



Solvency II – Newsletter

No. 10/en. November 2007

A proposal for a Framework Directive for the new future supervisory system – known as the Solvency II project – was submitted by the European Commission this summer. The Commission intends to introduce these new supervisory requirements in the EU member states by 2012. CEIOPS, the Committee of European Insurance and Occupational Pension Supervisors, conducted a third quantitative impact study QIS3 between April and June of this year. The preparations for the next impact study QIS4 are already in full swing.

Current developments

European Commission

Publication of a Framework Directive

The proposal for a “Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance” was published and introduced into the political consultation process on 10 July 2007.¹ The 13 existing European insurance directives have thus been combined into a single new directive. The proposal takes account of the Impact Assessment Report required since 2005.

By introducing new regulatory requirements, the Commission aims at achieving the following objectives:²

- Intensifying the integration of the EU insurance market
- Protecting policyholders and beneficiaries
- Strengthening the international competitiveness of EU insurance and reinsurance companies
- Promoting better regulation.

One of the impacts of the reform is that insurance companies will have to record all risks appropriately in future. Moreover, they will have to maintain sufficient capital for covering these risks. Besides having to comply with these purely quantitative requirements, companies will also have to meet qualitative risk management requirements.

The proposed Framework Directive also envisages a new group supervision, which is however politically controversial. It provides for the supervision of insurance groups essentially to be effected by a group supervisory authority. To this end, a group supervisor of the home country authority responsible for supervising the insurance group’s parent company is to be granted extensive



¹ The main new regulations are described in the 9th Solvency II Newsletter. The directive can be found online at http://eur-lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0361en01.pdf.

² Cf. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52007SC0870:EN:NOT>.

responsibilities and cooperate closely with the local supervisory authorities of the European member states in which the group's subsidiaries are located. Many national supervisory authorities, in particular those in the smaller EU states, remain opposed to this proposal. They fear that they may lose their ability to influence companies they have been able to control under the present regulations.

The EU Commission is under considerable time pressure to adopt the new supervisory regulations before the European Parliamentary elections are held in 2009. Since it is likely that the EU delegates will start making intensive preparations for the election campaign at the beginning of 2009, the Commission is adhering to its ambitious goal of adopting the directive if possible by the end of next year.

If this date is kept to, the EU Commission hopes to introduce the new regulations in the European member states as from 2010. The measures required for practical implementation are to be defined at national level at the latest 18 months prior to the directive's entry into force. The supervisory authorities of the EU member states need to be provided with guidelines well before the directive takes effect. The industry is to be given enough time to take any preparatory measures occasioned by the new supervisory rules at an early stage.

Provisional future timetable

In view of these objectives, the EU Commission submitted a provisional timetable for further action on the Solvency II project to CEIOPS in its letter ³ of 19 July 2007. In this letter, CEIOPS is asked to continue to actively support the Commission.

Schedule	
2007	Publication of QIS3 results Preparation for QIS4 CEIOPS submits proposal of technical specifications for QIS4 to EU Commission
2008	Consultation phase on technical specifications and implementation of QIS4 Publication of consultation papers: <i>Proportionality principle and group supervision and support</i> Report on the directive
2009	Formal acceptance of the framework directive by the European Parliament and Council Consultation phase concerning the implementing measures
2010	Publication of a proposal and adoption of the implementing measures (Level 2 of the Lamfalussy process)
2011	Translation of the directive into national law
2012	Introduction of the new supervisory requirements in the EU member states

CEIOPS⁴

New structure at CEIOPS

CEIOPS' Managing Board has undergone several changes. In addition, a new Secretary General has been appointed and the new function of internal auditor has been created. The amendments are shown in the following chart:



³ See letter by Director General Jörgen Holmquist to AEA VBA (CEIOPS), which can be found online at http://ec.europa.eu/internal_market/insurance/solvency_en.htm.

⁴ CEIOPS – Committee of European Insurance and Occupational Pensions Supervisors.



CEIOPS supports EU Commission

CEIOPS has been requested to support the EU Commission in carrying out the following activities in the next few months:

- Submitting draft specifications for the fourth impact study QIS4
- Providing advice regarding the *proportionality principle* and the *supervision of insurance groups* relevant for the adoption of the Framework Directive at European level.
- Offering assistance with issues related to the quantitative requirements based on the results of QIS3 and QIS4.

CEIOPS publishes work plan for 2007–2012

In September 2007, CEIOPS submitted a work plan for the years 2007 to 2012⁵, outlining the next process steps until final implementation of the new EU legislation.

In 2008, CEIOPS will be involved in both the quantitative impact study QIS4 and a number of consultation phases.

