The Path to Solvency II

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Barry Smith discusses progress towards implementing Solvency II with Karel Van Hulle, Head of Unit, Insurance and Pensions at the European Commission

Karel Van Hulle joined the European Commission in 1984. An experienced regulator, working with the Belgian Banking Commission for several years before joining the Commission, he has led the Insurance and Pensions Unit of the Directorate-General Internal Markets and Services since November 2004. In that capacity, his main responsibility has been preparation of the Solvency II Framework Directive, steering it through to formal adoption by the Council and by European Parliament.

Barry Smith: Karel, first of all many thanks for agreeing to share your thoughts with us on the path to Solvency II, and for taking the time to address representatives of the UK insurance industry at today's business breakfast. To begin with, can you give us an update on the status of the Framework Directive? What were the issues that delayed adoption?

Karel Van Hulle: The Solvency II Framework Directive was adopted in the plenary session of the European Parliament on 22 April 2009, having previously been approved by the Permanent Representatives Committee or "Coreper", which consists of the Member States' ambassadors to the European Union. On 5 May 2009, the positive vote by the European Parliament was acknowledged by Finance Ministers at the ECOFIN meeting. The main stumbling blocks until the very end related to group support and the treatment of equity risk. On group support, it was agreed to delete the section from the Directive but to add a revision clause which invites the Commission to come back to the issue three years after the implementation of the Directive. On equity risk, it was agreed to allow for the so-called duration approach as a Member State option but to limit the approach to occupational and private pension business. The approach will have to be agreed at EU level as it will be part of an implementing measure to be adopted during the course of 2011.

BS: Are the Implementing Measures on track? When will we see a draft, and will it be in time for the current planned Solvency II go-live late in 2012?

KVH: The Commission still aims to have the new system in operation at the end of October 2012.

This represents a challenging timescale, but we need Solvency II as soon as possible. CEIOPS [1] have already been preparing potential future Level 2 implementing measures for almost two years now and have recently issued the first wave of draft advice on a number of different issues. Two further sets of draft advice will follow in July and October respectively. All final advice from CEIOPS should be available by the end of December 2009.

By the end of May, the Commission will issue a letter to CEIOPS setting out the timetable for the development of Level 2 implementing measures, the list of issues to be dealt with, the form of the advice and the issues and options to be considered as part of the impact assessment. This letter will be made public so that everybody can see how we plan to proceed and can make sure that we remain on track.

No final decision has been made yet about whether to use regulations or directives at Level 2, but we want deep harmonisation and regulations would clearly be more likely to deliver that.

BS: Will the current turbulence in the financial markets impact the eventual shape of Solvency II, or the way it is implemented? In what areas and in what ways could this impact be felt?

KVH: We can of course make refinements at Level 2 if it proves necessary once we have had a chance to draw all lessons from the crisis. It is however important to remember that insurance is not banking and consequently a solution for one sector is not necessarily always appropriate for the other.

Already in the fourth quarter of 2008, the Commission officially asked CEIOPS as well as stakeholders whether the design of Solvency II needed fundamental changes. The unanimous response was that the best remedy would be a speedy adoption of Solvency II with some

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2 CEIOPS is the Committee of European Insurance and Occupational Pensions Supervisors, one of the EU's Lamfalussy committees

further fine tuning at Level 2 but no amendments of the Framework Directive itself.

On 19 March 2009, CEIOPS published a report on 'Lessons learned from the crisis…", in which it confirms this position, lists the issues that need further attention at Level 2 and makes clear that the main lesson learned from the current crisis is that Solvency II must be adopted for the following reasons:

- on-going field testing has demonstrated that the overall architecture of Solvency II is sound;
- in crisis situations supervisors have an even greater need for harmonised and risk-sensitive information;
- governance, risk management, internal controls and disclosure need to be strengthened;
- more emphasis needs to be put on supervision at group level.

