Solvency II

Main Results of CEA's Impact Assessment

June 2007

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Introduction

Solvency I has become outdated as risk management has improved

The European system for insurance supervision dates from the 1970s. For many insurance undertakings, the current Solvency I rules are perceived insufficient as a reference in conducting business and managing risk. As a result, some Member States have developed more advanced Solvency assessment models, and undertakings use rating agency models or their own internal models to manage their business of accepting and spreading risks. The so-called Solvency II project, initiated by the European Commission, is aimed at developing a common EU supervisory framework for insurance companies.

The Commission has indicated that the objectives of the Solvency II project include the following:

- Deepening the integration of the EU insurance market;
- Improving protection of policyholders and beneficiaries;
- Improving international competitiveness of EU insurers;
- Promoting better regulation.

The insurance industry strongly advocates a risk-based economic approach for Solvency II

The insurance industry has emphasised that a risk-based economic approach to insurance supervision, aligning capital requirements with the underlying risks of an insurance company, is the only method to achieve the objectives set by the Commission. This is because a truly risk-based economic approach:

- can be designed to provide a balance between policyholder protection and encouraging efficient operation by companies;
- can cope with evolution in the financial environment, increasingly sophisticated product design and innovation in capital markets;
- is transparent and will avoid providing opportunities for regulatory arbitrage;
- aligns regulatory capital requirements with best practice in internal risk management processes, providing underlying transparency in the management of insurance companies.

Aligning the regulatory framework with existing best practices

The development of Solvency II is a unique opportunity to create a harmonised framework at European level that allows undertakings to conduct their business and manage their risks more efficiently, aligning capital requirements with risks.

Results of the largest survey on Solvency II conducted among the insurance industry …

This challenge motivated no less than 442 insurance companies to contribute actively to CEA's Impact Assessment Survey, which was carried out in response to a request by the European Commission. The European Commission is required to assess the potential impact of every new regulation. CEA's Impact Assessment Survey formed part of this analysis. Participants in the survey expressed the industry's strong commitment to the Solvency II project and a risk-based economic framework for insurance supervision. This commitment is strengthened by the great consistency among all contributions, from small, medium-sized and large (re-)insurance companies, mutual and shareholders companies.

CEA worked closely with its members, National Insurance Associations and other insurance industry bodies such as AISAM, ACME, the CRO Forum and ICISA[1]. This co-operation resulted in the largest survey to date on the potential impact of the Solvency II framework. The response provides a fair representation of the EU insurance industry across geographies, business segments and company sizes.

… based on the assumption that Solvency II will follow a risk-based economic approach …

Since the final form of Solvency II is not yet known, the participants were asked to use certain key assumptions about the Solvency II framework when responding. These key assumptions are in line with the risk-based economic approach to insurance supervision, as advocated by the industry:

- Assets and liabilities will be valued at market-consistent values;
- A total balance sheet approach is to be applied so that the available capital is provided determined as the market-consistent value of the assets less the market-consistent value of liabilities, and eligible elements of capital are based on the economic capacity to absorb risk;
- There is a comprehensive risk analysis with full allowance for risk mitigation (including the risk-absorbing properties of future discretionary benefits);
- The benefits of risk diversification[2] are fully recognised;
- The system is appropriately calibrated;
- Group issues are recognised from the outset.

[1] *AISAM = Association Internationale des Sociétés d'Assurances Mutuelle*
ACME = Association of European Cooperative and Mutual Insurers
ICISA = International Credit Insurance & Surety Association
CRO Forum = Chief Risk Officers Forum, comprising the CROs of major European insurance companies and financial conglomerates. The CRO Forum aims at developing and promoting best practises in risk manegement.

Part I of this document presents the key findings of CEA's Impact Assessment Survey executed in summer 2006. This provides the reader with an insight into the potential impact of a risk-based economic Solvency II Framework on:

- Insurers' current risk management practices;
- Administrative costs[3];
- Maintaining strong and effective policyholder protection;
- The design and prices of insurance products;
- Insurers' investment strategies;
- Reinsurance contracts and Reinsurance Companies;
- Insurers' ability to raise capital.

… provides an insight into the potential impact of Solvency II on the insurance industry

Since our analysis is based on the assumption that Solvency II will follow a true risk-based economic approach as advocated by the insurance industry, the interpretation of the results of the impact assessment is conditional to this assumption. Deviating from this approach is not without negative consequences as described in part II of this publication.

