

Edited by PIERPAOLO MARANO
and MICHELE SIRI

Insurance Regulation in the European Union

SOLVENCY II AND BEYOND



Insurance Regulation in the European Union

Pierpaolo Marano • Michele Siri
Editors

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1

Introduction

Pierpaolo Marano and Michele Siri

What directions is the regulation issued by the European Union on insurance taking? This is the common thread of the chapters of this book. The success of the international conference held at the Catholic University of the Sacred Heart in Milan in November 2015 convinced the editors to promote research to answer this question.

The Directive Solvency II intends to set up a risk-based approach for the governance and supervision of the (re)insurance undertakings at national as well as transnational level, while the protection of the policyholders becomes the main objective of the regulation on insurance. Solvency II does not address the business conduct rules towards the policyholders, and the Insurance Distribution Directive (IDD) aspires to fill this gap, although the set of rules required by the IDD has not yet been completed.

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Beyond the specific content of each provision of the aforesaid Directives, the research aspires to grasp the cornerstones of this regulation. As Gabriel Bernardino, Chairman of European Insurance and Occupational Pensions Authority (EIOPA), said in his speech at the conference mentioned above, this regulatory activity has committed all the stakeholders involved in the insurance market: “But good regulation is just a first step. The second step (and actually even a more crucial one) is its implementation”.

The implementation of this regulation calls for a European supervisory culture, and the understanding of the cornerstones of that regulation facilitates the setting up of such a culture as well as its effectiveness over time. For this purpose, an interdisciplinary approach involving authors from different backgrounds seemed more consistent, in order to understand the full meaning of the changes introduced by the new regulations.

Therefore, Part I investigates the EU insurance regulation beyond Solvency II aspiring to grasp the essential features: the sources and tools of this regulation, the insurance contract, and the potential effects of both the business conduct rules introduced by the IDD and Brexit.

Part II focuses on Solvency II and analyses the origins of this discipline in the UK, the group supervision, and the risk governance, which has been approached from two perspectives: corporate governance and risk management.

Part III deals with the issues related to the Solvency calculation and reporting. Some actuarial factors are challenged from the perspective of life insurance as well as non-life insurance, while the rules of Solvency II on supervisory reporting and market disclosure, and the impacts of the new accounting standards, are also taken into consideration.

Part IV provides a scenario analysis and describes some market trends. The issues of the reasonable expectations from Solvency II and the impact of the insurance regulation for economic growth are addressed in this final part, together with the potential impacts of Solvency II on two business models and risk management strategies: bancassurance for life insurance and the captives for non-life insurance.

Part I

The Evolution of the Insurance Regulation Beyond Solvency II

2

Sources and Tools of the Insurance Regulation in the European Union

Pierpaolo Marano

Introduction

The regulation exists to get industry, organizations and individuals to modify their behaviour to gain compliance with the law, and ultimately to achieve desired outcomes.¹ Modern regulation is a complex interaction between politicians, civil servants, industry, interested groups, regulatory bodies and—occasionally—consumers.²

The regulation of financial services has dramatically increased in the last decade. Since the financial crisis in 2007–2008, a large supervisory and regulatory reform has been put forward in the European Union (EU). These reforms, albeit in different ways, are based on the recommendations of transnational bodies, primarily the G-20, where the EU itself and some of its Member States are actively engaged.³

With reference to the EU insurance sector, European Insurance and Occupational Pensions Authority (EIOPA) has replaced Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS),

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becoming an industry authority, Directive 2009/138/EC (Solvency II) recast the existing legislation by repealing 13 Directives and introducing new solvency capital requirements, a system of governance and mechanisms of cooperation/coordination between supervisory authorities, while the Insurance Distribution Directive (IDD) has increased the harmonized business conduct rules of both insurers and insurance intermediaries, in order to enhance customers' protection in the EU.

Solvency II and IDD allow the EU Commission and EIOPA to adopt implementing measures, while EIOPA runs its own missions and tasks,⁴ even adopting rules formally addressed to national supervisory authorities. Therefore, we are in front of several levels of regulation, which have originated from various EU regulators.

This chapter intends to explore the reported interaction of the stakeholders in the insurance regulatory process in order to highlight the key drivers of the recent insurance regulation issued by the EU. The approach will be focused on the regulatory environment in which that regulation is framed, rather than the contents of this regulation. Therefore, the Sections “The Transnational and Cross-Sectoral Sources of the EU Regulation on Insurance” and “The Impact of These Sources on the Recent EU Regulation: Solvency II and IDD” analyse the sources of the insurance regulation and their impact on the EU regulation; the Section “Insurance Regulation: Hard law v. Soft law and the Case of the EU” investigates the binding level of the EU regulation; and the Section “The Impact of the New Regulatory Drivers: The “Dilemma” of Regulated Entities and Other Stakeholders” refers to the involvement of the stakeholders in the regulatory process. Finally, the Section “Conclusions” provides the conclusions outlining the upcoming trends of the EU regulation on insurance.

The Transnational and Cross-sectoral Sources of the EU Regulation on Insurance

Two elements have certainly influenced the recent EU regulation on insurance: (1) the globalization of the response to the 2007–2008 financial crisis and (2) the cross-sectoral approach in delivering such a response.

As the crisis above deepened, the G-20 moved quickly from a crisis responder to a premier economic international forum.⁵ The G-20 *inter alia* aimed to guide, facilitate and even balance the dynamics in the international networks on financial services, that is, banking, insurance and securities.⁶ Networks have, therefore, played an essentially ancillary role to the G-20 in post-2008 international cooperation on finance.⁷

As previously reported, the EU is “structurally” engaged in the activities of the G-20. The EU and the G-20 made reciprocal comebacks because of their mutual influence on each other. The EU fills the breakthrough at international level and, in turn, the EU takes a step forward compared to the principles and guidelines issued at international level, and so on.

The EU Commission and EU authorities (European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and EIOPA, on one side, and the BCBS, IOSCO and IAIS, on the other side, are linked formally or informally to each other. Therefore, the mutual influence between the EU level and transnational level affects the EU rules including Directives and Regulations.⁸

An outcome of this mutual influence is most likely the definition of the objective of the EU insurance regulation and supervision.

The EU plays an influential role in the IAIS⁹ that issued the Insurance Core Principles (ICPs) in 2003.¹⁰ Standard 1.3 of the ICPs sets forth that the principal objective of supervision is to promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders.¹¹ Solvency II echoes the standard above by specifically stating that the main objective of insurance and reinsurance regulation and supervision is “the adequate protection of policyholders and beneficiaries” (see Recital 16 and Art. 27); per contra, the EU Directives on life and non-life insurance, which were issued from 1973 up to 2002 and repealed by Solvency II in 2009, were not as clear as Solvency II.

On the other hand, the Joint Forum, which was established in 1996 and is working under the aegis of BCSB, IOSCO and IAIS,¹² provides evidence of the cross-sectoral response to the financial crisis.

The Joint Forum has substantially increased the documents produced since 2008, compared to those produced in the previous decade.¹³ The final reports refer to point of sale disclosure in insurance, banking and securities sectors, and mortgage insurance and credit risk management

across sectors, whilst principles for the supervision of financial conglomerates have been issued too.

The EU replicates coordination between the three supervised sectors. The Joint Committee of the three European authorities (EBA, ESMA and EIOPA) was established in 2010, together with the authorities, increasing the previous cooperation between the “level 3” Committees as agreed between the former Committees Committee of European Securities Regulators (CESR), Committee of European Banking Supervisors (CEBS) and CEIOPS in the 3L3 Joint Protocol of 2003, amended in 2008.¹⁴

The Joint Committee serves as a forum in which the European authorities cooperate regularly and closely to ensure cross-sectoral consistency with them as well as supervisory convergence.¹⁵ The Joint Committee works almost on the same topics as the Joint Forum, that is, anti-money laundering, consumer protection and financial innovation, risk and vulnerabilities, and financial conglomerates.¹⁶

The Organization for Economic Cooperation and Development (OECD) through its Insurance and Private Pensions Committee is another source of transnational and cross-sectoral rules on insurance.¹⁷

The OECD issued the Guidelines on Insurer Governance in 2005; they were updated in 2011 and are currently under review.¹⁸ The OECD acknowledges having worked jointly with the IAIS in reviewing these Guidelines, which aspire to be the main legal instrument providing international guidance on the insurer’s corporate governance. These Guidelines, in fact, complement the G-20/OECD Principles of Corporate Governance and they are meant to provide non-binding guidance to the insurance sector as a whole, including stock companies, mutual insurers or any other type of insurance providers, operating as direct insurers or reinsurers domestically or internationally.

On the other hand, the OECD adopted the Code of Liberalization of Current Invisible Operations under which adherents have accepted legally binding obligations. This code deals with standards for the intangible trade, *inter alia*, in insurance, securities, banking and investments, and it allows a comparison of the degree of liberalization achieved by each adhering country in regard to the international transactions covered by the Code.

Last but not least, Solvency II expressly mentions transnational and cross-sectoral sources. This Directive adopted an economic risk-based

approach providing incentives for insurance and reinsurance undertakings to properly measure and manage their risks, in line with the latest developments in risk management, in the context of the IAIS, the International Accounting Standards Board (IASB) and the International Actuarial Association (IAA) (see Recital no. 15).

Therefore, the EU acknowledges international private standard-setting bodies as sources for the regulation of the insurance market, whilst IAIS and IAA are members of the Advisory Council of IASB and the EU Commission holds the status of observer at this association, and IAIS and IASB are partners of the IAA as external organizations.¹⁹

The Impact of These Sources on the Recent EU Regulation: Solvency II and IDD

The transnational and cross-sectoral sources on insurance are likely to have different influences on insurance regulation in the EU.

Solvency II sets forth rules on access *to* the (re)insurance activity, prudential rules *for* this activity, and rules on the coordination between national authorities *about* the supervision on the activity above. These rules, while aspiring to reach a discipline of maximum harmonization among Member States, have a “dual nature”. They are the recipients of transnational approaches to insurance by incorporating regulatory stimuli from abroad, but they also intend to be specifically a regulatory source or at least a benchmark for non-EU jurisdictions.

Solvency II adopted an economic risk-based approach in the context of the IAIS, the IASB and the IAA. Also, Solvency II complies with the ICPs issued by the IAIS where the EU plays a pivotal role, and it is close to the OECD Guidelines on Insurer Governance. On the other hand, Solvency II includes three areas for equivalence assessment²⁰ empowering the EU Commission to decide about the type of equivalence of a third country’s solvency and prudential regime.²¹ A benefit linked to such an assessment²² is an incentive for third countries to apply to be evaluated,²³ thus extending the influence of the EU regulation that is likely to become a regulatory source for other jurisdictions.²⁴

In conclusion, equivalence assessment leads to a “circular process” of harmonization of the (re)insurance regulation between jurisdictions. Transnational sources affect Solvency II, which requests the non-EU countries to progress their regulations in order to meet a type of equivalence accorded by the EU, thus helping to disseminate rules complying with transnational standards around the world.²⁵

The other EU standards governing insurance suggest different comments from the one above.

With reference to the distribution of insurance products, the IDD repeals Directive 2002/92/EC on insurance mediation, and expands the range of its provisions including direct underwriting of insurance. IDD is strongly influenced by Directive 2014/65/EU on Markets in Financial Instruments (iMIFID II) that represents the response to the EU Commission’s review of the previous MiFID in light of the 2007–2008 financial crisis.²⁶

Scholars are talking about a “Mifidization” of the insurance regulation,²⁷ and they have already identified the provisions on products oversight governance and customer protection as the regulatory areas in which influence is stronger.²⁸

The “Mifidization” not only prevents regulatory arbitrage between financial products and the so-called insurance-based investment products,²⁹ but it also concerns non-life insurance products. Therefore, rules which were designed for the case where investment risk is borne by the investor will apply to non-life insurance in which the insurer always underwrites the risk of the insured.

The IDD provides two layers of rules setting forth additional rules for the distribution of the insurance-based investment products, in order to avoid that inconsistency. However, the layer applicable to all insurance products should take into account the different risk events, thus leading to an assessment of their rules, such as those of advice and product oversight governance, in compliance with the principle of proportionality.

The “Mifidization” is also likely to affect the insurance contract law. The EU institutions have repeatedly manifested their interest in a European insurance contract law as an optional instrument, and the EU Commission has set up a Commission Expert Group to draft Principles of European Insurance Contract Law.³⁰ However, an insurance contract is currently the recipient of any EU discipline, except for some provisions

on motor insurance,³¹ some rules of Solvency II,³² some duties of the insurance distributors³³ and the EU provisions on consumer protection,³⁴ while Directives outside the scope of consumer protection also have an impact on insurance contract law.³⁵

Notwithstanding this, the IDD is requesting Member States to ensure as general principle that insurance distributors always act honestly, fairly and professionally in accordance with the best interest of their customers (see Article 17). These principles reproduce the provision of Article 24 of MiFID II.

When Member States implement the IDD into national laws, most of them will be requested to assess the compatibility of those standards with civil law principles, such as good faith and diligence, which are otherwise applicable. The choices made by the Member States will enable assessment of whether the principles introduced by the IDD are merely unnecessary repetitions of existing national principles, thus leading to a substantial non-application of the new standards.

On the other hand, if the principles above are implemented as well as interpreted as new principles into national jurisdictions, they will be a source of new and different obligations, thereby helping to create a harmonized EU contract law in the financial services, that is, financial products and insurance products.

Another possible scenario is that these principles relate only to the relationship between supervisory authorities and supervised entities (insurance undertakings and intermediaries). They can become general standards to assess the compliance of regulated entities with insurance regulation by supervisory authorities. European law thus achieves a process of abstraction from rules and principles which have an established national tradition, in order to create a common language for supervisors and supervised entities. This “language” reflects the need to facilitate the circulation of the supervised entities in the Single Market, at least with reference to their relationship with supervisory authorities of the host Member States.

If this perspective is well founded, the “Mifdization” is likely to affect not so much insurance contracts, but the relationship between supervisors and supervised by marking the distinction between insurance law and regulation on insurance (and financial services).

Insurance Regulation: Hard Law Versus Soft Law and the Case of the EU

The process of globalization and the cross-sectoral approach, which characterize the recent EU rules on insurance, suggest revising the meaning of insurance law.

Insurance law is a piece of the regulation on insurance. Insurance regulation is the definition of all rules governing the EU insurance market.

Insurance law properly refers to the rules that can be enforced in case of infringement because they lie within the paradigm “command–control”, namely, a command followed by a sanction for non-compliance.

Insurance regulation also includes rules that are outside of the paradigm above, despite them being addressed to insurers, insurance intermediaries and insurance supervisors. These non-binding rules call regulated entities to have certain behaviours in the insurance market regardless of a sanction in case of non-compliance. Therefore, they do not coincide with those constituting an organization, for example, a supervisory authority, sometimes defined as public law.

These non-binding rules are called “soft law”³⁶ as opposed to “hard law”, and their emerging role is a trend that insurance regulation shares with the regulation on financial services,³⁷ as a “conceptual spillover from the world of international public law, of treaties and governments”.³⁸

Explanations of soft law’s popularity are different. According to the contractual theory, the primary merit is the flexibility lowering the costs of contracting and allowing parties to amend it relatively easily compared to the “hard law” that demands a more formal and time-consuming procedure.³⁹ Other merits are fewer sovereignty costs⁴⁰ and lower risk of uncertainty.⁴¹

With reference to the international financial system, the popularity of soft law has also been explained in terms of networks theory. The international financial system would consist of collegial “networks” that foster collective problem-solving and innovation through interactions of regulatory peers,⁴² which execute and rely on less formal instruments that permit them to make rapid responses that keep pace with rapidly evolving financial markets.⁴³

These explanations, however, do not make specific reference to the EU legal system. They are related to the EU, when the EU bodies interact with other bodies of the international financial regulation networks.⁴⁴

Unlike international law, the increasing use of soft law by the EU authorities, when they regulate insurance in the EU, complies with legal bases that are unique because they cannot be found in the international financial regulation.⁴⁵

Regulation (EU) No. 1094/2010 of 24 November 2010 establishing EIOPA, as well as the statutes of the other authorities that are part of the European Supervisory Authorities (ESAs), requires the Authority *inter alia* to collect, analyse and report on consumer trends, and to monitor new and existing financial activities (see Article 9). These measures are different from those within the scope of the “comply or explain” procedure (see Article 16 of Regulation (EU) No. 1094/2010). EIOPA does not request national competent authorities to comply or inform the Authority, if they do not comply or do not intend to comply, stating the reasons.

Reports aim to identify risks for consumers arising from the insurance market which may require specific policy proposals or supervisory action from EIOPA and/or its members. In the framework of the monitoring activity, EIOPA may adopt guidelines and recommendations with a view to promoting the safety and soundness of markets and convergence of regulatory practice. The list of reports is increasing,⁴⁶ while EIOPA’s Fifth Consumer Trend Report⁴⁷ announced authority would assess the issues of automation on financial advice and the use of big data by financial institutions, in cooperation with EBA and ESMA.

Moreover, the Joint Committee between ESAs delivered several Reports, Guidelines, Discussion Papers and Good Supervisory Practices,⁴⁸ which intend to “clarify for national competent authorities”, or “establish a coherent and effective approach in the supervision of firms”, or “identify actual practices which are consistent with or contrary to the overarching principles and general rules of conduct for the protection of customers”.⁴⁹

The EU Commission also pursues the purpose of interpreting or informing our understanding of binding legal rules. An interpretative communication was issued on the problems associated in the insurance industry with the freedom to provide services and the general good,⁵⁰ in order to explain the Commission’s opinion concerning the legal

framework in which insurance business may be carried out. The EU Commission also issued Guidelines on the application of Directive 2004/113/EC implementing the principle of equal treatment between men and women in access to and supply of goods and services, to insurance. The aim is to facilitate compliance at national level with the Test-Achats ruling issued by the Court of Justice of the European Union (Case C- 236/09).⁵¹

In conclusion, the EU adopts soft law in instruments “which have not been attributed legally binding force as such, but nevertheless may have certain—indirect—legal effects, and that are aimed at and may produce practical effects”.⁵²

Soft law should be not confused with the principle of proportionality, which is defined in Solvency II and the IDD, including EIOPA’s Guidelines.

According to this principle, requirements should be applied in a way that is proportionate to the nature, scale and complexity of the risks inherent in the business (Solvency II), and in the activities performed, the insurance products sold and the type/size of the distributor (IDD). Therefore, proportionality does not mean “not applying” the requirements, instead it calls supervisors’ attitude towards the practical application of proportionality.⁵³ Supervisors should focus their attention on making sure that they achieve the desired transformation and change from the previous solvency regime as well as the distribution’s system.⁵⁴

The principle of proportionality makes the “hard law” more flexible and therefore more uncertain. It necessarily gives discretion to national supervisors and EIOPA is requested to be very attentive to a convergent implementation of the proportionality principle by national supervisors (and regulators), in order to achieve the goal of ensuring an effective and consistent level of regulation and supervision, as well as to promote a coordinated EU supervisory response, which is one of EIOPA’s tasks.

On the other hand, the principle of proportionality increases the demand for soft law to the extent that it allows the supervised entities to know in advance the behaviour expected by supervisors and, ultimately, what flexibility the authorities agree concerning the rules. In the

meantime, regulators are able to see the impact of rules in practice in order to better assess their benefits, avoiding formal legality.

The success of soft law has given rise to the question of democratic legitimacy in its adoption.⁵⁵ The issue should be considered differently when it refers to the EU.

In general terms, legislation and regulation play a pivotal role in the EU “because of the distinct characteristics of its institutions and the particular dynamics of the economic and political cooperation among the member states”.⁵⁶ The European Commission adopted its Better Regulation Agenda on 19 May 2015. It is a package of reforms covering the entire policy cycle and aiming to boost openness and transparency in the EU decision-making process. This is another step along the path towards improving the EU law-making process, which started with the Action Plan on “Simplifying and improving the regulatory environment” issued by the EU Commission in June 2002. The Better Regulation package introduces a set of tools and a growing institutional apparatus,⁵⁷ with the aim of engaging stakeholders at different stages of the decision-making process for all EU bodies.⁵⁸

With reference to insurance/financial services, bylaws of all the authorities of the ESAs already include one or two stakeholder groups, which must be consulted on regulatory or implementing technical standards, guidelines and recommendations.⁵⁹ Authorities have to provide them with a reasonable opportunity to comment on proposed measures, and those stakeholder groups should work as an interface with other user groups in the financial services area established by the EU Commission or by Union legislation.

Of course, the participation of the stakeholders in the decision-making process can be improved and the EU bodies should provide more proportionate analysis to support their proposals.⁶⁰ Moreover, whether the regulator has to bear the burden of proving that a rule does not fit, or if this burden lies with stakeholders, is a questionable matter. Nevertheless, the participation of stakeholders in the decision-making process and, more generally, the more active role that is required of them both in soft law and hard law will inevitably affect the stakeholders’ attitude towards the regulation.

The Impact of the New Regulatory Drivers: The “Dilemma” of Regulated Entities and Other Stakeholders

Regulators face review of the rules on a regular basis, and insurance regulation is likely to be often and rapidly modified.

Looking at the two key Directives on insurance, the Solvency II framework directive is planned to be revised in 2018, while about 1000 regulatory standards and guidelines were issued by the EU a year ago, despite the new solvency regime and governance system being considered “principle-based”.

On the other hand, the IDD will enter into force in early 2018 and it calls EIOPA to adopt 15 measures and the EU Commission to issue two delegated acts before that date. In the meantime, EIOPA issued “transitional” guidelines on product oversight governance in 2016, while the EU Commission will review the IDD in early 2021.

Moreover, EIOPA annually identifies the key trends on consumer protection in the insurance sector, and it is involved in issuing Opinions,⁶¹ Reports⁶² and Guidelines for national regulators,⁶³ in order to counteract the harmful practices for customers.

Ultimately, regulated entities—insurance undertakings and intermediaries—and other stakeholders of the insurance market—consumer associations, policyholders—are involved in a regulatory process which aims to assess on an on-going basis the shortfalls of adopted regulations compared to the market’s evolution.

The involvement of the supervised entities in the perpetual motion of the regulatory activities generates a cost for them which is not negligible.⁶⁴ This perpetual motion is also likely to affect the behaviour of the stakeholders with respect to the looming EU regulation by calling them to be more proactive.

Changes in insurance regulation are no longer sporadic or occasional. They are less and less tied to national events and more and more dependent on the European and international goals and needs. The growing transnational dimension of the regulatory process requires stakeholders to be organized in order to have a proactive approach in the dialogue that leads to changes in rules.

This awareness has led to the establishment of international associations of insurers,⁶⁵ insurance intermediaries⁶⁶ and customers⁶⁷ in recent years. All these associations are lobbying the interests of their members in front of the transnational regulatory bodies.

Similar associations are obviously operating at EU level.⁶⁸ A 2014 survey pictured the size and “fire power” of the financial lobby that is able to lobby over the EU financial regulation from the drafting stage (Commission expert groups and consultations), to the later decision-making procedures (Parliament consultations and informal lobby meetings with members of the Parliament) and the implementation phase (supervisory agency stakeholder groups).⁶⁹ With more than 700 entities, more than 120 million euros annual spending and at least 1700 lobbyists at their disposal, the financial lobby is clearly a powerful voice at all stages and levels of the EU legislation process.⁷⁰

In parallel to the European and international dimension of lobbying, regulated entities and other stakeholders of the insurance market must learn to live with the rule change. They are placed in front of the “dilemma of the regulated”.

Each regulated entity can passively accept the rules. Therefore, they can adopt a short-term strategy consisting in the transposition into their own organization of the rules, when issued by the authorities.

In contrast, regulated entities can develop a proactive strategy moving away from short-term tactics. They need to be able to manoeuvre and adapt to changes by planning and budgeting for a strategic solution that enables each of them to keep pace with changing regulations.

The rise of the latter scenario suggests further discussion.

The largest entities would be able to play a direct role in lobbying their interests because of their influential role in representative associations and the ability to relate to regulatory bodies,⁷¹ while the small and medium-sized entities can at most strive to ensure that their associations greet their specific interests as these interests are sometimes at odds with the positions of the largest entities.

Moreover, the increasing integration between financial services (insurance, banking, financial) is an incentive for some players, for example financial conglomerates, to call for uniform rules over the three sectors of financial services, while more specialized entities will tend to affirm the unique nature of their own sector.

When small and medium-sized entities as well as specialized operators are more aware of the need to “anticipate” the rules by playing an active role in the decision-making process, the positions within the representative associations will be barely compatible in the future. New associations are predictable and, ultimately, more lobbyists and money will feed the regulatory industry.

Conclusions

To sum up the findings of the analysis, the globalization of the sources of insurance regulation is influenced by the trend to set up cross-sectoral rules over financial services and their providers. This trend is based on the assumption that the need for customer protection and financial stability does not vary between the financial services (insurance, banking and financial). In this framework, the rules addressed to the banking and financial sectors tend to “attract” the rules for the insurance market.

The G-20 plays a pivotal role in this political approach in the design of the regulatory framework after the financial crisis which is implemented by technical organizations—FSB, IAIS, IOSCO and BCBS—operating outside the organizational structures of international law such as the WTO or United Nations.

This global network should ensure an increased flexibility in the identification of priority actions and relative rapidity in decision-making. The rules generated by this network are outside the command-and-control paradigm because they are primarily and formally addressed to the members of the network, including the EU, and they aim to merely coordinate the contents and priorities of their own decision-making processes. However, the increasing technicality of these rules and sharing them at transnational level are elements that lead states and the EU not to depart from them, when they carry out their own legislative and/or regulatory processes. Therefore, these transnational rules are likely to become the rules by which the supervised entities comply, that is, (re)insurance undertakings and intermediaries, and ultimately these will affect the other stakeholders in the insurance market.

Flexibility in the identification of priority actions in the ever-changing markets for financial services and the need to adopt decisions on

technically complex issues, and in a relatively short time, are not exclusive features of this international global network.

The EU has developed decision-making processes aspiring to achieve these goals on financial services for almost a decade, within an institutional framework that has dealt with soft law, self-regulation and co-regulation for even longer. The Better Regulation prescribes preliminary assessments of the likely effects of the regulatory intervention, which should publicly involve all stakeholders, in accordance with the principles of the subsidiary and proportionality of the EU intervention. Stakeholders are also involved in the design of the rules through the reported feedback expressed by experts' groups to the EU Commission as well as the EU supervisory authorities, and public consultations on the draft rules.

Regulatory actions therefore take on a diversified prescriptive content, which depends on the aim pursued by the regulator. Therefore, insurance regulation includes both hard law and soft law. Sometimes there are standards with a command to their recipients who shall observe it, although the principle of proportionality can lead to a different implementation of the same standard; other times, however, rules invite the recipients to orient their behaviour or their action in the pointed direction. These rules are not prescriptive, but their non-compliance may lead to the setting up of standards within the command-control paradigm, that is, a rule followed by a sanction for non-compliance.

Furthermore, the EU's decision-making process requires stakeholders to decide whether and how to be involved in such a process. Regulatory measures appear more and more as the result of a negotiation process between EU bodies and the stakeholders affected by the corresponding rules. The legitimacy resulting from the creation of rules by elected bodies is increasingly complemented by a legitimacy given by the—formal and public—involvement of the stakeholders. Stakeholders are requested to play an active role in the regulatory process by participating in all the steps that lead to the adoption of the rules. Understanding the market's dynamics and trends helps to better regulate it. Impact assessments and demonstrations supported by empirical data should be the standard for negotiations on the future rules, because persuasion based on data seems to be the right feed of a good regulation.

Notes

1. Veljanovski, [2010](#), at 87.
2. Veljanovski, [2010](#), at 89.
3. Both the EU Commission and European Council are members of the G-20 together with a few EU member states (France, Germany, Italy and the UK), while the EU Commission sits on the Financial Stability Board, together with six EU member states (the four above plus Spain and the Netherlands).
4. According to art. 1 of the Regulation No. 1094/2010 of 24 November 2010 establishing EIOPA, the objective of the EIOPA is to “protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses”. Therefore, the Authority shall contribute to: (a) improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision; (b) ensuring the integrity, transparency, efficiency and orderly functioning of financial markets; (c) strengthening international supervisory coordination; (d) preventing regulatory arbitrage and promoting equal conditions of competition; (e) ensuring that the taking of risks related to insurance, reinsurance and occupational pensions activities is appropriately regulated and supervised and (f) enhancing customer protection.
5. Kelly, Cho, [2012](#), at 517 ff.
6. The banking network includes the Financial Stability Board (FSB), the International Monetary Fund, the World Bank and the Basel Committee on Banking Supervision (BCBS), the insurance network refers to the International Association of Insurance Supervisors (IAIS), and the securities network relates to the International Organization of Securities Commissions (IOSCO).
7. Turk, [Vol. 36: 59], at 128.
8. Lowry, Rawlings, [2005](#), at 15 f.
9. Quaglia, [2014a](#), at 77.
10. Brown, [2009](#), [Vol. 34: 3], 964 ff. ICPs provide a globally accepted framework for the supervision of the insurance sector, and they can be used to establish or enhance a jurisdiction’s supervisory system, as well as for assessing the existing supervisory system in order to identify potential weaknesses.
11. See also Braunmüller, Warzilek, [2011](#), at 67.

12. The Joint Forum aims to support banking, insurance and securities supervisors in meeting their regulatory and supervisory objectives and, more broadly, to contribute to the international regulatory agenda in particular where risks exist across or in gaps between the three supervised sectors.
13. The list is available at <http://www.bis.org/list/jforum/index.htm>
14. The Joint Protocol on Cooperation between CESR, CEBS and CEIOPS, which were the committees between national banking, securities and insurance authorities of the EU member states, is available at http://www.knf.gov.pl/en/Images/cooperation_3l_protocol_tcm81-11491.pdf
15. The 2017 Working programme is available at <https://esas-joint-committee.europa.eu/Publications/JC%20Work%20Programme/JC%202016%2042%20%28Joint%20Committee%20Work%20Programme%202017%20-%20Final%29.pdf>. It includes guidance on the implementation of the new Packaged Retail and Insurance-based Investment Products (PRIIPs) rules, the monitoring of the automation in financial advice and the use of big data, the follow-up work on the Joint Committee guidelines on complaints handling, and the mapping of the rules established by the post-financial crisis Directives and aiming to facilitate the cross-border provision of financial services (IDD, MiFIDII, MCD) and/or the cross-border marketing of financial products (UCITS, Prospectus), by analysing any issues experienced by supervisors (home/host supervision).
16. On the other hand, in order to achieve its objective, the Joint Forum:
 - Addresses and promotes understanding of issues common to the banking, securities and insurance sectors, including the supervision of financial conglomerates;
 - Analyses cross-sectoral market and regulatory developments;
 - Examines cross-sectoral gaps and conflicts in regulation and supervision;
 - Develops guidance and principles and/or identifies best practices on cross-sectoral technical, regulatory and/or policy issues to encourage cross-sectoral consistency and alignment where appropriate, and reduce opportunities for regulatory arbitrage;
 - Facilitates cooperation, coordination and information sharing among banking, insurance and securities supervisors (or representatives of the Parent Committees, that is, BCBS, IOSCO and IAIS) and further supports the Parent Committees by identifying synergies or duplication in their work efforts.

17. The OECD is a forum of the governments of 35 countries, which work together to address the economic, social and environmental challenges of globalization. With reference to the membership, 22 of 35 members are EU member states, while the EU Commission takes part in the work of the OECD.
18. The public consultation ended on 29 August 2016. The draft paper is available at <http://www.oecd.org/daf/fin/insurance/insurer-governance-consultation.pdf>
19. The IASB promulgated the International Financial Reporting Standards (IFRS), which rival the US Generally Accepted Accounting Principles (GAAP) after the adoption of the IFRS by the EU in 2001. On the debate on GAAP/IFRS, see: Stahlin, Harris, Washington Arnold, and Kinkela (2009), *No. 1*; Newman, 2009, vol. 39, at 835 ff.
20. The areas of equivalence under Solvency II refer to Reinsurance (see Article 172), Solvency calculation (see Article 227) and Group supervision (see Article 260).
21. There are three types of equivalence under Solvency II for the three areas mentioned. Full equivalence can be determined for all three areas and for an unlimited time. In case progress is being made for full equivalence, the EU Commission can decide to grant: (1) temporary equivalence, which can be determined for reinsurance and third country groups operating in the European Economic Area (EEA) and for a limited period, that is, until 31 December 2020 with the possibility to extend by one year; and (2) provisional equivalence for EEA groups operating in the third jurisdiction and for a limited period of ten years, renewable for further ten-year periods.
22. With reference to reinsurance, if the third country's rules are deemed equivalent, EU (and EEA) supervisors must treat reinsurers based in that country in the same way as the EEA reinsurers. The EU believes that this is also likely to increase the attractiveness for EEA insurers of entering into reinsurance arrangements with reinsurers from third countries and vice versa. Solvency calculation is relevant for EEA insurers operating in a third country. A positive equivalence finding will allow EEA internationally active insurance groups to use the local rules relating to capital (own funds) and capital requirements rather than the Solvency II rules. This would relieve the related companies in the third country from having to recalculate their data in conformity with the Solvency II requirements. Therefore, EEA insurers will have an incentive to continue to carry out their business in such third countries, avoiding a consolidation process detrimental to competition in that market. As regards Group

supervision, it is relevant for insurers from third countries with activities in the EEA. If the third country's rules are deemed equivalent in this area, EEA supervisors will—under certain conditions—rely on the group supervision exercised by a third country. This would free the third country's international groups from being subject to the unnecessary burdens arising from dual group supervision.

23. The EU Commission granted full equivalence to Switzerland and Bermuda, temporary equivalence to Japan, and provisional equivalence to Australia, Brazil, Canada, Mexico, the USA and Japan.
24. In addition, the USA and the EU reached an agreement on reinsurance and insurance regulation on 13 January 2017. The Covered Agreement embraces three areas of prudential insurance oversight: reinsurance, group supervision and exchange of information between supervisors.
25. See also Kading, Madeiros, 2011, at 399.
26. See Recital No. 4 of MiFID II, which states: “The financial crisis has exposed weaknesses in the functioning and in the transparency of financial markets. The evolution of financial markets has exposed the need to strengthen the framework for the regulation of markets in financial instruments, including where trading in such markets takes place over-the-counter (OTC), in order to increase transparency, better protect investors, reinforce confidence, address unregulated areas, and ensure that supervisors are granted adequate powers to fulfil their tasks”.
27. Cousy, 2009, 89 (3), at 245 ff.; Marano, 2016; Cousy, 2017, *infra* in this book.
28. Marano, 2016; Cousy, 2017, *infra* in this book.
29. “Insurance-based investment product” means an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations (see Article 1 (1), No. 17 of IDD, for a list of products which are not included in the definition above).
30. The Final Report of the Commission Expert Group on European Insurance Contract Law was adopted on 24 January 2014 and it is available at http://ec.europa.eu/justice/contract/files/expert_groups/insurance/final_report.pdf. See also Basedow, Birds, Clarke, Cousy, Heiss, Locker, 2015.
31. See Articles 9, 13 and 18 of the Directive 2009/103/EC.
32. See Articles 132, 183–187.
33. See Chapter V—Information requirements and conduct of business rules.
34. See Directive 2002/65/EC on the Distance Marketing of Financial Services, Directive 93/13/EEC on Unfair Contract Terms.

