elements to cover the capital requirements

The Commission Services request CEIOPS to advise on the elements eligible to cover the SCR and the MCR. Among other issues, CEIOPS should consider IASB compatibility, cross-sector comparability and the recognition of innovative instruments.

- 19.1 As under the current Directives, CEIOPS' Draft Answer to Call for Advice 9 envisages rules on the eligibility of assets for covering technical provisions.
- 19.2 The answer also suggests that, in principle, the same requirements should apply to assets covering both the MCR and the SCR. This is because capital requirements and technical provisions serve the same purpose – policyholder protection. However, the practicalities of this approach would need to be subject to field-testing.
- 19.3 The development of rules on the eligibility of capital should be closely related to the objectives of the solvency system. Different types of financial resources will possess different characteristics. These characteristics may change in stress conditions. The Working Groups will need to consider the relevance of the banking approach in this context.
- 19.4 One important aspect of the future Supervisory Review Process will probably be the supervisor's task to address the acceptability of assets and the valuation of assets and liabilities for solvency and capital adequacy purposes and, if necessary, provide for appropriate adjustments to capital available.
- 19.5 When reviewing adjustments to an insurer's available capital, the value of the assets and liabilities may be different under different scenarios from what is reported on the insurer's public financial reporting balance sheet. The Pillar II Working Group will take such scenarios into account when discussing and assessing available capital as part of a capital adequacy and solvency regime.
- 19.6 The Group/Cross-sectoral issues Working Group deals with the eligible capital elements to cover the capital requirements in a group context. The issue addresses both the eligible capital elements to cover the group SCR and the eligible elements of undertakings belonging to a group.

Next steps

- 19.7 The Pillar I Working Group will develop a Draft Answer, in conjunction with the Pillar II, Pillar III & Accounting and Group/Cross-sectoral issues Working Groups and the Financial Stability Committee. A dedicated subgroup has been established to advance the technical aspects of the work.
- 19.8 The Working Group will seek to establish links with industry, actuarial and audit groups to support its work.

Cooperation between supervisory authorities

The Commission Services request CEIOPS to advise on the means to increase cooperation and exchange of information between Member States' supervisors.

- 20.1 Call for Advice 20 addresses the issue of co-operation between supervisory authorities in the group, as well as in the solo context.
- 20.2 The Pillar II Working Group will focus on the characteristics of co-operation on solo company only. Especially, the Working Group will reflect on the exchange of information on individual undertakings working on a cross-border basis. This exchange of information should be carried out materially to the same extent as prescribed in the current legislation, following processes laid down in the Siena protocol. However, changes possibly necessitated by the introduction of new features to the regime as a result of the current project must be discussed further. In this respect, the volume of the insurance undertaking's cross-border business could be taken into account, if deemed necessary.
- 20.3 The Group/Cross-sectoral issues Working Group will review this issue from mechanism of co-ordination with a central role for a group supervisor, powers of intervention of the group supervisors, models validation at group-level – the case in which no agreement is reached among the supervisors on the acceptance of a group internal model has not been addressed yet – the exchange of information among supervisors.
- 20.4 Another subject of interest is exploring practical ways and means to share information. As a possible alternative to regular mutual updates on normal day-to-day issues regarding cross-border via mail which might be cumbersome and costly, the Working Group might also explore the issue of setting up a database to facilitate interaction.

Next steps

- 20.5 The Group/Cross-sectoral issues Working Group will collaboratively produce a Draft Answer to this Call for Advice with the other Solvency II Working Groups.

Supervisory reporting and public disclosure

The Commission Services request CEIOPS to formulate a general approach for supervisory reporting and public disclosure for Solvency II.

- 21.1 The Pillar III & Accounting Working Group is focusing its attention on the role of public disclosure under Solvency II. Disclosure of information should result in appropriate transparency, leading the market to reward undertakings that are well managed. This behaviour of market participants is defined as market discipline. Market discipline can also reinforce capital regulation and other supervisory efforts to enhance soundness in insurance companies, by creating incentives to conduct business in a sound and efficient manner.
- 21.2 Pillar III of Solvency II should ensure market transparency and market discipline through public disclosure. The Working Group is investigating what information should be disclosed in order to facilitate an appropriate understanding of the risks associated with the insurance undertaking in its markets. That means to determine the qualitative aspects of disclosure. The quantitative information should be there to support the qualitative description.
- 21.3 Next to that, Pillar III has to ensure that information required by Pillar I and II is available for supervisory purposes. Parts of that information will be publicly disclosed whilst other parts will be available to supervisors only.
- 21.4 Supervisory reporting should consist both of information required by Pillar I and II and also information defined as part of the disclosure to support market transparency and discipline. The aim of Pillar II Working Group will be to develop elaborate some high-level principles which cover the intention of the SRP and to supplement these principles with a more specified description of the information needed for Pillar II purposes. The information requested should be retrospective (historical data) as well as prospective in terms of sensitivity, stress testing and scenario analysis. Comparable reporting and public disclosure requirements in the banking field will be taken into consideration as a starting point.
- 21.5 In order to draft an efficient overall Solvency II system which provides for sufficient information while avoiding excessive burden for the market, consistency among different requirements (public disclosure/supervisory reporting) should be sought. To this regard, the Pillar III & Accounting Working Group is analysing relationships among different sets of requirements.