[2] *Risk diversification is based on the principle that not all risks crystallise at the same moment - provided that the underlying sources of risk, i.e. risk drivers or triggers, are not fully dependent.*

[3] *Impact is based on additional research by CEA in 2007.*

Part I

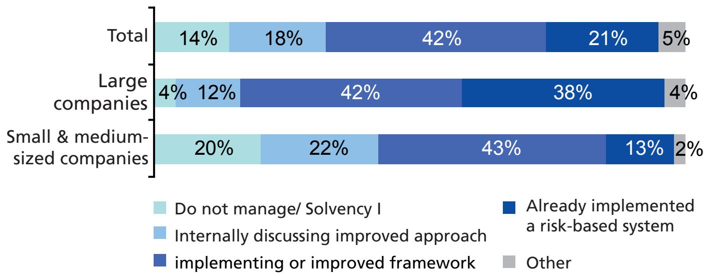
The impact of a true risk-based economic Solvency II Framework on the insurance industry

Insurers' risk management practices

The majority of companies are already improving their risk-management frameworks

The majority (80%) of the companies responding to the questionnaire have either already implemented a risk-based economic framework or are currently in the process of improving their risk management tools (see Graph 1). For those respondents that have already developed a risk management framework, there is a high level of commonality between the risk-based economic approach proposed by the industry and their current internal risk measurement processes.

Graph 1 | Current development of risk frameworks by company size

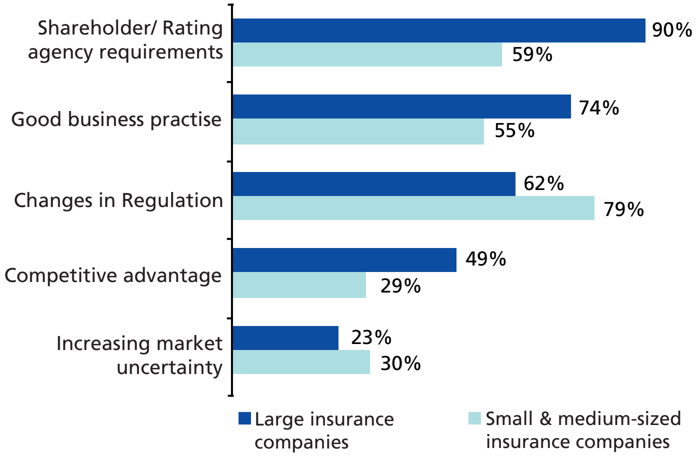


There are several reasons why insurers are already improving their risk management processes. Regulatory change is one of the main motivations (Solvency II is an example of a regulatory change), but it is certainly not the only one. For many companies, aligning their systems with good business practice, rating agency requirements and shareholder pressure is as important as adapting to regulatory changes (see Graph 2). This important finding is consistent across the different industry segments and company sizes.

Therefore, Solvency II represents an opportunity to align regulatory action with those best practices in risk management which have already emerged within the insurance industry, in various EU member states.

For those companies which do not have the most advanced risk management systems yet in place, improving their framework presents a number of challenges. These challenges include developing and training the appropriate internal staffing resources and implementing better information technology systems and risk measurement tools.

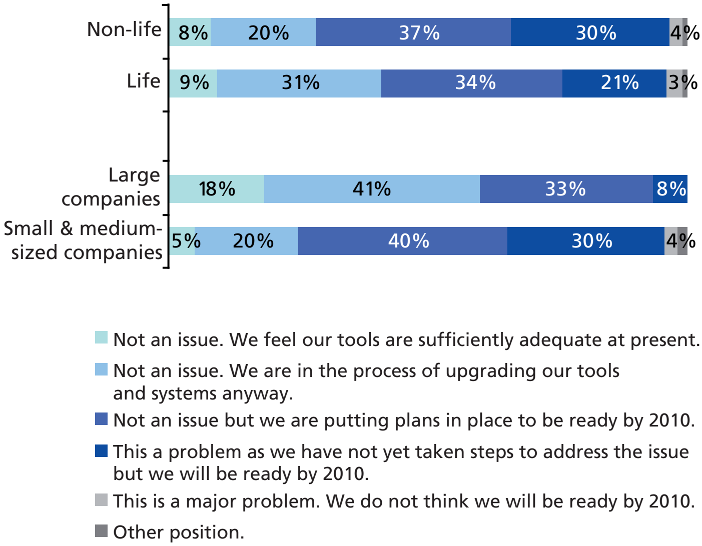
Graph 2 | Motivations for improving risk management



The great majority of insurers expect to be ready by 2010 if Solvency II follows a risk-based economic approach

While the efforts required to implement Solvency II are recognised, the vast majority (97%) of respondents expect that they will be ready by the time Solvency II comes into effect if Solvency II follows a risk-based economic approach. Only 3% of respondents believe that they will not be ready by 2010.

