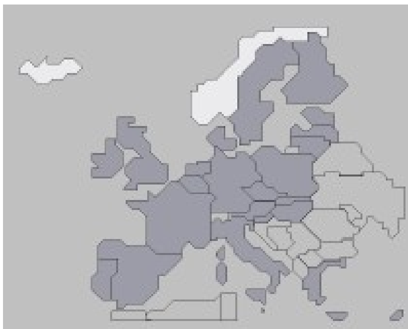

Solvabilität
Solvabilité
Οικονομική φερεγγυότητα
Solvibilità
Vakavaraisuus
Solvencia
Fizetőképesség
Solvabiliteit
Zdolność płatnicza
Solvabilidade
Lahustamisvõime
Solvens
Maksātspēja
Solventnost
Mokumas

Solvency II – Newsletter

No. 6/en. June 2006

Solvency II is well on its way to becoming the solvency standard for insurance companies in Europe. **The sixth issue of the Newsletter describes the latest developments in the reorganisation and harmonisation of existing solvency regulations and highlights the work planned for 2006.** Open dialogue between the supervisory authorities and the various interest groups will continue. The first Europe-wide Quantitative Impact Study was completed on 31 December 2005 and the second started in May following a pre-test phase. CEIOPS[1] has transmitted the responses on the third and last wave (for the time being) of "Calls for Advice" to the European Commission. It took into account the comments of interested parties submitted by February 2006.

Current developments

European Commission

Solvency II Impact Assessment

The European Commission is planning an "Impact Assessment" for Solvency II (not to be confused with the Quantitative Impact Studies QISs carried out by CEIOPS), which will aim to describe the possible impacts of Solvency II. The intention is to provide answers to important questions which will arise when new solvency requirements are introduced, for example the effects on:

- **Macro-economy and financial stability in the EU**
  Impact on pricing, policy terms and conditions and availability of insurance products, also on insurers' investment strategies and reinsurance markets.
- **Insurance undertakings and supervisory authorities**
  Will there be specific changes to products, for example in life assurance or in classes of business within non-life/personal accident insurance? Will there be changes which depend on companies' size or structure? What is the expected impact on administrative costs at companies and regulators?
- **Insurance products and insurance markets**
  Which products and markets will be particularly affected by the changes? Will EU member states be affected in different ways?
- **Final consumers of insurance products**
  Will any changes specifically affect particular types of policyholder (private individuals, small/large companies)?

[1] Committee of European Insurance and Occupational Pensions Supervisors

The European Commission will launch the “Impact Assessment” with a conference and public hearing in Brussels on 21 June 2006. In the coming months, various interest groups and players affected by Solvency II will be approached. It is planned to finalise the first draft of the report on the Impact Assessment in October 2006.

CEIOPS

CEIOPS publishes the Work Programme 2006 and the Fifth Progress Report

CEIOPS’ Work Programme for 2006 was presented at the end of 2005.[2] It covers both contributions to the preparation of EU legislation and, in particular, activities directly connected to the implementation of a new Directive and the consequences for the supervisory authorities.

Further work will focus on the valuation of technical provisions, the development of the MCR and SCR[3] formula and the recognition of reinsurance and other risk mitigation techniques. The Work Programme 2006 also provides information on the objectives of and the next stages in the Quantitative Impact Studies.

Both the Work Programme and the Progress Report describe the next phases required in the process from CEIOPS’ point of view. The “Fifth Progress Report”[4] includes a summary of the Calls for Advice.

CEIOPS will continue to support the European Commission to enable a first draft of a Framework Directive to be presented before the end of 2006. The draft should summarise all of the current solvency requirements. Following a consultation phase with all interested parties, the final version is expected to be available in mid-2007. After approval at political level, it will then be introduced throughout Europe.

Independance and accountability of supervisors

The CP 11 consultation paper submitted by CEIOPS in December 2005 on the independence and accountability of supervisory authorities[5] initiated debate on the need for additional regulations. It raised the issues of

- Guaranteeing the independence of the supervisory review process,
- Minimum prerequisites to guarantee independence,
- Accountability, i.e. defining to whom and to what extent a supervisory authority must account for its activities.

CEIOPS’ recommendations range from the independence of supervisory authorities from, for example, political groups and the insurance industry, to prior consultations with the various interest groups before the introduction of new Directives.

Third wave of consultation

CEIOPS’ document no. CEIOPS-DOC-09/05 on the third wave of consultation relating to the latest Calls for Advice covered the following issues:

- Eligible elements to cover capital requirements
- Co-operation between supervisory authorities
- Supervisory Reporting and Public Disclosure
- Procyclicality
- Small undertakings

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[2] Cf. *CEIOPS Work Programme 2006*, online at: www.ceiops.org.

[3] For the calculation of required solvency capital (i.e. minimum capital requirement (MCR) and solvency capital requirement (SCR)).