35. See Directive 2000/31/EC (Electronic Commerce), Directive 2011/7/EU (Late Payment), Directive 95/46/EC (Data Protection) and Directive 2004/113/EC (Gender Equality).
36. Guzman, Meyer, 2014, available at <http://ssrn.com/abstract=2437956> at 5, which provides the following definition of soft law: “those non-binding rules or instruments that interpret or inform our understanding of binding legal rules or represent promises that in turn create expectations about future conduct”.
37. Brummer, L. 623, 2010, 623–643.
38. Jordan, 2013 at 257.
39. Gersen, Posner, 2008, at 18, available at <http://ssrn.com/abstract=1113537>; Abbott, D. Snidal, 2000, at 434.
40. Abbott, Snidal, 2000, at 424. These are costs arising any time states are no longer able to follow their national prerogatives. Where organizations are informal, no delegation of powers is made to supranational authorities, and national regulators can choose not to adopt certain rules because agreements are not binding.
41. Abbott, Snidal, 2000, at 441 ff.; Shaffer, Pollack, 2010, at 719. Costs of uncertainty arise when full information as to the impact of any particular rule is not available and, therefore, terms adopted by hard law regulation are imprecise or vague.
42. Slaughter, 2000, 202.
43. Raustiala, 2002, at 30.
44. See, for example, EIOPA’s *Fifth Consumer Trend Report*, December 2016, which announced that EIOPA is playing an active role in the global debate around *Fintech/Insurtech* entities and their activities, which is taking place in the international *fora*, including the IAIS and EU Commission. The objective is to promote a well-functioning consumer protection framework while incentivizing financial innovation and equal competition in the markets (see at 51).
45. See Senden, 2005, at 22 ff. However, see also Van Gestel, Van Golen, 2014, at 768 ff.
46. The list of the Reports is available at <https://eiopa.europa.eu/publications/reports>
47. The Report was issued on 16 December 2016 and it is available at https://eiopa.europa.eu/Publications/Reports/06.0._EIOPA-BoS-16-239%20-%20EIOPA%20Fifth%20Consumer%20Trends%20report%20-%20Clean%20after%20BoS.pdf

63. See: *Guidelines on Complaints-Handling by Insurance Intermediaries* and *Guidelines on Complaints-Handling by Insurance Undertakings*, which are both available at <https://eiopa.europa.eu/regulation-supervision/guidelines>
64. A report issued by Oliver Wyman, *Managing Complexity. The State of the Financial Services Industry 2015*, p. 8, estimates that between 2.5 and 3.5% of North American, European and Australian financial institutions' total costs which come from meeting the elaborate new regulatory guidelines, equates to US\$0.7–1.5 BN per annum for the coming 2–3 years for large financial firms.
65. The Global Federation of Insurance Associations (GFIA) was established on 9 October 2012, and is active in commenting on a broad range of issues affecting the international insurance industry, including developments in the systemic risk debate, the common framework for the supervision of international groups, market conduct, trade issues, and initiatives in relation to financial inclusion and anti-money laundering. More information is available at the website of GFIA: <http://www.gfi-ainsurance.org/en/>
66. Insurance intermediaries have boosted in the same period the existing World Federation of Insurance Intermediaries (WFII), which was created to provide a powerful voice to advance insurance intermediaries' interests, to provide innovative solutions at international level. See the website of WFII: <http://www.wfi.net/en/bipar/objectives>
67. Consumers have their own international association, which is Consumers International (CI). In 2010, CI and its members successfully campaigned the G-20 to make new international recommendations for improving financial consumer protection. Since then, CI has been ensuring that the consumer voice is heard in the G-20 agenda on financial consumer protection. More information is available at the website of CI: <http://www.consumersinternational.org/our-work/financial-services/key-projects/g20-campaign/>
68. They are mainly Insurance Europe for insurance undertakings, European Federation of Insurance Intermediaries (BIPAR) for insurance intermediaries and Better Finance for financial services users.
69. Kenneth Haar, Hoedeman, available at https://corporateeurope.org/sites/default/files/attachments/financial_lobby_report.pdf
70. Kenneth Haar, Hoedeman.
71. See Quaglia, 2014b, at 125 (note that the concept of group supervisor was heavily backed up by large international insurance groups).

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3

Changing Insurance Contract Law: An Age-Old, Slow and Unfinished Story

Herman Cousy

Introduction

Insurance is a product of the Italian commercial genius. It all started in northern Italy, where the first real insurance transactions, mainly covering goods-in-transit against the perils of transportation, became a customary incident of trade, in the province of Lombardy from where the daring and adventurous merchants spread their practice of insurance to every conceivable trading town of the European continent. There is evidence that it was the enterprising Lombards who brought into England their practice of having their commercial ventures assured.¹ And the earliest known policies issued in London were written in Italian with an English translation attached.²

Since then insurance has constantly expanded and grown into an indispensable instrument of risk handling in today's society. The way in which a legal framework of this practice and business of insurance has been

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developed is remarkable and instructive. The process has been long and slow, but now appears to have come into a phase of intense acceleration. One may consider insurance law as a Europe-based construct. Insurance contract law was shaped and developed in the national law of several European countries. As regards the regulatory framework for the business of insurance, the EU has been and is presently playing a forerunner's role. At this moment, the focus of attention goes to the regulatory framework. This is no reason not to pay attention to the contract of insurance and the continuing adaptation of its legal framework. This is what this chapter intends to do.

Insurance and Insurance Business

Insurance is a financial service, presently offered by specialized and highly regulated financial service providers. But in the very first place, insurance is a legal transaction, and more specifically, a contract.³ At the early stages of its development, the parties to such a contract were in fact creating something new, that is, a transaction for which they did not find any adequate framework or rules in the existing laws. Creating their own *lex mercatoria*, the merchants slowly developed a set of clauses that would slowly evolve into a *lex assecurationis* regarding an autonomous and special contract under which one party, the insurer, promises another party, the policyholder, cover against a specified risk in exchange for a premium.⁴ As a speculative (and for that reason a suspect kind of) operation, and as an aleatory contract, insurance would, for a very long time, stay outside the mainstream of business and remain in a somewhat marginal legal position. No wonder that for many centuries, insurance law was mainly to be found in the contractual stipulations and conditions of the insurance policies, unilaterally drafted by insurers in a sphere of barely limited freedom of contract. The little amount of regulation, in the sense of a public law framework of the business of insurance, was found in corporate charters, professional codes, and in some, non-systematic, views on the insurance business held by judges in their judicial decisions.⁵

At present, the situation is the other way around, in the sense that the business of insurance is now governed by a vast and complicated body of insurance regulation, which is separate, but more and more embedded in a broader field of financial legislation and regulation. Like the other financial services (e.g. credit and investment), insurance now forms the object of a massive, detailed and ever-expanding body of regulatory law, which concerns such diverse matters as access to and exit from the market; licensing and regulating insurance undertakings and other persons in the business (like insurance intermediaries); corporate governance and risk governance; and financial solvency of insurance undertakings. In the modern view, the regulatory framework is even slowly extending to matters that are close to contract and tort law, like standardization of policies and documents, product information, and recently, product formation, control of market behavior, prevention of unfair trade practices, and consumer protection.⁶

The editors of this book deserve a word of praise for having reserved some space for reflection on the private law of insurance contracts in the midst of the massive developments in regulatory law. In previous times, lawyers and practitioners used to concentrate on insurance legislation as a matter of contract law. They may experience this brief reminder of some aspects of insurance contract law as a moment of nostalgia.

In this age of expanding regulation of the business of insurance, it may be instructive and indeed productive to keep an eye on the evolutions that occur in the law of contract and in the insurance contract legislation because there exist several meeting points between regulatory law and contract law.

Above, a short reference was made to the expanding field of regulatory rules and measures that directly concern or, to say the least, that have an influence on the legal relations between the parties to the insurance contract. The recent appearance of the so-called conduct of business rules or rules of conduct in the range of rules, that govern the relations between the contracting parties, offers a striking illustration. As will be explained hereafter (under the heading Mifidization), the rules of conduct are conceived and imposed by the legislative or the regulatory authorities with

the main goal of bringing about a smooth working of the (financial) market(s). They provide, *inter alia*, for obligations of honest and fair dealing, which in earlier times were considered to be specifications of the contractual obligations of “good faith”.

Another meeting point between contract law and regulatory law concerns the issue of the specificity of the different financial services (credit, insurance, investment) and their legal and regulatory framework. Like the Member States, the EU has so far held on to an approach of separate treatment. Even more than the other financial service providers, the insurance sector has traditionally insisted on its own specificity and on the need for a legal treatment that diverges from the common regime. In particular at the level of the insurance contract law, insurance has always been the object of specific legislations. However, both at the regulatory level and at the level of contract law, a certain tendency toward rapprochement becomes apparent. The same philosophies underlie both the Basel accords and the EU Solvency II regime. The demand for cross-sectional legislation becomes more explicit, as appears for example in the PRIIPS regulation. Comparable tendencies can be observed in the contract law area. A clear illustration, which will appear hereafter, is found in the phenomenon of “life insurance linked to investment funds” which requires a legal regime, which transcends the boundaries between insurance and investment.

So far, the move toward harmonization at the EU level of the national insurance regimes has not been accompanied by any comparable rapprochement or harmonization of the insurance contract law. This is due to the discussion both about the feasibility and about the desirability of such an operation. The issue will be discussed in the last chapter of this article.

But before turning to these issues, our attention must go to the time when a regulatory regime of the insurance industry was almost non-existent, and the insurance industry had developed with the contract clauses and a slowly developing insurance contract law as the sole legal companion.

Our journey will be one through the remarkable process that insurance and especially insurance contract law have undergone ever since the first

autonomous insurance policies were issued somewhere in the fourteenth century.⁷ Our focus will be on five major developments: (1) the emancipation of insurance and its gradual development into a fully normal legal institution; (2) the extension of the concept of insurable risk and the corresponding broadening of the domain or action radius of insurance; (3) the somewhat special position that insurance contract law occupies in the spectrum between business law (where insurance law originally belonged) and modern consumer law (into which insurance contract legislation has developed); (4) the gradual incorporation of insurance law into the broader branch of financial law and the tendency of insurance legislation to abandon the traditional idea that insurance is a special branch that requires a specific and derogatory legal regime; (5) the demand for harmonization of the national insurance contract legislation in the context of the creation in the EU of a large, single market of insurance.

This article will neither deal with the issue of the process of digital contracting nor with the more general issue of intermediation and distribution of insurance, however much these issues may raise important questions on matters of contract law. Nor will this article deal with the technical and legal techniques that are used for the purpose of alternative risk transfer (ART), such as captive (re)insurance, financial reinsurance, securitization, capital market solutions, etc.⁸

The Emancipation of Insurance

The most striking and constant feature that characterizes the evolution of insurance and insurance law is the slow but steady process of emancipatory growth of insurance from a highly suspect aleatory operation, similar to games and gambling, to a fully regular financial transaction which has become a normal and indeed indispensable ingredient of modern economic and social life. At the end of a slow and centuries-long evolution, insurance developed into a highly respected legal operation and contract, which in present days is no longer banned to the obscure outskirts of maritime law (as was, e.g., the case in the 1804 Napoleonic civil code), but has earned its place as an essential part of the economic law, and symptomatically, in some countries (even) as a part of civil law (as in

Book 7.17 of the New Dutch Civil Code).⁹ To understand this evolution, one must be aware of the fact that the shaping of insurance contract law has for a long time been influenced by an initial and long-lasting feeling and attitude of suspicion and distrust.

The fear that insurance is nothing else than speculative gambling and the fear that the insureds will abuse this instrument were indeed the basis for the development of principles and rules that are characteristic of the insurance contract, such as the concepts such as insurable interest, the indemnity principle, and the principle of good faith. It may be true that some modern legislations have more or less abandoned the requirement of an *insurable interest* as a complementary validity condition for all contracts of insurance, but it remains true that the concept has been developed as a tool to distinguish the valid contract of insurance from operations like games and gambling.¹⁰ Likewise, the *principle of indemnity* can and must be understood as a legal response to the ever-present fear of voluntary claims, that is the fear that the insured would be induced to voluntarily or intentionally cause the insured event to happen if he would have the chance of obtaining insurance cover for a higher amount than the loss actually suffered. The principle of indemnity is now a concept of insurance contract law, which distinguishes between indemnity insurance and the insurance of fixed sums.¹¹ The concept also lies at the basis of what constitutes a major and fundamental distinction between the two major branches of the business of insurance: life and non-life insurance.

It is equally the fear of abuse and misuse of the aleatory insurance operation that explains why the very special *duty of good faith* (even of utmost good faith) was introduced in the contract of insurance. Insurance is a “*contractus uberrimae fidei*”, as it was expressed in Article 17 of the famous and iconic English Marine Insurance Act 1906.¹² It is a clarifying approach to understand the concept of good faith in its objective sense, that is in the sense of the (unwritten) rule that is implied in each contract, and that imposes upon the contracting parties a duty of cooperation and solidarity with the other party. In insurance, such duty of good faith (in the objective sense) was understood as imposing upon the insured, and until the recent tendency toward consumer protection, almost exclusively upon him, a duty to take into account the

interests of the insurer, even as a duty to put the interests of the insurer above his own. Over time, these duties of objective good faith have been incorporated into the basic duties of the insured in every insurance contract, and they are now described in detail by every insurance contract legislation. This is the case with the duty of disclosure, both at the moment of conclusion of the contract¹³ and in the course of its implementation (e.g. in case of aggravation of risk¹⁴), that is the duty obliging the policyholder to make full and honest disclosure of the characteristics of the risk, even if this goes against his own interests. Equally described in the insurance contract legislation of most countries is the duty of mitigation of loss, obliging the insured in contracts of indemnity insurance to directly serve the insurer's interests by averting and limiting the losses that arise from the insured event.¹⁵

The history of insurance contract law can be understood as a process of a gradual softening of the suspicion and distrust that weighed on insurance as a whole and on the insured in particular. As was mentioned, some present-day legislations have dropped¹⁶ the explicit insurable interest requirement. In our view, the abandonment of the insurable interest requirement can also be seen as a step in the return of insurance law to general contract law principles. Another illustration of the gradual softening of the distrust is found in the legislative modifications of the duty of disclosure (described later in the section under the heading "Humanization of Insurance Law").

Extension of Insurable Risk and of the Domain of Insurance

The gradual emancipation of insurance was also due to the evolution of the concepts of insurability and insurable risk. Old insurance law took a contorted and restricted position vis-à-vis the limits of insurability. Modern insurance law takes a more relaxed attitude and a progressive view on the nature, complexity, and uncertainty of the insurable risks. The concept of insurable risk is extended and so is the action radius of insurance. Insurance has become an essential factor in the economic and social development of the modern society.

From Exogenous to Endogenous Risks

There was a time when only the so-called exogenous risks were deemed to be insurable, “exogenous” referring in this context to risks that originate from an outside source and are caused by an irresistible, sudden, and unforeseen source in the nature of an act of God or a force majeure. Since then matters have changed, and here again the change has much to do with the receding distrust and suspicion, and more particularly with the slow disappearance of the fear that the insured would fraudulently manipulate the risk.

Under modern insurance law, insurability is not limited to the exogenous risks, and a number of new insurance branches have been created where cover is given for risks which may be considered as more endogenous, that is risks which, to a large extent, are created by the behavior of the insured himself. With a reference to the concept of “condition potestative” in the law of obligations,¹⁷ some French authors speak of “risques potestatifs”.¹⁸ The examples are numerous.

Think, for example, of liability insurance where the insured event, that is the insured incurring liability for damage to a third person, depends entirely on an act or omission of the insured. Think of credit insurance where the insured creates the risk of default by allowing credit to an uncreditworthy person. Think of legal aid insurance where again the emergence of a need for legal protection will most often be due to a behavior of the insured. Think even of hospitalization insurance where the decision to seek medical help is taken by the insured.

There is also another way in which the concept of insurability is extended. In all insurance branches, including the traditional ones, the involvement of the insured in the causation of the occurrence of the insured event is considered less of a problem than it used to be. A very remarkable illustration of this evolution is found in the history of the legal exclusion from cover of behavior that can be considered as heavily faulty (“faute grave”) or grossly negligent. Whereas this type of faulty behavior used to be considered equivalent to intentional behavior (“culpa lata dolo aequiparatur”) and therefore excluded from cover under the title intentional fault, in many jurisdictions the law has been changed to allow an extended insurability of the “faute grave”.¹⁹ Even with respect

to the sacrosanct legal exclusion from cover of the intentional fault, one observes the same tendency toward a more lenient attitude to what is considered to be an intentionally caused event (“sinistre volontaire”). In several jurisdictions case law has evolved in the direction of imposing more stringent conditions before considering any willful behavior as intentional (and thus giving rise to exclusion from cover). An example of such a “more stringent condition” would be the test whether the insured had the will to cause a specific loss (and not just an unspecified damage), or even the will to acquire the insurance indemnification,²⁰ before he can be considered to have caused the insured event intentionally.

From Simple to Complex Risks

All the endogenous risks referred to above are complex in the sense that the insured event is not a single accidental event, but a complicated process, that gradually comes into existence. This change in the concept of the insured event from single event to a slowly developing process, makes it difficult, and at least delicate, to decide at what precise moment in the course of this ongoing process the actual insured event may be considered to have taken place. The problem is well known in credit insurance, and also in legal aid insurance, but let us concentrate our attention on liability insurance. Here the several phases of the gradually developing occurrence of the insured event (well known in legal jargon as the “triggers”) can be distinguished into at least the following three: one, the original act or omission that causes the damage; two, the occurrence of the loss; and three, the lodging of a claim for damages by the victim.

Insurance lawyers are well aware of the truly Copernican revolution that took place in the law and business of liability insurance when the American (re)insurers started to change their existing practice of giving cover “on act committed basis” (cover is given when the original damage-causing act or event took place within the insurance period) and decided to give cover “on claims made basis” (cover is given if the claim is within the insurance period even for occurrences/losses dating from before the start of the insurance period).²¹ The shift (which was inspired by the problems relating to the so-called long tail risks) was revolutionary

indeed and gave rise to intense judicial debate. One will remember that the French Cour de Cassation declared the “clause de réclamation” (the “claims made” clause) to be illicit and void.²² And other courts and even legislators were openly skeptical about this change, which was considered as leaving the insured in an uncertain situation about his cover and giving the insurer too much possibility to escape from giving cover.

What interests us here, is that this fundamental issue of insurance contract law has had and still has a profound influence and impact on the business organization of a liability insurer, among other things on the configuration of his “technical provisions” on his balance sheet. Someone has compared the transition from “act committed” to “claims made” in liability insurance with the change that has taken place in the financing of old-age insurance. In some countries, a system of “funding” (in French: “capitalization”) has been replaced with a system of “pay as you go” (in French: “répartition”). The transition from a loss-occurrence model to a claim-made model of liability insurance produces a somewhat similar change for the liability insurer. He does not have to build up and keep claims-outstanding provisions for very long periods of time (until the final claim for compensation has been made and decided upon). One could observe that liability insurers have lost a bit of their essential role and task by abandoning this task of building up claims-outstanding provisions and becoming a mere exchange of incoming premiums and outgoing insurance money.

Expansion of the Insurance Domain

The growth of insurance has stimulated the insurance industry to invade the domain of other financial service providers, like investment firms or banks. Here again the debate about the limits of insurance is focused on the concept of risk. A very good illustration is found in the recent debate about the question whether certain new (life) insurance products entail a sufficient degree of risk transfer (from the insured to the insurer) to qualify as an insurance operation. The debate was fierce and utterly important for the (life) insurance industry because, starting from a discussion of issues of contract law, the results of the debate were in fact

decisive for important regulatory issues like the correct qualification of certain financial services and for the delimitation of the proper domain of the different financial service providers.

The debate originated in the discussion on the correct legal qualification of certain so-called new life insurance products, and especially²³ of the life insurance formula known as life insurance linked to investment funds (in some cases also called “unit-linked life insurance”). As is well known, the typical and distinctive characteristic of such life insurance products is that the investment risk is not borne by the insurer (as is the case in a traditional life insurance, which offers a fixed capital calculated on the basis of an agreed technical interest rate), but is left with the insured. When a life insurance linked to investment funds comes to maturity (according to the terms covenanted in the contract), the insurer’s liability is limited to an amount which corresponds to the value at that time of the units of account that were acquired or accumulated through the (single or consecutive) premium payments into an investment fund. Having to pay only the countervalue of what at the date of maturity of the contract is found in the insured’s share in the (internal or external) fund, the insurer does not (in the absence of complimentary promises, like for example the payment of a fixed sum in case of early death of the person at risk) appear to bear any significant financial risk. The question whether such an operation is (still) an insurance contract was debated in several EU Member States, and varying and sometimes opposing views were taken by supervisory authorities, tax authorities, and courts. It would appear that a decisive role has been played by the position that was taken by the French Cour de Cassation in a number of solemnly pronounced decisions of 23 November 2004.²⁴ The gist of the reasoning of the French court was that a contract is sufficiently aleatory (a typical French requirement, dating back to the concept of “*contrat aléatoire*” in the Napoleonic Civil Code), and thus an insurance contract, by virtue of the mere fact that the insurer is confronted with uncertainty about the time of payment and about the identification of the beneficiary at the time of maturity of the contract. It may be said that by deciding in the way it did, the French court has saved the fate of the investment-linked life insurance, and even the fate of the French, and probably European, life insurance industry which at that time was heavily dependent on the

success of this type of life insurance contract. The European Court of Justice has also been confronted with the issue in the Alfonso Gonzales case of 1 March 2002. However, the ECJ's decision in favor of the qualification as insurance was based on the purely formal argument that the life insurance contracts in question are classified in the group of life insurance by the directives.²⁵

It must be clear that the issue of qualification of life insurance products is one of insurance contract law, but that the way of resolving this question has been of immense importance to issues of insurance regulation, and indeed to the durable success of the life insurance sector. Widening the concept of risk has contributed to the emancipation of the insurance contract and to its transformation into a modern financial transaction that far exceeds the cramped limits of traditional insurance.

It is interesting to observe that at approximately the same time another discussion was held about another borderline of the insurance domain, more precisely about the question as to what extent certain highly speculative transactions in the derivative business can or should come under the province of insurance. In this case the question concerned the qualification of certain types of credit derivatives, and more particularly the credit default swaps (CDS).

Whereas the issue of investment-linked life insurance contracts concerns the question whether these transactions imply a sufficient degree of risk transfer (from the policyholder to the insurer) to qualify these contracts as insurance, the issue of the default swaps concerns the borderline between insurance and highly speculative transactions which claim to fall outside the realm of insurance law. In its simplest form, a CDS is a contract between two parties (the buyer and the seller of protection) in which the buyer acquires, against payment of a premium, the right to a compensation when a "credit event" occurs, that is an event which casts a shadow on the value (including the probability of default) of a claim for payment (usually called the reference obligation). Although at first sight the construction looks very much like an insurance contract, more precisely a credit insurance transaction, this qualification has always been contested by the financial industry. They state that a CDS is closely linked to a credit transaction to such degree that it is not insurance, but a credit derivative that can be sold by credit institutions.²⁶ The question

is whether such bold statements about the nature and qualification of Credit Default Swaps are sufficient to withdraw them from the imperative legal rules that apply to the very comparable, if not similar operation that is called insurance. The question is whether the quintessential principle of insurance law, namely the rule, which requires the existence of an insurable interest on the part of the policyholder, is or is not applicable to Credit Default Swaps. The issue is hotly debated. An affirmative answer to this question would imply that CDS and certainly the “not-covered credit default swaps” (commonly called “naked default swaps”, that is a transaction where the buyer pays premium and will obtain the agreed cover, even if he does not own the reference asset) are null and void. As I pointed out at another occasion, the debate did go partly unnoticed because of the enormous size of the credit default swap market and the nature of the participants.²⁷ After the financial crisis 2008 the CDS market appears to have shrunk considerably, if not collapsed. The issue of qualification has become somewhat superfluous but loses none of its theoretical importance.

Humanization of Insurance Law: From Business Law to Consumer Law

As was explained above (see nr. 5), the overriding principle of objective good faith in insurance (insurance is a contract of “*uberrimae fidei*”) has in the course of time been translated into explicit legal rules on the existence of specific duties of the insured: the duty of disclosure (to allow the insurer to evaluate the risk); the duty of informing the insurer about the aggravation of risk; and especially the duty of the insured to mitigate the loss.

A remarkable trait of insurance contract law is that for centuries the duty of good faith, and the specific duties that were derived therefrom, were interpreted in a unilateral way, in the sense that these complementary duties were only imposed on the insured and not on the insurer. The explanation for this one-way orientation of the so-called good faith duties may be found under traditional insurance contract law in which the insurer was considered to be the party in need of protection. However astonishing this observation may appear to some of us, the fact is that

insurance law was for a very long time considered to be insurer-protective law. Matters have changed since then, and almost all of the recent changes and modernizations in the national legislations have introduced a new philosophy that is inspired by general consumer law. Accordingly, it is the consumer and not the professional who is in need of protection. It is fascinating to know why traditional insurance contract law was geared to protect the insurer. One reason is found in the very nature of the insurance contract where the risk is transferred from the insured, who is supposed to know the risk, to the insurer who does not know the risk and needs to be protected against possible bad behavior of the insured. Another more sociological explanation is that the one-sided, insurer-friendly attitude of early insurance law may have been the expression of a hidden and unspoken desire or intention to support the infant insurance industry, which would perhaps not have been “sustainable” otherwise.²⁸

Another characteristic of traditional insurance law, which goes along with the previous one (protection of the insurer), was its utmost severity: the stringency of the duties that were imposed on the policyholder and the insureds and harshness of the sanctions in case of violation of these duties. An explanation for this remarkable harshness of traditional insurance law can perhaps be found in the fact that in the early architecture of insurance the insurer was not considered to be protecting interests of his own. The insurer was rather considered to be the representative and the guardian and defender of the community of insureds. The severity and harshness were defended as being methods that would have a moralizing effect on the behavior of the insureds and therefore methods that were ultimately intended as ways to take care of the interests of the insureds.

Here again matters have changed and much of the harshness (sometimes considered to be exaggerated and inhumane) has been substantially reduced and softened. A good example is the requirement of disclosure of the risk by the policyholder. Whereas under traditional insurance law, applicants for insurance were fictionally considered to know the risk and to know every relevant feature of it, they were legally obliged to fully and correctly inform the insurer of all the aspects of the risk that might possibly have an influence on the “risk calculus” of the insurer. In many jurisdictions and systems, this duty of spontaneous declaration has been replaced by the instrument of the questionnaire. And as regards the implementation of

this duty, the evolution has equally been one of softening the traditionally hard and rigid sanctions. Under traditional insurance law, shortcomings of the insured were punished by the radical sanction of “loss or forfeiture of right”, even if there was no causal relation between the shortcoming and the risk of occurrence of the insured event. In a consumer-friendly law such a causal relation is required as a condition for imposing a sanction. In addition, in this new approach the sanction is proportional to the weight of the shortcoming and to the damage caused to the insurer.

At this point, it appears very symptomatic, that the legal regime of disclosure is changing even under English insurance law, where the very iconic Marine Insurance Act 1906 had introduced a model of insurance law that was clearly inspired by a philosophy of efficient risk handling, and indeed more protective of the insurers’ interests than most of the continental national legal systems. The Marine Insurance Act has been replaced by a new legislation in 2016 that treats the parties in a more balanced way. Very symptomatic in this respect is that the English legislation, under the guidance of the prestigious Law Commission, is abandoning, at least in the field of consumer insurance, the archetypical and legendary construction of the “warranty”. The end of the use of “warranties” (in consumer insurance) is to be considered as the “Fall of the Citadel” of a certain very English concept and philosophy of insurance law. The fall (or retreat) of the concept of warranties is also significant for another major, if not even spectacular, evolution, namely the beginning of a rapprochement between English insurance contract law and the insurance law tradition in the European continent. And this “rapprochement” may constitute the single most important event in the highly desirable move toward harmonization of insurance contract law (see hereafter, last chapter), and it is expected to have a beneficial effect on the integration of the internal market for insurance.

“Mifidization” of Insurance Law and Cross-Sectional Legislation

It was mentioned above that banks have started to play a role in the distribution of insurance products, and that even insurers themselves sell financial products, more precisely insurance products, which in reality

are, or at least look very much like, investment products. These developments are part of a more general tendency that can be observed in the business organization of the financial services industry, namely the tendency toward gradual “despecialization” between the main financial sectors: credit, insurance and investment. Despecialization (one also talks of the “blurring” of the frontiers) refers to such phenomena as bancassurance, bancassurfinance, financial conglomerates, integration of supervisory authorities, etc. The development manifests itself at different levels: at the level of distribution (especially the distribution of insurance products by banks), at the level of formation of groups of financial services providers (financial conglomerates), at the level of the supervisory authorities (integration) and even at the level of the nature of the financial products and services that are offered by the different financial sectors (especially those described as hybrid products like life insurances linked to investment products).

The development to which attention must be drawn here concerns the type of legal rules that govern the relationship between the (financial) services providers and their customers. Whereas in the field of insurance these relations (between insurer and insureds), even the precontractual ones, used to be governed by the insurance contract, and thus by the clauses of the policy, these relationships are now also subject to another (and new) set of rules, which are known as the “conduct of business rules” or simply the “rules of conduct”. The phenomenon of rules of conduct that are separate from the behavioral prescriptions of the insurance policy clauses was not unknown in the insurance field: such rules were found in the (mostly) voluntary codes of conduct of professional associations and even in voluntary, in the sense of unilateral, codes that were promulgated by individual insurers. It is, however, safe to say that the breakthrough of the concept of “rules of concept” originated in the law on investment services. Rules of conduct in the sense of rules prescribing a certain type of behavior in the relationship between financial market participants, first appeared²⁹ in the Investment Services Directive (Directive 92/22/EEC) and were further elaborated in the ISD2 or MIFID directive, that is. the Markets in Financial Instruments Directive (2004/39/EC). After that the rules were still further elaborated and specified in the delegated acts of the EU Commission (Commission Directive 2006/73/CE and

the Commission Regulation no. 1287/2006). Apart from institutional provisions on the free provision of services of investment undertakings, the MIFID directive contains a number of normative rules which govern the conduct of participants in securities markets, but which also apply to institutions (investment firms, banks) that offer investment products and services.

A remarkable evolution, which is situated on the borderline between contract law and (insurance) business regulation, is that the concept of rules of conduct has now massively invaded insurance. This evolution can be situated in the context of despecialization, and is more specifically due to the rethinking and reorganization of the structure of state supervision of financial institutions. As a reaction to the financial crisis of 2008, many countries have introduced the Twin Peaks Model, a model of state supervision, which entrusts separate organs or institutions with prudential control on the one hand and conduct control on the other. Whatever the institutional structure may be, the authority charged with conduct control and consumer protection, will of course be in need of a clear set of codes and rules that must be implemented.

As was noted above, the conduct of the insurer toward the insured used to be governed by the insurance contract, and within the contract more particularly contract clauses that have their origin in the rules of objective good faith. For ages the good faith requirement had been understood in a unilateral way, that is as imposing duties (only) on the insured and thus not upon the insurer. In more recent times, judges and after them legislators have, in a move toward more protection of the insured, used the concept of good faith to create complementary duties, like information and warning duties, and to impose them on insurers.

The new rules of conduct in insurance, the introduction of which is referred to as “mifidization”, differ from these jurisprudential conduct rules “avant la lettre” in several respects. The Mifid type of conduct rules are now autonomous rules, in the legal form of legislative rules or regulatory prescriptions, directly addressed at the insurers and insurance intermediaries. They are implemented by supervisory authorities, which are invested with the power to impose administrative sanctions.

As far as the contents of the rules of conduct are concerned, the new rules and duties of conduct are derived from the fundamental principle of

loyalty, which obliges the financial institutions (and thus the insurers) to act honestly, fairly, and professionally in accordance with the best interests of their customers. The loyalty principle implies that information to customers or potential customers shall be fair, clear, and not misleading. But the Mifid rules also imply broader rules like the “know your customer” (KYC) rule or the “best execution” rule. Their application to insurance may be delicate.³⁰ Conduct rules in the MIFID directive, and, so one must assume, also in the insurance field, to which they may be made applicable in varying degrees by virtue of EU or national law, have another, or at least a more complex, goal and finality than good-faith requirements. Where the latter aim at taking care of the interests of the other party to the contract, the Mifid-inspired rules of conduct are also meant to serve an additional goal, namely to take care of a public interest, like the efficient operation of a financial market.³¹ On top of that, there may exist another policy concern here, insofar as the phenomenon of mifidization includes a substantive change of the rules and an adaptation of insurance rules. The law should not disregard the specificity of the insurance contract and its autonomous characteristics. In my own country, Belgium, the legislature has, in a daring move, broadened the field of application of the Mifid rules (including those concerning the suitability and appropriateness of certain insurance products) to the insurance field, and this move has been severely criticized in doctrinal writings. The issue of, and the concern about the specificity of insurance contract law reappears here “loudly and clearly”.

Harmonization of Insurance Contract Law

An Old and Viable Dream of a Highly Desirable Harmonization

Only a few of us will remember that in 1979 the EC had launched a proposal for a directive aiming at coordinating certain legislative aspects of insurance contract law. Even after the proposed directive was modified in the following year, the proposal was ill received by the Member States³² and, in the end, even withdrawn³³ by the Commission. In its 1985 White

Paper on the Making of the Internal Market, the Commission had mentioned harmonization of insurance as an item in its list of 300 (or so) directives that were to be issued by the 1992 deadline in order to create the internal market (in this case an internal insurance market). But here again disappointment followed since at the end of the day the plan for a substantive harmonization was cancelled and replaced by an inefficient substitute, namely a set of harmonized conflict-of-law rules. The conflict rules were laid down in the second non-life insurance directive of 1998. What was and still is amazing is that these conflicts-of-law rules turned out to have a very discouraging effect on cross-border insurance of mass risks. In any case the new rules appear to achieve much less than what had been hoped for. The conflict-of-law rules of the internal market directives, as well as the very similar rules that were later on repeated in the Rome I Regulation did indeed, as regards the insurance of mass risks, provide for the application of the national contract law rules of the Member State where the risk is situated, that is the rules of the habitual residence of the policyholder. It is not difficult to understand that such a conflict rule discourages the insurer to engage in cross-border insurance contracts. To encourage such operations, harmonization of the national insurance contract laws is a must.

The old dream of harmonization was revitalized when the EU Commission, in an effort to pave the way to digital contracting, requested the creation of a “toolbox” of concepts of contract law in its well-known 2001 Communication on “An Action Plan for a more Coherent European Contract Law”.³⁴ One knows how the academic community has enthusiastically prepared much more than the toolbox that was asked for and has submitted several projects of European principles of private law,³⁵ a Draft Common Frame of Reference,³⁶ and several projects in specific branches,³⁷ among which is the Principles of European Insurance Contract Law.³⁸

The dream of discovering common principles of European insurance contract law is not an illusion. In fact, it can be affirmed that insurance contract law is a European creation, and that in all the national legal systems the basic principles are the same: insurable interest, principle of indemnity, utmost good faith, subrogation, etc. And where differences exist, they either concern details, or they are more fundamental but

are slowly disappearing (think of the declining importance of concepts like warranties in English law and the *Obliegenheiten* in the German law family, discussed above). One may state, without exaggeration, that insurance law is one of the branches where the discovery of common principles is easy and the effective harmonization should be perfectly feasible. Insurance contract law should be a model for all those who are in search of a European *Ius Commune*.

The answer to the question whether the goals of the internal market for insurance have effectively been realized by the Internal Market Directives is twofold. Insofar as the Internal Market Insurance Directive intended to transform the insurance market into a more competitive market,³⁹ the answer is that this objective was to a large extent effectively realized, mainly by the compulsory introduction of the principle of freedom of tariff by virtue of the (then) third non-life insurance directive, presently figuring in article 181 of the Solvency II Directive. However insofar as the goal of the said insurance directives was to realize the internal market by creating the possibility of cross-border free provision of services, the goal has not been realized. Pan-European players who are active in the cover of mass risks do not operate by making use of the cross-border freedom of services, but by operating through local subsidiaries and local branches and agencies. We believe that one of the main reasons for the lack of success of cross-border insurance contracts is due to the diversity of the insurance contract laws of the Member States, and the lack of their harmonization. The harmonization of national insurance contract law appears to be a necessity, if the goal exists to further develop the big internal market in the area of mass risks.

What Is the Problem?

If harmonization is feasible and highly desirable, then why was it not achieved? The answer is that the European legislator found himself confronted with an impossible choice. There appear to be three possible ways to solve the problem, but each of these is fiercely rejected by one or other of the factions or parties. The easiest way to enhance the cross-border provision of insurance services, and indeed to effectively make the

domestic insurance market operate, is to leave the difficulty of harmonization aside, and to make a choice of law rule that allows the insurer to market his products in other Member States in accordance with his own contract law. This is the formula that was envisaged with respect to contracts in general by the Rome Convention and by the Rome I Regulation, which accompanied this rule of free choice by a number of protective measures, insofar as the contract is dealing with consumer insurance. The formula was however rejected with respect to insurance contracts as being insufficiently protective of the insurance consumer.

So why not opt for the other solution and have a choice-of-law rule that imposes the application of the law on the policyholder, at least for those risks that need protection, like mass risks or (narrower) consumer risks? The protection of consumers is here deemed to stem from the fact that, under this system, consumers are familiar with the law that will be applied to them as insureds, and because they have the guarantee that in cross-border contracts too, they will always have the benefit of the degree of protection that is given to them by their own national law. This is the reasoning that was followed by the European legislators at the time of the second (1990) and third (1992) non-life internal market directives, and again at the time of the making of the Rome I regulation. But here a new problem arises insofar as this conflict-of-law rule is considered one of the reasons that discourage the use of cross-border insurance contracts. To appease both parties and serve the interests of the insurer and the insured, the only solution appears to be to harmonize the insurance contract law of the Member States. But this solution has also encountered opposition, from a perhaps unexpected source, namely the Member States, who appear to be very keen on preserving their own national insurance law and legislation.

The Magical Solution(?)

Given the criticisms on and opposition to each of the three solutions, the problem looks like an insolvable dilemma. There is however a magical formula, which appears to serve all the interests and desires involved. The formula was suggested and strongly advocated by the project group

“Restatement of European Insurance Contract Law”, which has also produced a fairly complete set of “Principles”.⁴⁰ The formula, known as “the optional instrument”, consists in giving the parties to an insurance contract (a cross-border contract, but, in the view of the project group, even a domestic one) the possibility to agree that their contract shall be governed either by a set of harmonized rules, like the Principles, which will be part of Community law and thus uniform throughout the EU, in each situation where by virtue of the Rome I regulation the national law of a Member State would otherwise be applicable.⁴¹ The formula has been positively received and a first use of the formula of the optional instrument was made in the Proposal for a Regulation on a Common European Sales Law (COM (2011) 635).