Graph 3 | Readiness for Solvency II by 2010



Administrative Costs

Additional analysis by CEA on the consequences of Solvency II for Insurers' administrative costs made clear that these would be manageable if the future Solvency II framework indeed follows a true risk-based economic approach.

If a true risk-based economic approach is followed ...

Under a risk-based economic Solvency II framework, companies can benefit from efforts already done or planned to improve their internal risk management systems. In such cases, the additional costs of Solvency II should be significantly lower (see table 1).

... the additional administrative burden as result of Solvency II will be manageable

Aligning business economics and best practices in the insurance industry with the future prudential supervisory framework would reduce the estimated initial compliance costs of Solvency II to a total of €2.0-3.0bn. The ongoing annual administrative costs is estimated around €0.3–0.5bn per year

Table 1 | Administrative costs for European insurers if Solvency II follows a risk-based economic approach

Costs in Billion Euro	Initial admin costs	Ongoing (p.a.) admin costs
Gross estimate	4.0 – 6.0	0.6 – 1.0
Estimated reduction for work already planned/done	2.0 – 3.0	0.3 – 0.5
Net estimate*	2.0 – 3.0	0.3 – 0.5

** The impact of tax relief on the associated expenses is not included as this will vary by type of business and jurisdiction.*

Maintaining strong and effective policyholder protection

Following a risk-based economic approach, Solvency II will maintain strong protection of the policyholder…

The protection of policyholders and beneficiaries will remain at the heart of the future framework. Solvency II will introduce risk measurement and supplementary requirements in Pillars I and II[4]. These elements will be strengthened via Pillar III by disclosure requirements encouraging economic discipline and introducing a holistic approach to policyholder protection.

…foster harmonisation across Europe …

Furthermore, regulatory harmonisation across European borders is needed to guarantee that consumer confidence will not depend on any insurers' legal form, size or location. This harmonisation should go hand in hand with the consistency of supervisory actions across companies, jurisdictions as well as over time.

… and ensuring efficient allocation of capital to where the true risks are

In the long term, a risk-based economic approach would further increase transparency in insurance pricing by allocating capital to where the true risks are. This approach would also bring many incentives for efficient risk management that would further foster innovation in the insurance industry. As a result, consumers can expect that Solvency II will ensure that necessary insurance coverage is available at affordable prices, along with enhanced policyholder protection.

[4] *Pillar I defines the financial resources that a company needs to hold in order to be considered solvent. Pillar II supplements Pillar I with more qualitative requirements, by addressing the supervisory review process. Pillar III defines the risk disclosure requirements. The three-pillar approach of Solvency II is explained in more detail in the CEA-Tillinghast publication (2006) Solvency II: An Introductory Guide.*

The design and pricing of insurance products

A risk-based economic Solvency II framework would also give greater transparency in the pricing of product features such as options and guarantees. This should allow policyholders to make better informed decisions between the cost of a product feature and the perceived added value.

A risk-based economic approach will also increase transparency…

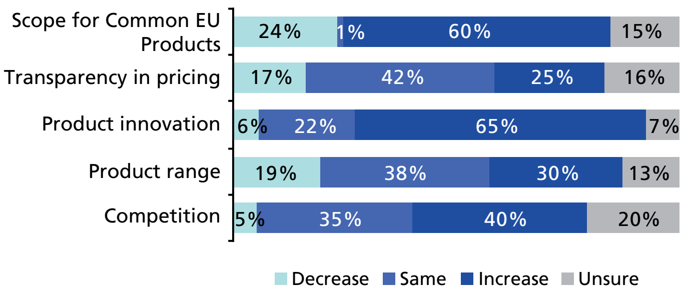
Insurance companies' core business is to accept and manage risk. In order to provide that service, companies should charge a reasonable and competitive price. Failure to do so is neither in the long term interests of the company, nor of companies, policyholders and the insurance industry as a whole.

