SOLVENCY II – COOPERATION AT EUROPEAN LEVEL ON THE INSURANCE MARKET

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The current solvency framework, introduced in the early 70s at the level of European Union, defined capital conditions for insurers, by specifying requirements for solvency margins. The specifics of each national insurance market brought about differences in legal requirements concerning the financial health of insurance companies. As the insurance industry became more and more active, as the awareness degree related to insurance activity among the population increased and as the insurance activity exceeded the national borders, the national supervisory authorities considered critical to implement a leveled form of monitoring the financial stability of those companies offering insurance products not only on the local markets but also on international markets.

After the first wave of EU directive related to solvency margin and guarantee fund was implemented, the local markets began introducing separate national legal provisions that changed a little the initial intention of the supervisors. It became clear that the capital required under Solvency I was inadequately allocated and so regulation in several countries had been strengthened, resulting in a patchwork of rules in place across Europe, requiring the introduction of new, leveled model of regulation – Solvency II.

The paper is due to present the common efforts of the European supervisors on the insurance markets to level the requirements for all insurers in order to offer the same degree of security for the consumers of insurance services.

Keywords: solvency, QS4, requirements, guarantee fund

In a world of permanent changes, the financial sector makes no difference, being constantly under the attack of new comers and new threats. Each national market records its own volume of turnover and responds in a distinct manner to external or internal influences.

The recent events from 2006 as a follow up of the ones in 2001 on the US market have significantly impacted any national market and brought about concern for better and stricter regulation of the industry such that a new threat will not have a disastrous impact on the general status of the markets.

Considering the fluctuations recorded on national markets due to natural disasters, concerning the level of paid compensations and therefore the level of financial position of the insurance companies, for the benefit and protection of policyholders[1], the insurance supervision authorities have the obligation of finding a comprehensive legal framework that will assure the consumer about the good will and the financial health of the players on the market.

The overlap and lack of a common approach to reporting requirements for financial groups operating cross –border businesses can be an unnecessary administrative burden, disrupting cost savings that should flow from a more integrated financial market.

Market participants can be required to supply similar information to different supervisors in different formats. Any change in reporting requirements will entail some cost

[1] Insurance Association of Insurance Supervisors : Insurance Core Principles and Methodology, October 2003

and this must be set against the potential benefits. Market participants having a predominantly local focus may be unhappy at adjusting reporting systems for the benefit of cross-border operators.

For the purpose of market integrity surveillance, transactions reporting obligations have been significantly simplified. Despite the fact that there will be a multiplication of trading places, companies will declare trades only to their home competent authorities. What remains to be done is the exchange of reports between authorities.

Thus, at the level of European market, starting with 2003, there have been interests in developing for a new set of prudential insurance undertakings which later on became what is known as Solvency II project. This project provided the EU with a window of opportunity to move towards more and more consistent approach.

CEIOPS[2] has been dominated by this work, directed at Level 1, where the Commission, the Council and the Parliament define framework principles and implementing powers, and at level 2 where the European Commission adopts detailed implementing measures.

CEIOPS has been intending through this project to enhance effective cooperation between national supervisory authorities and promote best practices. According to IAIS[3], "a well developed insurance sector also helps enhance overall efficiency of the financial system by reducing transaction costs, creating liquidity, and facilitating economies of scale in investment." Therefore, a sound regulatory and supervisory system was necessary for maintaining efficient, safe, fair and stable insurance markets and form promoting growth and competition.

Obstacles and challenges

National authorities moved from fairly different starting points, as differences in reporting mirrored different supervisory practices. For instance, some national supervisors relied more on comprehensive reporting of data and off-site surveillance, others on on-site inspections, others relied more on the information stored in the internal systems of the supervised entities. There were differences in human and technical resources and in the structure of supervisory processes. A lot of work was done but even in 2005 there was a realistic opinion that the national supervisory practices were not to be changed at once by harmonizing the reporting framework[4].

Different authorities asked for data in order to pursue different objectives (eg. prudential monitoring, checking compliance with conduct of business rules, analyzing potential threats to financial stability, pure statistical requirements). It was not easy to reduce this range of objectives ot a simple set of requirements. Especially in the Eastern part of Europe, the national insurance supervisors had to increase their requirements from the part of the insurers in order to converge to the same supervisory methods as the Western part of Europe.

Different methodologies were adopted and slightly changed from one year to another (eg. in Romania, the methodology to compute the solvency ratio recorded three modifications due to gaps between the national methodology and the common European one), as voluntary tool implemented by national authorities.

Each national legal framework is being added with several layers of reporting requirements until full commonality is achieved at the EU level and regulatory harmonization is to be achieved.