Notes

1. W.R. Vance, “The early history of insurance law”, *Columbia Law Review*, 1908, vol. 8, (pp. 1–17), p. 11.
2. *Ibidem*, p. 11.
3. In the present contribution, use is made of the terminology that is proposed and used in the Principles of European Insurance Contract Law (hereafter cited as PEICL). A first printed version of the Principles was edited by the Project Group “Restatement of European Insurance Contract Law” in 2009. A second and enlarged version of the Principles (containing not only provisions on general insurance contract law but also chapters on liability insurance, life insurance, and group insurance) was recently published by Otto Schmidt Verlag, 2016. The book contains the Principles with comments and notes, as well as translations of the Principles in 17 languages.
4. Art. 1.201(1) of the PEICL.
5. In English law, reference in this connection is often made to the role of eighteenth-century judge Lord Mansfield, who drew inter alia from “foreign authorities” and “intelligent merchants” (From Wikipedia, The Free Encyclopedia, headword Insurance Law, retrieved 8 November 2015).
6. For a rather Anglo-Saxon approach to the topics that are covered by insurance regulation, compare Burling and Lazarus (eds.), *Research Handbook on International Insurance Law and Regulation*, 2011, p. 229, hereafter cited as *Research Handbook*. In this book, a distinction is made between three groups of “regulatory themes”: (1) solvency (capital

requirements, technical reserves, investment restrictions, insolvency administration, guarantee funds); (2) insurance markets (corporate structure, mergers and acquisitions, market entry, market withdrawal, risk classification, residual markets, insurance distribution); and (3) consumer protection (insurance as a contract of adhesion, conduct of business rules, rate regulation and product regulation, claims handling practices, regulatory intervention in dispute resolution).

7. The year 1347 is generally cited as being the date of the oldest autonomous (not linked to another contract or transaction) policy that was found in the city of Genova.
8. For a general overview, see the *Research Handbook*, passim. Also see Booth and Dowding, 2000, pp. 125.
9. About the difference between *civil law* (reasoning in abstract terms, such as contracting parties, creditors, and debtors, without regard to the identity of the parties involved) and *economic law* (looking at the factual and concrete situation, and aiming at protecting (in the widest sense) the interests of a well-defined group of market players (e.g. consumers, competitors)), see Cousy, 2012, p. 82.
10. Fontaine, 2010, nr. 139.
11. Art. 1:201 PEICL. Indemnity insurance means insurance under which the insurer is obliged to indemnify against loss suffered on the occurrence of an insured event. Insurance of fixed sums means insurance under which the insurer is bound to pay a fixed sum of money on the occurrence of an insured event.
12. As one is aware, as from the year 2016 onward, the UK's insurance law regime has been altered by the Insurance Act 2015, inter alia by replacing the disclosure duty by the duty of "fair representation", and by introducing new, more proportionate remedies for non-disclosure, by reducing the severity of sanctions for breach of warranty. The application of the utmost-good-faith rule becomes subject to the provisions of the Insurance Act and of the Consumer Insurance (Disclosure and Representation) Act of 2012. These legislative changes in the English insurance law may be considered as a historic event, since it is a step toward closing the age-old and profound gap between the Anglo-Saxon and the continental national insurance laws.
13. Art. 2:101 to 2:104 PEICL.
14. Art. 4:202 to 4:203 PEICL.
15. Art. 9:101 to 9:102 PEICL.

16. So did indeed the Principles of European Insurance Contract Law. Compare J. Birds, 2011, p. 57.
17. That is, an arbitrary condition the fulfilment of which depends either principally or entirely on the discretion of a party to the contract.
18. Dubuisson, 1988, p. 44.
19. Belgian law is, in this respect, highly illustrative. Before the legislative change of 1992, the “faute grave” was indeed considered equivalent to intentional fault (“culpa lata dolo aequiparatur”) and thus considered to be “ex lege” excluded from coverage. Still in 1967 the Cour de Cassation had confirmed this equivalence for insurance purposes and declared the exclusion to be a rule of “ordre public” (Cass. belge, 2 Juin 1967, *R.C.J.B.*, 1971, pp. 1 ff, with a note by S. Fredericq), although by an earlier decision of 1959 (Cass. belge, 25 December 1959, *Pas.*, 1960, I, p. 113.) the Court had allowed the contractual exoneration from liability not only for a “faute légère” but also for a “faute lourde”. In 1992, the Belgian legislature caused a Copernican revolution in this matter by reversing the rule almost completely and providing that henceforward the “faute grave” will be covered unless with respect to the instances that are individually and explicitly excluded from cover by the terms of the policy.
20. Houben, 2003, pp. 490 ff.
21. For a brief comparative overview of the sometimes dramatic discussion, both in case law and in the legislature, see inter alia Cousy & Claassens, 1997.
22. Cass. fr, 19 December 1990 (7 decisions), *Revue Générale des Assurances Terrestres*, 1991, 155. For extensive comments, see *Lamy Assurances*, 2016, nr. 1477 ff.
23. Other examples of life insurance formulas that gave rise to discussion are lifelong life insurance and even the traditional mixed life insurance contract which, although construed by the joining of two (undisputedly real) insurance contracts (a term insurance joined with a deferred capital insurance) does not appear to imply significant risk transfer when considered as a whole.
24. Cass. fr 23 November 2004 (4 cases). For sources and comments, see *Lamy Assurances*, 2016, nr. 166.
25. At the time of the ECJ’s decision, Annex 1 of the Life Insurance Directive (2002/83/EC) of 5 November 2002.

26. Comp. Benton, Devine and Jarvis, 1997, p. 29; Kimball-Stanley, 2008, 241.
27. Cousy, 2014–2, pp. 227–242.
28. Compare my Belgian contribution to the 20th international Conference of the IACL (International Association of Comparative Law) on the theme: Insurance between business law and consumer protection (see note 9).
29. To be precise, the concept originated in earlier sources, like the IOSCO guidelines and a Communication of the EEC of 1997.
30. Take for example the “Know Your Customer” rule, which seems to be somewhat contrary to the traditional rule and principle of insurance contract law that the obligation to fully and correctly describe the risk to the insurer rests on the insured, that is without any interaction from the side of the insurer. For a nuanced approach to this issue, see e.g. article 2.202 of the PEICL imposing on the insurer a precontractual duty to warn the applicant of any inconsistencies between the cover offered and the applicant’s requirements of which the insurer is or ought to be aware, taking into account the circumstances and mode of contracting and, in particular, whether the applicant was assisted by an independent intermediary.
31. For a more profound investigation into the difference between contractually implied information duties and duties that are imposed by the law (like conduct rules), see the fascinating book by Loacker, 2015.
32. According to an eloquent comment, the problem is due to the pragmatism of the British, the dirigism of the French, the dogmatism of the Germans, and the solidarism of the Scandinavians.
33. *O.J.C.* 228, 24 Aug 1993, 14.
34. COM (2003) final *OJ C* 63/1.
35. Among the initiatives that were successfully achieved are: the (Lando) Principles of European Contract Law, Parts I and II (The Hague, 2000) and Part III (The Hague, 2003); the Code Européen des Contrats, avant projet of the Academy of European Private Law in Pavia, Milano, 2004; and the Principles of the Existing EC Private Law, München 2009, by the Research Group on the existing EC Private Law (Acquis Group).
36. The Study Group on a European Civil Code and the Acquis Group presented The Principles, Definitions and Model Rules of European Private Law, Draft Common Frame of Reference (Ch. von Bar, Eric Clive, Schulte Nölke, et al.) München, 2009. See also Terminologie contractuelle

- commune, *Projet de cadre commun de référence* (B. Fauvarque-Cosson, Denis Mazeaud, eds.), Paris, 2008.
37. See for example the *Principles of European Tort Law, Text and Commentary*, Springer, 2005. In some areas, like company law, competition law, and unfair commercial practices, an *acquis communautaire* has been developed by EU legislative texts themselves.
 38. Basedow, Birds, Clarke, Cousy, Heiss, Loacker, (eds.), (2016). *Principles of European Insurance Contract Law (PEICL)*, 2nd expanded edition (Otto Schmidt Verlag).
 39. After some hesitation and the fierce opposition of a majority of continental Member States (to the intermediary step of the second generation of insurance directives), the final option (laid down in the third generation of insurance directives of 1992) clearly favored the more competitive insurance model reigning in a small minority of Member States (i.e. the Member States of the maritime insurance tradition, i.e. the UK and the Netherlands). About the distinction between the continental (Alpine) insurance tradition and the maritime insurance culture, see Albert, 1991, p. 181 and also Cousy, 2013, p. 21.
 40. See the reference to the latest edition of the PEICL in footnote 38.
 41. Compare Article 1:102 of the PEICL.

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The Insurance Distribution Directive: What Does It Change for Intermediaries and for Others?

Nic De Maesschalck

Introduction

The Insurance Distribution Directive (IDD or previously IMD II)¹ is a product of its time. The revision of the Insurance Mediation Directive (IMD)² took place in the context of a financial crisis. In 2012, when proposing the revised Directive, EU Commissioner Barnier explained that “the EU will not truly have learnt from the crisis unless it adopts strong measures to restore investors’ and consumers’ trust”.³ He added that the insurance sector did not cause the crisis and that it should be distinguished from the banking sector.

However, at the beginning of the debates on the IMD revision, and much to the “frustration” of the sector, the difference between insurance products with an investment element (later called insurance-based investment products (IBIPs)) and the non-life/pure-risk life insurance was either ignored or not nuanced. Later in the debates and thanks to information campaigns of the sector, this difference was better recognised.

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It is interesting to recall that the IDD was also developed in parallel with MiFID II, Solvency II,⁴ PRIIPs⁵ and the (so-called) Mortgage Directive. During the IDD adoption process, developments regarding one proposal very often had an influence on the other proposals. Some elements became “horizontal” issues in the financial services legislations (such as cross-selling and sanctions provisions). The issue of whether or not conduct rules for IBIPs would have to be regulated under IMD II (later IDD), or under MiFID II⁶ or under a separate Directive together with all other “packaged retail investment products”, was one that popped up on a regular basis. The so-called IMD 1.5 (i.e. the IMD as revised by MiFID II) was probably a kind of compromise which helped to reassure the supporters of a MiFID II approach that there would be harmonisation between the rules applicable to IBIPs and the MiFID II rules. The IDD is also the only Directive of the above-mentioned list that moved over the June 2014 EP elections and over from one Commission to another, the 2014 Juncker Commission.

The Juncker Commission initiated a new approach to financial services regulation. The EU Commissioner, Jonathan Hill, stated in January 2015:

Because of the steps taken over the last five years, the financial system is more stable than it was before the financial crisis. But today there is another threat to financial stability: the lack of jobs and growth. That helps shape my approach to regulation. It is why I have said that I want to look at the cumulative effect of the laws we have passed to make sure we have got the balance right between reducing risk and fostering growth. And if we find we haven't got it exactly right, we should be confident enough to make changes. Now I am very conscious that businesses need regulatory stability in order to plan ahead. So I can say, although I will be taking forward measures to implement top level legislation, I do not intend to launch an avalanche of new regulation.⁷

A Long Process of Negotiation

The IDD tripartite talks (between the Presidency of the Council of the EU, the European Parliament and the European Commission, on the IDD proposal with the aim of finalising and adopting the Directive) was

difficult because the Council's approach regarding the IDD structure was rather different from that of the other two.

For example, even for insiders it was difficult to understand, when comparing the texts, what exactly the differences in scope were between the proposals. With the exception of some ancillary distribution channels (such as travel insurance and car rentals or telephone firms), there seemed to be an agreement between all parties to adopt a broad scope. In the Commission's early proposal, some of these operators would have become "declared intermediaries..." while in the Council's proposal they became "ancillary intermediaries". The general line was known but some (important) details were discussed up until the last minute before an agreement was reached.

Another issue was the ultimate fate of the provisions regulating the distribution of insurance-based investment products introduced in the IMD as amended by MiFID II colloquially known as "IMD 1.5". MiFID II was adopted in May 2014.⁸ Its Article 91 amends the IMD I and introduces specific provisions in this Directive—dealing mainly with conflict-of-interest issues—governing the distribution of insurance-based investment products by intermediaries and insurers (i.e. the so-called IMD 1.5). According to MiFID II, Member States had to implement the IMD 1.5 by 3 July 2016. In the meantime, there seems to be consensus that EU Member States will not implement IMD 1.5 but only the IDD.

IMD 1.5 was indeed a kind of "compromise". At the time of the MiFID II/PRIIPs discussions, the IDD discussions were lagging behind. Also in between the MiFID II and PRIIPs and the IDD, there were European elections and a new European Commission. In other words, there was the possibility that the newly elected Parliament and/or the Commission would withdraw the IDD proposal or change its view entirely regarding the regulation of conduct rules for insurance "PRIIPs" which later became "IBIPs" (insurance-based investment products).⁹ Some of the parties wanted safeguards that insurance-based investment products would come under a regime which would be "similar", "comparable", "harmonised" or "in line with" MiFID II-substitutable products. Some of the other parties did not want insurance-based investment products to be regulated in a MiFID II legal text. The IMD 1.5 was probably the compromised position. It guaranteed that conduct rules applicable to

IBIPs came under a similar regime and that this regulation came under an insurance regulatory framework.

On 20 January 2016, after a four-year process, the two EU legislators, the Council of the EU (the Heads of State and Government) and the European Parliament, officially signed the Insurance Distribution Directive (IDD). It was published in the Official Journal (OJ) of the EU on 2 February. The IDD will become operational 20 days after the publication (23 February 2016) and Member States will then have two years to implement the text (by 23 February 2018). On 24 February, the European Commission requested the European Insurance and Occupational Pensions Authority (EIOPA) for its technical advice on the preparation of IDD Delegated Acts. The IDD empowers the Commission to adopt Delegated Acts to specify various regulatory requirements of the IDD on a variety of issues (Product Oversight and Governance Arrangements, Management of Conflicts of Interest, Inducements etc). The Delegated Acts are expected to be adopted by autumn 2017 (after adoption by the Commission, the EP and the Council will have scrutiny rights). Delegated Acts are binding on Member States, which will have to implement them by February 2018, the IDD implementation deadline. EIOPA has also started its work on the technical standards (e.g. the format of the Product Information Document).

The IDD repeals the IMD and also the IMD 1.5 (IMD as amended by MiFID II). The IDD is a minimum harmonisation directive. In other words, Member States, as they transpose the directive into national law, cannot do less than is required under the directive, but they may introduce additional measures if they deem it to be necessary to ensure the protection of consumers in their market.

The revision of the IMD was part of a “Consumer retail legislative package”, together with two other legislative proposals: a proposal for a regulation on key information documents for packaged retail investment products (*PRIIPs*¹⁰) and a proposal to boost protection for those who buy investment funds (*UCITS*¹¹). The aim of the package was “to improve competition and create a level-playing field in the insurance markets, to provide European consumers with better advice on the insurance products most suited to their needs, and clear information in advance on the status of the people who sell the insurance product and the remuneration

which they receive and to introduce simplified, less burdensome rules on free provision and establishment of insurance services”.¹²

A Wider Scope

One of the objectives of the IDD was to guarantee an effective protection of customers across all financial sectors and to guarantee that the same level of protection applies regardless of the channel through which customers buy an insurance product.¹³

This explains why the IDD covers the distribution of not only non-life and life products, reinsurance products, but also insurance-based investment products (IBIPs). This also explains why the IDD applies to insurance distributors (when the IMD applied only to insurance intermediaries). Based on the new definition of the insurance distributor, the IDD encompasses a larger number of firms than the IMD.

The IDD applies to insurance intermediaries, of course, but also to direct writers, that is, to insurance undertakings which sell insurance products directly. The IDD (unlike the IMD) also expressly applies to certain activities conducted through price comparison websites: the IDD applies to persons whose activity consists of the provision of information on one or more contracts of insurance in response to criteria selected by the customer, via a website or other media or of the provision of a ranking of insurance products or a discount on the price of an insurance contract, when the customer is able to directly or indirectly conclude an insurance contract at the end of the process. This is a key criterion.¹⁴

The IDD applies to ancillary intermediaries. Who are they under the IDD? They are service providers and distributors of goods who distribute insurance products on an ancillary basis. The insurance products they distribute must be complementary to the goods or the services they are selling. And they must not cover life assurance or liability risks unless that cover complements the product or service which the intermediary provides as his principal professional activity. It is interesting to note that credit institutions or investment firms cannot fall under the definition of ancillary intermediaries. It means that when carrying out insurance distribution activity, those firms have to be entirely registered under the IDD.

However, those ancillary intermediaries are excluded from the IDD where the insurance they sell covers the risk of breakdown, loss of or damage to the goods or non-use of the service and also covers damage to or loss of baggage and other risks linked to travel booked with that provider; and where the amount of the premium for the insurance product does not exceed €600. In circumstances where the insurance is complementary to the good or service and the duration of that service is equal to or less than three months, the amount of the premium paid per person should not exceed €200.¹⁵

This is quite a wide exemption. It could, for example, exclude many of the insurance distribution activities of the travel or car rental industry. In this respect, most travel insurances such as assistance insurance—are not simple or uncomplicated products and consumers need advice or recommendation. There are sometimes more than 20 different sections within a policy with all sorts of complicated requirements and exclusions (e.g. premedical conditions that would render the cover void). If not provided with the adequate cover, customers could end up, for example, with a large medical bill that is not covered. This can have serious consequences. It is interesting to note that some EU countries found sufficient cause for concern to bring the travel industry within the scope of their intermediary regulation (e.g. the UK in 2009).

It could also exclude, for example, any household content insurance provided by (often multinational) web shops selling furniture, bicycles, electronics, etc., or any package assistance linked to an e-connected car. National implementation may extend the scope.

Trying to limit the impact of the exemptions on consumer protection, the IDD states that any insurer or intermediary using the services of an exempted insurance intermediary will have the obligation to ensure that the latter complies with a series of information and conduct requirements listed below:

- Prior to the conclusion of the contract, customers must be informed about the identity and address of the insurer or intermediary, about procedures to lodge complaints
- Appropriate and proportionate arrangements should be in place to comply with Article 17 (to act honestly in the best interest of cus-

tomers, no remuneration conflicting with the duty to act in the best interests of customers) and with Article 24 (cross-selling requirements)

- Appropriate and proportionate arrangements should be in place to consider the demands and needs of the customer before the proposal of the contract
- The Product Information Document (PID) is provided to customers before the conclusion of the contract.

The definition of insurance distribution contains important carve-outs excluding certain activities from that definition for the purposes of the Directive.

Although the IDD scope is wider than the IMD one, the insurance distribution activities of many ancillary intermediaries remain partly out of scope. This might be corrected in the implementation process. On the other hand, many private consumer protection rules are now also applicable to insurance for commercial clients. This may lead to unnecessary administrative burden.

New Information Requirements (Conflict of Interest Rules, Remuneration, Advice)

For the sake of better consumer protection, insurance distributors will have to act honestly, fairly and professionally in accordance with the best interests of their customers.¹⁶ In particular, they cannot make any arrangements by way of remuneration or sales target that could provide an incentive to recommend a particular product to a customer when they could offer a different product that would meet the customer's needs better.

Before the conclusion of the contract, consumers will be provided with clear information about the professional status of the person selling the insurance product and about the nature of remuneration which they will receive. This does not apply for large risks and for reinsurance distribution activities.

It is believed that the disclosure of these pieces of clear, meaningful and relevant information at contract level will help consumers to make

informed decisions when purchasing insurance products. For non-life insurance and for pure risk life insurance, any additional disclosures would, however, result in distortion and weakening of competition of which ultimately consumers will be the victim. It would also lead to a distraction of consumers away from the relevant information regarding his or her insurance policy such as levels of coverage, levels of service, policy exclusions or total premium.

Regarding insurance-based investment products (IBIPs), there is no ban on commission or fees introduced in the IDD. This situation should be welcomed as every intermediary has the right to be fairly remunerated for his or her services. A pure fee-based market, for example, would exclude many people from access to any level of advice or assistance in their search for an appropriate insurance product, as has been the practical experience in Member States that have prohibited commission payment approaches.

The IDD introduces a detailed standardised Product Information Document (PID)¹⁷ for all non-life insurance products. The PID is intended to be a precontractual and stand-alone document which aims to allow consumers to make an informed decision. The PID must be drawn up by the manufacturer of the insurance product. It shall be provided by the insurance distributor and shall contain information about the type of insurance, a summary of the cover, the means of payment of premiums and the duration of payments, the main exclusions, the obligations at the start, during the contract and in case of a claim, the term of the contract and the means of terminating the contract. The standardised presentation format of the PID will be developed by EIOPA through an “Implementing Technical Standard” (a form of secondary legislation).¹⁸

The concept of a Key Information Document seems more relevant in an investment context (where the risk is transferred from the financial institution to the consumer) than in a non-life insurance context. Whether or not the PID—in a non-life insurance context—will lead to more problems than solutions will depend upon the practical details, national implementation and future interpretation by the courts.

Where advice is provided, the insurance distributor has to provide the customer with a personalised recommendation explaining why a particular product would best meet the customer’s demands and needs. Member States can make the advice mandatory for the sales of any insurance

products. Important to note is that the Directive explicitly states that “Distributors operating under FOE/FOS in Member States where advice is mandatory, will have to comply with that stricter provision when concluding contracts with consumers having their habitual residence in that Member State”.

The IDD information requirements have been debated, discussed and studied by all those interested in the dossier both at national and European level for over six years. The result of the deliberations is seen in the Directive and it is the reflection of all these discussions. It is now probably time to stop discussions and implement the EU system that was decided.

Organisational Requirements

The key change is that the IDD introduces a new requirement of Continuing Professional Training and Development (CPD).¹⁹ EU Member States will have to establish and publish mechanisms to effectively control and assess the knowledge and competence of insurance and reinsurance intermediaries and employees of insurance and reinsurance undertakings and employees of insurance intermediaries.

This should be based on at least 15 hours of professional training or development per year. It should be welcomed that the format and the contents of these 15 hours is to a certain extent flexible: it can include courses, e-learning or mentoring—the contents should take into account the nature of the products sold and the role of or the activity carried out by the person following the training.

Member States may require that the successful completion of the training and development requirements is proven by obtaining a certificate (but this is not compulsory).²⁰

The principle of CPD is certainly good, but it must be noted that these CPD requirements have the potential to be a demanding charge for micro operations and SMEs in particular. The real impact will depend on how these requirements are implemented at the national level.

Another key change is that the IDD introduces in its annexure minimum relevant *professional knowledge and competence requirements*²¹ for

non-life, life and IBIPs products. Intermediaries will have to demonstrate compliance with these requirements.

The IDD does not introduce big changes regarding professional indemnity (PI) cover and financial guarantee requirements. The IDD sets a minimum professional indemnity insurance requirement for intermediaries of at least €1.25 million per claim or €1.85 m in the aggregate, unless such insurance or comparable guarantee is already provided by an insurance or other undertaking on whose behalf the intermediary is acting.²² Ancillary insurance intermediaries will also be required to hold professional indemnity insurance.

Training is important but it should be flexible and adaptable to the needs of the firm and the employee. The EU framework leaves some flexibility to the national level and individual companies.

New Rules on Tying and Bundling (Cross-selling) Practices

The IDD requires in principle that where the insurance product is ancillary to a good or service, the good or service should be allowed to be purchased separately without the insurance. For example, when a new car is sold at a bargain price together with motor insurance, consumers will have the choice to buy the main good or service without the insurance policy.

The IDD does not prevent the distribution of insurance products which provide coverage for various types of risks (multirisk insurance policies).

The IDD also requires that where the insurance product is the main product and is sold with an ancillary product or service that is not insurance, the customer is informed whether the components can be bought separately.

EIOPA may develop guidelines for the assessment and the supervision of cross-selling practices.

Without going into too much detail here, it will be necessary, at the time of national implementation, to cross-check the rules of say MIFID II and the Directive on Credit agreements for consumers relating to resi-

dential immovable property (*the Mortgage Directive*). In the latter, for example, there is a ban on tying practices with exemptions.

Regarding insurance in this respect, (*Article 12 Mortgage directive*) Member States may allow creditors to require the consumer to hold a relevant insurance policy related to the credit agreement. In such cases, Member States shall ensure that the creditor accepts the insurance policy from a supplier different to his preferred supplier where such policy has a level of guarantee equivalent to the one the creditor has proposed.

The IDD in Article 24 reads as follows: “Where an insurance product is ancillary to a good or a service which is not insurance, as part of a package or the same agreement, the insurance distributor shall offer the customer the possibility of buying the good or service separately. This paragraph shall not apply where an insurance product is ancillary to an investment service or activity as defined in point 2 of Article 4(1) of Directive 2014/65/EU (*“MiFID II”*), a credit agreement as defined in point 3 of Article 4 of Directive 2014/17/EU (*the “Mortgage Directive”*) of the European Parliament and of the Council, or a payment account as defined in point 3 of Article 2 of Directive 2014/92/EU (*Directive on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features*) of the European Parliament and of the Council”.

IDD however, requires from Member States—in all cases of packaging—to ensure that an insurance distributor specifies the demands and needs of the customer in relation to the insurance products that form part of the overall package or the same agreement.

New Rules Regarding Product Oversight and Governance (POG) Requirements

The IDD introduces product oversight and governance requirements for “insurance undertakings and intermediaries which manufacture” any insurance products. POG requirements do not apply to insurance products which consist of insurance of large risks. The Commission is empowered to adopt Delegated Acts to specify the IDD principles on POG.²³

Insurers and intermediaries manufacturing insurance products must maintain, operate and review a process for the approval of each insurance product (or significant adaptation) before it is marketed or distributed to customers. Insurers and intermediaries manufacturing insurance products must also make available to any distributor all appropriate information on the insurance product and the product approval process, including the identified target market of the insurance product.

Insurance distributors advising or proposing products they have not manufactured must have in place arrangements to obtain information on the insurance product and the product approval process and to understand the characteristics and identified target market of each insurance product.

It is important to pay attention to the product design and governance and to ensure that products on offer in the EU market are fit for consumers' needs. In this respect, manufacturers' POG arrangements setting out measures and procedures aimed at designing, monitoring, reviewing and distributing products for customers can play a role to avoid improper selling. However, too many prescriptive requirements on POG should also be avoided to minimise the resulting additional costs and administrative burden that could ultimately get passed on to consumers. In this respect, a clear distinction should be made between investment products and non-life products. Even more important is that the detailed rules (under preparation at the time of writing) should not lead to an overlap with the IDD point-of-sales rules.

Rules which are too prescriptive could result in a real administrative burden, a less innovative, less flexible and less consumer-friendly market.

It is worth noting that no study or impact assessment has indicated a particular need for detailed POG requirements for non-life insurance products (e.g. motor, home) or certain pure-risk life insurance products. It is also worth noting that Article 25 places product governance and oversight requirements mostly on "insurance undertakings, as well as intermediaries which manufacture any insurance product"—and not on intermediaries that do not manufacture products. Article 25 of the IDD furthermore refers to the need of appropriate and proportionate measures.

It is important that level 2 or national rules on POG do not lead to an overlap with the IDD point-of-sales rules and take into consideration the need of appropriate and proportionate measures. Too prescriptive rules could result in a less innovative, less flexible and less consumer-friendly market.

What Are the Key Changes Regarding Cross-border Activities Brought by the IDD?

One of the objectives of the IMD II proposal (later the IDD) was to facilitate single market integration and to promote cross-border activities of intermediaries.²⁴ More clarification is given in the IDD on the division of competence between the home and host Member States. Broadly speaking, when the intermediary is passporting on a *FOS basis*, its home Member State is responsible for ensuring compliance with all IDD requirements. When the intermediary is operating on a *FOE basis*, the host state concerned is responsible for ensuring compliance with IDD information and conduct-of-business requirements. Its home Member State is responsible for everything else.²⁵

All intermediaries are subject to relevant “general good” provisions that the host state may impose. Any Member State which possesses additional “general good”-type rules will need to ensure that these are made publicly available. See also above for the specific case of those Member States that make advice compulsory.²⁶

The host Member State receives more powers in the IDD than in the IMD. An example is the situation where the intermediary who is exercising FOS breaches IDD obligations: the new IDD regime includes provisions on the split of jurisdiction between home and host Member State regulators in such a case. Any breaches of the Directive will need to be referred back to the competent authority of the home Member State in the first instance which can remedy the situation. If not enough, the host Member State can take its own actions to prevent the intermediary from carrying out its activities on its territory or to penalise irregularities.

Another change in this respect, compared to the IMD, is that the Member State of the primary place of business of the intermediary can act as the host regarding Chaps. IV–VII of the IDD, that is, organisational requirements, information requirements and conduct-of-business rules, IBIPs and sanctions.

In other words, according to the IDD, the home Member State may agree that another Member State will act as home Member State if the intermediary's primary place of business is located in that other Member State.

The IDD does not clearly describe the triggering elements of the FOS and FOE activities of an intermediary. This creates legal uncertainty in some cases.

Additional Requirements in Relation to Insurance-Based Investment Products (IBIPs)

The IDD contains a specific chapter with additional requirements for insurance-based investment products distributed by insurance undertakings and intermediaries, meaning that they come on top of the requirements in the general part of the Directive.

The IDD explicitly recognises the differences between IBIPs and investment products and that IDD is the place to regulate them (recital 10) but at the same time indicates that there is need for alignment with MiFID II and that, due to their specific character, there is need for a separate chapter on IBIPs (recital 56).

Intermediaries and undertakings have to make (proportionate) arrangements to prevent conflicts of interest²⁷ from adversely affecting the interests of their customers and must take steps to identify conflicts of interest. If the arrangements are insufficient to ensure that the risk of damage will be prevented, there is a requirement of disclosure of the general nature or sources of conflicts of interest in good time before the conclusion of the contract. Disclosure has to be detailed and has to be done on a durable medium. The IDD contains Delegated Acts to define the “expected steps to be taken” to deal with conflicts of interest and to establish criteria for determining types of conflicts of interest that may damage the interests of customers. In this respect, it is probable that

EIOPA will look at its IMD 1.5 technical advice on conflicts of interest.²⁸

Information regarding the distribution and all costs and related charges has to be provided in good time, before the conclusion of the contract. This includes at least information on the availability or otherwise of a periodic suitability assessment; on the risks and on the costs including the cost of advice and how the customer pays for it including any third-party payments. The presentation of costs and information in general has to be aggregated, on request itemised, where applicable, to be provided regularly and in a comprehensible form (there is a possibility for Member States to standardise). It is to be noted that for IBIPs, there will also be a Key Information Document (KID) according to the PRIIPs Regulation.²⁹

The IDD does not contain a provision as the one in MiFID II on independent advice linked to a ban on commission.³⁰ Instead, IDD leaves it to Member States that for independent advice, they may require the assessment of a sufficiently large number of products available on the market that are adequately diversified.

Where MiFID requires benefits to enhance the quality of the service to the client³¹ (and not against the criteria to act honestly, fairly, professionally and in the best interests of the client), IDD allows them, if there is no detrimental impact on the quality of the service and it is not against the criteria to act honestly, fairly, professionally and in accordance with the best interests of its customers.

The IDD explicitly foresees the possibility for Member States to go beyond (e.g. prohibition of commissions, return to the client). Also in this chapter of additional requirements for IBIPs, the possibility of introducing mandatory advice is explicitly foreseen. Any stricter requirements have to be respected in case of FOS and FOE.

Delegated Acts are expected to specify the criteria for “detrimental impact” and the assessment criteria for compliance of inducements with the requirements to act honestly, fairly, professionally and in the best interests of the customer. They shall take into account the nature of the services and of the products.

Considering the Delegated Acts, the timeline of the IDD is probably not realistic, as legislators may have underestimated the time

necessary to develop realistic level 2 rules. Furthermore, national legislative mechanisms are probably not always adapted to the three-level EU system.

Implementation Challenges

Insurance intermediaries already registered under the IMD I will be given three years after the IDD comes into force, to comply with their respective and relevant provisions of national law related to professional and organisational requirements.

The most important challenge in the introduction of IDD will be to avoid goldplating and the introduction of measures that go beyond the requirements specified in the Directive. Another challenge will be to also have effective level 2 and level 3 measures that do not provide additional layers of requirements. It must be remembered that all of this regulation is cumulative and is extremely costly.

IDD level 2 and 3 measures have the potential, even before goldplating by EU Member States, to heap on additional and unnecessary costs. Sometimes well-meaning regulations or rules target abuses—that whilst serious are thankfully very peripheral to the market—with measures that have consequences for all contracts of insurance and all policyholders who are experiencing no difficulties whatsoever.

I hope that EU Member States won't overregulate and that the IDD will be treated as a maximum (and not a minimum) harmonisation Directive. Once implemented, also considering the new sanctions regime, time should be left to the market and the regulators and supervisors to bring the new rules to reality—this takes time—and to enforce them adequately before creating new rules. In this respect, a point for reflection: The sum of various layers of regulations results in an ever-increasing (often unnecessary) cost which is being borne by consumers and by the European economy at large.

Notes

1. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.
2. Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.
3. Michel Barnier, EU Commissioner responsible for the Internal Market and Services, “Revision of the Insurance Mediation Directive (IMD)—A Priority: consumer protection”- BIPAR Conference at the European Parliament, Brussels, 19 June 2012.
4. Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.
5. Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).
6. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.
7. Jonathan Hill, Commissioner responsible for Financial Stability, Financial Services and Capital Markets Union—“Insurance distribution in the single market—Meeting consumers’ needs in the internet age”—Speech at BIPAR mid-term meetings, Brussels, 30 January 2015.
8. Directive 2014/65/EC of the European Parliament and of the Council on markets in financial instruments.
9. Directive 6404/14 ADD 1 (IMD1.5), Article 98a, Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Chapter VI.
10. Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).
11. Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions.
12. European Commission’s memo on the revision of the IMD, 3 July 2012.

13. Commission 2012 staff working document executive summary of the impact assessment accompanying the document proposal for a Directive of the European Parliament and of the Council on insurance mediation.
14. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 1.2.
15. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 1.3.b-c.
16. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 17.1.
17. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 20.5-7.
18. EIOPA-CP-16-007 Consultation Paper on the proposal for the Implementing Technical Standards on a standardised presentation format of the Insurance Product Information Document (IPID) under the Insurance Distribution Directive (IDD).
19. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 10.2.
20. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 10.2.
21. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Annex 1.
22. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 10.4.
23. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 25.
24. Commission 2012 staff working document executive summary of the impact assessment accompanying the document proposal for a Directive of the European Parliament and of the Council on insurance mediation.
25. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 4.
26. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 4-5.
27. Directive 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, Article 19.
28. EIOPA-BoS-14/061, 21 May 2014, Discussion Paper Conflicts of Interest in direct and intermediated sales of insurance-based investment products (PRIIPs).
29. Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), Article 4.

30. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast), Art. 24.7.b.
31. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast), Art. 24.9.a.

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5

The Potential Effect of Brexit on Insurance Regulation in the UK

Julian Burling

Article 50 Notice

In the consultative referendum held on 23 June 2016, the UK electorate voted by a narrow margin that it should leave the European Union. The UK government has since announced that the requisite notice under article 50 of the Treaty on European Union (TEU) would be given no later than the end of March 2017.¹ The two-year notice period will therefore expire at the end of March 2019.

What Does the UK Government Intend?

Article 50 TEU provides that the EU shall negotiate and conclude an agreement with the leaving state, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship

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with the EU. The agreement is to be concluded on behalf of the EU by the European Council, acting by a qualified majority, after obtaining the consent of the European Parliament. The UK government has said that it is seeking a “bespoke deal” because its objectives of exclusive UK control over immigration and freedom from the direct application of EU legislation and the jurisdiction of the CJEU preclude membership of the EEA on the “Norwegian model”. It has also said that it wants the agreement “to give British companies the maximum freedom to trade with and operate in the single market and let EEA companies do the same in the UK”.² In her speech on 17 January 2017 at Lancaster House, London, on the UK government’s negotiating objectives for exiting the EU, the UK³ Prime Minister, Theresa May, stated 12 objectives which include an agreement giving UK companies the greatest possible access to the EU single market, with reciprocal access for EU companies to the UK market, short of a membership of the single market which would require the UK to accept the “four freedoms” and the jurisdiction of the CJEU. The UK government will seek a phased process of withdrawal to avoid a “cliff-edge” for business or a threat to stability. Otherwise, as at 31 January 2017, the UK government had given no indication of the framework it might seek to achieve for the continuing provision of insurance or reinsurance by UK (re)insurers to customers in EU member states after Brexit, or by EU member-state (re)insurers to customers in the UK.