In addition, it will be engaged in numerous activities revolving around the implementing measures (level 2 of the Lamfalussy procedure) for the new supervisory regulations. Some of these activities will not be completed until 2009. The following issues will be focused on:

- Valuation of assets and liabilities, including technical provisions
- Method of calculating eligible elements of capital
- Design and calibration of the standard formula for calculating solvency capital and minimum capital requirements
- Full and partial internal models
- Governance requirements
- Disclosure obligations and reporting to the supervisory authorities
- Additional capital requirements ("capital add-ons")
- Supervision of insurance groups and local supervision of group subsidiaries

In this context, it will have to closely follow the IASB's⁶ discussions regarding the accounting standards also currently being reformed. The aim of all participants is



⁵ See: "CEIOPS Work Plan for Solvency II Deliverables 2007–2012" at <http://www.ceiops.org/media/docman/CEIOPS-SEC-%20SolvencyIIDeliverables2007-2012.pdf>.

Quantitative impact studies

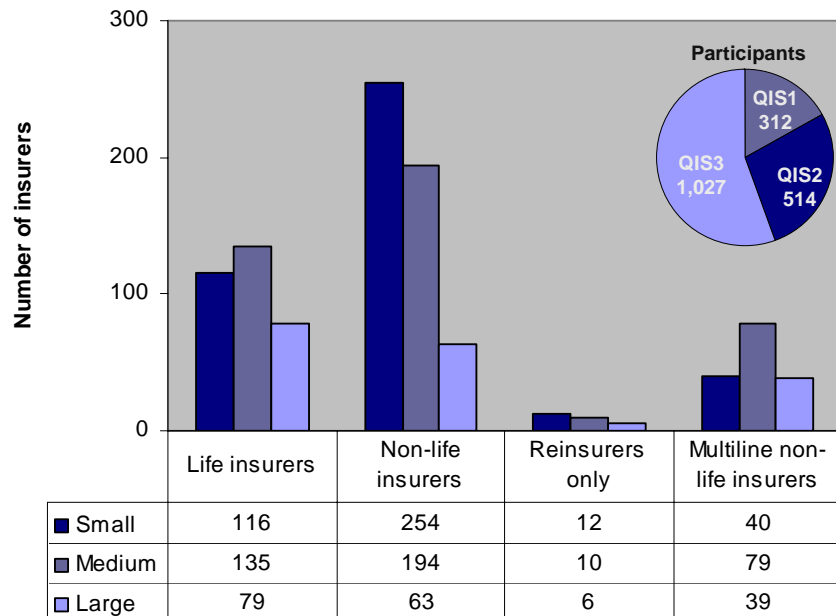
to find similar or at least complementary solutions to the same issues, e.g. the valuation of technical provisions.

It will generally be up to the insurance companies to decide whether to use a standard approach or their own internal models to calculate capital requirements. In order to be able to use an internal model, however, companies will need the supervisory authority's certification. Since 2005, CEIOPS has been carrying out studies to test the possible impact of future solvency requirements when the standard approach is used in practice.

Results of QIS3

CEIOPS conducted QIS3 from April to June of this year, but time constraints prevented the findings of this study from being included in the Framework Directive. The June issue of our Solvency II Newsletter already reported on this study. Besides testing improved valuation methods under the standard approach for calculating future solvency capital and minimum capital requirements, QIS3 also analysed a new method for determining eligible capital. Furthermore, insurance groups were also requested to calculate the requirements at group level.

The number of participants increased considerably, with more than 1,000 European insurers – twice the number for QIS2 – taking part. The studies are used by many insurers as a means of preparing now for the future requirements.



Source: CEIOPS Report⁷

CEIOPS submitted the QIS3 report in mid-November 2007. It includes both quantitative and qualitative results (based on the QIS3 questionnaire) and describes the impact that the envisaged supervisory system will have on the insurance industry. The report focuses on technical aspects such as the design of the standard formula for calculating the SCR and MCR and the method for determining eligible capital elements. In QIS3, various methods could be used for calculating the MCR, the advantages and disadvantages of which are described in the report, as are the national features.

The most important findings of the report are as follows: Under QIS3, the solvency ratio for many participants fell below that of Solvency I. This fact was not surprising, however. The future supervisory system will be based on risk, meaning that all risks will need to be recorded. Moreover, the method thus far used for calculating capital requirements has been fully revised. As expected,



⁶ IASB - International Accounting Standards Board.

⁷ Cf. "QIS3 – Summary Report" available online at <http://www.ceiops.org/content/view/118/124/>.

the life insurers' greatest capital requirement was for the market risk, whereas for non-life insurers it was the underwriting risk. Compared with QIS2, many correlation factors for QIS3 were set to a lower level. This resulted in stronger diversification effects, leading to a reduction in the solvency capital requirement.

Of course it is only partially possible to draw initial conclusions regarding an insurance company's solvency position from the results of QIS3. First of all, not all the details of the standard approach have been finalised yet and secondly, the calibration of the defined parameters remains provisional in part.

The third quantitative impact study clearly shows that many parts of the standard approach are much too complex for calculating the solvency capital requirement, in particular for small insurance companies. Life insurers had the greatest difficulties in valuation of future discretionary benefits, options and guarantees, whereas non-life insurers, by contrast, experienced difficulties in assessment of provisions and segmentation by lines of business.