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[2] Committee of European Insurance and Occupational Pensions Supervisors

[3] International Association of Insurance Supervisors

[4] Nielsen Henrik (CEIOPS): As far as it goes the Solvency II, February 2005, Munich

A common reporting framework brought about high costs, especially for the least developed national industries (eg. because of the change in the IT platforms) but the benefits are already starting to show themselves. (eg. in Romania, a common ledger for the actuaries, for the insurance intermediaries, a ledger for the each insurer's agents).

In spite of these difficulties, the market participants maintained their very ambitious targets – they asked for a very simple framework, reducing substantially the total amount of information to be reported and for a complete uniformity throughout EU, i.e. full convergence towards a minimum set of requirements. Especially taking into consideration the more sophisticated and risk-focused approaches in the industry, the Solvency II project is no longer seem so costly.

Solvency II project – a unique legal framework for Europe

Solvency II is part of the Financial Services Action Plan included in the Lisbon goals to make the European economy the most competitive in the world by 2010. The differences in the way the various members of the EU have structured their regulation and supervision of insurance companies made the process of finding a solution that satisfies everybody a challenge.

Solvency II is based on a three-pillar structure – not to be confused with the three waves - with pillar I covering minimum capital requirements, pillar II covering qualitative requirements, i.e. risk management and supervisory processes and finally pillar III covering disclosure requirements. This structure is also known from Basle II in the banking sector.

The new system assesses the overall solvency and builds on a more risk-sensitive approach, with incentives for proper risk management. Furthermore the system supports the harmonization of quantitative and qualitative supervisory methods and ensures consistency between financial sectors.

In this respect, the supervisory authorities are to evaluate on an ongoing basis the risk profile, the adequacy of financial resources and prudent conduct of insurance undertakings. This requires a forward-looking analysis of individual undertakings as well as the environment in which they operate.

Quantitative tools are part of supervision. Therefore, supervisors had to prescribe the use of quantitative tools by undertakings, a set of indicators which forms the basis for exchange of information, particularly in relation to companies operating cross border. Moreover, the Solvency II meant an optimal use of common statistics and a certain level of detail to be useful, having regard to the costs and benefits, and bearing in mind the data already collected by individual Member States, and how this data could be used.

Increased transparency will help to harmonize supervisory practices and promote convergence of best practices. This involves that the general criteria and methodologies used in the supervisory practices should be available to the public. The criteria according to which remedial action – including supervisory intervention – is taken and any sanctions are imposed should be available to the public as well as the procedures relating to the appeal process.

The most important issues when it comes to the common requirements of the Solvency II over the European insurance markets refer to *technical provisions* of the insurers and *solvency capital requirements*.

The development of standards to calculate technical provisions seems to be a very difficult task – not only stemming from technical issues, but also from more fundamental or political differences in the principles on determining the technical provision. Some countries are very much in favor of the fair valuation approach with the safety reflected in the capital requirement, whereas others support the more traditional way of calculating the liabilities on a prudent basis with the safety in the technical provisions.

Concerning the calculating the solvency capital requirements, one of the major drawbacks of the present solvency system for insurance is the lack of sensitivity to some of the type of risks assumed under the existing directives; risks which are not subject to any capital charges. The future capital requirements should aim at including as many risks as possible in order to present the most accurate picture of the assumed business. If in the banking sector, Basel II takes into consideration only two risks for its modeling, in the insurance industry, at least 5-6 risks should be taken into consideration[5]. (Needleless to say, there are still new markets that are stuck to 1 or to 2 risks when pricing new products or computing the solvency capital requirements)

There is a need for a detailed risk classification building on the work of insurers e.g. market risk, credit risk and underwriting risk. Operational risks should be analyzed and included in the calculation of the capital requirement to the extent feasible. Moreover, when aggregating different risks, their dependencies should be carefully analyzed to decide how, and to what extent, correlation effects should be taken into account. The estimation of parameters should also be analyzed in detail. e.g. which estimation periods should be chosen and how should the time-varying aspects (volatility clustering and "jumps", trend/regime changes etc) be addressed and to which extent these could be taken into account in Pillar II (through stress-testing scenarios for example)

Harmonization of the national frameworks with Solvency II

It is clear that one of the main purposes of this project is to ensure a level playing field with regard to prudential regulation and supervision of insurers throughout EU in a system where, even though within a harmonized regulatory framework, much more room for discretion will inevitably be left to supervisors. This is inherent in the three pillar structure, where the supervisory review process in pillar II, i.e. the assessment of the capital adequacy of the individual company, represents the essential component for reaching the goal of having an upper(relative) bound on the expected shortfall of any European insurer. But this will also make the current differences in terms of supervisory culture and practice which still exist in EU, more critical. These differences, in addition, are often underpinned by the objective variety of market environments. How to strike the right balance between harmonization of the regime and recognition of diversities is, again, a problem which requires a pragmatic and evolutionary approach.

