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Mr Henrik BJERRE-NIELSEN
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Director-General
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Subject: Solvency II – Amended Framework for Consultation

Dear Henrik,

In December last year, you requested the Commission to reflect on some issues that would require further policy guidance concerning Solvency II. This would facilitate CEIOPS' work in answering the Specific Calls for Advice on Solvency II. It was felt that the number of possible solutions to some of the Calls for Advice needed to be narrowed down.

As the Framework for Consultation sets out the policy guidelines and principles within which CEIOPS should develop its advice, this guidance should be incorporated in that Framework. Before revising the Framework, the Commission committed itself to consult the Insurance Committee / European Insurance and Occupational Pensions Committee (IC / EIOPC). This was done at 2 occasions.

At the meeting of the Insurance Committee on 8 April 2005, members discussed a draft Amended Framework for Consultation. A second discussion took place at the first EIOPC meeting on 29 June 2005. This was based on a revised document taking into account the comments made in the April meeting and comments of other stakeholders.

The enclosed Amended Framework for Consultation takes account of the comments received and the IC / EIOPC discussions and provides you with additional detail and guidance.

Continuing the work

I would also like to use this opportunity to thank you for the timely submission of the answers to the first wave of Specific Calls for Advice and to congratulate you with the quality of the answers. The draft second wave answers, which I understand are now out for consultation, indicate that still a lot of work needs to be done by both CEIOPS and

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the Commission. I would like to stress that we suggest you to work further on the development of in particular the standard formula in the time to come. This of course is the main issue at stake. I would appreciate to receive any further request for guidance if you feel this would help your work to advance.

Transparency

Throughout the discussion between the European Parliament and the Council, great emphasis has been placed on maximum transparency. Therefore, I should also like to suggest that my letter be made available on our web sites.

Should you have any queries on the Amended Framework for Consultation, please let me know.

Yours sincerely,

(signed)
Alexander SCHAUB

Annexes: Amended Framework for Consultation

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EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS

Insurance and Pensions

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**AMENDED
FRAMEWORK FOR CONSULTATION ON SOLVENCY II**

Purpose of this document

This paper provides a revised Framework for Consultation 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 assurance, 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 has been requested to provide advice on detailed aspects of the new solvency system through “Specific Calls for Advice”, which are annexed to this Framework for Consultation.

The Framework for Consultation may be revised and updated in the future after EIOPC consultation.

FRAMEWORK FOR CONSULTATION ON SOLVENCY II

The European Commission, having consulted the Insurance and Occupational Pensions Committee (EIOPC), requests CEIOPS and other stakeholders to advise on the development of a new solvency system to be applied to life assurance, non-life insurance and reinsurance undertakings, which Member States and supervised institutions are able to apply in a robust, consistent and harmonised way. The solvency system aims at the protection of policyholders and beneficiaries. It should also improve the competitiveness of EU insurers and provide for a better allocation of capital resources, without causing significant market disruptions and impeding innovation in the insurance industry.

SUBJECT to the following conditions:

General features

1. The new solvency system should provide supervisors with the appropriate tools and powers to assess the “overall solvency” of all institutions¹ based on a prospective and 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.). The new solvency system is likely to result in changes to most of the present insurance Directives.
2. This solvency system defined in a broader sense should take its starting point in a three-pillar structure inspired by Basel II/CRD (Capital Requirements Directive): quantitative requirements (Pillar 1), supervisory activities (Pillar 2) and supervisory reporting and public disclosure (Pillar 3). This implies that special considerations are made concerning the interaction between quantitative and qualitative supervision, as well as concerning the role of disclosure. The importance of the supervisory review process in pillar 2 is to be highlighted. It should be noted that the scope and magnitude of the individual pillars do not need to be identical to Basel II.
3. In Pillar 1 the new solvency system contains two capital requirements with different purposes and calculated accordingly: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The SCR may not be lower than the MCR.

¹ Life assurance, non-life insurance and reinsurance undertakings as defined in the relevant Directives.