- 21.6 The Pillar III & Accounting Working Group is also analysing links with financial reporting in order to take into consideration the accounting regime which is applicable within the EU. The endorsed IAS will be an obvious reference to be used for the Pillar III regime of the new solvency system. However, there might be a need for more insurance specific disclosure requirements in order to support the overall objective to contribute to market transparency and discipline.
- 21.7 In any case, the compatibility of Solvency II system with IAS/IFRS should also allow for items to be disclosed or reported which are currently not part of the IFRS framework. Hence, particular attention should also be paid to the differences between IAS requirements and the accounting regime applicable to non-IFRS insurance companies.
- 21.8 In addition, due to the different possible purposes of the IAS principles and the solvency regime, there could be a need for some prudential adjustments to public financial data. The effective width and depth of such adjustments can be defined only at a later stage of the project, taking also into account the need not to overburden insurance undertakings.

Next steps

- 21.9 The Pillar III & Accounting Working Group will develop a Draft Answer, in conjunction with the other Solvency II Working Groups.

Procyclicality

The Commission Services has requested CEIOPS to advise on the potential existence and impact of procyclicality in Solvency II and, if the impact is significant, to suggest solutions to remedy the effect.

- 22.1 'Procyclicality' is a term often used to refer to the possible economic impacts of the new solvency standards in insurance and banking. However, depending on the context in which this concept is employed, it can be understood differently. Setting out working definitions which semantically distinguish between these meanings is therefore essential for a proper analysis of the potential impact of Solvency II.
- 22.2 As a second step, possible reinforcement and feedback effects and their sources and impact will be discussed which may be triggered or reinforced by solvency capital requirements (SCR/MCR) under Solvency II. To this end, examples will be elaborated in connection with every single risk category already determined by the Pillar I Working Group in the answers to the 'second wave'. Finally, possible solutions to alleviate these effects on a supervisory as well as companies' level will be discussed before advice is being set out.
- 22.3 In developing a response to the 'second wave', CEIOPS' Working Groups have considered the possibility of a countercyclical 'equalisation' mechanism. This could be included in the calculation of technical provisions or as an adjustment to the SCR.

Next steps

- 22.4 The Pillar II Working Group will develop a Draft Answer, in conjunction with the Pillar I and Group/Cross-sectoral issues Working Groups. Procyclical effects will be considered further in the development of proposals for technical provisions and the SCR.

Small undertakings

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

- 23.1 In its *Framework for Answers* to the 'first wave' of Calls for Advice, CEIOPS noted that the level and frequency of supervisory scrutiny should
- "...depend on the nature, scale and complexity of the activities of each insurance undertaking."*
- 23.2 In developing a response to the 'second wave,' CEIOPS' Working Groups have noted several areas where quantitative requirements under Pillar I might need to be adapted for smaller undertakings. For example, a 'best estimate + risk margin' approach to technical provisions could include guidance on methods that could be adopted to achieve the required level of confidence.
- 23.3 To ensure a level playing field, any treatment for smaller undertakings should not mean a lower standard of protection for policyholders. There might be a recognition that the same results can be achieved through simpler means for smaller insurers – reducing the systems cost of complying with requirements. However, there is a possibility that simplifying regulatory treatments will result in relatively higher quantitative requirements – for example, because it is not possible to reflect different levels of risk diversification (and therefore conservative assumptions have to be applied).
- 23.4 CEIOPS will also need to consider whether size alone is the most relevant consideration. Comparatively small insurers can specialise in esoteric risk classes that are not adequately addressed by the SCR standard formula. In such circumstances, the development of internal models might be more appropriate than any simplified treatment.
- 23.5 Pillar II Working Group has started with drafting a specific issues paper. The aim of this document has been to identify the Pillar II issues which should be included in the answer to Call for Advice 23, principally, whether small undertakings should be excluded from the scope of the future Framework Directive and how, if at all, the framework and requirements (e.g. Supervisory Review Process) would need to be adapted to deal with small undertakings.
- 23.6 Following the first discussion on the topic, it would appear that there might be need to define a set of common criteria for defining 'small'

insurance undertakings so as to ensure equal competitive conditions across the EU. Various criteria could be used for the categorisation of insurance undertakings, including total premiums, insured sum or other figures based on business volume or risk.

- 23.7 In order to comprehend better the magnitude of the issue and to understand how many undertakings could possibly be affected, the Working Group is surveying CEIOPS members to ascertain the number of companies which are below the current threshold of 5.000.000 Euro premium income or concentrated around this threshold, their legal status (e.g. mutual companies) and possible reporting or disclosure facilitations.

Next steps

- 23.8 The Pillar I Working Group will develop a Draft Answer, in conjunction with the Pillar II and Pillar III & Accounting Working Groups. A dedicated subgroup has been established to advance the technical aspects of the work.
- 23.9 The Working Group will seek to establish links with industry bodies representing small undertakings and the mutual sector to support its work.
- 23.10 CEIOPS especially encourages comments on the practicalities of its advice as applied to small undertakings.