Insurance companies expect that a risk-based economic approach would lead to greater product innovation and increased opportunity for Europe-wide offerings (see Graph 4). For products where the economic capital requirements are justifiably increased, companies have the possibility of adjusting their pricing, the product features, the risk mitigation strategy and the product mix.

…which in turn could lead to greater product innovation and opportunities for Europe-wide offerings

A prerequisite for this is that diversification and risk mitigation are fully recognised within the Solvency II framework.

Graph 4 | Expected overall impact of the new framework on the product offering/pricing



A risk-based economic approach to Solvency II is consistent with the objective of deepening the EU market integration

Insurers' investment strategy

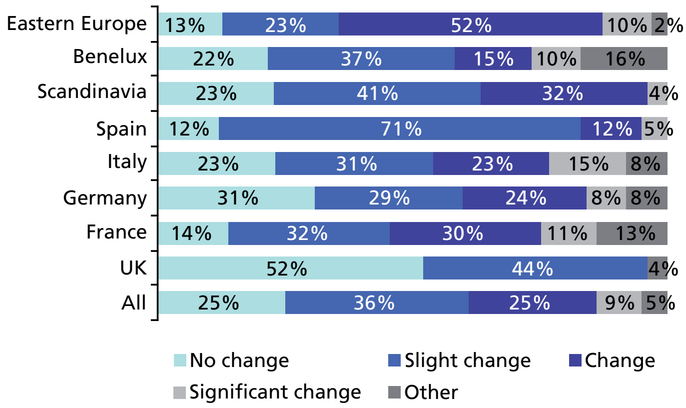
Insurers and reinsurers are major institutional investors

At a macro level, insurance companies are major players in the investment markets, with more than €6 371bn invested in the economy in 2005[5]. The largest investments are traditionally in fixed interest securities followed by shares, property and cash-like investments.

A risk-based economic framework for insurance supervision would encourage improved asset-liability management (ALM). Although this may not be fully recognised in Solvency I, most companies have indicated that they already closely manage asset-liability mismatching risk and understand the implications thereof.

Consequently, building the principles of the risk-based economic approach into the regulation would reinforce the company's current best practises.

Graph 5 | Impact of the risk-based economic framework on asset-liability management (ALM)



Changes in investment strategies are expected to be manageable

The majority of respondents expect no changes or only limited changes in their investment strategies as a result of the introduction of a risk-based economic supervisory framework (see Graph 5). However, there is a particular concern within some markets on the capital charge for shares.

[5] *CEA (2006) European Insurance in Figures.*

Most respondents believe that financial markets are sufficiently well developed to provide the range of assets allowing for good asset-liability management. Concerns were, however, expressed on the availability of financial instruments in certain regions such as Eastern Europe and other developed non-Euro regions (e.g. Scandinavian countries).

Respondents believe that financial markets are able to provide the required range of assets

Reinsurance contracts and reinsurance companies

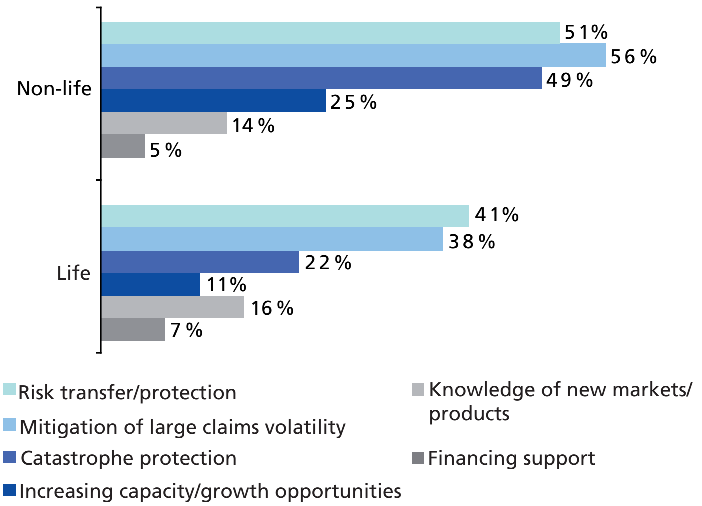
Despite the limited recognition of risk mitigation instruments in Solvency I ...