Quantitative Impact Study – QIS4

The preparations for the next quantitative impact study QIS4 are already well under way. Unlike all preceding studies, this one is not being conducted by CEIOPS but by the EU Commission. From the Commission's point of view, various aspects should be tested in QIS4, including the possibility of introducing simpler methods of calculating capital requirements and their implementability in practice.

The results of QIS4 at European level are expected to be published in November 2008. The envisaged timetable is as follows:

- 20 December 2007: CEIOPS submits the final draft QIS4 specifications to the EU Commission.
- End of January–mid-February 2008: Consultation phase regarding the draft QIS4 specifications. The EU Commission is planning hearings and meetings with stakeholders and CEIOPS.
- April 2008 – July 2008: Carrying out QIS4.

Consultation Paper

Risk management will gain even more importance under Solvency II. CEIOPS submitted the Consultation Paper *Risk Management and Other Corporate Issues* in mid-July of this year. The principles and minimum quality standards drafted in this paper could serve as a basis for European insurers' risk and management structure in future. The main aim of risk management, according to the paper, is to continually identify, analyse, control and monitor all material risks incurred by a company. A risk management system should be supported by suitable internal control systems and a clearly defined organisational structure. The general requirements stipulated in it include the following:

- There should be a robust system of governance comprising at least the organisational structure.
- The system should be suitably designed to take account of the nature, scale and complexity of the company's activities.
- Regular internal reviews of the system should be carried out.
- Policies on risk management and internal control need to be stipulated in writing and verified annually.

Actuarial know-how will play an important role in risk management in future. According to the paper (see also a proposal for a Framework Directive of the EU Commission) this know-how has to be available to all insurance companies. Sufficient knowledge of actuarial and financial mathematics is needed for exercising this actuarial function. The actuary will be responsible for preparing an annual solvency report containing results and recommendations to company management.

The stakeholders had the opportunity to comment on the requirements until mid-October.



European actuaries – Groupe Consultatif

Annual Meeting

The Annual Meeting of the Groupe Consultatif was held on 4 and 5 October 2007. An important issue dealt with by several committees was the proposal for a Framework Directive, with special focus on the following topics:

- Requirements of actuaries with a view to the actuarial function described in Article 47
- Method of calculating technical provisions
- Solvency report

Groupe Consultatif, which represents the European actuarial associations, has supported CEIOPS since its foundation, especially with regard to actuarial issues and risk theory. To do this efficiently, Groupe Consultatif chose a working group structure for the Solvency II project in 2004 which is similar to CEIOPS' expert group structure. When CEIOPS restructured its Solvency II expert groups in 2007, Groupe redesigned its Solvency II working groups to reflect this new structure, thus ensuring further close and active cooperation.

The actuaries will concentrate on the following activities in the next few months:

- Comparison of actuarial methods for calculating the best estimate (as part of the technical provisions) in non-life
- Valuation standards for internal models
- Structure and actuarial contents of the solvency report

Coordination Group on Proxies

At the beginning of 2006, Groupe Consultatif pointed out that a major role in the introduction of Solvency II had been assigned to the calculation of the best estimate of the technical provisions (at least in non-life). It was not important so much in the calculation of the SCR but rather for the calculation of eligible elements of capital in the Solvency II balance sheet. The calculation of the best estimate plays a significant part in the proposal for a Framework Directive. The aim is to determine the best estimate of future cash flows for liabilities already incurred. This requires sufficient statistical data from every company (run-off triangles for claims) and actuarial know-how. In Europe, there are currently quite a few small and medium-sized companies that cannot provide either one or both of these prerequisites.

At Groupe Consultatif's suggestion and CEIOPS' initiative, working groups consisting of representatives of the respective supervisory authorities were therefore established in a number of countries at the beginning of this year. Their purpose is to draft solutions for approximating the best estimate in non-life if it cannot be calculated using actuarial methods.

Since then, newly established groups in 12 countries have taken up their work. Towards the middle of this year, the Coordination Group for Proxies comprising representatives of these national groups was founded. It is jointly headed by CEIOPS (Olaf Ermert) and Groupe Consultatif (Rolf Stölting). The national proxy solutions are to be compared and aligned as far as possible to ensure that the harmonisation requested by the EU Commission is achieved here as well. One of Coordination Group's first duties is to incorporate the findings of CEIOPS' Financial Requirements Expert Group in the proposal for QIS 4.

IAIS/IAA

Cooperation between the IAIS and IAA will be intensified. In this regard, the IAIS has asked the IAA to produce publications on a variety of subjects, including the adequate valuation of technical provisions and internal models. Furthermore, work on another publication dealing with enterprise risk management has begun. A first presentation on this subject was held by the IAA before the IAIS subcommittee Solvency and Actuarial Issues.



These topics are, of course, also of great significance in the context of Solvency II in Europe. The strong involvement of European actuaries in the IAA's working groups ensures that the relationship with Groupe Consultatif will remain close. The input provided by the internationally operating IAA can therefore be made available to Solvency II by Groupe Consultatif.

If you would like more information on this subject, please contact us directly:

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