BS: Solvency II, like the Basel II Framework before it, emphasises the topic of "solvency" over and above other issues that affect the survival of institutions, such as stability of earnings or liquidity. "Solvency" is taken to mean something like the ability of capital to absorb unexpected losses of a supposedly unlikely magnitude – the regulatory standard for Pillar 1 being a 99.5% confidence level, i.e. a one-in-200 year loss experience. But at this point on the tail, it is very hard to arrive at stable and convincing loss estimates, and many internal models in the Banking sector appear to have seriously underestimated the likelihood of losses on the scale that actually occurred. Worse still, in the light of recent experience, it also seems clear that the survival of an institution can be compromised by other issues such as investor, customer and counterparty confidence well before losses mount to that level. Is it therefore still right, in the case of the insurance industry, to continue to focus primarily on solvency, and primarily on the 99.5% capital adequacy standard? Will the Pillar 2 ORSA[2] process be sufficiently robust to fill this gap?

KVH: Firstly, let me comment on the comparison between Solvency II and Basel II. Although Solvency II follows the basic design of Basel II, the two regimes are very different. This is a result of the fact that the insurance industry follows a different business model and that we have learned from the weaknesses of Basel II in designing Solvency II. For instance, Solvency II looks at all risks which insurers face both on the asset and on the liability side. Basel II does not follow this total balance sheet approach. One of the key weaknesses of Basel II highlighted by the crisis is that it did not cover liquidity risk. Furthermore, Solvency II adopts a consistent approach to valuation and risk assessment of all assets and liabilities, unlike Basel II which adopts different valuation and risk assessment approaches to the banking and trading books of credit institutions. Solvency II also allows for the consideration of diversification effects because diversification is an integral part of the way in which insurance is organised.

Secondly, let me also comment on the use of internal models. We believe that the move towards greater reliance on internal models is an important step forward, and will contribute to more risk-sensitive and innovative risk management, efficiencies in terms of capital and costs, and more effective discussion between insurers and their supervisors as well as with shareholders, analysts and rating agencies. Furthermore, there are a number of criteria that need to be satisfied for internal models to be approved, covering the extent to which the model is used for management decisions, statistical quality standards, calibration standards, validation standards, and documentation standards.

As for the ORSA, it is an important element of the new regime and CEIOPS has already provided a lot of advice on this issue. It was supported by the *Groupe Consultatif Actuariel Européen*[3], and we are confident that the process will be robust and provide a strong safeguard to make sure that we avoid the problems experienced in the banking sector.

BS: Is pro-cyclicality an issue for Solvency II? Will there be an effort to address it?

KVH: The need to counter pro-cyclical effects was an important issue during negotiations on the Framework Directive, with new provisions having been introduced to limit these effects. In particular, the treatment of equity risk is subject to two dampener mechanisms. Firstly, the Pillar 1 equity risk sub-module includes a symmetric adjustment mechanism to the standard equity capital charge. Secondly, under Pillar 2, supervisory authorities may extend the recovery period for breaches of the Solvency Capital Requirement in the event of an exceptional fall in financial markets, taking into account all relevant factors.

BS: Does the example of US insurer AIG suggest that additional safeguards are needed for insurers that turn themselves into large, diversified financial services groups? What approach will be adopted for firms offering a mixture of insurance, banking, asset management and other types of financial services?

KVH: AIG is clearly a special case. It is still unclear who in the end supervised AIG. Under Solvency II a great deal of attention is paid to introducing a real group supervision with a requirement for all groups to appoint a group supervisor who will chair a college of supervisors. As far as mixed financial groups are concerned, it is clear that the financial conglomerate model has become less popular now than before the financial crisis. A review is currently underway to consider lessons learnt from the financial crisis, including revisions to be made to the Financial Conglomerates Directive. The planned review of that Directive will clearly have to take account of changes that will have taken place meanwhile in Banking

3 ORSA is the *Own Risk and Solvency Assessment* – a more demanding equivalent of the FSA's existing ICA review process required under Solvency II's Pillar 2..

4 The *Groupe* was established in 1978 to bring together the actuarial associations in the European Union to represent the actuarial profession in discussion with the European Union institutions on existing and proposed EU legislation which has an impact on the profession.

(Capital Requirements Directive) and Insurance (Solvency II).

BS: Are there plans to include more detailed and prescriptive requirements relating to stress testing?

KVH: Stress testing has been an important issue under Solvency II from the very beginning. There was some discussion in the Solvency II negotiations aiming at reducing the possibility for supervisors to impose stress-testing. The Commission took a firm line on this. In the end, it was decided to retain the original Commission proposal, as it was felt that following the crisis it was important for supervisors to require companies to perform stress tests when necessary.

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