... companies are already actively using reinsurance

Reinsurance can be used to transfer a part of the risk portfolio of an insurer to a reinsurer. Many insurance companies already use reinsurance as a risk management instrument, despite the limited recognition of such risk reduction measures under Solvency I (see Graph 6). A significant change in the use of reinsurance by companies is therefore not to be expected. Allowing for full recognition of risk mitigation within the Solvency II framework would align regulation with current risk management practice and provide a better reflection of companies' actual risk exposures.

Protection against large claims and catastrophes belong to the main reasons for using reinsurance

Graph 6 | Main reasons to use reinsurance



Availability of reinsurance is expected to remain adequate

The majority (90%) of reinsurers indicated that one of the main benefits of a risk-based economic approach is an increase in future product innovation. Most companies surveyed believe that the current availability of reinsurance is sufficient, with only the availability of longevity risk reinsurance as an area of concern. Respondents do not expect Solvency II to adversely impact the availability of reinsurance. They suggest that the supply of reinsurance will remain adequate.

Insurers’ ability to raise capital

The majority of participants (65%) indicated that a common risk-based economic framework for Solvency II would increase transparency across Europe and would help potential investors to better understand insurance companies. This would most likely make it easier for insurers to raise capital.

Increased industry transparency will make it easier to raise capital

Under Solvency I, there is limited recognition of certain capital instruments, for example hybrid and other innovative forms of capital. Respondents see Solvency II as an opportunity to update the legislation in line with recent market innovations. This brings the eligible elements more in line with the economic capacity to absorb risks. As a result, the cost of raising capital could reduce.

Solvency II is an opportunity to update regulation with the evolution and innovation in capital markets

However, there are concerns that the ideas underlying the risk-based framework would be open to misconception if not properly explained to investors. In order to avoid this, it is important that not only the framework follows an economic approach, but that it is clearly communicated externally as well.

Solvency II should be clearly communicated to investors community

Comments from participants indicate that the nature and calibration of the Solvency Capital Requirement (SCR) will be important to determine the need for companies to raise additional capital. The industry has expressed its concerns over the calibration of the latest Qualitative Impact Studies (e.g. QIS 2).

Solvency II should be considered as an important target level of capital

Moreover, the industry believes that the SCR should be considered an important target level of capital while recognising that from time to time even well run companies may dip below the SCR. This would mitigate the need for companies to raise capital during adverse economic circumstances.

Part II

The dangers of not following a risk-based economic approach

Consequences of deviating from current and ongoing industry trends

If Solvency II does not follow a true risk-based economic approach …

The survey has been carried out based on the assumption that the Solvency II framework follows a coherent risk-based economic approach described in the introduction and in further detail in previous CEA publications (see Appendix). For the sake of clarity, it must be noted that although QIS 3 is an important step forward compared to QIS 2, neither approach did meet the required all standards of a true risk-based economic approach.

… substantial adverse consequences can be expected…

The results of the impact assessment as described above should therefore be interpreted with some caution. Should the Solvency II framework not follow a risk-based economic approach, this would have the following major disadvantages:

- Solvency II would not follow the ongoing industry trend (and de facto market requirements) towards a risk-based economic approach and hence the principles underlying the regulation will diverge from business economics. Companies will consider Solvency II as a regulatory burden and therefore actively seek opportunities for regulatory arbitrage.
- Solvency II would result in double work for companies if it gives rise to parallel reporting lines, i.e. internal versus supervisory reporting. This might be especially harmful to small and medium-sized undertakings as they normally have less economies of scale to absorb these additional costs;
- It would provide inappropriate incentives for companies in managing their risks, thereby allowing companies to accept risks on non-economic terms. This will be to the longer term detriment of both policyholders and investors.

… that could be harmful for policyholder protection and affordability of insurance products

Over 80% of the insurance companies indicated that Solvency II will be complex and inefficient if:

- the framework does not follow clear economic principles;
- the capital requirements are greater than economically justified;
- the requirements are in conflict with good risk management.