4. The solvency system should be designed in such a way that it 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 Capital Requirement 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 formula and can be appropriately validated.
5. An internal model can result in a higher or lower amount for the SCR than the amount based on the standard formula, subject to a floor (the MCR). Supervisors can require undertakings for which the activities deviate substantially from the assumptions underlying the standard formula to develop an internal model.
6. 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 (98/78/EC) and the Financial Conglomerates Directive (2002/87/EC)).
 - 6.1. The application of internal models in a group or conglomerate context is a key issue in this regard, as well as possible diversification benefits/costs and how to allocate these.
 - 6.2. It should be recognised that management decisions are increasingly being taken by the ultimate parent company. The relevant rules therefore need to be set at the relevant level. This includes an appropriate split of responsibilities between the supervisors involved in the supplementary supervision of financial groups, in particular concerning the validation of internal models.
 - 6.3. Solo supervision remains the responsibility and task of the national supervisor. Any rules on the adequate distribution of capital should be reinforced, to ensure that at the solo level sufficient capital is available. However, this does not exclude any streamlining of the supervisory activities for groups subject to supervision in several Member States.
7. The Solvency II regime will contain prudential valuation standards for assets and liabilities of insurance undertakings, as well as rules on supervisory reporting and public disclosure. In order to ensure convergence of valuation rules, supervisory reporting and public disclosure, as well as to limit the administrative burden for supervised institutions, the Solvency II rules should be compatible with accounting rules elaborated by the International Accounting Standards Board (IASB). The following clarifications of this approach can be given:

- 7.1. IASB is currently working on Phase II of its “Insurance Contracts” project, but it will take significant time until the final standard is presented. It is therefore likely that the Solvency II rules on valuation, reporting and disclosure will be elaborated without having an adopted IFRS in place. The likely outcome (cf. paragraph 7.2) of the IASB work should however be taken into account. Additions and adjustments to the IASB accounting rules may be proposed, provided specific reasons are given. The Solvency II rules may be adjusted when the IASB has finalised Phase II of its “Insurance Contracts” project.
- 7.2. The following elements are likely to be part of a future IFRS on insurance: use of a prospective asset-liability valuation approach; the valuation methodologies should take account of information provided by the financial markets; cash-flows related to assets and liabilities should be discounted; for technical provisions the “best estimate”² as well as the risk margin should be disclosed.
- 7.3. Presently only listed EU insurance companies are required to present consolidated financial statements according to endorsed IAS/IFRS, although Member States may broaden the field of application. The Solvency II regime will not require full use of IAS/IFRS by all insurance undertakings. Certain prudential valuation rules, reporting and disclosure rules may however be similar to IAS/IFRS rules, and in those cases a wider use of IAS/IFRS-like methods by insurance undertakings is not unlikely. Certain simplifications may apply for certain types of insurance undertakings, but the general principles should apply to all insurance undertakings.
8. The aim to attain an appropriate level of harmonisation that is at the same time higher than the present one should be reflected by solvency rules which do not need additional requirements. The new solvency system should provide for uniform application and sufficient consumer protection whilst supporting fair competition.
9. The solvency system sets a uniform level of prudence, both for technical provisions and for the Solvency Capital Requirement.
10. 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. However, the use of a more accurate or appropriate approach for measuring risks should be encouraged.

² In international fora also “current” and “central” estimate are used. However, this terminology may not always have the same meaning.

11. 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). The IAIS work on a Framework for insurance supervision and on Cornerstones for the formulation of regulatory financial requirements provides a valuable basis for the development of a new system.
12. In order to evaluate the impact of the new solvency system on insurers, one or more quantitative impact studies (QIS) will have to be made. Coherent data is a fundamental requirement to perform such studies. The data collection requirements, the methodology and timing for these QIS all need analysis. CEIOPS has been asked to perform these quantitative impact studies in cooperation with the industry. The Commission Services will provide an Impact Assessment to accompany the Proposal for a Directive, which will have a broader scope and less detail than the QIS.
13. Guarantee schemes are a last resort for policyholders and beneficiaries to be indemnified for their loss. The calibration of the new solvency system should not take into consideration the existence of a guarantee scheme. The new solvency system should provide enough safety and confidence in the insurance industry without relying on guarantee schemes.
14. Solvency II should not be overly costly for small undertakings but does not intend to have an entirely special treatment of them. Small undertakings should respect the same basic principles as all other institutions. However, in certain areas, it may be necessary to provide for specific rules for them.
15. Solvency II should take due account of the particularities of reinsurance undertakings.

Quantitative requirements (Pillar 1)

16. An increased level of harmonisation for technical provisions is a cornerstone of the new solvency system. In line with expected IASB developments a best estimate³ of the technical provisions should be calculated topped up with a risk margin. A quantitative benchmark for the confidence level of technical provisions should be set at 75% of the probability distribution. This percentage reflects a working hypothesis. However, the risk margin should as a minimum be equal to half a standard deviation in order to take account of strongly skewed distributions. The specificities of life and non-life insurance will require further attention when harmonising the rules for the valuation of technical provisions.