In designing the new legislative framework, the actual harmonization of financial and disclosure requirements appears to be a precondition for ensuring a level playing field of supervision in EU and fostering the creation of a stable and truly single market in this sector. More flexibility should be given to the provisions regulating the supervisory review process.

In the current situation, actual convergence is better achieved by facilitating equal reactions to similar problems than by forcing supervisors to use the same procedures and tools. In other words, priority should be given to the creation of a European supervisory culture, rather than to the identification of too detailed harmonized rules which could result in being less effective or even becoming a constraint when applied to varying situations.

Issuance of standards, assistance and peer pressure mechanisms for their actual implementation, a platform for the creation of European operational networking and a sharing of experience: all the level 3 activities should be exploited and developed.

Solvency II should represent not only a package of rules, but a new set of principles for conducting supervision[6]. Proceeding in this way, however, required that more exercises of aligning the specificities of Solvency II to the particularities of the each Member State

[5] Ciuncan Alexandru: A new rising European star, pg.4-5, PRIMM insurance & pensions, Nr.2/2008, Bucharest
[6] Steffen Thomas (CEIOPS) : New evolutions of Solvency II project, November 2007, Frankfurt

insurance market to be carried out (in the banking sectors, when Basel II was implemented, 5 quantitative impact studies were carried out by the participants[7]).

The **quantitative impact studies[8] (QIS)** have the objective of highlighting the relevant issues and tentatively indicating possible solutions. They provide fixed instructions and a range of different methodologies on a number of aspects, for calculating both the technical provisions and the capital requirements.

This "modular" approach has the purpose of giving CEIOPS more elements for refining the technical advice. Quantitative feed-back on the calculation of the technical provisions according to the different methods for defining the risk margin will help in further discussion on the level of prudence to be embedded in them, while the results of calculation of the capital will help in identifying the appropriate structure for the standard formula.

If the focus of QIS2 was on design rather than on calibration, the third QIS exercise were necessary to refine the calibration of parameters and ensure its consistency with the prudential objective of Solvency II.

Started in 2005, QIS3 benefited from a larger interest from the part of insurance markets – over 1000 companies took part in the exercise (double than for QIS2 that ended in 2004), which is impressive, taking into consideration that for the same phase in the Basel II implementation only 260 banks were involved[9].

The main achievements of QIS 3[10] were:

- The qualibration exercises of the ratios in order to better compute the minimum capital requirements – MCR and the solvency capital requirements – SCR);
- A more comprehensive approach of the interaction between the minimum capital requirements and the solvency capital requirements.

As only 51 insurance groups took part in QIS3, no clearer conclusions were drown for these entities and therefore this was be a key issue included in the following QIS exercise (started in April 2008).

Concerning the latest exercise, QIS 4 is targeting at least 25% of the insurance and reinsurance companies around EU and 60% of the insurance groups activating on the European territory[11]. The main objectives concern the sharing of information related to evaluation of assets and liabilities, the evaluation of technical reserves and owners' equity.

Conclusions

Solvency II tries to strike a balance between all the different interests at stake, providing for a good degree of standardization but also leaving some room for national flexibility. Transparency of the framework should allow initiating a process which will gradually lead to further convergence, but is also a very complex and resource intensive process.

Solvency II will set a benchmark for financial services supervision which includes banking. And it will certainly serve as mental impetus for a further fruitful dialogue with our supervisory partners around the globe. It is a modern, risk sensitive system for the 21st

[7] Popescu Rodica (CSA): Conferinta anuala CEIOPS, pg.13, Buletin Informativ II, nr.1, March 2008, Bucharest
[8] In April 2008, the fourth QIS was launched by CEIOPS, still at Level 1 Directive – concerning the principles and not the methodologies.
[9] Popescu Rodica (CSA): Conferinta anuala CEIOPS, pg.13, Buletin Informativ II, nr.1, March 2008, Bucharest
[10] Steffen Thomas (CEIOPS): Main challenges and priorities for 2008, November 2008, Frankfurt
[11] Marin Ionel (CSA): Un nou studio de impact privind introducerea Solvency II, pg.4-5, Buletin Informativ II, nr.1, March 2008, Bucharest

century that brings supervisors and supervised firms closer together with clear responsibilities on both sides:

Supervisors will better understand insurance firms, their risks and internal control processes while supervised firms must rely on their own ability to measure, control and steer risks rather than rely on regulatory rules. That is why Solvency II is not just about capital. It is a change in behavior - for the sake of enhanced consumer protection, financial stability and efficiency of insurance markets

Insurance supervisors in CEIOPS have invested three years and countless man-days in the preparatory work and in bridging diverging traditions within Europe that had never been bridged in the decades before to achieve the utmost degree of consensus and convergence in our advice to the Commission. It is essential that convergence based on a maximum level of harmonization is kept in the legislative process limiting the room for national discretion and national options.

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