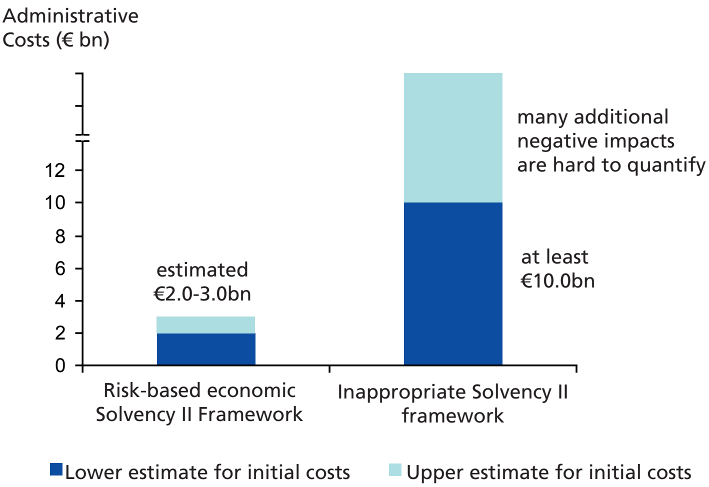
[6] *For more information, please consult the paper 'CEA's preliminary feedback on QIS 2' (16 October 2006) available on www.cea.assur.org.*

This is also likely to damage the confidence of investors and their willingness to supply capital to the insurance industry.

Additional work of the CEA indicates that if Solvency II would not follow a risk-based economic approach, the initial and annual cost of compliance for companies would at least double. However, the true costs of an inappropriate Solvency II framework cannot be expressed in monetary terms, because there will be no incentive for companies to manage risks and would even include inverse incentives for companies.

Whilst costs of an inappropriate Solvency II framework can hardly be expressed in monetary terms, the compliance costs for companies would at least double

Graph 7 | Estimated administrative costs of Solvency II



Appendix - Relevant CEA publications

CEA has released a range of publications covering a wide range of aspects of Solvency II. Indeed, it is important to note that the comments in this document should be considered in the context of other publications by the CEA as they constitute a coherent package. All CEA Solvency II work is published on the Solvency II section of the CEA website (www.cea.assur.org). Highlights include:

- **Solvency II - Building Blocks for the Solvency II Project** (May 2005)

  This CEA Working Document provides 9 important building blocks for Solvency II. The building blocks are: (1) Total Balance Sheet Approach; (2) Liability Valuation; (3) Interaction between prudence, total capital requirement and SCR; (4) Solvency Assessment Typology; (5) Risk Measure and Time Perspective (6) Risk Classification; (7) Risk Aggregation; (8) Risk Mitigation; and (9) Group Treatment

- **Solutions to Major Issues for Solvency II – Joint submission by the CRO Forum and the CEA** (February 2006)

  This paper identifies the highest priority issues for Solvency II and provides a solution to the highest priority issue. It focuses especially on the principles of a sound economic risk based framework that is desired by the industry such as a market consistent valuation of liabilities and the definition of the SCR.

- **Solvency II – Introductory Guide** (June 2006)

  Provides a high level overview of the Solvency II framework, including an explanation of why Solvency II is necessary. It considers the impact of Solvency II on supervisors, the insurance industry and for policyholders.

- **Impact Assessment Survey Report** (February 2007)
  The full report of CEA's Impact Assessment Survey of which the main results are summarised in this brochure. It is based on a request by the European Commission to assess the Impact of Solvency II. Another part of this request resulted in the Topography EU25 Report which describes the various European Insurance markets.

- **Solvency II - Understanding the process** (February 2007)

  This paper provides a brief introduction to Solvency II for those who are interested in the project but have not yet started to participate in the debate. To that end, it describes the key elements of Solvency II and provides an overview of the important stakeholders in the debate.

- **Solvency II - FAQs** (February 2007)

  This document tries to focus on the most frequently asked questions with regard to Solvency II and provides the best answer possible given the current development of the project.

- **Solvency II Glossary** (March 2007)

  This paper is an overview of the important terms and definition in the Solvency II debate. It is a joint production of the Group Consultative and the CEA.

CEA

CEA is the European insurance and reinsurance federation. Through its 33 member bodies comprising of national insurance associations, CEA represents all types of insurance and reinsurance undertakings, be they pan-European companies, monoliners, mutuals or SMEs. CEA represents undertakings which account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €978bn, employ over one million people and invest more than €6,300bn in the economy.

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CEA's publication 'Solvency II: Main Results of CEA's Impact Assessment' is available free-of-charge at CEA's website: www.cea.assur.org

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