[4] Cf. CEIOPS-SEC-07/06: Fifth Progress Report to the European Commission on CEIOPS’ work in the field of Solvency II project (March 2006), oline at: www.ceiops.org.

[5] Cf. CEIOPS-DOC-04/06: *Recommendation on Independence and Accountability*, Consultation Paper No. 11, May 2006, online at: www.ceiops.org.

In addition to making initial proposals regarding the capital components eligible to cover the solvency capital requirement, CEIOPS recommended the introduction of three tiers of capital, according to quality, each valued differently for solvency capital purposes, as in Basel II. Tier 1 capital would include all of the highest-quality components, such as retained earnings, reserves and shareholders' equity. Capital components which cannot be allocated to tier 1 because they do not meet the quality requirements would be included in tier 2 or 3. Whilst tier 2 capital components, such as perpetual cumulative preference shares and perpetual subordinated debt, could be eligible to cover the solvency capital requirement up to a previously defined level, the inclusion of tier 3 capital components, such as zillmerising amounts and contingent capital, would require prior authorisation by the supervisory authority. CEIOPS has advised the European Commission also to introduce certain requirements within each classification. For example, it would be conceivable for untertakings to be obliged to have a minimum amount of highest quality eligible tier 1 capital and that tier 2 and tier 3 capital should be subject to appropriate limits.

The main aim of the discussions between the various European supervisory authorities was to strengthen the central role of the "Group supervisor". At group level, it would not only adopt the lead role in the validation process for internal models, but also be responsible for assessing

- Fitness and properness of the senior management and the board of directors,
- Internal control,
- Risk management,
- Financial situation of the group, and
- Diversification effect on group level.

Since publication of the Third Wave, there has been more discussion on which Solvency II requirements should be applicable to small undertakings. The question of the extent to which small undertakings should in principle be exempted from the new solvency requirements, or whether they might be subject to simplified disclosure requirements, has not yet been finally resolved. CEIOPS recommends that certain of the exceptional arrangements existing under Solvency I be retained. Small undertakings with annual premium income below a level yet to be determined could then be exempted from the new Solvency Directive. On one point the European Commission and the various interest groups have already reached agreement: as a matter of principle - the same rules for measuring solvency are to be applied to all undertakings in order to achieve harmonisation within Europe. The protection of policyholders also remains an important objective.

The final answers to the third wave of Calls for Advice were submitted to the European Commission at the beginning of May, so that CEIOPS can now continue work on the Solvency II project as planned. In 2006, the focus will be on preparation of a first Framework Directive, the final draft of which should be presented in mid-2007 by the European Commission.

Quantitative Impact Studies – QIS

In order to investigate the possible impacts of the new solvency standard on the solvency capital of undertakings, CEIOPS initiated a series of tests within the framework of Quantitative Impact Studies (QISs). These compared the currently applicable national valuation regulations with the probable future requirements under Solvency II.

QIS1

The first impact study, launched in October last year and finished on 31 December, focused on the level of prudence in the current technical provisions and tested various assumptions as to how the valuations might be introduced in the Solvency II project. It also examined both the technical and the actuarial feasibility of the new valuation rules and methods. A number of problems came to light. There were, for example, company reports which contained either no data or no qualitative answers to the questions asked, for example on the quantiles required.[6] More seriously, however, some insurance companies were not able to provide any “best estimate”[7] information.[8] A total of 312 insurance untertakings[9] took part in the tests. Over a quarter of the untertakings were small insurers, a third medium-sized and the remainder large.[10] The most significant results of the study were:[11]

Life undertakings

- Best estimates of technical provisions, including risk margins for the various quantiles (75% and 90% quantile), are lower than the current base.
- There is insufficient information on the feasibility of alternative methods, for example the cost-of-capital approach suggested by some untertakings, to enable conclusions to be drawn on their suitability for future valuation guidelines.
- The inclusion of future bonuses appears to affect the estimated provision considerably.

General insurers

- Generally speaking, the discounted values of best estimates and risk margins (75% or 90% quantile), are below current balance sheet figures.
- The discounting effect of technical provisions appears to have a major impact.[12] In many countries, it amounts to 10–15 percentage points.
- Information provided on alternative methods and clear valuation rules for risk margins on provisions was inadequate.

However, this initial study provided CEIOPS with valuable information on both the impact of best estimates and risk margins on technical provision requirements, and the feasibility of the new methodologies and valuation principles. For most insurance undertakings and lines of business, the best estimates and risk margins appear to be lower than current requirements. CEIOPS' report illustrates the diverse effects of different national approaches to determining provisions. Bearing in mind the importance of technical provision valuation, further efforts must therefore be made to achieve harmonisation within the framework of Solvency II.

The first test also had its limitations. Not all European countries approached took part in the QIS. Insufficient time and a lack of expertise were given as reasons for not doing so. As a result, the conclusions which CEIOPS was able to draw for the European Economic Area as a whole were limited.