In the meantime, different committees of the House of Lords and of the House of Commons of the bicameral UK parliament have been considering evidence given to them by insurers and others on what framework would be most desirable. The EU Financial Affairs Subcommittee of the House of Lords has published its report “Brexit: financial services”⁴ (15 December 2016) and the volume of evidence given to it.⁵ The House of Commons Treasury Committee published a report on 27 May 2016, before the referendum, on the economic and financial costs and benefits of the UK’s EU membership⁶ and continued to hear evidence after the announcement of the referendum result⁷ on, inter alia, the allegedly detrimental effect of Solvency II on the expansion of UK (re)insurers’ business outside the EU. The House of Commons Treasury Committee has since then been conducting an inquiry into Solvency II,⁸ on the basis that Solvency II will continue to have an impact on UK insurers if the UK

remains in the EEA or UK companies establish subsidiaries in EU states to gain a EEA passport, and may continue to have an influence even if the UK has a looser relationship with the EU. The Treasury Committee has published the written evidence,⁹ and some of the oral evidence,¹⁰ given to it but has not yet reported any conclusions on it. The parliamentary committees' inquiries and the evidence and conclusions to date are discussed below. It may reasonably be supposed that they will inform the UK government's negotiating position.

The UK government has indicated that it intends to introduce a "Great Repeal Bill" into Parliament in spring 2017.¹¹ That bill is intended to repeal the European Communities Act 1972 (which gives effect to EU legislation as UK domestic law), to transpose into UK law, "wherever practical", all directly applicable EU laws in force at the date on which the two-year notice period under article 50 TEU expires, and to give ministers delegated powers to adapt such transposed legislation to reflect the outcome of the withdrawal negotiations.¹² EU directives previously transposed will be retained in their UK statutory form until so adapted.

Insurance Regulation in the UK: EU Directives

The principal sources of the law currently regulating the carrying on of insurance business and the conduct of insurance mediation activities in the UK are now the "maximum harmonising" Solvency II Directive 2009/138/EC¹³ and the "minimum harmonising" Insurance Mediation Directive 2002/92/EC (IMD), the latter to be replaced with effect from 23 February 2018 (before any Brexit date) by the Insurance Distribution Directive (EU) 216/97 (IDD). Those directives have been transposed into UK primary or subordinate legislation, and EU-Commission-delegated regulations made under the Solvency II Directive¹⁴ have direct effect in the UK, as will the delegated regulations to be made under the IDD. The commencement date of the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation,¹⁵ which will require the provision of a "key information document" to potential purchasers of investment-type insurance products, has been postponed to early 2018, pending resolution of disagreement over the ESA's drafts of the regulatory

technical standards necessary for implementing it, but it can be assumed that it will be included in the Great Repeal Bill. Further, the Association of British Insurers (ABI) has published EU Exit: EU Legislation Mapping Exercise¹⁶ which identifies some 80 EU directives, regulations and decisions that have a particular impact on the insurance and long-term savings market. This chapter focuses primarily on the transposition of the Solvency II Directive and the IMD/IDD and any replacement of them.

Solvency II

The significance of the Solvency II Directive in the context of Brexit is twofold. First, it prescribes the system and the substantive requirements of the authorisation and prudential regulation of insurers (and corporate groups of which they are members) in the UK and other EEA member states, and requires that authorisation by the insurer's home-state supervisor be recognised¹⁷ by the supervisors in other member states. Secondly, in pursuance of the single market in insurance within the EU, it confers "passporting rights", that is rights to provide cross-border services¹⁸ and rights of establishment of agencies or branches throughout the EEA, on all insurers so authorised whose head offices are in the member states. The IMD has a similar twofold function (as will in due course the IDD) as regards insurance mediation activities. These two aspects, authorisation and passporting, require separate consideration in this chapter. Once EU legislation ceases to apply within the UK upon Brexit, any passporting (or similar) arrangements after Brexit for UK firms within the EEA, or for firms from other EEA member states within the UK, will need to be the subject of specific agreement between the UK and the EU under article 50 TEU, and possibly also with each member state concerned. Such arrangements as regards insurers are likely to be part of a larger agreed package including other financial services industries, which may not be precisely focused on the needs of insurers in the UK and the EEA. Failing such an agreement, UK companies wishing to establish a "branch"¹⁹ in a member state will have to apply for authorisation to the supervisor in each member state concerned, which will not be obliged to grant it, under the "third country" provisions in Chapter IX of Title I of the Solvency II

Directive. The substance of the Solvency II authorisation and prudential regulatory regime applicable within the UK, on the other hand, will be continued by the Great Repeal Bill until modified under its provisions.

Current Regime in the UK

Solvency II

The Solvency II Directive is transposed into UK law²⁰ by means of a combination of primary legislation in the form of the Financial Services and Markets Act 2000 (as amended from time to time) (FSMA), orders and regulations made by HM Treasury under FSMA or under the European Communities Act 1972, and rules made by the Prudential Regulation Authority (PRA) (a part of the Bank of England) and published in the *PRA Rulebook* under powers conferred by FSMA. A person or body (other than a firm exercising EEA passport rights) that wishes to carry on “regulated activities”²¹ in the UK, including the regulated activities of “effecting contracts of insurance” or “carrying out contracts of insurance”,²² must have authorisation from the PRA with permission under FSMA Part 4A to carry on those activities and must comply on a continuing basis with the threshold conditions set out in Schedule 6 to FSMA. A (re) insurer authorised by another EEA member state as its home state may exercise its EEA passport rights if it satisfies the establishment conditions or the service conditions set out in Schedule 3 to FSMA.

The prudential rules in the Solvency II Directive are transposed mainly in the *PRA Rulebook*. The conduct regulator, the Financial Conduct Authority (FCA), makes rules under FSMA about the conduct of business, published, together with copious guidance, in the *FCA Handbook*.

The provisions for portfolio transfers and their effect throughout the EEA consolidated in the Solvency II Directive are transposed in Part VII of FSMA. The Solvency II Directive also consolidated other insurance directives such as the Insurers Reorganisation and Winding-Up Directive (2001/17/EC), which provides for coordination by the home-state competent authorities of reorganisation measures throughout the EEA and priority for direct insurance policyholder claims (subject to any rights

in rem) in the event of a winding up. These are transposed into UK legislation by the Insurers (Reorganisation and Winding-Up) Regulations 2004²³ and the Insurers (Reorganisation and Winding-Up) (Lloyd's) Regulations 2005.²⁴ Both sets of provisions are valuable measures irrespective of the merits or otherwise of the Solvency II prudential regulation regime and seem worth preserving in the withdrawal arrangements if feasible.

In addition to rules transposed from the Solvency II Directive, the PRA has recently introduced a Senior Insurance Managers Regime²⁵ (SIMR), complementary to Solvency II, which amended the FSMA-approved persons regime to include some aspects of the Senior Managers Regime introduced for banks, increasing individual responsibility. The PRA considers this a key reform and is not likely to weaken it.

IMD/IDD

The IMD was transposed into UK law by means of amendments to the definition of “regulated activity” for the purpose of FSMA²⁶ to include buying or selling “relevant investments”²⁷ as agent, making arrangements for another person to buy or sell relevant investments; assisting in the administration and performance of insurance contracts (otherwise than mere expert appraisal, or loss adjusting or managing claims on behalf of an insurer); and advising on buying or selling relevant investments. These activities are labelled “insurance mediation activities” in the *FCA Handbook*, broadly in line with, but not identical to, the definition in the IMD. Following the IMD, activities relating to large risks situated outside the EEA (inter alia) are excluded from the list of regulated activities in the Regulated Activities Order.²⁸ Persons or bodies wishing to engage in insurance mediation activities in the UK need, unless they have EEA passporting rights, to be authorised by the FCA under FSMA with Part 4A permission to carry on the relevant regulated activities. The FCA registration and professional, financial and solvency requirements that transpose the IMD are also in the *FCA Handbook*, including detailed client money rules. Anticipating the IDD, the *Insurance: Conduct of Business Sourcebook* (ICOBS) (non-investment conduct of business requirements)

contained in the *FCA Handbook* extends beyond intermediaries to insurance selling and distribution activities carried on directly by insurers in the UK. ICOBS also transposed (in part) the EU Distance Selling of Financial Services Directive (2002/65/EC) and the EU E-Commerce Directive (2000/31/EC).

The IDD builds on the IMD in several respects. It covers all sellers of insurance products, including insurers that sell directly to customers. “Insurance distributor” is defined so as to include any insurance intermediary, ancillary insurance intermediary²⁹ or insurance undertaking. It covers “insurance distribution” activities: in summary advising on, proposing, or carrying out other work preparatory to the conclusion of contracts of insurance, concluding such contracts, or assisting in the administration and performance of such contracts, in particular in the event of a claim, but claims-related activities carried out on behalf of insurers remain excluded as under IMD (and the RAO). It also includes the operation of aggregator websites or other media when the customer is able to directly or indirectly conclude an insurance contract using a website or other media.

The IDD simplifies passporting by requiring each member state to provide a “single information point” for access to all registers of (re)insurance intermediaries and ancillary insurance intermediaries; and requiring the European Insurance and Occupational Pensions Authority (EIOPA) to maintain a website coordinating such single information points. “General good” type rules applicable to passporting intermediaries will be required to be publicly available. EIOPA will establish links to the relevant websites for that purpose and will be required to review such rules. Unlike the current regime, host member states will not generally be able to take action for breaches of the directive by passporting intermediaries but will have to refer them back to the home state’s supervisor. This will, pending Brexit at least, affect the FCA’s current practice.

The IDD introduces principles that insurance distributors must “always act honestly, fairly and professionally in the best interests of customers” and that information provided to customers must “fair, clear and not misleading”, virtually repeating two of the FCA’s Principles for Businesses. The IDD introduces new requirements for the provision of information to be provided to customers about the nature and basis of remuneration received in relation to an insurance contract but not the

amount of remuneration received from the insurer or other third parties. These requirements add little to what is already required of the customer's agent by English common law or by ICOBS.

It also imposes stricter organisational and professional competence requirements and higher professional indemnity insurance limits.

The IDD also imposes new requirements about cross-selling in packaged products (to be the subject of EIOPA guidelines) and product oversight and governance requirements (to be subject to principles specified by the EU Commission in Delegated Acts). These new requirements parallel similar requirements already imposed by the FCA in the UK. There are additional requirements concerning the identification and prevention of conflicts of interest, information to customers and product suitability applicable to PRIIPs.

How the IDD is to be transposed in the UK is not yet known: a consultation document due to be published by the FCA on 24 February 2017 will allow for a three-month consultation period with a feedback date in July 2017.³⁰ Amendments are expected to the SYSC, TC, MIPRU, IPRU(INV), ICOBS and DISP sourcebooks within the *FCA Handbook*.

Rather than rely on the formal ICOBS rules in regulating conduct, the FCA has tended to rely on the Principles for Businesses in the FCA Handbook. Principle 6 requires that a firm pay due regard to the interests of its customers and treat them fairly. This became known as the “treating customers fairly” principle, or “TCF”, which was expressed in 2006 in a set of six desired “outcomes”. The FCA now focuses on “conduct risk”, the potential risks to customers arising from poor conduct by financial services providers, and expects those providers to be able to identify and mitigate such risks.

Brexit and Solvency II: How Far Can Passporting Survive?

At the time of writing, the attention of many UK general insurers is focused on preserving, so far as possible in substance if not form, current passporting rights throughout the EEA. It is widely assumed that the price of any equivalent of passporting rights will be the continuation

of an authorisation, solvency and prudential supervision regime which substantially embodies the Solvency II acquis. If negotiations failed to obtain some kind of provision for sufficient continuing access to the single market, there might be some pressure from parts of the UK insurance industry for a prudential regulatory regime that was perceived as less onerous than Solvency II but sufficiently rigorous and compatible to be accepted by supervisors in significant non-EEA markets as a basis for entry to them. The House of Commons Treasury Committee is currently conducting an enquiry into the Solvency II regime, including proposals for change to the UK solvency regime in a variety of alternative outcomes to the EU Brexit negotiations. Accordingly, this chapter considers various possible options or potential outcomes as regards the continuing participation by UK insurers in the various EU insurance markets, together, in each case, with what modifications of, or alternatives to, Solvency II might be adopted in those outcomes.

The main possible alternatives for (reciprocal) UK–EU market access after Brexit seem to be as follows.

1. A framework agreement conferring the equivalent of passporting rights on UK (re)insurers throughout the EEA and reciprocal rights in the UK for EEA member-state-authorised (re)insurers.
2. If general passporting rights cannot be achieved, then a UK direct insurer will set up a subsidiary in an EU member state and have it authorised in what will be the subsidiary's home state and so entitled to actual passporting rights, but subject to the group provisions in the Solvency II Directive. If the UK were to retain sufficient elements of Solvency II in its own regulatory regime, it could be afforded equivalence status for group solvency (art 227) and group supervision (art 260) purposes in the EU, with reciprocal equivalence recognition for EU member state company subsidiaries established in the UK.
3. Reinsurance provided by UK reinsurers to EU member state (re)insurers could be treated in the same manner for solvency purposes as that provided by EU member-state reinsurers, recognising the UK solvency regime as equivalent to Solvency II under art 172.
4. Rather than establishing and capitalising subsidiaries, some UK direct insurers may set up "third country branches" in EU member states.

Some of the requirements for third-country branches, particularly deposit and asset localisation requirements, could be modified by ad hoc provisions in the withdrawal agreement in their application to UK insurers on the basis that the UK's solvency regime is "equivalent" and sufficiently rigorous.

In any event, to avoid disruption to direct policyholders and those covered by reinsurance in EU member states and the UK, some period of transitional grandfathering of the mutual recognition of the current authorisations of (re)insurers under Solvency II will be necessary.

Initially at least, each of the above alternatives will probably be dependent on the UK and EU solvency regimes remaining substantially parallel, with no significant divergence by the UK from Solvency II (or any successor EU regime) and some kind of equivalent within the UK system of any substantial and significant developments of Solvency II.

Each of the above alternatives is now briefly discussed in turn.

1. *Reciprocal rights equivalent to passporting rights*

In 2016, 220 UK authorised insurers had at least one outbound EU passport under the Solvency II Directive and 726 EEA insurers held at least one inbound passport,³¹ so there may be interest in some other EU member states in reciprocity as regards the best that can be achieved analogous to passporting.³² One of the written questions put by the House of Commons Treasury Committee inquiry on Solvency II was

2 e) "Is Solvency II a price worth paying for the passporting of insurance services across the EEA?"

A large majority of the 38 written responses thought that it would be.³³ Negative or equivocal responses largely came from life insurers or pension and annuity providers whose business was wholly or mainly outside the EEA. If the UK government's refusal to permit the absolutely unrestricted movement of member-state residents into the UK, and reservations generally about the disruptive influence of Brexit on the coherence of the EU, could somehow be accommodated, it would then be necessary to

retain the transposition of the Solvency II Directive and transpose extant (and future) Delegated Acts and Implementing Technical Standards (but not the enforcement powers of the EU Commission or of EIOPA) into the UK statutory framework, initially under the Great Repeal Bill, or to devise some adequate equivalent of it—an ad hoc overall “equivalence” provided for by the withdrawal agreement. Continued passporting might have to be provisional, conditional on the UK’s continuing readiness to transpose that EU legislation or maintain that (developing) equivalent. It might be possible to devise a two-tier system, with the Solvency II regime (or equivalent) applying only to UK-authorized insurers having EEA passports and a different one covering, for example, life insurers carrying on business only in the UK, for which the Solvency II regime was in some respects inappropriate. There is already a separate set of provisions in the PRA rulebook for smaller insurers (non-Solvency II firms) but to establish an additional regime for substantial life insurers might require disproportionate effort.

2. Establishment of subsidiaries in member states

Many groups with head offices in the UK (and many non-UK head office groups with branches or subsidiaries in the UK) have established insurance subsidiaries with head offices in (other) EEA states to write new or renewal business there and to exercise EEA insurance passporting rights. Lloyd’s has also announced its intention to do so in anticipation of Brexit. Such subsidiaries are authorized and supervised by the competent authority in the EEA state where their head office is. In addition to their application to each EEA insurer on an individual (“solo”) basis, Solvency II supervision, solvency requirements, reporting requirements and governance and risk management requirements are applied to entire company groups that contain one or more EEA-state-authorized insurers.

Supervision of a group with insurance operations in more than one EEA member state is exercised and coordinated by the authorising supervisor in one of those states, identified in accordance with art 247 of the Solvency II Directive. That group supervisor chairs a “college of supervisors” comprising EIOPA and the supervisors in each state where one of the subsidiary insurers is authorized. Supervisors in states where there are

significant branches or “related undertakings”³⁴ may also be included. Where a group having insurance operations within the EEA is headquartered in a non-EEA jurisdiction that has an “equivalent” supervision regime (as determined under art 260), EEA state supervisors must under art 261 rely on the group supervision exercised by the supervisory authority of that non-EEA state, applying the group supervision facilitation requirements of arts 247–258 *mutatis mutandis*. Where there is no such equivalence, the group will be supervised within the EEA by applying Solvency II requirements *mutatis mutandis* to the entire group or by other methods agreed by the EEA group supervisor after consulting the other relevant EEA state supervisors.³⁵ At the time of writing (27 January 2017), only Switzerland and Bermuda were recognised as having such equivalent regimes. Japan is temporarily equivalent.

A solvency capital requirement (SCR) and own funds have to be calculated for all the insurers in the group in aggregate, as well as for each individual EEA-headquartered insurer. Where an EEA headquartered group has operations outside the EEA, it may be possible to apply local capital rules to those operations, if the group SCR is carried out using the “deduction and aggregation” method, where the jurisdiction in question is regarded as having an “equivalent” solvency regime under art 227. At the time of writing, only Bermuda and Switzerland are regarded as fully equivalent for art 227 purposes. Australia, Brazil, Canada, Japan, Mexico and the USA are temporarily equivalent.

“Equivalence” for the purposes of arts 227 and 260 is to be determined in the first place by the EU Commission, by Delegated Act, with the assistance of EIOPA, in accordance with criteria adopted by the Commission for that purpose.³⁶ The determinations are subsequently to be reviewed regularly. The published criteria do not require exact replication of the respective Solvency II regimes. Because of concern that EEA groups operating in important non-EEA markets would be at a disadvantage where the regimes in those markets had not attained full equivalence status, “provisional” equivalence status can be granted for (successive periods of) ten years for the purpose of art 227 and “temporary” equivalence status for up to six years for the purpose of art 260, in each case by Delegated Acts of the EU Commission, if certain specified criteria are satisfied. However, the “temporary” equivalence status under art 260 as regards the

supervisory regime can be granted only in the case of an undertaking whose parent has its head office outside the EU on 1 January 2014, which would seem to exclude UK-headquartered groups after Brexit.

Subsidiaries of UK-headquartered groups and their other group members will hope to be able, after Brexit, to (continue to) apply UK rules for calculating the SCR and own funds of group members with head offices in the UK under the “equivalence” provisions in art 227 of the Solvency II Directive. They will also hope to avail themselves after Brexit of the requirement in art 261 that the EEA home state of the subsidiary rely on the group supervision exercised by the PRA on the basis that the UK group supervision regime is recognised as “equivalent” under art 260. In the initial period, this is likely to depend on the retention by the UK of much of the substance of the Solvency II regime. EEA groups with UK insurance subsidiaries will realistically hope for reciprocity in this respect, given the UK government’s stated objective of maximising operation by EEA and UK companies within the EEA and the UK. “Temporary” equivalence (until 2020) under art 260 might be too short-lived, so this would have to be provided for ad hoc in the withdrawal agreement. “Provisional” equivalence could be recognised under art 227 for a succession of periods of ten years. It should be borne in mind that “equivalence” provisions are described in the House of Lords EU Financial Affairs Subcommittee report as “patchy, unreliable and vulnerable to political influence”.³⁷ Similar observations were made in evidence given to the House of Commons Treasury Committee’s inquiry into Solvency II.

There are no “equivalence” provisions as regards group governance and risk management and reporting requirements such as those to produce an ORSA and SFCR for the group.

Incidentally, the IMD and IDD contain no equivalence provisions, but it is much easier to set up and capitalise a new insurance intermediary subsidiary than an insurer.

3. *Reinsurance*

The London Market is a primary centre for reinsurance. Article 172 of the Solvency II Directive requires that reinsurance contracts concluded with a reinsurer having its head office in a non-EEA state with a solvency regime

deemed equivalent under that article shall be treated for solvency purposes in the same manner as reinsurance contracts concluded with EEA-state-authorised reinsurers. In the absence of such equivalence, EEA member states would be able to require the provision of collateral by the reinsurer. “Temporary” equivalence until 2020 might be too short-lived. Again, considerations of reciprocity for EEA reinsurers of UK companies would suggest more permanent ad hoc provision within the withdrawal agreement.

4. *Third-country branches*

Some UK direct insurers will apply for third-country branch authorisations in EU member states under Chapter IX of Title I of the Solvency II Directive. Supervisory authorities may give such authorisations under those provisions but are not obliged to do so. Article 162 requires, inter alia, the local maintenance of accounts and records relating to business transacted through the branch; the localisation in the host state of assets equal to at least half of the absolute floor prescribed by art 129(1)(d)³⁸ for the MCR as regards the business effected through the branch and the maintenance there of a deposit equal to a quarter of that floor; the giving of an undertaking to calculate and cover the MCR and SCR in respect of operations effected through the branch and the submission of a scheme of operations and fulfilment of the Solvency II governance requirements. Branches have no cross-border services rights.

Where the insurer concerned has branches in more than one EEA member state, then under art 167, if all the host state supervisors so agree, the localised assets and the deposit may all be maintained in any one of the member states concerned and the SCR shall be calculated for the totality of the branch business carried on in the EEA.³⁹ The application for those advantages under art 167 is to select the supervisory authority which is to be responsible for supervising the solvency of the entire business of the EEA branches of that insurer. The advantages conferred under art 167 are precarious because on the request of any one of the host-state supervisors they must be withdrawn by all of them.

Article 171 provides for the EU to agree with third countries different arrangements from the third country branch provisions in arts 162–171 “for the purpose of ensuring, under conditions of reciprocity, adequate protection for policyholders and insured persons in member states”. It is

not known how this provision is intended to be applied but presumably some of the requirements under arts 162–166, particularly deposit and asset localisation requirements, could be omitted or modified in their application to UK insurers on the basis that the UK’s solvency regime is “equivalent” and sufficiently rigorous. More ambitiously, whereas authorisation by member states’ supervisors under art 162 is permitted rather than mandatory, recognition of the UK’s solvency regime as substantially equivalent to Solvency II could be a basis for mandatory authorisation of branches of UK insurers throughout the EU under an art 171 agreement or under the withdrawal agreement. Whatever is negotiated will presumably be reciprocally applicable to EEA insurers, *mutatis mutandis*. Two witnesses to the House of Commons Treasury Committee on Solvency II considered that art 171 potentially gave provision for the codification of a third-party regime and reciprocity agreement.⁴⁰

There is no consistent approach on how third-country insurers are to be regulated in the mere cross-border provision of services into EEA member states. This depends mainly on the interpretation by each member state of “the taking up and pursuit, within the community, of the self-employed activities of direct insurance and reinsurance”.⁴¹ In the UK, the regulated activities of effecting or carrying out contracts of (re)insurance involves the carrying on of the relevant activities within the UK,⁴² whether by the principal insurer or through an agent. There is no general provision in the insurance regulatory regime which prohibits UK persons taking out insurance abroad with non-EEA insurers not authorised by the PRA in respect of UK situs risks, as long as the overseas insurer in question does nothing that is regarded as carrying on insurance business in the UK. The EU Commission has, however, recently opined⁴³ that the insurance of EEA situs risks by a third-country insurer requires the establishment of a branch.

UK Insurance Regulation After Brexit

Insurance industry evidence to House of Commons Treasury Committee inquiry on Solvency II

The House of Commons Treasury Committee contemplated four possible options for the UK’s future relationship with the EU:

- (a) Remaining in the EEA;
- (b) Leaving the EEA but seeking passporting rights for financial services;
- (c) Severing all connections with the EU/EEA, releasing itself from any obligation to adhere to EU law but retaining all UK legislation which up to Brexit had implemented EU directives;
- (d) Severing all connection with the EU and EEA and repealing all legislation derived from EU law, replacing it with whatever domestic legislation is thought desirable, for example reinstating the Insurance Capital Adequacy Standards (ICAS)⁴⁴ regime which preceded Solvency II in the UK.

It decided to inquire into the operation of Solvency II and its strengths and weaknesses in the context of those options. The objects of the inquiry were to

- (a) consider the options for the UK insurance industry that are created by the decision to leave the EU;
- (b) assess any impact of Solvency II on the competitiveness of the UK insurance industry;
- (c) examine the impact of Solvency II on the role of insurance in meeting the needs of UK customers and the wider UK business economy;
- (d) assess any learning for both regulators and industry from the introduction of this major piece of insurance-harmonising legislation.⁴⁵

The Treasury Committee was at the outset much influenced by a remark of Lord Turnbull, former Permanent Secretary to the Treasury and former Cabinet Secretary (who had subsequently for a time been a director of Prudential plc) in evidence given to the Committee on 28 June 2016 following up its earlier report on the economic and financial costs and benefits of the UK's EU membership, that Solvency II was in his opinion "an absolutely dreadful piece of legislation" because it treated insurers like banks, as though they had to mark to market every day.⁴⁶ He went on to say that companies with very little business in the EU single market were hampered by Solvency II in expanding into other

markets in Asia and the USA and were disadvantaged relative to a US or Canadian company. The Treasury Committee's written questions in its Solvency II inquiry asked whether respondents agreed with that view, whether the creation of a two-tier regulatory system fostered regulatory arbitrage.

As regards the future development of Solvency II the Committee's written questions were as follows:

- (a) What are the principal developments or adjustments that you would like to see made to Solvency II in an ideal world? Where relevant, please include an indication of time scale, priority, rationale and "real world" constraints.
- (b) Given the potential increased flexibility that may be available following the UK's exit from the EU, should the UK seek alternatives to Solvency II for insurance regulation (such as a regime similar to the old ICAS regime, or a differentiated regulatory regime which varied according to an insurer's size or customer base)?
- (c) Lord Turnbull said in evidence to this Committee that "it will actually help insurance companies if we can leave the [Solvency II] arrangement" which "treats insurance companies as though they were banks". Should the UK Government seek to withdraw from Solvency II?
- (d) Sam Woods⁴⁷ said in evidence to the Committee⁴⁸ that there were elements which he would like to change—he said that the calculation of the risk margin (projecting forward insurance and capital grants until they run off and then discounting them back at the risk-free rate, so that the risk margin increases as the risk-free rate drops) "is the most obvious one" and "I would like to have some more macro-prudential flexibility in the regime".⁴⁹ Should the UK seek to amend, or withdraw from, these, or any other elements of Solvency II?
- (e) Is Solvency II a price worth paying for the passporting of insurance services across the EEA?

The Treasury Committee received 38 written responses⁵⁰ and started hearing oral evidence on 17 January 2017. There was no overwhelming appetite for a fundamental review of Solvency II. General insurers

having business in EEA member states considered that Solvency II was a price worth paying for the single market passport. Among these, the Lloyd's and London Market insurers⁵¹ were also very reluctant to abandon Solvency II after spending so much time and money implementing it. General insurers not having business in EEA member states were less concerned to preserve it. Many commentators were reluctant to lose a rigorous system of global repute which is often treated as an equivalent regime by non-EEA state regulators.

Life (and composite) insurers and annuity providers considered that Solvency II capital requirements were disproportionately onerous, failed to take adequately into account the long-term nature of their business and could not sufficiently quickly be modified to do so. Some regarded the risk margin as fundamentally flawed. The risk margin and the matching adjustment and volatility adjustment in the long-term guarantee package, as implemented by the PRA,⁵² with a requirement for a separate fund, in their view exacerbated procyclical risk, exacerbated by the PRA's use of benchmarking. They were not sufficiently permitted by the SCR rules to invest in infrastructure projects or real property suitable to match their long-term liabilities; rules did not keep up with the development of new asset classes. This was regarded by some of them as a serious hindrance to the competitive development of life and annuity business in Asia. Written and oral evidence given by the ABI reflected these concerns. Some large life insurers echoed Lord Turnbull's view that banking regulatory technology had been inappropriately imported into insurance regulation.

A common complaint among both general and long-term insurers was that the PRA had implemented Solvency II unduly rigorously, a matter that was in the PRA's gift. The SCR internal model approval process was thought to be unduly protracted.

Evidence given by accountants and actuaries advising the industry, and their professional bodies, reflected the views of their general and life insurer clients.

There was a widespread view that a period of transition would be needed to whatever regime followed Brexit to give policyholders certainty of cover.

Reform of the UK Regulatory Regime After Brexit

As the PRA observed in its written evidence to the Treasury Committee on Solvency II,⁵³ reviews of various aspects of Solvency II by the EU Commission and by EIOPA are already in train, and further reviews are contemplated. The first, relating to the Solvency Capital Requirement (SCR) is due to be completed by the end of 2018 and a review of long-term guarantee measures by the end of 2021. In September 2015, the European Commission called for evidence in relation to the EU regulatory framework for financial services. The Bank of England's (PRA's) response noted the Commission's support for sensible adjustments to the Solvency II framework. The PRA is considering the inclusion of macroprudential tools in Solvency II. Reflecting the views of many insurers who were subsequently to give evidence to the Treasury Committee, the PRA also proposed revision of the risk margin because of its excessive volatility in response to current interest rates. The Commission has already proposed amending the standard formula for the treatment of infrastructure assets, a major concern of life insurers and pension and annuity providers. The PRA also supports lowering capital charges for simple, transparent and standardised (STS) securitisations and a review of charges for non-STS capitalisations. The PRA has also recommended a review of differences between currencies in the extrapolation of discount rates to the ultimate forward rate (UFR) and of the definition of "financial institution" for the purpose of calculating group solvency. It can reasonably be supposed that any such revisions would be tracked by the UK regulatory scheme after Brexit.

Thus the PRA has already been addressing some, but by no means all, of insurers' complaints about the implementation and operation of the Solvency II regime in the UK, irrespective of Brexit. In the short term, Brexit may prove a distraction from the pursuit of such revisions by the PRA and the EU bodies concerned.

In the longer term, it is conceivable that the concerns of very large and influential life insurers with no interest in developing business within the EEA might be accommodated by the establishment of (another) separate non-Solvency II regulatory regime in the UK devised for their (and

their customers’) needs. Less likely seems the establishment of an additional non-Solvency II UK regime for those general insurers who have no interest in EEA business. Another possibility is that the monetary limits of the scope of the existing regime for “non-Solvency II firms” might be increased to accommodate some such general business insurers. General insurers wishing to avail themselves of whatever quasi-passporting rights might be achieved for UK insurers in the Brexit withdrawal negotiations, or those wishing to establish subsidiaries or third-country branches in EEA member states are likely to have to comply with some regime that is more or less equivalent to Solvency II, inheriting many if not most of its features (as revised from time to time), rather than being subject to a newly developed UK model. Judging by evidence to the Treasury Committee inquiry on Solvency II, there is insufficient appetite among general insurers for resurrecting the pre-Solvency II ICAS system (although some suggested it). In any event, the current development of the Risk-Based Global Insurance Capital Standard (ICS) by the International Association of Insurance Supervisors (IAIS) for internationally active insurance groups seems likely to influence the future development and convergence of national regimes applicable to individual insurers, including the EU review of the SCR.

The UK transposition of the IDD (and quite possibly the transposition under the Great Repeal Bill of the delegated acts) seems unlikely to be significantly modified after Brexit. The UK has already goldplated the IMD to such an extent that the IDD adds little to the current UK regime for intermediaries.

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Notes

1. Reply of the Secretary of State for Exiting the European Union on 15 December 2016 to Parliamentary written question: <http://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2016-12-08/56750/> (last accessed 13 January 2017).

2. Prime Minister's speech to the Conservative Party Conference 2 October 2016 <http://www.conservativehome.com/parliament/2016/10/britain-after-brexit-a-vision-of-a-global-britain-theresa-mays-conservative-conference-speech-full-text.html> (last accessed 14 January 2017).
3. <https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech> (last accessed 25 January 2017).
4. 15 December 2016 <http://www.publications.parliament.uk/pa/ld201617/ldselect/ldcom/81/8102.htm> (last accessed 14 December 2016).
5. <http://www.parliament.uk/documents/lords-committees/eu-financial-affairs-subcommittee/Brexit-financial-services/Brexit-financial-services-evidence-volume.pdf> (last accessed 14 December 2016).
6. *The economic and financial costs and benefits of the UK's EU membership*, 27 May 2016. <http://www.publications.parliament.uk/pa/cm201617/cmselect/cmtrasy/122/12202.htm> (last accessed 14 December 2016).
7. <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-economic-and-financial-costs-and-benefits-of-uks-eu-membership/oral/34669.html> (last accessed 14 December 2016).
8. And the UK legislation transposing and implementing it; for announcement and terms of reference: <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/eu-insurance-regulation-inquiry-16-17/> (last accessed 30 January 2017).
9. <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2015/eu-insurance-regulation-16-17/publications/> (last accessed 14 January 2017).
10. Given on 17 January 2017, <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/oral/45352.html>; and 25 January 2017, <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/oral/46149.html>
11. HC Deb 10 October 2016 c40.
12. For an indication of what might be involved see the House of Commons Library briefing note *Legislating for Brexit: the Great Repeal Bill*. <http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7793> (last accessed 13 January 2017).

13. As amended.
14. Principally the Delegated Regulation 2015/35.
15. Regulation (EU) No. 1286/2014.
16. <https://www.abi.org.uk/-/media/Files/Documents/Publications/Public/2016/EU%20exit/EU%20legislation%20mapping.pdf> (last accessed 13 January 2017).
17. Subject to possible conditions in the “general good”: Solvency II Directive arts 77, 85.
18. The EU Commission regards this as necessary for covering a risk situation in another member-state even if the contract of insurance is concluded in the insurer’s home state: *Commission Interpretative Communication—Freedom to provide services and the general good in the insurance sector* Official Journal C 043, 16/02/2000 P. 0005–0027. <http://publications.europa.eu/en/publication-detail/-/publication/7a36e3e8-de3f-4942-b18b-153817da3b8d/language-en> (last accessed 13 January 2017).
19. Defined in Solvency II Directive art 13(11) as “an agency or branch of an insurance or reinsurance undertaking which is located in the territory of a Member state other than the home Member state”.
20. The relevant legislation applies throughout the entire UK although England and Wales, Scotland and Northern Ireland have separate legal systems.
21. Defined in the Financial and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001/544, as amended from time to time, (in this chapter the “Regulated Activities Order” or “RAO”).
22. ie paying claims.
23. SI 2004/353.
24. SI 2005/1998.
25. See PRA CP 26/14. *Senior insurance managers regime: a new regulatory framework for individuals*, November 2014. <http://www.bankofengland.co.uk/prd/Documents/publications/cp/2014/cp2614.pdf> (last accessed 15 January 2017).
26. Provided in the Financial and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001/544, as amended by the Financial and Markets Act 2000 (Regulated Activities) (Amendment)(No 2) Order 2003 SI 2003/1476.
27. Redefined (*ibid*) so as to include all types of insurance.
28. RAO art 72D.

29. A person whose principal professional activity is other than insurance distribution and who distributes only insurance products that are ancillary to a good or service and who does not distribute life assurance or liability risks unless that cover complements the goods or services provided as the principal professional activity.
30. FCA Policy Development Update 24 January 2017. <https://www.fca.org.uk/news/policy-development-update> (last accessed 26 January 2017).
31. FCA letter 17 August 2017 to the House of Commons Treasury Committee <https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.PDF> (last accessed 14 January 2017).
32. Further, 2758 UK authorised firms held at least one outbound passport under the IMD, and 5727 at least one inbound one: *ibid.*
33. <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2015/eu-insurance-regulation-16-17/publications/> (last accessed 14 January 2017).
34. As defined in art 212(1)(c).
35. Art 262.
36. Arts 379–380 respectively of the Delegated Regulation 2015/35.
37. Summary, p3.
38. For example, a minimum of €2.5 m for pure non-life insurers except where one or more of classes 10–15 are written, in which case it is a minimum of €3.7 m.
39. Solvency II Directive, art 167.
40. Portas, Smart, 17 January 2017: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/oral/45352.html> (last accessed 30 January 2017).
41. *Ibid.*, art 2(1).
42. As extended by FSMA s.418 in certain cases.
43. At a meeting of the “Expert Group on Banking, Payments and Insurance” on 14 July 2015, http://ec.europa.eu/finance/general-policy/docs/expert-group/150714-minutes_en.pdf (last accessed 15 January 2017). For comments on this see Maddock, G. “Authorising third country insurance firms: has the Commission got it wrong?” In Herbert Smith Freehills’

- Financial Services Regulation and Corporate Crime Notes*, 25 August 2015. <http://hsfnotes.com/fsrandcorpcrime/2015/08/25/authorising-third-country-insurance-firms-has-the-commission-got-it-wrong/> (last accessed 15 January 2017).
44. ICAS itself built on Solvency I and was influential in the design of Solvency II.
 45. Terms of reference and written questions for consultation. <http://www.parliament.uk/documents/commons-committees/treasury/Terms%20of%20reference/EU-insurance-regulation-ToR-16-17.pdf> (last accessed 15 January 2017).
 46. Treasury Committee, Oral evidence: Follow up to the Committee's Report on The UK's Future Economic Relationship with the European Union, HC 483, Tuesday 28 June 2016, Q23.
 47. From 8 April 2016 Deputy Governor of the Bank of England and CEO of the PRA, previously Director of Insurance, PRA.
 48. Giving evidence to the committee on his appointment as chief executive officer of the PRA on 19 July 2016: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/appointment-of-sam-woods-as-deputy-governor-for-prudential-regulation-and-chief-executive-of-the-pra/oral/35233.html> (last accessed 30 January 2017).
 49. He also told the Committee, at the same hearing, that he did not agree with Lord Turnbull.
 50. For a list of written responses see <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2015/eu-insurance-regulation-16-17/publications/> (last accessed 15 January 2017).
 51. The views of some of whom were represented in written submissions by the International Underwriting Association (IUA), the London Market Group (LMG) or Cooley LLP.
 52. Huw Evans, Director General, ABI, gave evidence that the ABI had identified 23 different areas where the PRA had discretion under Solvency II (including the risk margin, a view disputed by the PRA): HoC Treasury Committee 25 January 2017, Q 136: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/oral/46149.html> (last accessed 30 January 2017), q.