³ In international fora also “current” and “central” estimate are used. However, this terminology may not always have the same meaning.

17. 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 and beneficiaries. When an undertaking does not fulfil the SCR, it shall re-establish the amount of capital covering the SCR in due time, based on a concrete and realisable plan submitted to the supervisor for approval. The parameters in the SCR should be calibrated in such a way that the quantifiable risks to which an institution with a diversified portfolio of risks is exposed are taken into account and based on the amount of economic capital corresponding to a ruin probability of 0.5% (Value at Risk of 99.5%) and a one year time horizon. This percentage reflects a working hypothesis. Ruin occurs when the amount of admissible assets is lower than the amount of technical provisions as defined in paragraph 16. The methods used to check that this level is effective must be defined. The SCR should be based on a going-concern basis. These principles shall apply regardless of whether a standard formula or an internal model is used.
18. The standard formula 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 formula taking into account the specificities of life, non-life and reinsurance business, which consequently vary according to the specific sector concerned, requires analysis.
19. The Minimum Capital Requirement (MCR) reflects a level of capital below which ultimate supervisory action would be triggered. The level of the MCR will be set once quantitative impact studies have been performed. 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 a sufficient level of prudence. It will have an absolute floor.
20. 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 are given. To the extent these risks are not quantifiable they will be taken into account in Pillar 2.
21. Internal models may be used to replace the standard formula of the SCR if the internal model has been validated for this purpose. The validation criteria and the validation process should be developed and harmonised. Partial use of models may also be authorised, if these models fulfil validation conditions, including compatibility with the standard formula.

Supervisory activities (Pillar 2)

22. The supervisory activities should aim to identify institutions with financial, organisational or other features susceptible to producing a higher risk profile. Such institutions can be required to hold a higher solvency capital than under the SCR and/or to take measures to reduce the risks incurred. In addition, it should increase the level of harmonisation of supervisory methods, tools and powers by developing common standards and methods, e.g. for the validation process of internal models. The scope therefore goes beyond that of the supervisory review process defined in Basel II. The supervisory activities also include increased cooperation between supervisors combined with peer reviews.

Supervisory reporting and public disclosure (Pillar 3)

23. Harmonised reporting from insurance undertakings to their supervisors ("*supervisory reporting*") will be an important part of the future regulatory architecture in the EU. Supervisory reporting goes beyond the notion of financial reporting rules, and includes different types of information that a supervisor needs to perform his functions. This information is normally not in the public domain. In addition, transparency and disclosure of information by undertakings to the public will serve to reinforce market mechanisms and discipline ("*public disclosure*").
24. In the Basel II framework, pillar 3 requirements deal only with public disclosure, and supervisory reporting is only harmonised to a limited extent. Whilst remaining compatible, it is deemed necessary to explicitly include both areas in the Solvency II exercise.
25. Supervisory reporting and 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 are given. Confidentiality aspects linked to disclosure requirements need careful consideration.

IN ADDITION,

Revision of Framework for Consultation

26. This Framework for Consultation may be revised by the Commission, after consultation of the European Insurance and Occupational Pensions Committee (EIOPC). The Framework for Consultation will therefore function as a dynamic reference document for the development criteria of the new solvency system.
27. 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

28. Solvency requirements of institutions for occupational retirement provision (IORPs) are linked to those of life assurance 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

29. This Framework for Consultation is 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 EIOPC before requesting a Specific Call for Advice from CEIOPS.
30. 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.
31. A Specific Call for Advice may be revised in the same way as the Framework for Consultation.

Reporting Modalities

32. CEIOPS should provide regular progress reports covering advice on the new solvency system to the Commission at four-monthly intervals. Where warranted, reports should be provided more frequently, e.g. where policy decisions may be required.
33. After preparation of the Framework Directive, it will be necessary to develop more detailed rules and guidance: both through detailed implementing measures and/or supervisory recommendations, as appropriate. Consequently, CEIOPS should continue to develop and deepen its analysis accordingly. To assist the Commission in the preparation of the potential mandates for these implementing measures, as well as to keep EIOPC informed of its work, CEIOPS should continue to provide regular progress reports at four-monthly intervals. Subject to the attainment of the objectives of any Call for Advice, CEIOPS will enjoy a general discretion in the drawing up of these four-monthly reports, unless otherwise requested.

Publication

34. In the interests of transparency, after consultation of EIOPC, the Commission will publish on its insurance web-site this Framework for Consultation and Specific Calls for Advice.