QIS2

The supervisory authorities would like to use the second Quantitative Impact Study (QIS2), launched in May 2006, to compare the rules currently applicable to technical provisions with the future Solvency II regulations again, and also current Solvency I capital requirements with those under the new rules. The study, in which insurance undertakings may participate until 31 July 2006, will focus on the calculation of SCR[13] and MCR[14]. The diagram below shows the risks which generate the solvency capital requirement.

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[6] Provision valuations should attain a defined level of confidence (e.g. 75% or 90% quantile).

[7] (Discounted) current value of future obligations relating to existing claims.

[8] Cf. CEIOPS-FS-01/06: *QIS1 – Summary report*, of 17 March 2006, p. 4, point 7, online at www.ceiops.org.

[9] Including 150 life assurance companies, 190 general insurance companies and 4 reinsurers – these figures are based on treatment of the various fields of business of companies operating in a number of fields (life, general and reinsurance) as separate companies.

[10] These statistics relate only to those companies which provided information on the size of their insurance business.

[11] A detailed report on the results of CEIOPS-FS-01/06 can be found online at www.ceiops.org.

[12] Cash flows must be discounted at the risk-free interest rate for the applicable term.

[13] Solvency capital requirement

A considerably more detailed view is taken than under Solvency I. For example, in QIS2, for Germany it was decided only to take into account those claims events which also occur in accordance with the calibration (15-year time series) in the calculation of the premium and provision risk for the general insurance sector. Also worthy of note is the separate consideration of rare events in the calculation of the solvency capital requirement. Regulations relating to cover for catastrophe risks are laid down by national supervisory authorities, and not by CEIOPS, as it often has special national features.

CEIOPS proposed that, during a transition period following introduction of the new solvency regulations, the MCR be based on the Solvency I solvency margin.

Calculation of reserves is required to determine both capital requirements and ASM[15]. The calculation takes account of the current value of future cash flows and includes appropriate assumptions relating to future inflation.

Expected values and the 75% quantile of the future payments must be calculated for both life and general insurance.

Technical provisions must also comply with a specified level of confidence. Insurers may chose between two methods to calculate the risk margin:

- The quantile approach
- The cost-of-capital approach

It is intended to use stress tests to calculate certain results.

The results of this second study are expected to be available in October 2006.

European Actuaries – Groupe Consultatif

Standard calculation of technical provisions

Solvency II must harmonise calculation not only of required solvency capital (SCR/MCR) in Europe, but also of the capital an insurance undertaking has available to cover SCR and MCR. It is therefore necessary to achieve a uniform definition of the amount of technical provisions required which is independent of current, differing national accounting regulations. At the present time, the new

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[14] Minimum capital requirement

[15] Available Solvency Margin

solvency regime does not yet provide for a clear method of calculation of technical provisions. Various actuarial estimation methods such as the Chain Ladder procedure[16] are available. They provide an estimate of the expected ultimate loss value.

A uniform calculation of the "best estimate" poses a particular problem for the determination of technical provisions for property-casualty lines of business. It creates two possible difficulties for some insurance companies: they lack either the necessary historical claims-handling data (statistics relating to underwriting years over a long period) or the actuarial knowledge required for the careful calculation of the values. However, with the aim of achieving a harmonised procedure at European level, the Groupe Consultatif proposed in a letter to CEIOPS that actuaries, supervisors and industry associations pool their efforts to produce standard procedures for sectors and countries. The objective of such a standard approach would be to determine best estimates on the basis of data available without the need for additional actuarial expertise. Appropriate working groups will be formed in the near future.

A risk margin will also be introduced. The question for a level of confidence in reserves is more complicated than at first thought. In the last issue of our Solvency II Newsletter (no. 5), we reported on the objectives and possible calculation methods of the risk margin. We presented the two approaches to calculation – quantile and future capital costs. To date, no decision has been taken. To achieve a better estimation of the impact of each method, insurance undertakings have been requested in the current QIS2 to calculate their risk margins according to both approaches if possible.

International Actuarial Association/regulators

IAIS

The IAA[17] and the IAIS[18] have founded a working group instructed to prepare a proposed method of calculation of the risk margin. The aim is to prepare solutions capable of being adopted where possible in future IASB accounting standards, or at least of substantially complying with such standards. The working group is expected to produce its first proposals in the course of this year. They will then be discussed in detail in the IAIS "Insurance Contracts" and "Solvency and Actuarial Issues" sub-committees and in all probability incorporated in relevant IAIS publications.

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

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[16] See Mack, T. (1997): *Schadenversicherungsmathematik*, Schriftenreihe Angewandte Versicherungsmathematik, Heft 28, Karlsruhe: Verlag Versicherungswirtschaft, 1997.

[17] International Actuarial Association

[18] International Association of Insurance Supervisors