53. <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/written/43626.html>

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Part II

Supervision and Risk Governance Under Solvency II

6

Solvency II in the UK: Evolution Rather than Revolution

David Humphry

Background

This chapter provides a brief overview of the UK insurance industry. It goes on to describe the problems affecting the industry that motivated a fundamental change in prudential regulation post the turn of the twenty-first century. In making these changes, the UK felt that it could not afford to wait for the arrival of Solvency II. The chapter describes the changes the UK made. It then compares the common elements between the UK's regime that pre-dated Solvency II and Solvency II. The chapter highlights that Solvency II represented an evolution of insurance regulation for the UK rather than a revolution. Nevertheless, despite the similarities, there have been challenges in adapting to Solvency II.

The author can be contacted via: david.humphry@bankofengland.co.uk. Any views expressed in this chapter are solely those of the author and so cannot be taken to represent those of the Bank of England or to state Bank of England policy. This paper should therefore not be reported as representing the views of the Bank of England or members of the Monetary Policy Committee, Financial Policy Committee or Prudential Regulation Committee.

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Overview of UK Insurance Industry

The UK insurance industry is the third largest in the world (behind that of the USA and Japan) and the largest in Europe.¹ It manages investments of £1.8 trillion, equivalent to approximately 25% of the UK's total net worth.² Approximately, 500 firms are authorised to provide insurance in the UK.³ Subsidiaries and branches of non-UK firms accounted for 58% of UK gross premiums for non-life insurance and 16% of life gross premiums in 2014.⁴

The UK insurance industry provides cover against a diverse set of risks and it plays an important role in the savings market. It consists broadly of the following:

- general or non-life insurance, which provides protection against the impact of particular events happening. This includes personal and commercial lines of business. The London market is a prominent part of the provision of general insurance. It consists of the Lloyd's insurance market, insurers, reinsurers, Protection and Indemnity clubs, brokers and other companies that are typically physically located in the City of London;
- life insurance, which are long-term policies offering protection, saving and investment, and decumulation products, such as annuities; and
- reinsurance, which is insurance purchased by an insurance company from one or more other insurance companies (the "reinsurer") as a means of risk management.

Around 325 firms are authorised to write general insurance liabilities and 195 are authorised to write life insurance.

The Turn of the Twenty-First Century—Difficult Times for the Industry—An Impetus for Regulatory Changes

Around the turn of the century, the UK insurance industry found itself in a state of malaise. It had been beset by mis-selling scandals and weak financial performance. Starting with the life insurance sector, there had

been mis-selling of personal pensions. The government provided incentives from 1988 to 1993 to encourage individuals to contract-out from the State Earnings Related Pension Scheme (SERPS), by making tax rebate contributions to a personal pension in return for the individual foregoing their claim to the SERPS.^{5,6} By April 1989, 3.5 million Approved Personal Pensions had been taken out, a figure which rose to 5.6 million in 1994–1995.⁷ Many of these sales turned out not to be in the customer's interest and were the result of poor advice. Insurers and intermediaries had to pay redress to policyholders amounting to £13.5 billion.⁸

Following not long after the pension mis-selling scandal came claims of mortgage endowment mis-selling. Mortgage endowments saw a boom in the 1980s compared with traditional repayment mortgages. Mortgage endowments were intended to be used to repay an interest-only mortgage and were popular as they benefitted from advantageous tax treatment afforded by Life Assurance Premium Relief (LAPR) until 1984 and the introduction of Mortgage Interest Relief at Source (MIRAS) in 1983. In 1988, over 80% of new mortgages used an endowment as the repayment basis.⁹ Many advisers failed to explain, however, to their customers how their money would be invested, the risks involved, or that the policies did not guarantee to repay their mortgage loan. When investment returns fell, many customers found they would face a significant shortfall on their endowment when the time came to repay the principal amount outstanding on their mortgage. Compensation in excess of £2.7 billion was paid to policyholders.¹⁰

Inevitably insurers were affected by compensation payments.¹¹ These payments could not have come at a worse time because life insurers' financial strength was under pressure in other ways. Insurers were adapting to a period of lower inflation and low interest rates, and coming under strain from the terms of business written in the past, and contractual guarantees, in particular. The most high-profile casualty was the enforced closure of Equitable Life to new business in December 2000.

Equitable Life's policyholders were left with significantly lower payments on maturity than they had expected to receive by way of discretionary benefits. The primary reason for this was that Equitable Life had offered a high proportion of its with-profits policyholders a minimum annuity rate on maturity, regardless of the prevailing market rates (known

as a Guaranteed Annuity Rate, or GAR). These guarantees were written at a time of high nominal interest rates. Alongside the GARs, Equitable Life had a policy of 'full and fair' distribution of each year's investment returns, which left it without sufficient free assets above minimum regulatory requirements to meet their GAR liabilities. As a mutual, it also had limited access to additional capital so when the House of Lords ruled in 2000 that Equitable Life could not penalise policyholders exercising their GAR by imposing lower terminal bonuses, the firm was close to breaching its minimum solvency ratio. This led to failed attempts to sell the mutual, closure to new business and one of the biggest crises of the British insurance and pensions sector.^{12,13}

The collapse of Equitable Life was a symptom of wider strain in the UK life insurance industry. Prior to the dot-com crash, firms had begun to run down their capital surpluses in an effort to maintain bonus payouts.^{14,15}

The dot-com crash placed a further strain on insurers' solvency as the UK's FTSE 100 share index dropped by 27% between 2001 and 2003,¹⁶ reducing the value of assets backing with-profit business and solvency. During this time, many insurers also saw their credit rating downgraded, making it costlier to access capital markets.¹⁷

Nevertheless, to address financial weaknesses, a number of companies raised capital during the period 2001–2003.^{18,19} Approximately £13 billion was raised in total.²⁰

Firms also took other measures to alleviate their solvency problems by reducing risk. O'Brien and Diacon (2005) showed that the pace of closure of life funds in the five years post 2000 increased relative to the five years preceding it.²¹ The firms that closed tended to be smaller, financially weaker, and have a higher proportion of their liabilities that were with-profits.

Post the dot-com crash, insurers also took other measures to reduce risk. First, they shifted their asset allocation away from equities to bonds in order to meet embedded guarantees in with-profit products. This change had the effect of worsening investment returns, reducing the scope to pay bonuses, and lessening the attractiveness of with-profits products.^{22,23}

Second, they reduced the proportion of bonuses declared as annual ones and increasing the proportion paid as a final bonus when the policy

matured, giving them increased scope to adjust bonus levels. With fewer guarantees and increased public criticism of the opaqueness and operation of these funds, the sale of new with-profits products fell.

The combination of the effects of mis-selling, a loss in consumer confidence, and solvency problems had a profound effect on the life insurance sector. With-profits products, which had been the flagship product, accounting for the majority of liabilities at the turn of the century never recovered from the problems the industry experienced.

The General Insurance sector was not immune to problems. One of the largest general insurers—Independent Insurance—failed in 2001. Independent Insurance, founded in 1987, had rapidly grown its market share in both personal and commercial insurance, joining the FTSE 100 share index of largest companies in the 1990s. It eventually failed in 2001 because of expansion into riskier commercial lines and fraud, which masked poor underwriting results.²⁴ It became one of the most significant cases administered by the Financial Services Compensation Scheme (FSCS) in the UK with payments totalling over £400 million over a 13-year period.²⁵ Creditors were only able to recover 15 pence in the pound.²⁶

Whilst Independent Insurance was the most high-profile failure, in the decade that preceded its failure, a total of 21 general insurers failed and had their claims administered by the FSCS. The FSA commented in 2003: “We do not seek to operate a regulatory regime with no failures. However we consider that the current capital requirements and practices have contributed to too high a rate of failure amongst non-life insurers over the last 20 years”.²⁷

Revolution—Departure from Solvency I

Against this backdrop of weakened financial performance and diminished consumer confidence, the Financial Services Authority (FSA) overhauled the prudential regulation of insurance in the UK, in what were to become known as the Tiner reforms, after FSA Managing Director John Tiner.²⁸ The UK was until this point regulated for the most part under what were known as the European Solvency I Directives, which estab-

lished minimum solvency margins for general insurers in 1973 and for life insurers in 1979. These were implemented in the UK under the Insurance Companies Act in 1982.²⁹

For life insurance, Solvency I capital requirements were calculated using a prescribed formula.^{30,31} The value of these capital requirements depended on the value of total life insurance liabilities and capital at risk (the present value of benefits payable on death, less the value of life insurance liabilities), amounting to approximately 4% of liabilities. For writers of unit-linked business, capital requirements were calculated using a slightly different formula, and were based on expense risk, resulting in lower capital requirements than for other types of insurance liability (around 1% of liabilities).

To satisfy Solvency I capital requirements, insurers needed to hold an excess of admissible assets over liabilities. Assets were valued largely in line with the accounting treatment, predominantly a market value basis, although there were limits on the extent to which certain items, such as future profits, could be counted. Liabilities were valued on a prudent actuarial basis.

For general insurers, the calculation of the Solvency Margin under Solvency I was also formulaic. It was the greater of:

- 18% of claims up to euros 7 million and 16% of claims above that amount (with claims averaged over 3 years)
- 26% of premiums up to euros 10 million plus 23% of premiums above euros 10 million.

The FSA, however, adopted an informal approach of encouraging general insurers to hold at least twice the level of Solvency I requirements, and higher for some lines of business.³²

The FSA became concerned that Solvency I was insufficiently risk sensitive and backward looking, being based on past business. Credit risk, market risk, and operational risk were not included in the assessment of solvency.³³ In addition, there were other problems with the way Solvency Margins were calculated. The fixed ratio approach to Solvency Margins did not recognise hedging and may have encouraged under-reserving, since liabilities were a key part of Solvency Margins.

Life Insurance

In response to the collapse of Equitable Life, the FSA made important changes to its regulation of firms with with-profits liabilities of over £500 million.

The FSA introduced the concept of Realistic Reporting for With-Profits business, applying it to the largest 40 life insurers writing this business.³⁴ Realistic reporting required insurers to value guarantees and options as part of valuing with-profits liabilities. Building on Realistic Reporting, the FSA consulted on new capital requirements for with-profits business, known as Pillar 1, Peak 2 (Solvency I capital requirements were Peak 1),³⁵ which applied to firms with with-profits liabilities exceeding £500 million. Smaller firms could opt in voluntarily. The core features of these requirements were Realistic Reporting and capital for prescribed market, credit and insurance risks, known as the Risk Capital Margin.³⁶ If the value of realistic liabilities and the Risk Capital Margin exceeded the Solvency I value of liabilities and capital requirements, then insurers had to meet this higher amount (the difference was known as the With-profits Insurance Capital Component). The Peak 2 regime took effect in 2005.

In 2003, the FSA also specified what qualifies as capital for regulatory purposes—for Pillar 1 capital requirements, introducing tiering of capital instruments.^{37,38}

At the same time as the Pillar 1 changes, in 2002 the FSA introduced the Individual Capital Adequacy Standard (ICAS) regime,³⁹ which it described as Pillar 2. The regime, which took effect in 2005, was designed to ensure that firms held sufficient capital to withstand a variety of stresses to assets and liabilities, and other risks, tailored to the specific business model of the firm over a one-year horizon, calibrated to a confidence level of 99.5% (equivalent to a BBB credit rating). Firms modelled their own capital requirements.⁴⁰ The FSA reviewed their modelling of capital requirements on at least a three-yearly basis, but it did not approve models.

During its reviews of firm models, the FSA could give Individual Capital Guidance (ICG) where it believed risks were undercalibrated

(which could include for firms with poor controls and weak management; greater underwriting risk; with-profits business with complex options and guarantees; or rapid growth).

The ICAS regime was based on a market-consistent valuation of these assets and liabilities, with liabilities discounted at the risk-free rate, although firms could adjust this rate for annuity liabilities to reflect an illiquidity premium earned by the assets held to maturity to back the liabilities.

Under ICAS, capital requirements were mostly set at solo entity level rather than group level. These requirements remained confidential between the firm and the regulator. Firms had to meet whichever of the Pillar 1 and Pillar 2 (ICAS) was the most prudent amount of capital.

General Insurance

Like for the regulation of life insurance, the FSA made changes to its Pillar 1 regime.⁴¹ It introduced the Enhanced Capital Requirement (ECR) for general insurers in 2002. The ECR was intended to be an additional Pillar 1 requirement, but over the next few years it was not implemented in this way. Instead it became an input into a new the Pillar 2, ICAS, regime, rather than an additional component of the Pillar 1 capital regime.⁴² Firms reported their ECR privately to the FSA.

The ECR was a formulaic measure of risk. The calculation was based on net premiums by line of business, net technical provisions⁴³ by line of business, and types of asset exposure. These measures of risk exposure were then multiplied by set of risk factors to arrive at the value of the ECR. Asset factors were designed to recognise market and credit risk. Liability factors recognised that technical provisions could turn out to be underestimates of actual outcomes. Net premium factors addressed the risk of underpricing. The factors were calibrated to produce a one-year probability of survival of a 99.5%, roughly equivalent to a BBB credit rating.

Again, like the regulation of life insurance, the FSA introduced a new Pillar 2, ICAS, regime for general insurance. As with life insurance, the FSA did not prescribe an approach to calculating Pillar 2 capital requirements, but it did specify the types of risk that should be considered—credit, market, insurance, operational, and liquidity—and the nature of

the assessment (stress or scenario analysis). However, in a change to life insurance, Pillar 2 capital requirements were set on the basis of being able to cover all unexpected losses until the business was run-off, rather than a one-year probability of survival.

In cases where the FSA set ICG, it was frequently a multiple of ECR. ICG was more likely for firms with poor controls or management problems; lower diversification across lines of business; small volumes of business; longer-tailed business; higher unearned premium reserves; and rapid growth. Like life insurers, ICG tended to be applied at solo level for general insurers.

The Effect of ICAS on Policyholder Protection

During the period that ICAS was in operation—2005 to 2015—no life insurance firm failed. This included during the financial crisis that started in 2008. Market-consistent valuation meant that life insurers saw their solvency levels come under pressure during this period, but for annuity writers this pressure was alleviated by the illiquidity premium applied in the valuation of liabilities to recognise the effects of market volatility on asset values.⁴⁴ In 2009, to pre-empt procyclical sales of risky assets, the FSA officially reaffirmed that a breach of ICAS capital requirements would not lead to automatic consequences where breaches were a result of exceptional market movements rather than poor management.⁴⁵

The failure rate of general insurance firms was much lower than had been the case pre-ICAS. In the ten years after its introduction, only nine firms failed. These tended to be small firms, and several of them had provided insurance services in the UK under European passporting arrangements (i.e. solvency requirements were governed by their home regulator).

Evolution—The Arrival of Solvency II

The development of Solvency II was already underway by the time the FSA consulted on changes to the prudential regulation of life and general insurers. The FSA felt that it could not wait even a few years for the arrival of Solvency II; it was necessary to make the changes without delay.

The decision to go ahead with the prudential changes rather than wait for Solvency II was prescient. Eleven years elapsed between the introduction of the prudential changes made by the FSA in 2005 and the arrival of Solvency II in 2016.⁴⁶

Those familiar with the broad content of Solvency II⁴⁷ will see similarities between it and the UK's ICAS regime.⁴⁸ Both involve stress-testing a balance sheet valued at market prices for a similar set of risks to calculate capital requirements. Modelling of capital requirements plays a prominent role in both regimes. Both allow the regulator to increase capital requirements if there are deficiencies in the firm's assessment of capital requirements or if there are governance failings. Both rely on market-consistent valuation, with the illiquidity premium used in the discounting of annuity liabilities playing the counterpart to Solvency II's Matching Adjustment.

Despite the significant similarities, Solvency II introduced several important changes. First, Solvency II is a 'going-concern' regime. A key feature of this is the Risk Margin which is an additional amount of financial resources above the best estimate of liabilities that supports continued operation of the firm following a shock that wipes out capital held to meet a firm's requirements. Second, it introduces consolidated capital requirements at group level, including for non-insurance entities, and facilitates group supervision in a way that was not possible under the minimum harmonising Solvency I patchwork of national regimes. Third, it reduced the flexibility in setting capital requirements the regulator had in setting ICG under ICAS, and unlike ICAS, any additional capital required by regulators under Solvency II must be disclosed to the market. Fourth, whilst models were a feature of the ICAS regime, they were not required to be approved by the regulator, as they are under Solvency II—the FSA reviewed the adequacy of the economic capital estimates generated by the models. Fifth, it increased the quality of capital resources relative to ICAS, for which a wider set of assets could be included in calculating regulatory capital. Sixth, Solvency II introduced a harmonised set of risk management and governance requirements. These were not totally new requirements for the UK, but had existed largely in guidance, meaning that practice could vary between firms. Lastly, Solvency II introduced higher levels of disclosure and supervisory reporting than had existed under ICAS.

The final shape of Solvency II that emerged from the Omnibus II Directive in 2014, and in particular the measures for long-term business, contained sufficient similarities to ICAS that the Prudential Regulation Authority⁴⁹ (PRA) did not expect financial resource requirements as a whole across the insurance sector to change. This was in contrast to an initial assessment of the effect of introducing Solvency II regime made in 2011, before Omnibus II discussions had commenced and internal models had been developed for approval. At the time of this initial assessment, it had been expected that financial resource requirements could rise.⁵⁰

In the end, the measures announced in the Long-Term Guarantees package from Omnibus II were expected, in 2014, to have a broadly neutral effect on capital levels in the UK. In aggregate, the Matching Adjustment reduced capital shortfalls anticipated in 2011 for the life sector by 70%–90%. This in combination with internal-model approvals left financial resources broadly unchanged compared with the previous ICAS regime.⁵¹

Nevertheless, despite financial resource requirements remaining broadly unchanged, UK firms and the regulator incurred substantial administration costs in implementing Solvency II. Estimates from the PRA put the total costs of implementation around £2.1 billion, of which its expenditure was in the region of £110 million. Much of the cost to firms stemmed from the technical expertise needed to adapt to the new regime and develop internal models, and from updating systems to meet new reporting requirements.⁵² The UK initially approved 19 models of which nine were life insurance groups, which accounted for 80% of UK life liabilities.⁵³

Solvency II—Evolutionary Challenges

At the time of writing, Solvency II has been in place for only a year, even so enough time has passed for some aspects of the regime to assert themselves. The environment of low interest rates in which Solvency II has been introduced has played its part in bringing them to the fore.

Post implementing Solvency II, falls in the already low interest rates have led to a marked increase in the values of liabilities for life insurance. Solvency II transformed the UK's regime from one based on requiring

that insurers be resourced so that they could be wound down in an orderly way (a 'gone concern') regime to a 'going-concern' regime. A key difference being the introduction of the 'risk margin', which is designed to bring the value of a best estimate of liabilities up to the level at which a third party would be willing to accept them. Despite the ICAS regime being based on market-consistent valuation, no such construct existed in the previous regime. Hence liabilities written before the introduction of Solvency II were valued at a lower amount than the equivalent under Solvency II.⁵⁴

The value of long-term liabilities has proved to be very sensitive to interest rate movements from a base of a low and flat yield curve. The PRA estimated that a reduction of 100 basis points in the risk-free yield curve would increase the risk margin by 27%.⁵⁵ The PRA has also been concerned that international differences in regulation between Europe and other regions may enable firms to reinsure liabilities in a way designed to avoid the effects of risk margin, but at the same time weaken standards of policyholder protection.^{56,57}

To enable a smooth transition to the new regime, the UK implemented transitional measures contained in the Long-Term Guarantees package, which has alleviated the effect of the risk margin for past business.⁵⁸ These included the Transitional Deduction from Technical Provisions (liabilities) which the PRA implemented in a way that maintained financial resources for past business at levels consistent with the previous ICAS regime. Given that these resource requirements were regarded as adequate under the previous regime, the PRA saw no reason to increase requirements for business written in the past. It emphasised therefore that Transitional Deductions from Technical Provisions are regarded by the PRA, and by other European regulators, as high-quality capital.⁵⁹ New business, however, remains affected by the increases in the risk margin.

Other challenges have also emerged. Firstly, with many internal models now approved, the PRA has turned its attention to ensuring that standards remain robust and that changes to models are not made selectively with the aim of reducing capital requirements.^{60,61} Secondly, in the low-interest-rate environment, insurers have increased their investments in illiquid assets. Such assets pose challenges from valuation uncertainty and are generally marked-to-model. The PRA is addressing the challenges by

adapting to Solvency II requirements which are different to the ICAS regime for ensuring appropriate ongoing valuation and capital treatment of such investments.⁶²

Conclusion

Around the turn of the twenty-first century, both the UK Life Insurance and General Insurance sectors had been beset by reputational and solvency problems. In response to this, the FSA undertook a fundamental set of changes to the prudential regulation of insurers, both enhancing Pillar 1 solvency requirements and introducing an entirely risk-based Pillar 2 capital regime—ICAS. It felt that these changes, which took effect in 2005, were urgent and could not wait for the arrival of Solvency II, which in fact only arrived 11 years later. The changes the FSA made enhanced policyholder protection and proved themselves to be robust during the financial crisis that started in 2008.

Solvency II represented an evolution of prudential regulation for the UK. Solvency II introduced financial resource requirements allied to a ‘going-concern’ regime rather than a ‘gone concern’ regime, as had existed under ICAS. It introduced consolidated capital requirements at group level and facilitated group supervision in a way that was not possible under the minimum harmonising Solvency I patchwork of national regimes. It improved the quality of capital resources relative to ICAS requirements. It also introduced a harmonised set of risk management and governance requirements. Lastly, Solvency II introduced higher levels of disclosure and supervisory reporting than had existed under ICAS.

Inevitably there have been some challenges arising from the introduction of Solvency II. In the move to a ‘going-concern’ regime, financial resource requirements have increased and proved to be very sensitive to falls in interest rates. For past business, the effect of this factor has been mitigated by transitional arrangements, but new business continues to be affected. Solvency II reduced the flexibility in setting capital requirements the regulator had in setting guidance for additional capital under ICAS, and hence there is a greater focus on ensuring that changes to internal models of capital requirements and valuation of assets are prudent.

Solvency II continues to evolve with reviews of Standard Formula Capital requirements scheduled by 2018 and of the Long-Term Guarantees package by 2021.

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30. The Solvency I Directives (The First Life Directive, 1979, introduced the capital requirements calculation and the definition of admissible assets. It was revised in 1990 and 1992 to encourage cross border trade, introducing a single operating licence. It was consolidated in 2002, and strengthened by placing further restrictions on admissible assets and ensuring liabilities include a margin for possible adverse experience over the best estimate). http://ec.europa.eu/finance/insurance/legislation/index_en.htm#maincontentSec1
31. Solvency I was a minimum harmonising set of Directives, which meant European Countries could introduce additional prudential requirements for the regulation of insurance companies. Prior to 2002, the UK requirements was set out in the Insurance Companies Act 1982, the Insurance Companies Regulations Act 1994, which was superseded by the Financial Services and Markets Act 2000, and in particular, the Financial Service Authority's (FSA) Interim Prudential Sourcebook for Insurers, 2001a. <http://www.legislation.gov.uk/ukpga/1982/50/contents>; <http://www.legislation.gov.uk/uksi/1994/1516/contents/made>; http://media.fshandbook.info/Legislation/2001/2001_12.pdf

32. FSA (2003c) Enhanced capital requirements and individual capital assessments for non-life insurers.
33. The FSA included a Resilience Test in the prudent valuation of life liabilities, which included reserving requirements for equity stresses. This was subsequently developed into a Resilience Capital Requirement for market risk for equities, real estate, and fixed income assets.
34. FSA (2002a) Feedback Statement on the With-Profits Review. Realistic Reporting became effective at 31 December 2002 (FSA (2002c) The Future of Regulation of Insurance—A progress report).
35. FSA (2002b) Integrated Prudential Sourcebook: Feedback on Chapters of CP97 applicable to insurance firms and supplementary Consultation, Consultation Paper 143. This consultation introduced the concept of the With-Profits Insurance Capital Component. It was further refined in FSA (2003b) Enhanced Capital Requirements and Individual Capital Assessments for Life Insurers, Consultation Paper 195.
36. Market risk (equity, interest rate, and property), credit risk, and insurance risk (persistence).
37. FSA (2003c) Enhanced capital requirements and individual capital assessments for non-life insurers and FSA (2003b) Enhanced Capital Requirements and Individual Capital Assessments for Life Insurers.
38. Core tier 1 (ordinary shares, member contributions, and audited reserves), non-ordinary shares (perpetual non-cumulative preference shares) and innovative tier 1. Upper Tier 2 (perpetual cumulative preference shares and perpetual subordinated debt) and lower tier 2 (long-term subordinated debt).
39. ICAS applied to life insurers and reinsurers.
40. Risk categories: Market (equities, property, interest rate risk); credit (default on corporate bonds, commercial mortgages, or reinsurance arrangements); Insurance (mortality, morbidity, longevity, pandemics, persistence, expenses); Operational (business conduct, administration, systems); Diversification; Group.
41. For further details, see O'Brien (2006).
42. ICAS applied to general insurers and reinsurers.
43. Net technical provisions consisted of unearned premiums net of deferred acquisition costs, outstanding claims, and those incurred but not reported, and unexpired risks.

44. Bank of England and the Procyclicality Working Group (2014) Procyclicality and structural trends in investment allocation by insurance companies and pension funds.
45. FSA (2009), Letter from Paul Sharma to Angela Knight: 'ICG and GENPRU 1.2.26R'. http://www.fsa.gov.uk/static/pubs/other/letter_to_bba.pdf
46. In the interim, the UK, like other member-states, implemented the Reinsurance Directive. The changes, however, were relative minor since the UK relied on its ICAS regime. See FSA (2006) Implementing the Reinsurance Directive, CP06/12.
47. http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm
48. See also Swain and Swallow (2015) for a summary of Solvency II.
49. The PRA replaced the FSA as the prudential regulator of insurers in 2013.
50. HM-Treasury (2011) Transposition of Solvency II.
51. PRA (2014) Transposition of Solvency II: Part 3.
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53. Bank of England (2016c) The Solvency II Landscape—A speech by Andrew Bulley.
54. Bank of England (2015) Adapting to Solvency II—Speech given by Sam Woods.
55. Bank of England (2017) Solvency II one year in—Speech given by David Rule.
56. Bank of England (2016b) Solvency II: Approaching the Try Line—Speech given by Sam Woods.
57. Bank of England (2016c) The Solvency II Landscape—A speech by Andrew Bulley.
58. The transitional measure does not apply to new business.
59. Bank of England (2015) Adapting to Solvency II—speech given by Sam Woods.
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7

Corporate Governance of Insurance Firms After Solvency II

Michele Siri

Introduction

Corporate governance refers to the relationship between a company's senior management, its board of directors, its shareholders, and other stakeholders and it determines the structure used to define a company's objectives as well as the means to achieve them and monitor the results obtained.¹ Since the 1970s, managerial accountability, board structure and shareholders' rights have become central issues, especially with regard to listed companies. This new attention to corporate governance issues quickly set up a link among corporations, academia and private practice. While corporate governance has traditionally been recognised as a global movement, industrial companies and financial institutions took a different path. Although several regulations have targeted the banking and insurance industry in order to enhance corporate governance requirements specific to these sectors and, in particular, to implement efficient internal control systems, the supremacy of the chief executive

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officer has actually continued to be a dominant feature of the financial sector, also after the financial scandals of the early 2000s.²

In the financial services sector, corporate governance should take into account the interests of other stakeholders (depositors, savers, life insurance policy holders etc.), as well as the stability of the financial system, due to the systemic nature of many players involved.³ The interests of financial institutions' creditors (depositors, life insurance policy holders, beneficiaries of pension schemes and, to a certain extent, employees) are potentially at odds with those of their shareholders. The latter benefit from a rise in the share price and maximisation of profits in the short term and are potentially less interested into a too low level of risk. Although the perception may be different, obviously there is some level of alignment, too. Good and reliable returns for investors make sure that the insurer retains access to the capital markets at acceptable rates, which ultimately also benefits other creditors and policyholders. For their part, depositors and other creditors are focused only on the financial institution's ability to repay their deposits and other mature debts, and thus on its long-term viability.⁴

Largely as a result of the particularities relating to the nature of their activities, most financial institutions are strictly regulated and supervised. More clearly, the internal governance of financial institutions cannot be reduced to a simple problem of conflicts of interest between shareholders and management. Consequently, according to the European approach, the rules of corporate governance within financial institutions must be adapted to take into account the specific nature of these companies.⁵ As to the insurance sector, it is worth noting that in both the USA and Europe a new regulatory intervention was supported, albeit with different goals. In fact, in the USA the supervision of the insurance industry—in order to improve the state-based regulatory system for financial stability—seems to have been the main concern of post-crisis reforms. In Europe, prudential supervision has been a major concern, although the Solvency II directive deals not only with capital requirements but also with governance issues.

The 2008 financial crisis showed that financial institutions' corporate governance was unsuccessful mainly because of the excessive risk-taking, boosted by generous executive remuneration.⁶ In this scenario, the insurance industry has been less affected by the financial crisis in comparison to the banking system, although it was still partially involved in the derivatives turbulence (e.g., AIG in the USA).⁷ Along this decade various reforms

relating to banks, insurance and investment firms have been enacted in response to the financial crisis. However, the USA and Europe have not followed the same approach. The main focus of the Dodd Frank Act lies on financial stability, disclosure and transparency requirements, rather than on corporate governance, with the exception of “say on pay”, proxy access and disclosure on the separation of the roles of chief executive officer and chairman. By contrast, the European Union (EU) has seemingly reserved more attention to corporate governance issues.⁸ Special consideration has been paid to the structure and functioning of the board, the risk-management policy and internal control system, and the executive remuneration and supervision⁹. Still, at the core of the European reforms in reaction to the perceived governance failure stands the idea of strengthening the role of the board to avoid excessive and imprudent risk-taking.¹⁰

As for the corporate governance of banks, even if similar conclusions can be assumed to hold for the entire financial sector, scholars have argued that the primary justification for regulating internal control systems is to maximise the “efficiency” with which exposure to risk is managed.¹¹ It is a very different focus, far from the traditional approach to governance which emphasises shareholder rights.¹² Moreover, the banks with the most “pro-shareholder” boards and the closest alignment between executive returns and stock price were those which took the most risks prior to, and suffered the greatest losses during, the crisis. Consequently, a significant rethink about the way in which banks are governed is required.¹³ Therefore, one of the primary objectives of international standard setters in the banking sector is to provide guidance for supervisors that favour “weaker rights” for shareholders and “stronger rights” for other stakeholder groups.¹⁴ This is commonly referred to as “risk governance”, because the focus is on ensuring that risks are adequately managed and disclosed.¹⁵

The effectiveness of the corporate governance of financial institutions is thus a central topic of international standard setters in the banking sector¹⁶ and has been included into the regulatory framework of the guidelines and technical advices issued by the European Supervisory Authorities for all financial institutions.¹⁷ Recent significant risk incidents and corporate scandals caused by misconduct in the banking sector suggest that financial institutions need to further enhance corporate governance measures as well as ethics and culture.¹⁸ The European legislation after the financial crisis clearly shows that the regulation of corporate

governance goes beyond the traditional approach of company law, because the governance regime should ensure not only the “integrity of the market”¹⁹ to reduce the excessive risk-taking but also the “investor protection” as far as the MiFID regime is concerned and “policyholder protection” as far as insurance is regulated under the Solvency II regime.

The focus on trust is even more apparent in insurance legislation. In fact, the main goal of the Solvency II directive is to ensure an adequate protection of policyholders and beneficiaries, also through a new risk management, financial reporting and corporate governance assessment.²⁰ Unlike banking regulation, financial stability and fair and stable markets, albeit important objectives of the insurance and reinsurance regulation, should not impair the main objective.²¹ Therefore, in the insurance sector the regulation and supervision of the internal governance mechanisms is central in the risk management framework, because some risks may only be properly addressed through governance requirements. An effective system of governance requires a proactive approach on the part of insurance firms, with a significant impact on the duties and obligations of the members of the board, on the one hand, and on the supervisor’s ability to assess the compliance of the internal governance with these specific requirements, on the other.²²

Last but not the least, ineffective internal control systems in banking institutions have also been significant factors in several cases of fraud.²³ This has called for closer cooperation between regulators, and external and internal auditors, so as to win back public trust in financial institutions.²⁴ It is worth noting that the Sharma report²⁵ identified a causal relationship between firms that either fail or are inherently vulnerable and “underlying management weakness or operational weakness”. Good governance practices and strong risk management are therefore essential aspects of a prudential regulatory framework.²⁶

The System of Governance in the Solvency II Framework

The Solvency II requirements are designed to provide an enhanced and more consistent level of protection for policyholders throughout Europe. There are structured into three “pillars” that cover quantitative requirements,

qualitative requirements and supervisory review, and reporting and disclosure.²⁷ Solvency II seeks to ensure that firms identify, quantify and manage their risks on a proportionate and forward-looking basis. In this regard, it introduces improved governance and risk-management requirements. It is worth saying that Solvency II is a largely “maximum harmonising” regulatory framework, which introduces a single set of requirements that are to be applied consistently across Europe. The Directive already comprises a considerably high level of detail concerning principles and requirements of the system of governance, especially compared to the Level I and/or Level II texts implementing measures of other EU directives on financial services.

The Solvency II directive covers the most important issues to be regulated to ensure appropriate governance standards within insurance and reinsurance undertakings. Therefore, the scope of essential and extensive measures on Level II - with some specific exceptions, such as the Level II rules on outsourcing, remuneration, risk management and valuation - has been limited.²⁸ Moreover, article 50 of the Directive stipulates the minimum contents of the Level II implementing measures. For this reason the provisions of the II Pillar concerning the corporate governance of insurance undertakings also include the European Insurance and Occupational Pensions Authority (EIOPA) Guidelines supplementing the Solvency II requirements, as provided by the Directive and the Implementing Measures, to foster supervisory convergence across the European Union Member States.

With regard to the overall system of governance for insurance and reinsurance undertakings, Sect. 2 of Chap. IV of the Directive focuses on the regulation of the following main issues: general governance requirements, fit and proper requirements, risk management, internal control, outsourcing and prudent person principle. The “general governance requirements” (art. 41) aim at the implementation of an effective and proportionate system of governance, which provides for sound and prudent management of the business and sets out the implementation of written policies concerning the main functions of the undertaking (i.e. risk management, internal audit, internal control, outsourcing), including the development of contingent plans. The “fit and proper requirements for persons who effectively run the undertaking or have other key functions” (art. 42–43) aims to ensure that all the persons that effectively manage the undertaking or perform key functions within the undertaking are fit and proper, meaning that they comply with both

professional and reputational standards. The “risk management” (art. 44) aims to implement an effective risk-management system within the undertaking, comprising strategies, processes and reporting procedures necessary to identify and manage the main risks to which the undertaking is exposed, at both an individual and group level, including the “own risk and solvency assessment” activity (art. 45). “Internal control”, “internal audit” and “actuarial function” (art. 46–48) aim at ensuring the implementation of an effective internal control system, internal audit function and actuarial function with the undertaking.

These governance requirements are addressed and, in some cases, further developed in the Implementing Measures and the EIOPA Guidelines on the System of Governance. It is worth remembering that both the Solvency II directive and the EIOPA Guidelines are addressed to the competent national authorities that should implement—at the national level—suitable measures within the specified time framework to ensure compliance with the provisions of the Solvency II directive and the EIOPA Guidelines.²⁹ This chapter analyses the EIOPA Guidelines, with a special focus on what we consider to be the most relevant provisions to achieve a suitable governance.

General Governance Requirements

The Directive requires all insurance and reinsurance undertakings to have in place an effective system of governance which provides for a sound and prudent management of the business.³⁰ That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities, as well as an effective system for ensuring the transmission of information.³¹

In line with corporate governance best practices, the EIOPA Guidelines put particular emphasis on the company’s organisation referring, as usual, to four main areas: an effective system of governance (comprising risk), the internal control system, the organisational and operational structure and the decision-making process. Therefore, in an enlarged perspective, most EIOPA Guidelines do not present a particular degree of innovation, except for some aspects that are nonetheless open to debate. Like with the

existing governance requirements for credit institutions and investment firms set out in the regimes laid down in the Capital Requirements Directive and the Markets in Financial Instruments Directive, also under Solvency II the administrative, management or supervisory body (AMSB)³² is at the centre of the governance system.

The first Guideline of the general governance requirements (Guideline 1) focuses on the duty of the administrative body to be informed.³³ Committees (if established), senior management and key functions are the interlocutors with whom the board has to interact, “proactively requesting information from them and challenging that information, when necessary”. It seems impossible to overlook that the provision requires directors to behave proactively. This means that the board has to carry out a rather strict duty of monitoring. Indeed, directors not only have to check the information provided but should also collect sensible information on their own. This solution could affect the general principle that directors can rely on officers’ information. In this case, the liability area of non-executive directors would increase dramatically. Furthermore, it is necessary to highlight that the Solvency II directive does not make any explicit reference to a proactive behaviour, but it rather refers to, among other things, an effective system of governance and requires to set up an appropriate segregation of responsibilities. It is questionable whether a too wide monitoring duty fits with effectiveness, and whether it allows to easily separate executive and non-executive tasks.

Moving to the organisational and operational structure (Guideline 2), a close link exists between organisation and effective operation, provided that they support each other. Both are necessary to ensure a proper flow of information among the undertaking’s different levels of hierarchy. In this regard, the organisation structure determines the tasks and assignments, while the operational structure settles the way of performing the tasks. In any case, it is ultimately the AMSB that has the responsibility for the execution, and it is not bound by the suggestions in the findings of the key functions. Although EIOPA in the explanatory text to Guideline 5 clearly states that the AMSB is obviously not entitled to suppress or tone down the results of the key functions,³⁴ it is not clear how the AMSB can reach different conclusions without pressing the several functions in order to get new data able to support its position. A similar problem

arises in relation to the Guideline 4, which requires the undertaking to appropriately document the decisions taken at the AMSB level. Moreover, this provision determines how the information flow from the risk-management system has to be taken into account. If the first part of this provision is clearly aiming to make the decisions of the AMSB traceable, the second part is quite ambiguous, in that it does not specify in which way and under which conditions the AMSB can move away from the results of risk management.

Lastly, organisational and operational structure are based on a cost and benefit approach. This represents a fundamental change to the Solvency I directive, which was based on the “one size fits all” principle. This new approach, on the one side, introduces more flexibility in the corporate governance system of each undertaking and, on the other side, increases the responsibility of the board, if compared to the previous regulatory framework. Obviously, undertakings have to review their system of governance periodically (as well as in the case of particularly significant events), under the ultimate responsibility of the AMSB (Guideline 6).³⁵ In relation to key functions, EIOPA does not require a mandatory organisational structure of separate units focusing on risk management, compliance, internal audit and actuarial function.³⁶ Still, the undertaking may combine each function based on its own features. Moreover, the Solvency II regime provides a mandatory model for the written policies required by art. 41, Sect. 3, relating to the risk management, internal control, internal audit and, where relevant, outsourcing and for any further policy the undertaking decides to implement (Guideline 9).

It is uncertain whether it is possible to infer from the Directive (Chap. IV, Sect. 2) that the “four-eyes principle” (i.e. the principle that, prior to “implementing” any significant decision concerning the undertaking, at least two persons must review any such decision) should be complied with by all (re)insurance undertakings. Supporting the view of the CEIOPS, the Implementing Measures states that, in line with the existing requirements for other financial sectors, in the context of the system of governance, insurance and reinsurance undertakings “shall ensure that at least two persons effectively run the undertaking” (art. 258, par. 4).³⁷ The EIOPA Guidelines include some more specific requirements with reference to the four-eyes principle. As for the decision-making process

the four-eyes principle foresees that every significant decision is effectively taken by at least two persons “before the decision is being implemented” (Guideline 3). Significant decisions are decisions that are unusual or that could have a material impact on the undertaking (Guideline 3).³⁸

The Guideline does not specify whether these two persons must necessarily be directors or not. Arguably, the second option is the most suitable, because the provision refers generally to “persons”. Several situations could arise in practice, considering, for example, the case of two executive directors or (only) one executive director. In the first hypothesis, if the two executives are in charge of the business and take the decision jointly, there seems to be compliance with the Guidelines. By contrast, the case in which a delegation of different exclusive tasks is given to each director appears to be more problematic.³⁹ Overall, it seems that in both cases, the question is whether the “two people rule” is aimed to ensure either a better level of competence or a better monitoring function. Considering that quite rarely an undertaking appoints two executives for the same area of competence and that the regulator is well aware thereof, it can be assumed that the goal of this principle is to ensure a better monitoring function.

Fit and Proper

Insurance and reinsurance undertakings shall ensure that all persons who effectively run the undertaking or have other key functions at all times fulfil the following requirements: (a) their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit); and (b) they are of good repute and integrity (proper).⁴⁰ These requirements apply to all persons who effectively run the undertaking. The “fit and proper” requirements are not limited to the members of the AMSB, but could include other individuals such as senior managers. Therefore, senior management could include persons employed by the undertaking who are responsible for high-level decision making, and implementing the strategies devised and the policies approved by the AMSB.⁴¹ The other “key functions” are those considered

critical or important in the system of governance and include at least risk management, compliance, internal audit and actuarial functions.⁴² Other functions may be considered key functions according to the nature, scale and complexity of an undertaking's business or the way it is organised. The fit and proper requirements do apply also in case of outsourcing of key functions to persons employed by the service provider. The Directive also requires undertakings to notify the supervisory authority whenever the identity of persons running the undertaking or holding other key functions changes.⁴³

The EIOPA Guidelines clearly reaffirm that the persons who effectively run the undertaking or are in charge of other key functions are fit and that the directors' duties are assigned according to their specific qualifications, knowledge and experience (Guidelines 11–13). With particular regard to the AMSB, this body must collectively possess at least qualifications, experience and knowledge in the following fields: insurance and financial markets, business strategy and business model, system of governance, financial and actuarial analysis, and regulatory framework and requirements. Moreover, the notion of “fitness” provides a partial solution to our previous question about the rationale of the “two persons” rule, since it points out that the members of the AMSB must not have an individual “knowledge, competence and experience” within all areas of the undertakings, but only a “collective” knowledge, competence and experience as a whole, to provide for a sound and prudent management of the firm. Therefore, it seems that the rule that requires two people to effectively run the business wants to ensure a “better monitoring” activity. Notwithstanding that, the absence in the Level II text of a requirement that the members of the AMSB should, as a whole, be able to provide for the “sound and prudent management” of the undertaking is rather regrettable. However, every individual board member should have a basic knowledge as well, in order to be able to function properly as a board, follow and participate in discussions, challenge other board members, etc. This level of “basic” knowledge is already quite a hurdle for some to enter to a board. Obviously the business of insurance is quite technical, which means that even seasoned directors from outside the insurance industry may struggle to grasp the matter.

In line with Article 273 Sect. 4 of the Implementing Measures, the “proper” requirement refers to the person's honesty and financial soundness,

and is based on the relevant evidence concerning their character, behaviour and business conduct, including any criminal, financial and supervisory aspects, and, obviously, any possible conflicts of interest. Proper considerations are relevant for every person working in the undertaking, although a specific assessment can be applied only to employees. Otherwise, the persons who effectively run the undertaking or have other key functions are always required to have the same adequate level, irrespective of the nature, scale and complexity of the risk of the business or the undertakings' risk profile.⁴⁴

Risk-Management System

Insurance and reinsurance institutions shall have in place an effective risk-management system, comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis, the risks, at both an individual and aggregated level, to which they are or could be exposed, and their interdependencies.⁴⁵ The AMSB is responsible for ensuring that the implemented risk-management system is suitable, effective and proportionate to the nature, scale and complexity of the risks inherent to the business, as well as for the approval of any periodic revision of the main strategies and business policies of the undertaking in terms of risk management.⁴⁶ Accordingly, the EIOPA Guidelines reflect a common view about the need of the involvement of the board in the most important corporate issues, clearly including risk management.⁴⁷

The board is the ultimate body responsible for ensuring the effectiveness of the risk-management system, setting the undertaking's risk appetite and overall risk tolerance limits, as well as approving the main risk-management strategies and policies. In this regard, executive and non-executive directors share the same task; however, given the presence of asymmetric information, they must still be viewed as two different categories (and therefore subject to different liability criteria). It is worth mentioning that EIOPA affirms that the undertaking is expected to "designate at least one member of the AMSB to oversee the risk management system" on behalf of the board.⁴⁸

Such a solution is uncertain in the case an executive or a non-executive director is appointed to oversee the risk-management system. In the case

of an executive, there would be an excessive concentration of power in her hands, because she would be involved in managing the risk strategy and at the same time she should check it. In the case of a non-executive director, there would be a kind of separation in respect to the other non-executive directors and many problems would arise: how would the liability regime of the non-executive director be designated to oversee the risk-management system set? How about her remuneration? Probably, a better solution would be to assign this function to a risk-management committee in which non-executive directors could better support each other in the fulfilment of their task.

For the rest, risk management consists above all of two main areas. First of all, the assessment of the risk appetite (through a description that has to be clear and detailed enough in order to express and reflect the strategic high level of objectives of the AMSB), based on quantitative assessment in terms of risk and capital. Risk appetite will be defined by the appropriate directions of the AMSB. The other area consists of the overall risk tolerance limits that express the restrictions that the undertaking imposes on itself when taking risks, and that has to be “metabolised” and “supported” by the board. It is worth mentioning that the explanatory text of the EIOPA Guideline 17, dealing with the risk tolerance, allows undertakings to adopt stricter constraints.⁴⁹ This option is fully in line with a top-down approach to be followed by the board.

As usual, the risk-management system has to be supported by adequate processes and procedures and internal risk reporting is required to be a continuous process within all levels of the undertaking, and the risk-management function has to report to the AMSB on risks that have been identified as potentially material. In relation to the risk-management policy, Guideline 18 requires a minimum of policies that the undertaking has to establish.⁵⁰ On the one side, the undertaking has to define the risk categories and the methods to measure the risks; on the other side, the undertaking has to consider each risk globally in relation to its potential effect. In this regard, stress tests are a crucial tool of the risk assessment process.

A final comment is needed with reference to the absence of a general provision inspired by the principle of proportionality. According to art. 44 of the Solvency II directive on the risk-management system, the

EIOPA Guidelines describe each area of risk that the risk-management system has at least to cover: underwriting and reserving risk management, operational risk management, reinsurance and other risk-mitigation techniques, asset-liability management, investment risk-management and liquidity risk-management policy. It is worth noting that both the Solvency II directive and the EIOPA Guidelines refer to a rather rigid risk-management system that recalls an environment based on the “one size fits all” principle. The regulator probably wanted insurance companies to keep a homogenous approach to risk management. Nevertheless, it is doubtful whether this system can be implemented with the same standards by each undertaking in a market comprising companies of different sizes and complexity.

Toward an “Effective” Board Governance

As a consequence of the financial crisis, supervisors are now adopting a more “intrusive” approach which is focused on making forward-looking judgements about firms. This proactive attitude also includes the supervision on how the board agrees and oversees the firm’s risk framework. This is a profound change which introduces a ‘four-eyes’ principle to decision making and the specific role of signing off the strategic plan and monitoring its execution to managers. Most of the firms that failed during the crisis were typically characterised by a domineering chief executive officer, a dysfunctional board, individuals without the required technical competence, a weak understanding of the risks and inadequate “four-eyes” oversight. In a nutshell, good governance increases the probability that good decisions will be made, also because poor governance is a strong lead indicator of more significant problems. Since the management is responsible for running firms and firms fail because of the decisions taken by their board and management, supervisors are interested in enhancing an effective role for the board of directors.⁵¹

An effective board is one which understands the circumstances under which the firm would fail and constantly asks the relevant “what if” questions. To do this well, a board needs to understand its business model, understand and focus on material risks, and challenge the executive on

the execution of a strategic plan.⁵² With regard to technical skills, the EIOPA Guidelines require that the board collectively understands and addresses the business. However, it is not expected that certainly every member of the board have the same degree of technical knowledge. A diverse board encourages creativity and is less likely to follow a one-way thinking. This key feature is instrumental to allowing that the management and supervisory function of the management body of an institution interact effectively. However, any board, included those that are highly qualified and independent, entirely rely on the management for the information they need to fully perform their function. Therefore, any board should resist the “informational capture” by the chief executive officer and the management.

When dealing with strategic or significant decisions, the management body in its supervisory function should be ready and able to challenge and review critically propositions, explanations and information provided by members of the management body. It should also be able to monitor the strategy, the risk tolerance and appetite. Moreover, it should assess whether the policies of the institution are implemented consistently and performance standards are maintained in line with its long-term financial interests and solvency.⁵³ In this context, the EIOPA Guidelines require that the AMSB interacts with the senior management and key functions holders—including the audit, compliance, actuarial and risk management—“proactively requesting relevant information from them and challenging that information when necessary”. This, in turns, refers to the quality of the debate among the board members. The meetings often appear to be too well orchestrated. Challenge is usually inadequate, possibly as a result of ineffective leadership styles or, more often, dominant leaders that suppress the debate.

The importance of “constructive challenge” in terms of effective decision making is a lesson learned from the inquiry in the RBS collapse. In 2009, the decision of the RBS to take over ABN AMRO together with Fortis and Santander was evaluated in a UK Financial Services Authority Report,⁵⁴ whose conclusions are self-explanatory: “In summary, the Review Team concluded that the judgement of the RBS Board in respect of the ABN AMRO acquisition was not characterised by the degree of moderation and sensitivity to strategic risk appropriate to a bank. With

so much at stake, there was a critical need for more fundamental probing, questioning and challenge by the Board”.

Therefore, in keeping with the emphasis of the financial regulation on the decision-making process, the EIOPA Guidelines state that “challenge”—on the basis of accurate information—is essential to effective decision-making.⁵⁵ Unfortunately, a useless discussion has grown around the word “challenge”. This rule does not intend to originate a conflict between the board and the chief executive officer or between non-executives and the executive, but only to underline that ultimately the board has to make a unitary decision after a constructive debate. It is crucial that such result is conceived after a proper debate about pros and cons of various scenarios—for example negative, neutral, positive—and an assessment of all the risks originating from any decision. The chair of the board needs to stimulate an environment where this is valued. From this perspective, it is clear that “challenge” should be interpreted as an attitude to understanding the issues discussed and enhancing the quality of the decision through an open-minded debate, supported by diversity of skills, experience and background.

The board should make a forward-looking judgement in overseeing the running of the firm. In pursuing this task, a good constructive challenge from non-executives improves the quality of the discussion. On the contrary, an annoyed reaction on the part of the chief executive officer or the senior executives would be the sign of a negative attitude. A “four-eyes” principle to decision-making requires to challenge the executive in all aspects of the firm’s strategy, which includes the viability and sustainability of the business model and the establishment, maintenance and use of the risk appetite and management framework. A board may perform in such effective style only if, on the one side, the executives are capable of explaining in simple and transparent terms these complex matters to non-executives and, on the other side, the executives try to understand the uncertainty around judgements, in what circumstances they could be wrong, and how different ways may be reasonably adopted to measure the Own Risk Self Assessment (ORSA) and, last but not least, the Internal Risk Model.⁵⁶ In pursuing an open and fair confrontation, the board can prove to be effective.

At the core of the board functions there is the setting establishment, maintenance and use of the risk appetite and management framework through the ORSA process. According to EIOPA, it is crucial that the board is aware of all material risks the undertaking faces, regardless of whether the risks are captured by the Solvency Capital Requirement calculation and whether they are quantifiable or not.

As noted by Solvency II experts, the board should view the ORSA as “an annual process or cycle, rather than just a document or report”.⁵⁷ The board should initially be involved in directing the process and deciding how the assessment is to be performed. The “ORSA should inform discussion between the board and senior management with regard to the undertaking’s risk appetite and how best to deal with risk exposures that may breach the undertaking’s capital requirements under its own solvency assessment”.⁵⁸ It is also crucial that the board takes an active role. Moreover, “directing the process and challenging the results” of the ORSA should enable the board to review the developments and achievements.⁵⁹ If the board is not satisfied with the ORSA, it may advise the senior management to take an alternative view in the ORSA process more adequate for the business and risk profile of the insurance undertaking.⁶⁰

The EIOPA Guidelines specifically state that the “challenge” process performed by the board should be documented. Throughout the year, the minutes of the board meetings, including any remarks and comments relating to the ORSA, should be clearly traceable. Such documentation can then be used to give evidence of the board’s involvement in the process. The approval of the ORSA absolutely requires the active involvement of the board in the drafting process, as “it would be difficult for the board to stand over the formal approval of a process that it has not fully engaged with along the way”.⁶¹ The ORSA process needs to gradually become more embedded within the undertaking’s business planning process, as the senior management begins to see the benefits, and the board and senior management need time to become completely comfortable with the process.⁶²

The facts and figures of the ORSA should enable the board to advance its understanding of the risks that the undertaking is exposed to and any changes to risk exposures on a continuous basis. Therefore, the flow of data and information directed to the board has to be sufficiently detailed

to enable it to use them in its strategic decision-making activity. As stated by the EIOPA Guidelines, the ORSA is a very important tool for the board, as it provides it with a comprehensive picture of the risks the undertaking is exposed to or could face in the future. It has to enable the board to understand these risks and how they translate into capital needs, or alternatively require risk-mitigation techniques. In line with this process, taking into account the insights gained from the ORSA, the board also approves the long and short-term capital planning, whilst considering the business and risk strategies it has decided upon for the undertaking.⁶³ This plan includes alternatives to ensure that capital requirements can be met even under unexpectedly adverse circumstances.

Role of the Board in Assuring a “Fair Treatment” of Customers

During the financial crisis, many national authorities witnessed a significant number of complaints concerning products that did not fit the customers’ profile or meet the expectations of the customers. They also reported about cases where the product provided a very limited coverage excluding main risks to which policyholders were typically exposed. This was reflected in the confidence in insurance firms and products across the sector. Defective products may also affect financial stability, if distributed on a mass scale. Moreover, in the current peculiar era of low interest rates, the insurance industry has evolved to design products aimed at purposes beyond the mere risk coverage, for instance, investment and money saving. As a consequence, insurance products and contracts tend to be more complex and shift financial risks that may not be easily perceived by the average customer.⁶⁴

Adapting the MiFID style approach to the insurance sector,⁶⁵ the EIOPA Guidelines on product oversight and governance try to target the product design and put forward requirements for manufacturers and distributors of insurance products.⁶⁶ In addition, the guidelines introduce some key elements for the cooperation between manufacturers and distributors, underlining the importance of strengthening the exchange of product-related information. EIOPA considers that product oversight and governance arrangements play a key role in customer

protection, by ensuring that insurance products meet the needs of the target market and thereby mitigate the potential for mis-selling.⁶⁷

It is worth noting that an emerging regulatory trend encompasses the role and responsibility of the board in monitoring the risk of mis-selling. According to the evidences reported to EIOPA by various national authorities, conduct weaknesses have been widespread not only among the insurance-based financial products but also in the personal payments insurance. As far the insurance sector is concerned, the EIOPA Guidelines on product oversight and governance arrangements set the tone from the top and assign an ultimate responsibility to the board.⁶⁸ A governance framework has culture at its heart, which influences the way in which individuals behave.⁶⁹ The culture within the insurance firm needs to be set from the top from the board and senior management. It is paramount that the board is effectively involved in, and accountable for, promoting good business conduct. Even more, the public supervision of insurance products plays a special role in customers' protection, but it is one of the key areas on which the board needs to focus with a long-term view.

From a supervisory perspective, customer detriment caused by the purchase of unsuitable and/or poorly designed products can either be addressed *ex post*, by product interventions or banning of products causing customer detriment, or *ex ante*, by addressing the product design process and selling practices. This is the reason why the board has to devote special attention to the process of designing the products and deploying the best effort to give proper consideration to the needs of the target market and to prevent a customer detriment.⁷⁰

Product oversight and governance arrangements aim to ensure that the consumer interests are taken into consideration throughout the life cycle of a product, namely the process of designing and manufacturing the product, bringing it to the market and monitoring the product once it has been distributed. They are an essential element of the new regulatory requirements under the IDD.⁷¹ Because of their relevance in terms of customer protection, the role and responsibility of the board are further detailed and specified. In this respect, the board ensures that the product oversight and governance arrangements are appropriately designed and implemented into the governmental structures of the manufacturer, and may involve any relevant key functions in the establishment and subsequent reviews of the product oversight and governance arrangements.

Notwithstanding the implementations of various product oversight arrangements within insurance undertakings, the ultimate responsibility should remain at the board level. This is made possible by the provision of the EIOPA Guidelines, prescribing that product oversight and governance arrangements, as well as any changes, are subject to prior approval by the manufacturer's AMSB. In fact, the ultimate responsibility of the board has been considered a sufficient tool in order to ensure an effective oversight and responsibility lines over product oversight and governance arrangements of the manufacturer. Ultimately, this requirement reflects the principle of responsibility of the board set in the Solvency II requirements on the system of governance.

Ratings and Quality Assessments of Corporate Governance

Good governance is critical to the long-term sustainability of any company. EU banking and insurance prudential standards require regulated institutions to have a rigorous governance framework, founded on the premise that a well-governed institution is critical to the protection of the interests of depositors and policyholders. The ultimate responsibility for the sound and prudent management of an institution rests with its board. Key requirements of the prudential standards concern the size and composition of the board, independence of the chair, and board renewal and performance assessment. After Solvency II, and possible capital add-ons in case of governance failure,⁷² a formal system to rate the governance of insurance undertakings in the EU must be designed, which could be useful for both the firms and the supervisors. For instance, a rating is provided by a supervisory authority in the event of an on-site inspection on the results of this activity. There is no permanent evaluation of the governance based on a quantitative approach, but only on a single basis on the result of the annual reports.

To build up a rating system for the effectiveness of the board, a common methodology at the European level is needed. Therefore, such a rating should be neutral as to the governance model that is being applied (one tier, two tier, etc.). In performing these quality assessments, a proportionate approach is paramount to consider the size and complexity of the firm's operations. Looking at the practical aspects of quality assessments, there

should be a guide for supervisors by EIOPA as to how each of these factors should be considered and rated. It should include suggestions for documents and other sources which would help in the quality assessment, and these are used to compile the assessment.⁷³ They include board papers and minutes, prudential consultations, risk reviews, and discussions with the management and board. To be consistent in the quality assessments of each area and in the ratings of firms, a benchmarking exercise would be useful, given the wide variety of institutions in the European landscape. It is worth noting that the Solvency II Guidelines on the system of governance do not include any peer comparison. The results of any quality assessments of risk governance and the board effectiveness depend crucially on benchmarking, which would help improve most institutions. Moreover, the development of a methodological framework for corporate governance quality assessment conducted by national competent authorities would be beneficial for the supervisory convergence across the EU. Best practices should also be identified and made public, with the aim of strengthening the self-discipline of the insurance firms involved. Lastly, because this is not necessarily a primarily role for the supervisory authorities, these should develop the necessary skills and mindset. In this landscape there is a complementary as well proactive role for the corporate governance self-regulatory industry bodies.

Remuneration

One of the most prominent issues that has been attracting the attention of different stakeholders is related to the remuneration practices applied to the members of the board and senior management of financial entities, as well as to personnel undertaking activities that involve risk-taking. Specifically, for insurance firms, remuneration policies that excessively reward short-term profit and give incentives to take risks that are not in line with the undertaking's risk profile can undermine sound and effective risk management, exacerbate excessive risk-taking behaviour and lead to potential conflicts of interest.

Although the majority of these situations occurred in sectors other than insurance, in the context of the Solvency II regime it was considered that some principles should be applied and preventive measures should

be allowed for and implemented by insurance undertakings. Therefore, notwithstanding the absence of any provision in the Directive,⁷⁴ having considered that an adequate system of governance should include the implementation of an appropriate remuneration policy, the Implementing Measures require undertakings to adopt a remuneration policy that is in line with its business strategy and risk profile, and should avoid any potential incentives for unauthorised or unwanted risk-taking.⁷⁵

In order to ensure the adequacy of the process, the undertaking's shareholders should be involved in the approval of the remuneration policy with reference to the remuneration of the board. The latter should define the remuneration applicable to the key functions, senior management, personnel undertaking activities that involve significant risk-taking and other staff. The remuneration policy should be subject to a regular (at least annual) and independent internal review, with specific attention to preventing incentives for excessive risk-taking and the creation of conflicts of interest between the employees and the undertaking as a whole, and generally not undermining sound and effective risk management. In this review, the appropriateness of the basis on which the variable component of remuneration is set, as well as its proportion, should be assessed, and recommendations should be provided when appropriate.

Final Remarks

Under EU law, following the issuance of the CRD IV and Solvency II directives, the prudential authorities operate as supervisors in charge of the application of judgement against a complex and multilevel framework of rules and guidelines which also encompasses the system of governance.⁷⁶ Conversely, the regulation of corporate governance should be based on a limited number of standards, with which boards should comply under the *ex post* supervision of supervisory authorities. A similar approach is preferable to the extent that it is respectful of the autonomy of insurance undertakings, while leaving supervisors with the “effectiveness” of corporate governance from the perspective of the safety and soundness of the institutions concerned. Narrow rule-based approaches to regulations create inflexibility and can easily lead to arbitrage.⁷⁷ In the context of the

EU, it will depend on the European Supervisory Authorities whether to continue having regulations of the highest standards on corporate governance, which sort out a fair relationship between harmonisation and reliability, but a more principle-based regulation should be developed under a common framework of a peer review of supervisory practice—both at national and European level—within European cross-sectoral metrics of quality assessment.

The regulation has a deep influence on the development of the risk culture, risk-management and internal control systems. However, understanding how firms take and manage risk and the controls they perform is at the heart of the job of a board. The standards of this work have been improved since the crisis, which was probably necessary also in corporate governance as a whole. However, it remains to be seen if the exceptional extension of the duties and responsibilities assigned to the board of directors, far beyond the traditional role both of monitoring the chief executive officer and assessing the overall direction and strategy of the business, will be successful in achieving a better risk governance.

Furthermore, it seems that insurance regulation has a twofold approach to corporate governance issues: on the one side, it endorses criteria traditionally adopted in the European context; on the other side, it enacts specific rules and procedures that already characterise the corporate governance in the banking sector. European insurance regulation should aim to create a more flexible corporate governance structure, with particular emphasis to the additional duties of the board of directors or to the risk-management requirements established in the Level III Guidelines. In both cases, they do not seem to fully endorse the proportionality principle, since they require a “one size fits all” risk-management structure for every insurance undertaking, irrespective of the size, business model and whatever essential characteristics. A possible explanation is that European insurance regulation aims to adopt a strict regulatory framework for these aspects, believing that they deserve particular attention because of their crucial role in enhancing corporate governance. This approach can be useful for fostering corporate governance culture, although procedures can sometimes be either too broad or too narrow tools for any undertaking.

Regulators must play an active role in ensuring that insurance undertakings have in place the right governance and culture.⁷⁸ But it is not up

to the supervisor to determine the culture, business strategy or remuneration policy. The right cultures are rooted in strong ethical frameworks and in the importance of individuals making decisions in relation to principles, rather than only business-oriented values. However, there is room for conflicting views between the regulator and the firms, given the natural short-terminisms of management.⁷⁹ In the middle—or, one could say, in the firing line—stands the board.

The crisis revealed significant failures in the governance and risk management of financial firms—although the insurance sector proved to be involved only to a limited extent—as well as their underlying culture and ethics. These deficiencies are not so much a “structural” issue, but are rather the result of conducts, attitudes and, in some cases, competence of the boards and senior management. Indeed, “more work remains: national authorities need to strengthen their ability to assess the effectiveness of a firm’s risk governance, and more specifically its risk culture, to help ensure sound risk governance through changing environments”.⁸⁰ Boards should promote an ethical culture, in which critics and observation can be openly expressed.

Risk governance, inclusive of risk culture, is a relatively new approach to the corporate governance of both insurance firms and other financial institutions; it implies a crucial role for the board, pushing towards a strategy of effectiveness of risk structures and risk culture within the firm, and opens up new challenges for the supervisor, during the assessment and comparison of the results across the industry.⁸¹ A responsive, yet not intrusive, regulation would be even more helpful.

Notes

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3. European Commission, *Green Paper, Corporate governance in financial institutions and remuneration policies*, COM (2010), 284 final, p. 3, available at http://ec.europa.eu/internal_market/

4. P. O. Mülbert, *Corporate Governance of Banks*, European Business Organisation Law Review, v.11 n.3, 2008, p. 427. See also R. D. Citlau & P. O. Mülbert, *The uncertain role of banks' corporate governance in systemic risk regulation*, ECGI Law Working Paper n. 179, 2011, available at www.ecgi.org/wp
5. European Commission, *Green Paper, Corporate governance in financial institutions and remuneration policies*, COM (2010), 284 final, p. 4. For a critical view on stakeholder governance see G. Ferrarini, *Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda*, Law Working Paper n. 347, 2017, available at www.ecgi.org/wp
6. de Larosière High Level Group, *Report on the future of financial supervision in the EU*, 25 February 2009, Brussels. The Report stated that corporate governance was one of the most important elements underlying the financial crisis. Corporate governance failure was not the only cause of the financial crisis and probably not even the most important one. Other factors played a crucial role, such as “the lax monetary policy of the American Federal Reserve Bank, the policy and practice of credit financing the housing of broad masses of the population, the securitisation of credit in complicated and opaque financial instruments”: see K. Hopt, *Corporate Governance of Banks and Other Financial Institutions after the Financial Crisis*, J. Corp. L. Studies, 2013, p. 237.
7. In the aftermath of the crisis, US regulators and scholars question the effectiveness of the existing corporate governance system in overseeing insurance companies and their excessive risk taking; see N. Boubakri, *Corporate governance and issues from the insurance industry*, Journal of Risk and Insurance, 78, 2011, 3, p. 501.
8. In the banking sector with the CRD IV Directive 2013/36/UE and the Regulation No. 575/2013 on prudential requirements for credit institutions and investments firms (the so-called CRD IV/CRR regime) the European legislator has introduced a comprehensive governance framework for banks. In the securities sector the MiFID II Directive 2014/55/EU and the Regulation 600/2014 (the so-called MiFID framework) include key governance requirements of the CRD IV Directive relating to, in particular, the composition and the obligations of the boards into the legal regime applicable to the investment firms. See N. Moloney, *EU Securities and Financial Markets Regulation*, 2014, p. 357 ff.
9. M. Hilb, *Redesigning corporate governance: lessons learnt from the global financial crisis*, Journal of Management and Governance, v. 15 n.4, 2011, p. 533 ff. See also OECD Steering Committee on Corporate

- Governance, *Corporate governance and the financial crisis*, p. 15, available at <http://www.oecd.org/>
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 14. Basel Committee on Banking Supervision, *Principles for enhancing corporate governance*, 2010, available at www.bis.org. See at par. 13: “Indeed, in addition to their responsibilities to shareholders, banks also have a responsibility to their depositors and to other recognised stakeholders. The legal and regulatory system in a country determines the formal responsibilities a bank has to its shareholders, depositors and other relevant stakeholders. This document will use the phrase “shareholders, depositors and other relevant stakeholders”, while recognising that banks’ responsibilities in this regard vary across jurisdictions.”
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19. See MiFID II Directive, Recital 53: “It is necessary to strengthen the role of management bodies of investment firms, regulated markets and data reporting services providers in ensuring sound and prudent management of the firms, the promotion of the integrity of the market and the interest of investors”. See C. E. de Jager, *A Question of Trust: the Pursuit of Consumer Trust in the Financial Sector by Means of EU Legislation*, J. Consumer Policy, 40, 2017, p. 25, at p. 24.
20. M. Dreher, *Treatise on Solvency II*, Springer, 2015. The Author clearly states, in chapter 3 p. 67 ff., that consumer Protection is not addressed in Solvency II directive as well as in the Level II and III, the protection of policy holders and beneficiaries of indemnity payments being the main objective of Solvency II. Therefore, “consumer protection is a significant by-product of the Solvency II rules”, and the “EIOPA provisions, too, address consumer protection solely in the realm of collective consumer protection”.
21. See Solvency II Directive, Recital 16: “The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policy holders and beneficiaries. The term beneficiary is intended to cover any natural or legal person who is entitled to a right under an insurance contract. Financial stability and fair and stable markets are

other objectives of insurance and reinsurance regulation and supervision which should also be taken into account but should not undermine the main objective.”

22. See Solvency II Directive, Recital 29: “Some risks may only be properly addressed through governance requirements rather than through the quantitative requirements reflected in the Solvency Capital Requirement. An effective system of governance is therefore essential for the adequate management of the insurance undertaking and for the regulatory system.”
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27. The initial work for the EC Solvency II project was largely based on the Basel II framework for banking regulation and the three pillars approach has been discussed in a report commissioned by the Internal Market Directorate General of the European Commission: KPMG, *Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision*, May 2002, available at http://ec.europa.eu/internal_market/insurance/. See also J. van der ENDE and R. Ayadi, *Insurance Regulation and Supervision in the EU: Report of a CEPS Task Force*, Brussels, 2006 and A. V. Guccione,

- From Solvency to Omnibus. Historical Origins and Normative Evolution*, in M. Andenas, R. G. Avesani, P. Manes, F. Vella, P. R. Wood (eds.), *Solvency II: A Dynamic Challenge for the Insurance Market*, Il Mulino, 2017, chapter I, p. 35 ff.
28. CEIOPS, *Advice for Level 2 Implementing Measures on Solvency II: System of Governance* (former Consultation Paper 33), October 2009, p. 3, available at <https://eiopa.europa.eu/CEIOPS-Archive/>. The Advice, at para. 1.3, remarks that “the Level I text already comprises a considerably high level of detail concerning principles and requirements on the system of governance, especially compared to the Level I text and/or Level II implementing measures in other EU directives on financial services.” Accordingly, there is not any general Level II provision in the implementing measures with regard to proportionality. No doubt that proportionality requirement applies to every element of the system of governance. However, it is the responsibility of the AMSB to ensure that the undertaking’s organisational structure delivers a system of governance proportionate to the nature, scale and complexity of the risks it faces in its business activities. Regarding the fulfilment of the internal audit function it should be noted that this cannot be combined with other operational duties or functions. The internal audit function shall be objective and independent from the operational functions. In effect, this means that in the view of the Solvency II regime, the internal audit function—in contrast to the other functions explicitly mentioned in the Directive—needs to be a separate unit or an individual without other duties within the undertaking, unless the function is outsourced. See CEIOPS, *Advice to the European Commission on the Principle of Proportionality in the Solvency II Framework Directive proposal*, CEIOPS-DOC-24/08, May 2008, available at <https://eiopa.europa.eu/CEIOPS-Archive/>
 29. EIOPA, *Guidelines on system of governance*, 28 January 2015, EIOPA-BoS-14/253, available at <https://eiopa.europa.eu/>. The “General Governance requirements” are detailed in Sect. 1 (Guidelines 1–8), “Remuneration” in Sect. 2 (Guideline 9 and 10), “the Fit and Proper” in Sect. 3 (Guidelines 11–16), the “Risk Management” in Sect. 4 (Guidelines 17–26), the “Prudent person principle” in Sect. 5 (Guidelines 27–35).
 30. P. Manes, *Corporate Governance, the Approach to Risk and the Insurance Industry under Solvency II*, in M. Andenas, R. G. Avesani, P. Manes, F. Vella, and P. R. Wood (eds.), *Solvency II: A Dynamic Challenge for the Insurance Market*, Il Mulino, 2017, chapter IV, p. 115 ff.

31. According to the Implementing Measures (art. 258) the undertaking's system of governance should: (a) establish, implement and maintain effective cooperation, internal reporting and communication of information at all relevant levels of the undertaking; (b) establish, implement and maintain effective decision making procedures and an organisational structure which clearly specifies reporting lines, allocates functions and responsibilities, and takes into account the nature, scale and complexity of the risks inherent in that undertaking's business; (c) ensure that the members of the AMSB collectively possess the necessary qualifications, competency, skills and professional experience in the relevant areas of the business in order to effectively manage and oversee the undertaking in a professional manner; (d) ensure that each individual member of the AMSB has the necessary qualifications, competency, skills and professional experience to perform the tasks assigned; (e) employ personnel with the skills, knowledge and expertise necessary to carry out the responsibilities allocated to them properly; (f) ensure that all personnel are aware of the procedures for the proper carrying out of their responsibilities; (g) ensure that the assignment of multiple tasks to individuals and organisational units does not or is not likely to prevent the persons concerned from carrying out any particular function in a sound, honest and objective manner; (h) establish information systems which produce complete, reliable, clear, consistent, timely and relevant information concerning the business activities, the commitments assumed and the risks to which the undertaking is exposed; (i) maintain adequate and orderly records of the undertaking's business and internal organisation; (j) safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question; (k) introduce clear reporting lines that ensure the prompt transfer of information to all persons who need it in a way that enables them to recognise its importance with regard to their respective responsibilities; (l) adopt a written remuneration policy.
32. The nature and structure of the AMSB varies with the national company law applicable in the jurisdiction in which the insurance undertaking is incorporated. The term "administrative, management or supervisory body" covers the single board in a one-tier system and the management or the supervisory board of a two-tier board system. According to the Directive, the responsibilities and duties of the different bodies should be seen as having regard for different national laws. When transposing the Level I text, each Member State has to consider its own system and attribute each responsibility and duty to the appropriate board.

33. According to CEIOPS, the predecessor of EIOPA, the AMSB is ultimately accountable and responsible for the compliance of the undertaking with legal and administrative requirements pursuant to the Directive. Therefore, “[d]elegating to committees consisting of members of the administrative, management or supervisory body does not in any way release the administrative, management or supervisory body from collectively discharging its duties and responsibilities. The administrative, management or supervisory body needs to ensure that it has regular and robust interaction with any board committee on the one hand, and with senior management and with key functions on the other hand, and to recognise that part of its duties include requesting information proactively and challenging this information when necessary” (CEIOPS, *Advice for Level 2 Implementing Measures on Solvency II: System of Governance*, October 2009, p. 10, para 3.4, available at <https://eiopa.europa.eu/CEIOPS-Archive/>). Therefore, each undertaking’s AMSB should consider whether the structure of a committee is appropriate (e.g. forming audit, risk, investment or remuneration committees) and, if so, what its mandate and reporting lines should be. See also K. Van Hulle, *The challenge of Solvency II: Lecture to the faculty of actuaries*, British Actuarial Journal, 2008, 14, 1, p. 27.
34. EIOPA, *Final Report on Public Consultation No. 14/017 on Guidelines on system of governance*, available at <https://eiopa.europa.eu/>, at part 2, n. 2.17, states: “The AMSB does not exert influence to suppress or tone down key function results in order that there is no discrepancy between the findings of key functions and the AMSB’s actions.”
35. Undertakings have to ensure that the system of governance is internally reviewed on a regular basis. To this purpose, according to para n. 3.13–3.14 of the Advice, they have to determine the appropriate frequency of the reviews taking into account the nature, scale and complexity of their business and assign responsibility for the review to be documented as appropriate. Suitable feedback loops should exist to ensure follow-up actions are continuously undertaken and recorded. In order to allow an adequate revision of the system of governance, appropriate reporting procedures encompassing at least all key functions should be established. The reports to be produced shall encompass an assessment of the effectiveness of the system of governance and should contain suggestions for improvements. They should be presented to the AMSB at least annually, according to the principle of proportionality, and discussions on any challenge provided or improvements suggested

should be documented as appropriate. Suitable feedback loops should exist to ensure follow-up actions are continuously undertaken and recorded.

36. According to the para. 3.11 of CEIOPS Advice “The undertaking should ensure that each key function has an appropriate standing in terms of organisational structure. Considering the principle of proportionality, CEIOPS believes that in large undertakings and in undertakings with more complex risk profiles the key functions should generally be performed by separate units” (CEIOPS, *Advice for Level 2 Implementing Measures on Solvency II: System of Governance* (former Consultation Paper 33), October 2009, p. 12, para 3.10, available at <https://eiopa.europa.eu/CEIOPS-Archive/>). An adequate interaction between the key functions has to be fostered and adequately defined by each undertaking, including the establishment of communication and reporting procedures. In this context, all key functions should have access rights to the relevant systems and staff members, including any records, necessary to allow them to carry out their responsibilities.
37. CEIOPS, *Advice for Level 2 Implementing Measures on Solvency II: System of Governance* (former Consultation Paper 33), October 2009, p. 12, para 3.3, available at <https://eiopa.europa.eu/CEIOPS-Archive/>
38. EIOPA, *Final Report on Public Consultation No. 14/017 on Guidelines on system of governance*, available at <https://eiopa.europa.eu/>, in part 2, n. 2.10 states: “Significant decisions as opposed to day-to-day decisions do not concern the spate of usual decisions to be taken at the top level of the undertaking in the running of the business, but are rather decisions that are unusual or that will or could have a material impact on the undertaking. This could be e.g. decisions that affect the strategy of the undertaking, its business activities or its business conduct, that could have serious legal or regulatory consequences, that could have major financial effects or major implications for staff or policyholders or that could potentially result in repercussions for the undertaking’s reputation.”
39. This situation might not comply with the EIOPA Guidelines, since each director has a different specific area of business. Possible solutions could be to involve the board or to require the approval of the other executive although in charge of a different area of business. However, in both cases, it is difficult to understand if these solutions comply with the EIOPA Guideline, considering that there is not a definition of the “two people running the business” requirement. On the one hand, it might mean that the executives have to jointly undergo the decision-making process;

therefore, neither of the abovementioned solutions would comply with the EIOPA Guideline. On the other hand, though, we could assume that the concept of “effectively running the business” just requires that the people involved in the significant decision manage the undertaking, regardless of their specific area of competences. In the first scenario, there seems to be compliance with the EIOPA Guideline; in the second, it is clear that there is no compliance with the EIOPA Guideline, since only one director has been appointed as executive. As above, a possible solution could be to involve the board, but the same problems would arise. Other solutions could be the involvement of a non-executive director or of the director general. In the first case, it is difficult to assess that a non-executive director effectively runs the company; in the second, the major concern is the fact that the director general is hierarchically subordinated to the executive director.

40. See Solvency II Directive at Article 42. The Implementing Measures do not specify any general criteria for the assessment of fitness and propriety—to be developed under the EIOPA Guidelines. Notwithstanding the cross-sectoral work in this area of the ESA, the Level II should have considered the scope of the assessment of the competence in terms of management and in the area of the business activities carried out by the insurance undertaking. Also, the Implementing Measures, given the absence of any provision in the Directive, contain no rules on the methodology to be followed by supervisory authorities when assessing the suitability of a person, with particular reference to past behaviour, nor provide any clarification of the power to require the undertaking not to appoint, or replace, the person in question.
41. The board and the senior management are under strict fit and proper requirements, because they represent the “starting point for setting the undertaking’s core values and expectations for the risk culture of the institution”: see P. Manes, *Corporate Governance, the Approach to Risk and the Insurance Industry under Solvency II*, in M. Andenas, R. G. Avesani, P. Manes, F. Vella, and P. R. Wood (eds.), *Solvency II: A Dynamic Challenge for the Insurance Market*, Il Mulino, 2017, chapter IV, p. 118.
42. See also M. Dreher, *Treatise on Solvency II*, Springer, 2015, in chapter 7, p. 217 ff., explaining the interplay between the key functions considered critical or important in the system of governance.
43. The scope of the information requirement to enable the supervisory authority to assess the fitness and propriety of the persons is the same as the scope of the notification requirement. It comprises the persons who

effectively run the undertaking or those considered critical or important in the system of governance (such as the risk management, the compliance, the internal audit and the actuarial functions) and may in addition include persons responsible for other key functions, depending on the nature, scale and complexity of the business.

44. It is worth noting that, in relation to the propriety requirement, all persons who effectively run the undertaking or have other key functions should each be proper. According to the CEIOPS Advice, “[t]he proportionality principle does not result in different standards in the case of the propriety requirement, since the repute and integrity of the persons who effectively run the undertaking or hold key functions should always be on the same adequate level irrespective of the nature, scale and complexity of the business or of the undertaking’s risk profile.” (CEIOPS, *Advice for Level 2 Implementing Measures on Solvency II: System of Governance*, October 2009, p. 12, para 3.43, available at <https://eiopa.europa.eu/CEIOPS-Archive/>).
45. See Solvency II Directive in article 44. The Implementing Measures requires, in article 259 para. 1, that a risk management system includes: “(a) a clearly defined risk management strategy which is consistent with the undertaking’s overall business strategy. The objectives and key principles of the strategy, the approved risk tolerance limits and the assignment of responsibilities across all the activities of the undertaking shall be documented; (b) a clearly defined procedure on the decision-making process; (c) written policies which effectively ensure the definition and categorisation of the material risks by type to which the undertaking is exposed, and the approved risk tolerance limits for each type of risk. Such policies shall implement the undertaking’s risk strategy, facilitate control mechanisms and take into account the nature, scope and time periods of the business and the associated risks; (d) reporting procedures and processes which ensure that information on the material risks faced by the undertaking and the effectiveness of the risk management system are actively monitored and analysed and that appropriate modifications to the system are made where necessary.”
46. The “strategies” are high-level plans that are developed by the AMSB and are further specified via policies and business plans to ensure implementation in day-to-day business. The “policies” are internal guidelines established by senior management in line with the relevant strategies to outline the framework that staff has to take into account when exercising their responsibilities (CEIOPS, *Advice for Level 2 Implementing Measures*

- on Solvency II: System of Governance*, October 2009, p. 12, para 3.67, available at <https://eiopa.europa.eu/CEIOPS-Archive/>).
47. FSB provides a useful summary of the key principles of risk governance as follows starting from a stronger risk oversight at board level. See Financial Stability Board, *Thematic review on risk governance*, 2013, p. 30, available at www.financialstabilityboard.org. See also P. Manes, *Corporate Governance, the Approach to Risk and the Insurance Industry under Solvency II*, in M. Andenas, R. G. Avesani, P. Manes, F. Vella, and P. R. Wood (eds.), *Solvency II: A Dynamic Challenge for the Insurance Market*, Il Mulino, 2017, chapter IV, p. 115 ff.
 48. EIOPA, *Final Report on Public Consultation No. 14/017 on Guidelines on system of governance*, available at <https://eiopa.europa.eu/>, in part 2, n. 2.74 states as follows: “While risk management is the responsibility of the undertaking’s AMSB as a whole, the undertaking is expected to designate at least one member of the AMSB to oversee the risk management system on its behalf.”
 49. EIOPA, *Final Report on Public Consultation No. 14/017 on Guidelines on system of governance*, available at <https://eiopa.europa.eu/>, at part 2, n. 2.77.b) states as follows: “Risk tolerance limits” expresses the restrictions the undertaking imposes on itself when taking risks. It takes into account: (1) the relevant constraints that effectively limit the capacity to take risks. These constraints can go beyond the framework of solvency as defined in Solvency II (2) the risk appetite; (3) other relevant information (e.g. current risk profile of the undertaking, interrelationship between risks).”
 50. EIOPA, *Guidelines on system of governance*, 28 January 2015, EIOPA-BoS-14/253, available at <https://eiopa.europa.eu/>, Guideline 18—Risk management policy states: “The undertaking should establish a risk management policy which at least: (a) defines the risk categories and the methods to measure the risks; (b) outlines how the undertaking manages each relevant category, area of risks and any potential aggregation of risks; (c) describes the connection with the overall solvency needs assessment as identified in the ORSA, the regulatory capital requirements and the undertaking’s risk tolerance limits; (d) specifies risk tolerance limits within all relevant risk categories in line with the undertaking’s risk appetite; (e) describes the frequency and content of regular stress tests and the situations that would warrant ad-hoc stress tests.”
 51. H. Sants, *Delivering effective corporate governance: the financial regulators’ role*, Speech by Hector Sants, Chief Executive, FSA at Merchant Taylors’

Hall, 24 April 2012, available at <http://www.fsa.gov.uk/>. He observes, *inter alia*, that “Boards must be able to set a strategy and risk appetite and oversee implementation, but they do not substitute for the role of the executive. Likewise, Supervisors challenge hard and can ask for changes, but they do not substitute for the Board or the Executive”. On the role of governance as possible substitute of regulation see I. MacNeil, *Governance and regulation: resetting the relationship*, Law and Financial Markets Review, 6, 2012, 3, p. 169.

52. Among corporate scholars the subject has been largely neglected in the academic literature with the exception of P. Marchetti, G. Siciliano, and M. Ventoruzzo, *Dissenting Directors*, ECGI Working Paper No. 332/2016, October 2016, available at www.ecgi.org/wp. See again H. Sants, *Delivering effective corporate governance: The financial regulators role*, Speech by Hector Sants, Chief Executive, FSA at Merchant Taylors’ Hall, 24 April 2012, available at <http://www.fsa.gov.uk/>. He also remarks that “it is the Chair’s role to construct and manage a Board that has the appropriate and relevant skills and experience to enable it to function effectively”.
53. EIOPA Guideline 1—The administrative, management or supervisory body. See par. 1.24. “The administrative, management or supervisory body (hereinafter “AMSB”) should have appropriate interaction with any committee it establishes as well as with senior management and with persons having other key functions in the undertaking, proactively requesting relevant information from them and challenging that information when necessary.” and par. 1.25. “At group level the AMSB of the participating insurance or reinsurance undertaking, the insurance holding company or the mixed financial holding company should have an appropriate interaction with the AMSB of all entities within the group that have a material impact on the risk profile of the group, requesting information proactively and challenging the decisions in the matters that may affect the group.”
54. Financial Services Authority, *The failure of the Royal Bank of Scotland*, December 2011, p. 228, available at www.fsa.gov.uk/rbs. The Report observes the following: “With reference to the acquisition of ABN AMRO, the Review Team attached special significance to three closely related factors that may have influenced the quality of the RBS Board’s decision-making: ...it was not apparent to the Review Team that the Board discussed in sufficient depth the risks involved in the acquisition, including its exceptional complexity, unprecedented scale and how it was

to be financed, especially as so little effective due diligence was possible. The Board drew comfort from the fact that the limited due diligence, which seems to have focused on identifying the scope for synergies and cost cutting, with less emphasis on identifying the risks and potential exposures, identified no 'show-stoppers' in particular business or functional areas. In the absence of detailed due diligence, the Board also placed reliance on the fact that ABN AMRO was regulated by the DNB and the FSA, on ABN AMRO's publicly available SEC filings, on Sarbanes-Oxley conformity, on reports by the rating agencies and on Barclays' persistence in pursuing its bid. The minutes of the Board meeting on 28 March 2007 record that the RBS CEO '*provided background to the project... A bid for [ABN AMRO] was not seen as a "must do" deal*'. The CEO advised the Board that '*execution risk would be high*' and that '*any bid for [ABN AMRO] and subsequent integration would be more difficult than previous transactions*'. However, the Review Team has not found evidence that the Board undertook any penetrating analysis of the risks on an enterprise-wide basis in respect of capital and liquidity. During interviews with the Chairman and other Board members, it was indicated that, while the assumptions and plans were discussed on a regular basis, '*...at no stage did any Board member propose that we should not proceed*'. One former Board member reflected, with hindsight, that there was an element of 'group-think' in the Board's decision to acquire ABN AMRO and that, to his knowledge, no Board member ever said that he or she was worried about the deal. In the opinion of the Review Team, it is very difficult to reconcile this approach with the degree of rigorous testing, questioning and challenge that would be expected in an effective Board process dealing with such a large and strategic proposition."

55. A prominent experience on supervisory evaluation of the decision-making process is a distinctive feature of the Dutch Prudential Supervisor: "DNB's supervision of behaviour and culture considers balanced and consistent decision making as two essential building blocks of an institution's effectiveness... The relevance of balanced and consistent decision making is based on three assumptions. The first of these is that financial institutions can only achieve solid long-term performance and financial performance by carefully considering the interests of all stakeholders. Second, balanced decision making prevents that decisions are taken prematurely and based on incorrect or incomplete information and assumptions. And finally, institutions have to be constantly aware of possible changes in the environment in which they operate. They must adapt to

these changes to remain successful. It is important that Board members create a clear and shared understanding about the institution's environment, its 'fit' with this environment (...), and how to adapt to changing circumstances (...). Such accurate shared mental models help Boards to adapt to changing circumstances and lead to effective and efficient coordinated management of group behavior." See De Nederlandsche Bank, *Supervision of Behaviour and Culture Foundations, practice & future developments*, November 2015, p. 108, available at <https://www.dnb.nl/>

56. A. Bailey, *Governance and the role of Boards*, Speech by Andrew Bailey at Westminster Business Forum, London, 3 November 2015, available at <http://www.bankofengland.co.uk/>. A Board is required to assess the key elements of model design, the significant assumptions, the expert judgements, the key sensitivities of the internal model, the significant limitations of and the uncertainty in the internal model. According to Bailey, "the challenge is to reduce complexity to simplicity, so that Board members feel that they understand where is the model expected to work well; in what circumstances is it likely to break down; if is the overall model output credible; what are the drivers in terms of key assumptions or judgements; if those assumptions and judgements are reasonable. Non-Executives should be put in a position to possess a general understanding of the model and meet these expectations without detailed technical knowledge. That's the job of the Executive, to explain complexity, provide good management information and enable challenge and thus accountability."
57. D. Lavelle, A. O'Donnell, D. Pender, D. Roberts, and D. Tulloch, *The Solvency II ORSA Process*, Society of Actuaries, November 2010, Ireland, available at <https://web.actuaries.ie/>
58. S. Clarke and E. Phelan, *Stepping stones to ORSA: Looking beyond the preparatory phase of Solvency II*, Milliman Research Report, August 2015, p. 18, available at <http://www.milliman.com/>. The Report observes the following: "These discussions should influence the strategic decision making of the undertaking and may lead to changes in the undertaking's business plan. For example, risk management techniques such as reinsurance or hedging programmes may be introduced where the ORSA indicates risk exposures that are in excess of the Board's risk appetite. Alternatively, the assessment of overall solvency needs may show that the undertaking has a significant amount of own funds in excess of its overall solvency needs and the Board may decide to issue a dividend as a result, provided that it has the distributable earnings to do so without impacting

- on the undertaking's liquidity position. Such discussions and decisions should also be recorded and documented.”
59. EIOPA, *Guidelines on Own Risk and Solvency Assessment*, 28 January 2015, available at <https://eiopa.europa.eu/>. See “Guideline 2—Role of the AMSB: top-down approach. 1.14. The AMSB should take an active part in the ORSA, including steering, how the assessment is to be performed and challenging the results.”
 60. EIOPA, *Guidelines on Own Risk and Solvency Assessment*, 28 January 2015, available at <https://eiopa.europa.eu/>. See Explanatory text on Guidelines on own risk and solvency assessment para. 2.11 “The AMSB challenges the identification and assessment of risks, and any factors to be taken into account. It also gives instructions on management actions to be taken if certain risks were to materialise.” and 2.12 “As part of the ORSA the AMSB challenges the assumptions behind the calculation of the SCR to ensure they are appropriate in view of the assessment of the undertaking's risks.”
 61. S. Clarke and E. Phelan, *Stepping stones to ORSA: Looking beyond the preparatory phase of Solvency II*, Milliman Research Report, August 2015, p. 18, available at <http://www.milliman.com/>. See also M. Dreher, *Treatise on Solvency II*, Springer, 2015, in chapter 5, explaining the ORSA process from a legal perspective with special reference to the principle of materiality and proportionality as shaped by the Solvency II directive. As stated at p. 178, “The business strategy of an insurance undertaking thus becomes (...) the indirect subject-matter of supervisory review. In the light of this, and in order to maintain the sole responsibility of the management bodies and the supervisory exemption of the management tasks of the managing board, the supervisory review of ORSA requires particular sensitivity and restraint”.
 62. EIOPA, *Guidelines on Own Risk and Solvency Assessment*, 28 January 2015, available at <https://eiopa.europa.eu/>. See “Guideline 4—Policy for the ORSA—1.16. The AMSB of the undertaking should approve the policy for the ORSA. This policy should include at least a description of: (a) the processes and procedures in place to conduct the ORSA; (b) the link between the risk profile, the approved risk tolerance limits and the overall solvency needs; (c) the methods and methodologies including information on: (1) how and how often stress tests, sensitivity analyses, reverse stress tests or other relevant analyses are to be performed; (2) data quality standards; (3) the frequency of the assessment itself and the justification of its adequacy particularly taking into account the undertak-

ing's risk profile and the volatility of its overall solvency needs relative to its capital position; (4) the timing for the performance of the ORSA and the circumstances which would trigger the need for an ORSA outside of the regular time-scales.”

63. P. Manes, *Corporate Governance, the Approach to Risk and the Insurance Industry under Solvency II*, in M. Andenas, R. G. Avesani, P. Manes, F. Vella, and P. R. Wood (eds.), *Solvency II: A Dynamic Challenge for the Insurance Market*, Il Mulino, 2017, chapter IV, p. 119 ff.
64. ESA, *Joint Committee Report on Risks and Vulnerabilities in the Eu Financial System*, 7 September 2016, p. 7, available at <https://esas-joint-committee.europa.eu>, observing that “Search for yield, combined with structural shifts in the financial system due to regulatory changes, is likely to promote the further growth of the fund industry, the asset management sector in general and the trend towards unit-linked and market-based products.”
65. As regards to the interaction between different pieces of EU financial legislation see V. Colaert, *Mifid II in relation to other investor protection regulation: picking up the crumbs of a piecemeal approach*, in D. Busch and G. Ferrarini, *Regulation of the EU Financial Markets: MiFID II and MiFIR*, Oxford University Press, 2017, chap. 21, and P. Marano, *The “Mifidization”: The Sunset of Life Insurance in the EU Regulation on Insurance?* available at <https://ssrn.com/>
66. On the MiFID requirements about product governance see D. Busch, *Product Governance and Product Intervention under MiFID II/MiFIR*, in D. Busch and G. Ferrarini, *Regulation of the EU Financial Markets: MiFID II and MiFIR*, Oxford University Press, 2017, chap. 5.
67. EIOPA, *Strategy towards a comprehensive risk-based and preventive framework for conduct of business supervision*, 11 January 2016, available at <https://eiopa.europa.eu/>. See par. 3.4 “Conduct issues not only harm individual consumers, but can have wider prudential impact as seen with the Payment Protection Insurance mis-selling scandal. Indeed, at national level, there are different approaches to addressing conduct risks with differences in priority setting and levels of resources allocated. These divergences in models and practices across the EU only help to reinforce the current fragmented situation. The interrelationship between conduct and prudential issues plays a key part, on the one hand, regarding the— sometimes— conflicting goals and tension between the two, and, on the other hand, the fact that the ultimate objective of a prudential framework such as Solvency II, is the protection of policyholders.

Moreover, poor conduct of business—such as mass mis-selling—can have a systemic impact on the market, i.e. contribute to the development of systemic risk. The overall aim of such a conduct of business supervisory framework is to avoid or to become early enough aware of consumer detriment to be still in a position to act.”

68. EIOPA, *Consultation Paper on the proposal for preparatory Guidelines on product oversight and governance arrangements by insurance undertakings and insurance distributors*, EIOPA-CP-15/008, 30 October 2015, available at <https://eiopa.europa.eu/>. See Guideline 3—Role of the manufacturer’s administrative, management or supervisory body. “The manufacturer’s administrative, management or supervisory body should endorse and be ultimately responsible for the establishment, implementation, subsequent reviews and continued internal compliance with the product oversight and governance arrangements.” Article 21 of the IDD introduces product oversight and governance arrangements for manufacturers and distributors of insurance products. Until the transposition and application of the IDD, there is the possibility that insurance products are offered or sold which not have been subject to internal approval processes aiming at minimising the risk of customer detriment resulting from inappropriate products. Furthermore, there is the possibility that Member States have a diverging view on how the new requirements of IDD should be understood and applied in practice resulting in differences in supervisory approaches and legal uncertainty for market participants expected to take preparatory steps for the implementation of the new rules under IDD. As this matter is being addressed by ESMA and EBA, there is also potential for the coexistence of different regulatory/supervisory approaches in the three financial sectors. See also EIOPA, *Final Report on Public Consultation on Preparatory Guidelines on product oversight and governance arrangements by insurance undertakings and insurance distributors*, 6 April 2016, available at <https://eiopa.europa.eu/>. In the Guideline 1.25 at par. 1.13. EIOPA underlines that “The administrative, management or supervisory body of the insurance undertaking is responsible for the establishment and subsequent reviews of the product oversight and governance arrangements. However, implementing product oversight and governance arrangements should not be understood as introducing a new key function for insurance undertakings. Moreover, these arrangements are not necessarily linked with the risk management, internal audit, actuarial or compliance functions of insurance undertakings, as prescribed by Solvency II.”

69. IAIS, *Draft Issues Paper on Conduct of Business Risk and its Management*, 17 June 2015, p. 15, available at <https://www.iaisweb.org/>. IAIS remarks that “In order to mitigate conduct of business risk, a culture of fair treatment needs to be properly reflected in the governance framework and business objectives and strategies and in implementing a governance framework that promotes fair customer outcomes.”
70. G. Bernardino, *Insurance distribution in a challenging environment*, Speech at the European Federation of Insurance Intermediaries (BIPAR), Brussels, 4 June 2015, p. 7, available at <https://eiopa.europa.eu/>. About the conduct risk regulation and supervision Bernardino underlines as first line of action: “Strengthening corporate governance, i.e. to better integrate conduct of business concerns in the institutional governance arrangements and ensuring that boards of financial institutions take full responsibility for ensuring that consumer interests are taken into account throughout the product lifecycle.”
71. EIOPA, *Technical Advice on possible delegated acts concerning the Insurance Distribution Directive*, 1 February 2017, p. 14, available at <https://eiopa.europa.eu/>. The chapter Role of Management states “21. The administrative, management or supervisory body of the manufacturer or equivalent structure (in the case of two tier systems) is ultimately responsible for the establishment, subsequent reviews and continued compliance of the product oversight and governance arrangements. The manufacturer’s administrative, management or supervisory body also ensures that the product oversight and governance arrangements are appropriately designed and implemented into the governing structures of the manufacturer. 22. The product oversight and governance arrangements, as well as any material changes to those arrangements, are subject to prior approval by the manufacturer’s administrative, management or supervisory body or equivalent structure.” As well as in relation to insurance distributors EIOPA emphasises that “the ultimate responsibility with regard to the product distribution arrangements lies with the insurance distributor’s administrative, management or supervisory body or equivalent structure even though it is possible that the tasks are delegated either internally or even externally (e.g. in cases of outsourcing). In particular, the ultimate responsibility for the organisational measures and procedures lies with the management of the distributor which is registered and responsible for the distribution activities. For sole traders, it is evident that they bear the responsibility for their entire business.”

72. The capital add-on is a “tool of last resort”, as notes M. Dreher, *Treatise on Solvency II*, Springer, 2015, at p. 63, but this does not rule out lesser measures that address violations. He also highlights that “In order to impose a capital add-on, the supervisory authority must convert a qualitative deficiency into a quantitative measure, thus, in a manner of speaking, squaring the circle”.
73. The quality assessment of risk governance addresses various aspects, including the effectiveness of the board in relation to risk governance, the functioning of the main committees (audit, risk and remuneration), the remuneration policy, the risk management framework and the internal control functions. The risk culture should be out of the scope of this assessment, because it is fair to rely on the board’s assessment of the institution’s risk culture and the process followed for this assessment. The quality assessment of the board should consider the following areas: board charter and self-assessment; the quality, skills and experience of all directors; the board composition and independence; the fitness and propriety matters; the conflicts of interest policy; the internal control framework and the outsourcing policy.
74. See Article 275 of the European Commission Delegated Regulation 2015/35. These requirements include the obligation for the establishment and maintenance of remuneration policies and procedures to avoid conflicts of interest and promote sound and effective risk management. The remuneration requirements for the insurance sector is not as prescriptive and detailed as CRD IV, AIFMD or UCITS V.
75. Although Solvency II and the EIOPA Guidelines are not as prescriptive as CRD IV, they differ in a number of significant ways. First of all, there is more limited scope to dis-apply the remuneration requirements on a proportionate basis, even if Article 275(3) of the Solvency II Regulation provides for the application of the proportionality principle with the internal organisation of the insurance or reinsurance undertaking, and the nature, scale and complexity of the risks inherent in its business. Secondly, it does not limit variable pay deferral to significant bonuses. Third, Article 275(2)(c) of the Solvency II Regulation requires firms to defer a substantial portion of the variable remuneration component for a period of not less than three years. There is no flexibility in the Solvency II Regulation to prefer a shorter period than the three-year period. Firms are required to ensure that the period (three years or longer) is correctly aligned with the nature of the business, its risks and the activities of the employees in question. Deferral of variable remuneration allows firms to

apply downwards adjustments, in particular by application of the malus (during the three-year deferral period) prior to the award vesting, to take account of specific risk management failures. The wording in the Solvency II Regulation is identical to the text of the CRD, which applies to banks, building societies and investment firms, even though the latter includes a specific 40 % minimum deferral threshold.

76. Prudential regulations should abstain from setting very detailed requirements as to the organisation and functioning of boards: see G. Ferrarini, *Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda*, Law Working Paper No. 347, 2017, available at www.ecgi.org/wp. Moreover, various regulatory provisions “petrify existing corporate governance best practices” as state L. Enriques and D. Zetsche, *Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive*, *Theoretical Inquiries in Law*, 16.1, 2015, p. 211, at p. 240.
77. A. Bailey, *Governance and the role of Boards*, Speech by Andrew Bailey at Westminster Business Forum, London, 3 November 2015, available at <http://www.bankofengland.co.uk/>
78. Managerial and supervisory attention should be paid to ensure that culture and remuneration structures support risk management in financial institutions. As risk culture varies at the local level, it should be measured and managed at the local level. Senior leaders cannot rely on their own perceptions; rather, they should rely on independent assessments of risk culture: see E. Sheedy and B. Griffin, *Risk governance, structures, culture, and behavior: A view from the inside*, *Corp Govern Int. Rev.* 2017, available at <https://doi.org/10.1111/corg.12200>. See also L. Redmond, *Risk Culture: A View from the Board*, in P. Jackson (ed.), *Risk Culture and Effective Risk Governance*, Risk Books, 2014, chapter 3, p. 47 ff.
79. In banking and regulation literature, there is still meagre attention to the diffusion of governance principles that impact longer-term performance, with the exception of the following: M. Moschella and E. Tsingou, *Regulating finance after the crisis: unveiling the different dynamics of the regulatory process*, *Regulation and Governance*, 7, 2013, p. 407 and T. Rixen, *Why reregulation after the crisis is feeble: shadow banking, offshore financial centers, and jurisdictional competition*, *Regulation and Governance* 7, 2013, p. 435.
80. Financial Stability Board, *Thematic review on risk governance*, 2013, p. 1, available at www.financialstabilityboard.org

81. In response to the financial crisis, the Dutch prudential supervisor decided to include aspects of behaviour and culture into its supervisory approach. See De Nederlandsche Bank, *Supervision of Behaviour and Culture Foundations, practice & future developments*, November 2015, available at <https://www.dnb.nl/>. The ECB is even more interested in corporate governance. In 2016, the issue of internal governance was one of the top supervisory priorities of the Single Supervisory Mechanism (SSM) and one of the key elements of the Supervisory Review and Evaluation Process (SREP) on an annual basis. It is worth noting that a key recommendation states as follows: “Boards should challenge, approve and oversee the management’s implementation of the bank’s strategic objectives, governance and corporate culture”: see European Central Bank, *SSM supervisory statement on governance and risk appetite*, June, 2016, p. 2, available at <https://www.bankingsupervision.europa.eu/ecb/>

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8

The Impact of Solvency II and Relevant Implementing Measures on the Insurance Firm's Risk Management Maturity

Simon Grima, Pierpaolo Marano, and Frank Bezzina

Introduction

A combination of the challenges posed by globalisation, digitisation, technology and the fast pace of change has further complicated the complex web of intermingling of risks, putting more demands on boards and public authorities which hold the ultimate responsibility for internal controls (risk management, internal audit and compliance). The public authorities are responsible for ensuring that boards are competent and able to take responsibility for:

- ensuring the design and implementation of appropriate risk management and internal control systems that identify the risks facing the company and enable the board to make a robust assessment of the principal risks;

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- determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its risk appetite);
- ensuring that appropriate culture and reward systems have been embedded throughout the organisation;
- agreeing how the principal risks should be managed or mitigated to reduce the likelihood of their incidence or their impact;
- monitoring and reviewing the risk management and internal control systems, and the management's process of monitoring and reviewing, and satisfying itself that they are functioning effectively and that corrective action is being taken where necessary; and
- ensuring sound internal and external information and communication processes and taking responsibility for external communication on risk management and internal control (Financial Reporting Council (FRC) 2014).

Regulatory authorities are concerned with regulations and policies that better achieve an entity's mission/s, and seek ways to improve accountability. According to GAO (1999), a key factor to achieve these outcomes and minimise operational problems is to implement appropriate internal control. Continual assessment and evaluation of internal control is necessary to assure that "the control activities being used are effective and updated when necessary" (GAO 1999, p. 1).

The Financial Crisis of 2008 and the large failures or losses by corporations from the financial sector (e.g. Societe Generale, Orange County and Barings Bank), from non-financial sector and failures related to catastrophic environment tragedies (Deep Water Horizon, Fukushima or, prior to this, Bhopal and Seveso), to those related to accounting fraud and foreign bribery (e.g. Olympus, Enron, WorldCom, Satyam, Parmalat and Siemens) (OCED 2014) have all made the headlines and put pressure on public authorities to identify and manage the factors that have led to these crises through better internal controls.

Gibson (2004) highlights the need for non-bank firms to apply similar internal controls and regulations as applied by banks, since the "knee-jerk" reaction applied by these non-bank firms threatens to damage both the financial markets and non-financial companies that are needed to create economic growth. Garrett (2010) explains that AIG's health failure was attributed to incompetent risk assessment of its mortgage-backed security (MBS)

and Collateralized Debt Obligation (CDO) portfolios. The former is an asset-backed security secured by a mortgage or collection of mortgages and the latter is a structured financial product which repackages pools of cash flow-generating assets into discrete tranches (Lepke, Lins and Picard, 2014).

Since insurance companies, for a fee, take on financial responsibility for losses that result from risk-taking—that is, they allow for the transfer of risks that entities are not comfortable with—the ultimate weight of risk is carried by these institutions. This suggests that solvency of insurance and non-insurance firms depends highly on the risk management processes maintained by a few large insurance firms. In fact, the Chief Executive of the US-based insurance company Allstate argued “that it was an insurance product that contributed to the risk that almost brought down the global economy. It should be no surprise that a big insurer like AIG would be a major issuer of credit default swap” (The New York Times 2009). Thus, the insurance industry was involved in the start and evolution of the financial crisis and is potentially the backbone of any economic disaster or survival.

The public authorities’ role is to ensure that each country state has a regulatory framework, which allows insurance competition that benefits and protects both the consumers and businesses. That is, allowing the business of insurance to grow but also ensuring that firms are adequately identifying, monitoring and managing the risks proactively through parameters, limits and restrictions that protect both the client and the entity from large potential losses. In fact, Solvency II—Pillar 3, market discipline: disclosure and transparency, is concerned with strengthening market mechanisms and risk-based supervision, since inadequate information on an insurer makes an already bad situation worse. Therefore the rules of disclosure need to balance both the public’s interest and the insurer’s interest on competition (Naghi 2013).

The nature of the business and the risks determines solvency, Pillar I capital requirements will capture and adequately quantify all risks on a balance sheet. Pillar II will supplement Pillar I and promote good corporate risk management. Pillar III completes the framework by developing market discipline and a risk dialogue among stakeholders. (Naghi 2013)

Considering solvability as being of utmost importance, the financial regulatory authorities have developed and implemented methods and

systems for evaluating it. This commenced with banks through the recommendations of Basle, transposed as regulations in the EU by the Capital Requirement Directives (CRD) and the changes made in the international accounting standards (IAS) (Naghi 2013). In the insurance industry this was transposed into the Solvency I model and now the Solvency II model, aiming to have a coherent framework with similar and consistent solvency measures within the EU. The framework ensures the quality of risk management and the accuracy of its measurement.

Literature Review

Birkinshaw and Jenkins (2010) noted that risk management must be personal and owned by the organisation to be successful. They note that while some organisations such as Lehman Brothers and Bear Stearns were destroyed by the latest financial crisis and others the likes of UBS, Citibank, Merrill Lynch and Royal Bank of Scotland were hit badly, several other banks, which included Goldman Sachs and JPMorgan Chase, just cruised through without any damage. They explained the different fortunes of these winners and losers in the period of turbulence as being due to the fact that these organisations focused totally on the formalisation of risk management by developing “multistage procedures, with many signatories, to evaluate what risks were worth taking. They also relied on externalisation of risk management to a large degree—the use of expertise and approval from outside parties such as auditors, regulators and credit-rating agencies.” They further note that risk management had become overly specialised, prescriptive and rigid encouraging depersonalisation and a lack of ownership on the part of organisations and their employees. They continued to highlight the fact that major losses were mainly reported in the larger banks and blamed this on the fact that contrary to the smaller organisations, large banks’ decision makers were distant from the action and likely less knowledgeable and accountable for the outcomes of their decision. This brings out the importance of communication of the appetite and tolerance with important robust informal systems enabling information to flow naturally between the different units within the organisation. This will ensure that all those responsible for the evaluation of risk, for

making judgement around risk and for taking the ultimate decisions are knowledgeable of what is needed, of the parameters set and of how to achieve objectives. Moreover, it will ensure that they live with the consequences of those decisions, that is, not allowing these persons to detach themselves legally and morally from the system they are working in.

Arthur Levitt, former chairman, Securities and Exchange Commission in the USA, notes in the foreword to the book *Governance Risk Management and Compliance* that the core of the problems of the financial crisis and large losses resulted from “the failure of governance, oversight, and risk management at the corporate, legislative and regulatory levels.” (Steinberg 2011). This is further backed by the findings of Grima (2012), who reported that weak corporate governance arrangements contributed to this. He noted that the governance setup in many financial firms did not safeguard against unwarranted risk-taking. OCED (2014) emphasised this argument by noting that governance failures resulted because of boards who did not understand and appreciate the risk-taking of the companies they represented and that they sometimes engaged in reckless risk-taking using inadequate risk management systems.

The need for good internal controls is the only thing that has remained the same. Organisations will continue to face crises and thereby necessitating internal controls until such time, as Madison highlights in his Federalist Papers (1788), ‘Angels Govern’—“If angels were to govern men, neither external nor internal controls would be necessary” (Barth et al., 2006) (The Founders’ Constitution 2000). However, since this is not the case, good controls ensure that events such as senior management taking unhappy decisions, tolerating bad practice or being compromised by actions of colleagues and other staff members are managed efficiently.

The OCED (2014) found that the main driving force in business and entrepreneurship is risk-taking and that the consequence of management failures in terms of Euro is often miscalculated. They highlight that “Corporate governance will ensure that risks are understood, managed, and appropriately, communicated.” Bezzina et al. (2014) and Pritsch et al. (2008) report that to strengthen stability there is a need for effective management structures, sound governance and a consistent, improved risk management framework. They note that ensuring strong and transparent governance structures with good communication between depart-

ments and clearly defined risk appetite and risk culture leads to a healthier and more efficient organisation. They also note that firms reach a high level of performance through proactive risk management strategies that become systematically incorporated into the corporate strategy and strategic planning, usually with well-documented and communicated policies and procedures.

Therefore, as noted above, theory and practice suggest that as entities (including insurance firms) strengthen their governance, their solvency position is also strengthened, putting the insurance firms' risk management maturity at a stronger level. Thereby, it is expected that an insurance firm with strong risk management maturity has owned and documented procedures and policies, risk conscious management, good communication (of appetite, tolerance and between the internal control functions), strong risk management practices and proactive risk management.

Having noted this, the aim of this chapter is to determine whether the Solvency II rules and implementing measures have had any influence on the maturity level of organisations' risk management. In fact this study seeks to understand the status of the organisation's risk management maturity prior to and after the introduction of Solvency II and the relevant implementing measures.

Research Method, Results and Discussion

To answer this research question, the authors provided in the first section a legal framework of the risk management system as designed under the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS) and implemented under the EU Directives Solvency II showing the link of this with good internal controls. In the second section the authors then provided the methodology and results of the questionnaire sent out to targeted controllers (risk managers/consultants/officers, auditors and compliance managers/officers) and managers (CFOs, CEOs, COOs, directors and investment managers) within European insurance firms located in the UK, Italy, Holland, Spain, Belgium, Luxembourg, Czech Republic and Malta. Thereby, a conclusion can be made on whether there was an impact of

Solvency II and relevant implementing measures on the Insurance firm's risk management maturity.

Legal Framework of the Risk Management System

This section provides the legal framework of the risk management system as designed under the ICPs issued by the IAIS and implemented under the EU Directives Solvency II.

The ICPs are issued by the IAIS, and they provide a globally accepted framework for the supervision of the insurance sector.¹ The ICPs apply to insurance supervision in all jurisdictions regardless of the level of development or sophistication of the insurance market and the type of insurance products or services being supervised.

The ICPs can be used to establish or enhance a jurisdiction's supervisory system. They can also serve as the basis for assessing the existing supervisory system and in so doing may identify weaknesses, some of which could affect policyholder protection and market stability.

The ICP statements are the highest level in the hierarchy of IAIS supervisory material and prescribe the essential elements that must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection. Standards are the next level in the hierarchy and are linked to specific ICP statements,² while guidance material is the lowest level in the hierarchy and typically supports the ICP statement and/or standards.³

ICPs push, *inter alia*, for the full integration of risk management in the organisation and operations of insurers.

ICP n.7 on Corporate Governance sets forth that the supervisor requires insurers to establish and implement a corporate governance framework, which provides for sound and prudent management and oversight of the insurer's business and adequately recognises and protects the interests of policyholders. In particular, insurer's board of directors is required to have appropriate policies and procedures to ensure that senior management promotes a culture of sound risk management, compliance and fair treatment of customers (see standard 7.9).

ICP n.8 on Risk Management and Internal Controls sets out the elements of these systems and functions, which should cover not only prudential risks but also conduct of business risks as described in ICP n. 19 on Conduct of Business. The risk management system should be integrated into the culture of the insurer and into the various areas and units of the insurer with the aim of having appropriate risk management practices and procedures (see guidance 8.1.4). Therefore, the insurer's risk policies should help explain the relationship of the risk management system to the insurer's overall governance framework and to its corporate culture (see guidance 8.1.5).

ICPs, however, do not limit the risk culture to the identification of risks.

ICP 16 pushes supervisors to establish enterprise risk management (ERM) for solvency purposes that require insurers to address all relevant and material risks. ERM aims to provide satisfactory methods for measuring and managing risks, or for determining related capital requirements to cover those risks. Internal models and scenario analysis are both key elements of ERM and they are recognised as powerful tools to provide an embedded risk culture in the insurer (see guidance 16.0.6), as well as to facilitate the integration of the insurer's ERM framework with its business operations and culture (see guidance 16.1.16).

ICPs do not identify the precise objectives of supervision, which are remitted to the choices of the different legislators, and acknowledge that often the supervisor's mandate includes several objectives.

Nevertheless, ICPs set forth that supervision promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders. Therefore, it is important that all insurance supervisors are charged with the objective of protecting the interest of policyholders.

Solvency II

The Directive Solvency II complies with the ICPs above and provides for an integration of the risk management in the organisation and operations of (re) insurance undertakings.

Solvency II states that the main objective of insurance and reinsurance EU regulation and supervision is the adequate protection of policyholders

and beneficiaries, that is, any natural or legal person who is entitled to a right under an insurance contract. Financial stability and fair and stable markets are other objectives of insurance and reinsurance regulation and supervision which should also be taken into account but should not undermine the main objective.⁴

Therefore Solvency II clearly identifies the purpose of the EU regulation on insurance and reinsurance, after the three generations of Directives on life and non-life insurance as well as the Directive 2005/68/EC on reinsurance, which mainly aimed to create an internal market opening national insurance markets to international competition.

In order to adequately pursue the objective of protection of policyholders and beneficiaries, Solvency II aims to introduce an economic risk-based approach, which provides incentives for insurance and reinsurance undertakings to properly measure and manage their risks. This approach is adopted because it would be in line with the latest developments in risk management, as well as in the context of the IAIS, the International Accounting Standards Board (IASB) and the International Actuarial Association (IAA), and with recent developments in other financial sectors.⁵

Accordingly, Solvency II comprises three pillars: (i) quantitative requirements regarding solvency capital, (ii) supervisory review and (iii) disclosure requirements. Whether the starting point for the adequacy of the quantitative requirements in the insurance sector is the Solvency Capital Requirement,⁶ and additional solvency capital requirements should be imposed only under exceptional circumstances,⁷ Solvency II acknowledges that some risks may only be properly addressed through governance requirements rather than through the quantitative requirements reflected in the Solvency Capital Requirement.⁸

This approach requires an effective system of governance for the adequate management of the insurance undertaking and for the regulatory system,⁹ while such a system of governance includes four key functions, that is, risk management, compliance, internal audit and actuarial.¹⁰

This system of governance provides for sound and prudent management of the business and shall at least include an adequate transparent organisational structure “with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information”.¹¹

The system of governance shall be subject to regular internal review and proportionate to the nature, scale and complexity of the operations of the (re) insurance undertakings, which are requested to have implemented written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing.¹²

With reference to the risk management system, Article 44 of Solvency II requests (re) insurance undertakings to have in place an effective risk management system “comprising strategies, process and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risk, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies”. Furthermore, the rule above sets forth that the risk management system shall be effective and well integrated into the organisational structure and in the decision-making process of the undertakings with proper consideration of the persons who effectively run the undertaking or have other key functions.

After a preparatory phase in 2013–2015, European Insurance and Occupational Pensions Authority (EIOPA) issued the final version of the Guidelines on the system of governance under Solvency II in September 2015. Several Guidelines have been expressly addressed to the risk management system.

The task of the risk management function is to report to an administrative, management and supervisory board as identified by the national competent authorities, on risks that have been identified as potentially material, as well as on other specific areas of risks both on its own initiative and following requests from the boards above.

The driving factors of the Guidelines on the risk management system are documented policies and procedures, and the interplay between such a function and other key functions and boards.

In general terms, all the policies required as a part of the system of governance have to be in written form and aligned with each other and with the undertaking’s business strategy. Furthermore, each policy should clearly set out at least the contents indicated in Guideline 7,¹³ including the positions of the key functions within the undertaking, their rights and powers. Finally, the administrative, management or supervisory body must have appropriate interaction with any committee it establishes as well as with senior management and with persons having other key

functions in the undertaking, thus including also the risk management function, proactively requesting relevant information from them and challenging that information when necessary.¹⁴

The undertaking is requested to establish a risk management policy, and Guideline 18 identifies the minimum content of this policy.¹⁵ Other Guidelines specify the contents of the risk management policy with reference to underwriting and reserving risk,¹⁶ operational risk,¹⁷ reinsurance and other risk mitigation techniques,¹⁸ strategic and reputational risk,¹⁹ asset-liability management,²⁰ investment²¹ and liquidity risk.²²

The specifications above are even provided at their minimum level. Therefore, we can state that each undertaking has to increase the contents of the risk management policy, if this is necessary to provide for sound and prudent management of the business of the undertaking. EIOPA acknowledges that there is no single risk management system that is appropriate to all undertakings; the system must be tailored to the individual undertaking.²³

Furthermore, the risk management policy has to be personalised also in case of a (re) insurance group.

EIOPA calls groups to implement governance requirements at group level in order to have in place a robust governance system applied to one coherent economic entity (holistic view) comprising all entities that are part of the group, and in a consistent manner in the group.

Therefore, Guideline 65 requests the participating (re) insurance undertakings, the insurance holding company or the mixed financial holding to set adequate internal governance requirements across the group appropriate to the structure, business model and risks of the group and of its related entities.

The undertakings above should consider the appropriate structure and organisation for risk management at group level, setting a clear allocation of responsibilities at all entities that are part of the group and by appropriate processes and procedures to identify, measure, manage, monitor and report the risks that the group and each individual entity are or might be exposed to.

Finally, they have to consider in their risk management system the risk both at individual and group level and their interdependencies, as identified by Guideline 67²⁴ and specified in Guidelines 68 (risk concentration) and 69 (intra-group transactions).

Questionnaire Method (and Results)

The online survey entitled “Insurance firms’ Maturity in Risk Management” was purposely designed for the present study after consulting the various ICPs highlighted earlier and the relevant literature on the subject. Given that two of the authors are members of the Federation of European Risk Management Association (FERMA) and that they are also actively involved in various insurance-related forums (e.g. LinkedIn), an e-mail containing a link to the online survey above was sent to potential respondents, these representing a critical case purposive sample (Saunders 2012).

The respondents were requested to provide in Section A of the questionnaire information concerning (a) their position/role with their institution, (b) their experience (in years) in the field of risk management, (c) their institution’s main sector of activity and (d) the number of full-time employees registered with their institution.

In Section B, the respondents were presented with 18 four-point Likert-type items (ranging from 1 = strongly disagree to 4 = strongly agree) to reflect the state of the risk management maturity of organisations. These items comprise (a) four items on owned and documented procedures and policies (e.g. “Our institution has a risk committee and defined terms of reference”), (b) three items on risk-conscious management (e.g. “We have a risk culture oriented towards profit increase rather than risk-profit balance”), (c) four items on good communication—communication of appetite/tolerance and between internal control functions (e.g. “We have a single approach to risk culture with set limits”), (d) four items on the due importance given to risk management practices (e.g. “Risk management practices are critical in providing added value to our institution”), and (e) three items concerning proactive risk management (“Any recommendations made are appropriately addressed and remedial action is taken in good time”). Higher scores were indicative of higher maturity in risk management.

These 19 statements were randomly ordered while some were reversed to keep respondents from answering carelessly and to help correct for agreement bias. Respondents were informed that there were no ‘right’ or ‘wrong’ answers, that their responses would be kept confidential and that the overall findings would be used only for research purposes.

The URL was restricted to allow only one respondent per IP address and respondents had the option to edit the survey until they submitted it. A total of 710 respondents completed the survey during January 2014. These measures represented the organisations' risk management maturity before the introduction of Solvency II.

The same respondents were invited to participate again in our survey during June 2015 using the e-mail addresses that they had previously provided, and this time we received 507 complete responses; these measures representing the organisations' risk management maturity after the introduction of the Solvency II and the relevant implementing measures. Hence the data set used in this study consists of pre-post measures of 505 respondents, with the remaining 202 completed surveys gathered in the first survey having been discarded.

The 505 respondents participating in the survey occupied the following roles/positions within their institution: control functions (64.5%) and managerial functions (35.5%). They had on average circa three years of experience in the field of risk management ($M = 3.10$, $SD = 0.87$). Their institutions' main sectors of activity were: both life and non-life insurance (50.5%), non-life insurance (31.3%) and life insurance (18.2%). Additionally, 25.3% of the institutions employed 11–50 employees, 52.5% employed 51–100 employees (52.5%) and 22.2% employed 100–250 employees.

Results

Table 8.1 exhibits a summary of descriptive statistics for the ordinal scales based on the median (Med), interquartile range (IQR) and mean ranks (MR) as well as Wilcoxon signed ranks tests—namely the z-score (z), the degrees of freedom (df) and the corresponding p-value (p).

Given that higher scores are indicative of higher maturity in risk management, Table 8.1 shows that the introduction of Solvency II and relevant implementing measures had a significant impact ($p < 0.001$) on the overall respondent ratings in 15 out of the 18 items presented, with this occurring across all themes, namely “owned and documented procedures and policies”, “risk conscious management”, “quality of communication”,

Table 8.1 Descriptive Statistics and Wilcoxon Signed Ranks test results

Statement	Before	After	Wilcoxon ^a	
	Md (IQR) MR	Md (IQR) MR	z	Effect size r
<i>Owned and documented procedures/policies</i>				
Our Institution has a risk committee and defined terms of reference	2 (3) 127.0	4 (0) 32131.0	-14.27*	0.64
Our Institution has a defined and communicated formal risk management policy/charter	2 (1) 204.1	4 (0) 83436.0	-18.17*	0.81
Our risk management function includes a formal risk register and database in which all risks are collated and addressed	2 (1) 208.0	4 (0) 86320.0	-18.34*	0.82
The risk management function and risk register and database are owned by all/most within the organisation	2 (1) 208.0	4 (0) 86320.0	-18.34*	0.82
<i>Risk conscious management</i>				
We have a reward culture oriented towards profit increase rather than risk-profit balance (Reversed)	2 ^b (0) 88.0	2 ^b (0) 15400.0	-12.49*	0.56
There is a lack of experience, knowledge and skills on risk management amongst senior executives and nonexecutive management personnel (Reversed)	2 ^b (0) 253.0	3 ^b (0) 127765.0	-20.75*	0.92
The Risk management function is very influential and strong	2 (0) 209.0	3 (0) 87153.0	-20.41*	0.91
<i>Quality of communication</i>				
We have a single approach to risk culture with set limits	4 (0) 0.0	4 (0) 0.0	0.00	0.00
Nearly all processes are documented and minutes are taken at every board and committee meeting	2 (0) 199.5	3 (0) 79401.0	-18.41*	0.82
We have oversight structures such as audit, risk and compliance functions and these functions are integrated	2 (0) 237.5	4 (2) 112575.0	-19.48*	0.87
We have informal risk processes, information sharing and escalation, and risk representation on key committees, which are clearly defined	2 (0) 237.5	3 (1) 112575.0	-19.48*	0.87

(continued)

Table 8.1 (continued)

Statement	Before	After	Wilcoxon ^a	
	Md (IQR) MR	Md (IQR) MR	z	Effect size r
<i>Due importance to risk management practices</i>				
Risk management practices are vital to the performance and success of our institution's objectives	3 (0) 110.5	3 (0) 24310.0	-14.83*	0.66
Our institution's strategy provides clear articulation of its objectives while observes its boundaries through defined risk management practices	3 (0) 110.5	3 (0) 24310.0	-14.83*	0.66
Risk management practices are critical in providing added value to our institution	3 (0) 110.5	3 (0) 24310.0	-14.83*	0.66
Risk management controls within our institution utilise a great deal of resource effort for compliance purposes without providing added value (Reversed)	3 ^b (1) 0.0	3 ^b (1) 0.0	0.00	0.00
<i>Proactive risk management</i>				
The effectiveness of the risk management system and the institution's risk appetite are regularly challenged and documented	2 (1) 188.0	3 (1) 70500.0	-17.33*	0.77
The strategic risk policy is being regularly challenged and/or endorsed for better effectiveness	2 (1) 0.0	2 (1) 0.0	0.00	0.00
Any recommendations made are appropriately addressed and remedial action is taken in good time	2 (1) 188.0	3 (1) 70500.0	-17.33*	0.77

^aWilcoxon signed ranks tests based on negative ranks

^bscale has been reversed

* $p < 0.001$, $N = 505$

“importance given to risk management practices” and “proactive risk management”. Additionally, effect sizes range from 0.56 to 0.92, all qualifying as medium or large in size (Cohen 1998). The only exceptions occurred for three items, namely:

1. “We have a single approach to risk culture with set limits”, where respondents strongly agreed with this item both before and after the introduction of Solvency II;
2. “Risk management controls within our institution utilise a great deal of resource effort for compliance purposes without providing added value (reversed)”, where respondents agreed with this item both before and after the introduction of Solvency II after reverse coding;
3. “The strategic risk policy is being regularly challenged and/or endorsed for better effectiveness”, where respondents disagree with this item both before and after the introduction of Solvency II.

Another interesting aspect was the fact that the respondents disagreed that they have a reward culture oriented towards risk-profit balance rather than profit increase both before and after the introduction of Solvency II, despite a significant improvement in mean ranks.

To conclude, the above findings provide empirical evidence that the organisations’ risk management maturity improved with the introduction of Solvency II regulations and the relevant implementing measures. They demonstrate that regulations and the implementing measures of Solvency II have an impact in ensuring that insurance organisations better manage their risks; personalising their governance structures and ensuring that all those responsible for evaluating and making judgement around risk and those taking the ultimate decisions are knowledgeable of what is needed, the parameters set and how to achieve objectives, and are required to live with the consequences of those decisions.

This shows the importance of regulations and implementing measures for authorities within the countries surveyed to ensure insurance competition that benefits and protects both the consumers and businesses. It demonstrates that the Solvency II and ICPs’ push, for the full integration of risk management in the organisation, culture and operations of insurers in these countries, has been achieved, with the implementation of a corporate governance framework (ICP n.7), covering both prudential risks and also conduct of business risks (ICP n.8), providing satisfactory methods for measuring and managing risks, or for determining related capital requirements to cover those risks.

Notes

1. ICPs are supervisory material which is available at the IAS's website: www.iaisweb.org
2. Standards set out key high-level requirements that are fundamental to the implementation of the ICP statement and should be met for a supervisory authority to demonstrate observance with the particular ICP.
3. Guidance material provides details on how to implement an ICP statement or standard. Guidance material does not prescribe new requirements but describes what is meant by the ICP statement or standard and, where possible, provides examples of ways to implement the requirements.
4. See Recital n.16.
5. See Recital n.15.
6. Recital n.16.
7. Recitals nn. 26 and 27.
8. Recital n. 28.
9. Recital n. 29.
10. Recital n. 30.
11. Article 41, Solvency II.
12. Article 41.
13. Therefore: (a) the goals pursued by the policy; (b) the tasks to be performed and the person or role responsible for them; (c) the processes and reporting procedures to be applied; (d) the obligation of the relevant organisational units to inform the risk management, internal audit, compliance and actuarial functions of any facts relevant for the performance of their duties.
14. Guideline 1.
15. The risk management policy at least: (a) defines the risk categories and the methods to measure the risks; (b) outlines how the undertaking manages each relevant category, area of risks and any potential aggregation of risks; (c) describes the connection with the overall solvency needs assessment as identified in the Own Risk and Solvency Assessment (ORSA), the regulatory capital requirements and the undertaking's risk tolerance limits; (d) specifies risk tolerance limits within all relevant risk categories in line with the undertaking's risk appetite; (e) describes the frequency and content of regular stress tests and the situations that would warrant ad-hoc stress tests.

16. Guideline 20.
17. Guideline 21.
18. Guideline 22.
19. Guideline 23.
20. Guideline 24.
21. Guideline 25.
22. Guideline 26.
23. See the Introduction to the Guidelines, at point 1.8.
24. Guideline 65 makes reference to: (a) reputational risk and risks arising from intra-group transactions and risk concentrations, including contagion risk, at the group level; (b) interdependencies between risks stemming from conducting business through different entities and in different jurisdictions; (c) risks arising from third-country entities; (d) risks arising from non-regulated entities; (e) risks arising from other regulated entities.

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9

Insurance Group Supervision in the European Union

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Introduction

Group structures have emerged as a common feature of the insurance industry. The growth of insurance groups has been substantial since the 1990s, mainly as a consequence of a growth in mergers and acquisitions,¹ and nowadays ever more insurers are part of groups with presence in many countries around the world, that also include other financial intermediaries, and commercial and industrial entities. In many European Union (EU) member states foreign-controlled insurance companies hold a significant market share, and this confirms the growing international nature of the insurance business.² For example, in 2014, in the life insurance sector, the market share of foreign-controlled companies and branches of foreign companies grew as high as 54% in Portugal, 31.3% in Italy, 26% in Germany, and in the non-life insurance sector the growth in market share was just as high as 84.2%, 57.8%, and 28.9%, respectively in Portugal, the UK, and Italy.³

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Groups facilitate international diversification and generate broader market opportunities. Risks can be better diversified and the financial soundness of the group entities may be strengthened by financings from the holding company or other constituent entities. Group structures may also give access to greater technical resources and more sophisticated expertise that might be useful, for example, in asset management and rate setting, to the benefit especially of the smaller insurers.⁴

Being part of an (international) insurance group, however, carries with it additional risks for the solvency of member companies. Insurers that belong to a group may be subject to group policies that can be favorable for the group but not for the entities taken individually. Conflicts between the general interest of the entire group and that of the individual entities may arise, for instance, with regard to the distribution of financial resources within the group. The size of the group may also incentivize morally hazardous behaviors based on a “too-big-to-fail” perception.⁵

Multi-tiered group structures and the possible lack of transparency of the group organization may render supervision more complex. Regulatory inconsistencies across countries might permit multiple gearing of capital within a group, so that the same capital is used to meet the solvency requirements of more than one insurer. There are also risks related to intra-group transactions that may become a means of distracting resources from an insurance entity to the advantage of other group entities, in particular in the case of groups with non-homogeneous activities.⁶ Excessive intra-group transactions, in turn, increase contagion risk, that is, the risk that financial troubles of an individual entity adversely impact the financial solidity of another entity within the group due to direct or indirect relationships between them. Contagion may spread from one group subsidiary to another.⁷ Insurers may also be affected by reputational risk, so their capacity to pay policyholders’ claims can be associated with the reputation of the group as a whole or of other group members.⁸

As the financial crisis of 2008 highlighted, the risks posed by group membership as well as the growingly complex and international character of insurance groups entail the need for adequate group-wide supervi-

sion in order to ensure policyholders' protection and financial stability.⁹ This chapter examines the supervision of insurance groups in the EU, highlighting the evolution from the Insurance Groups Directive¹⁰ to the Solvency II Directive.¹¹ Solvency II deviated from supplementary supervision, turning to a system of consolidated supervision that rests on the concept of the group as a single economic entity rather than a collection of entities. The chapter discusses the changes made by Solvency II and argues that the system is based on a clear and appropriate allocation of responsibilities among the group supervisor and the other supervisory authorities, to the benefit of enhanced accountability in the exercise of group supervision. The concentration of powers and responsibilities in the group supervisor is conducive to both more efficient and effective group supervision. Further centralization of supervisory responsibilities for the oversight of systemically significant insurance groups, however, would be sensible. The chapter suggests the prospect of the centralization at the EU level of the supervision of groups that are systemically risky as the next step of the evolutionary process of insurance group oversight.

The chapter is organized as follows. After this introduction, the Section "Starting from Scratch. Supplementary Supervision Under the Insurance Groups Directive" considers the innovations made by the Insurance Groups Directive in a system that up to then had only focused on solo supervision. Section "Steps Forward. Supervisory Convergence Through the Helsinki Protocol and the CEIOPS' Guidelines for Coordination Committees" points out the shortcomings of the Insurance Groups Directive, particularly in relation to the organizational forms of supervision, and discusses the implementing measures that were issued thereafter to ensure more effective insurance group oversight. Section "Up to Scratch. Group-wide Supervision Under Solvency II" then builds on the previous sections to explore the major changes introduced by Solvency II. Finally, Section "Looking Ahead. Toward EU-level Supervision for Systemically Significant Insurance Groups" advances the prospect of the centralization of supervisory responsibilities at the EU level for systemically significant insurance groups.

Starting from Scratch. Supplementary Supervision Under the Insurance Groups Directive

The evolution of insurance group supervision in the EU is clear. Before the Insurance Groups Directive was introduced in 1998, solo supervision was the norm. The Third Life and Third Non-Life Insurance Directives, indeed, limited the scope of insurance supervision to the financial situation of the individual companies as such.¹²

The Insurance Groups Directive set minimum measures of harmonization to eliminate divergences between member states as regards the prudential rules for group companies and achieve the mutual recognition of prudential control systems.¹³ It provided for a system of solo-plus supervision, requiring supplementary supervision of (re)insurance undertakings within a group in order to enable supervisory authorities to have a more accurate assessment of their financial situation.¹⁴ Supplementary supervision does not substitute supervision of individual insurance undertakings by the national competent authorities. Solo supervision remained the essential principle of insurance supervision,¹⁵ but an additional layer of supervision was imposed to take into account the group's structure and assess the solvency of the constituent (re)insurance undertakings.

The adoption of common basic rules on insurance group supervision was considered in the best interest of the Community since it favors the creation of an internal insurance market, prevents distortion of competition, and protects policyholders. The measures aimed at strengthening the prudential supervision of the insurance companies, thereby contributing to the stability of financial market and the development of a firm economy in general.¹⁶

The Directive required to calculate an adjusted solvency situation for (re)insurance undertakings within a group in order to prevent double gearing of capital,¹⁷ but also introduced rules on intra-group transactions, access to information relevant for supplementary supervision, and cooperation between national supervisory authorities.

Intra-group transactions, such as loans, guarantees and off-balance-sheet transactions, reinsurance and retrocession operations, agreements

to share costs, increase the interconnectedness of group entities and the extent to which those entities are exposed to contagion risk. The Directive, therefore, provided for monitoring and disclosure rules, requiring (re) insurance undertakings to have in place adequate risk management processes and internal control mechanisms to identify, measure, monitor and control these transactions adequately. It also prescribed at least annual reporting of significant transactions to the competent authorities, so as to allow them to take action at the level of the (re)insurance undertaking in case of solvency concerns.¹⁸

The importance of gathering information on (re)insurance companies in a group was recognized. Competent authorities were given the power to request any information relevant for the purpose of supplementary supervision as well as the power to carry out within their respective territory on-the-spot verification of relevant information.¹⁹ In order to gather any data and information necessary for supplementary supervision, every (re)insurance undertaking subject to the supplementary supervision was requested to have adequate internal control mechanisms in place.²⁰ As for the cooperation between the national supervisory authorities in the case of transnational insurance groups, the Directive set the requirement for the supervisory authorities to cooperate in exchanging relevant information that may allow or facilitate supplementary supervision.²¹

Steps Forward. Supervisory Convergence Through the Helsinki Protocol and the CEIOPS' Guidelines for Coordination Committees

The Insurance Groups Directive represented an important change in group supervision in the EU and enhanced the mutual confidence between the national authorities responsible for prudential supervision. Until then, supervisory authorities had only focused on solo supervision. As mentioned previously, the Directive, however, was a measure of minimum harmonization. In particular, it did not provide for specific rules for the organizational form of group supervision and for cooperation between national supervisory authorities.

In the case of a cross-border insurance group, in fact, the Directive did not require the appointment of a lead supervisor, but merely provided that the competent authorities of the member states involved come to an agreement as to which of them is responsible for supplementary supervision, nor it specified any criteria to use for reaching such an agreement. The absence of an authority responsible for the coordination of supervision at the group level may result in a system of supervision that is inefficient and burdensome for both the undertakings and the supervisor, but also inadequate to ensure effective group supervision. In addition, although the Directive established the supervisors' duty to cooperate and exchange information relevant to the supplementary supervision, it did not lay down rules on how to achieve such a cooperation or on the type of information to be communicated.

Implementing measures were issued thereafter to ensure a more effective and consistent approach to group supervision and enhance and facilitate cooperation between supervisors. Supervisors from all EU member states established in 2000 the Helsinki Protocol on the collaboration of the supervisory authorities of the EU member states with regard to supplementary supervision.²² The CEIOPS' Guidelines for Coordination Committees followed in 2005.²³ The convergence in supervisory methods achieved as a consequence of these two documents should be taken into account when assessing the system of supervision established by the Insurance Groups Directive.²⁴

The Helsinki Protocol was intended to foster common supervisory practices in order to create a more level-playing field for insurance groups based in more than one European Economic Area (EEA) member state and reduce possible regulatory arbitrage.²⁵ The Protocol required supervisory authorities to create a coordination committee for each insurance group operating in more than one EEA country. The coordination committee consisted of supervisory authorities from every member state involved in the supplementary supervision.²⁶ It decided on the organizational form of supplementary supervision, the information to be collected from the insurance groups and exchanged among the supervisors,²⁷ and it coordinated any measures to be carried out against the insurance undertakings being part of a group. A list of information relevant for supplementary supervision was also provided, that included any granting

or withdrawal of authorizations, changes in the management board of any undertakings involved, measures considered or taken by a supervisor that can have an influence on other group members, solvency concerns regarding members of the group, and major acquisitions by one of the members of the group.²⁸

It is worth noting that the Helsinki Protocol acknowledged the importance of appointing a leading supervisory authority to ensure efficient and effective supervision at the group level. It provided for the appointment of one or more supervisors as key coordinator(s) chairing the meetings of the coordination committee and arranging and managing the coordination of the activities necessary for the supplementary supervision, and it also highlighted that in practice it may be useful to assign authority to a lead supervisor to carry out most or all of the supplementary supervision, whenever the Insurance Groups Directive left a choice in that respect. The lead supervisor was responsible to act as the key coordinator as well, and had to be appointed unanimously by the members of the coordination committee. As for the criteria for selecting the lead supervisor, the Protocol suggested that the lead supervisor be the supervisor of the member state where the dominant insurance undertaking of the group is established, but it did not provide for a definition of “dominant insurance undertaking”; it merely suggested that a possible dominant insurance undertaking within a group may be defined in terms of premium income.²⁹

The need for a lead supervisor was also considered in the CEIOPS’ Guidelines for Coordination Committees which highlighted the central role that a lead supervisor can play especially in gathering and analyzing information relevant for group supervision. In particular, communication and exchange of information between the national supervisory authorities were considered essential in order to assess the overall financial situation of an insurance group and anticipate possible financial problems. The Guidelines acknowledged that many groups have complex structures and simply adding individual or country risks together does not make it possible to assess the complete risk profile of the whole group. Thus, the Guidelines emphasized the role of the coordination committees to conduct additional qualitative consolidated supervision at the level of the group holding company.³⁰

The Helsinki Protocol and the CEIOPS' Guidelines aimed at an optimal rather than minimalist implementation of the Insurance Groups Directive³¹ and represented important steps to achieve more effective group supervision and enhance convergence in the way coordination among national supervisory authorities is realized. The cooperation achievable through the coordination committees permits a tailor-made supervision in connection with the peculiarity of each insurance group, while the appointment of a lead supervisor has a central role in ensuring effective group supervision since a lead supervisor may play a role of impulse and coordination among the national supervisory authorities, and may also facilitate the spirit of mutual trust and cooperation that should permeate the activity of the supervisors, reducing the burden of group supervision for both the insurance companies and the supervisors themselves.³² It should be emphasized, however, that neither the Helsinki Protocol nor the CEIOPS' Guidelines established the mandatory appointment of a lead supervisor. Although it may be considered that the issue had no relevance in practice since a lead supervisor was appointed for almost all insurance groups with EU activities,³³ the introduction of harmonized rules at the EU level providing for the mandatory appointment of a lead supervisor under fixed criteria, and laying down the powers of the lead supervisor along with those of the other supervisory authorities, was necessary to ensure legal certainty and a more level-playing field among the member states.³⁴

Up to Scratch. Group-Wide Supervision Under Solvency II

Solvency II repealed the Insurance Groups Directive and introduced substantial changes in the supervision of insurance groups in the EU. The Directive acknowledges the increasing cross-border nature of the insurance business and the need for more coordinated rules at the EU level on group supervision in insurance to favor the proper functioning of the internal market and allow the supervisory authorities to form more soundly based judgments of the financial situation of (re)insurance undertakings in a group.³⁵

The supervision of individual (re)insurance undertakings remains the essential principle of insurance supervision.³⁶ Solvency II, however, introduces a system of consolidated supervision that rests on the concept of the group as a single economic entity rather than a collection of entities.

Group supervision applies at the level of the ultimate parent undertaking which has its head office in the EU.³⁷ In the case of multinational insurance groups, member states may allow their supervisory authorities to decide to apply group supervision at the lower, national level, if they deem it necessary³⁸; in that case, the supervisory authorities can also reach an agreement with supervisory authorities in other member states where another related ultimate parent undertaking at national level is established, in order to carry out group supervision at the level of a subgroup covering several member states.³⁹

In addition to rules on the calculation of group solvency—that are not within the scope of this Chapter—Solvency II introduces rules on the supervision of the system of governance at the group level, acknowledging that some risks may only be properly addressed through an effective system of governance rather than through quantitative requirements.⁴⁰ In particular, the governance requirements established for individual undertakings have to apply *mutatis mutandis* at the group level.⁴¹ It follows that an effective system of governance, proportionate to the nature, scale, and complexity of the operations of the (re)insurance group, has to be implemented and regularly reviewed, providing for sound and prudent management of the group business.⁴² The risk management and internal control systems and reporting procedures have to be implemented consistently in all undertakings included in the scope of group supervision, so that those systems can be controlled at the level of the group.⁴³ The responsible entity⁴⁴ has to set adequate internal governance requirements across the group, taking into account the structure, business, and risks of the group and its related entities. This, however, does not impair the responsibilities of the administrative, management and supervisory body of each entity in the group when setting up its own system of governance.⁴⁵

An own-risk and solvency assessment at the group level is mandated, which has to reflect the nature, structure and complexity of the group and identify all group-specific risks and assess the sufficiency of funds to support those risks. To this end, adequate group internal control mechanisms

have to be established and ensure sound reporting and accounting procedures for the monitoring and management of intra-group transactions and risk concentrations.⁴⁶

The Directive also sets specific requirements for the members of the administrative, management and supervisory body of the responsible entity, that are expected to collectively possess relevant knowledge, skills and expertise with respect to the business of the whole group, and to be of good repute and integrity. In particular, they are required to have adequate knowledge of the corporate organization of the group, the business model of its different entities, the links and relationships between the group entities and the risks arising from the group's structure.⁴⁷

Finally, as for the organizational form of group supervision, Solvency II introduces an innovative model that builds on the organizational form provided for by the Helsinki Protocol and the CEIOPS' Guidelines for Coordination Committees.⁴⁸ The Directive institutionalizes the role of the group supervisor, designated from among the national supervisory authorities involved in the supervision of the group and responsible for the coordination and exercise of group supervision. The solo supervisors maintain an important role and operate through supervisory colleges. Acknowledging that the powers and responsibilities of supervisors are tied to their accountability,⁴⁹ the Directive lays down in detail the tasks of both the group supervisor, that coordinates group supervision and plays an essential role of impulse, and the college of supervisors, that should ensure effective cooperation and consultation among the supervisory authorities.

In line with established international practices, Solvency II recognizes that the appointment of a lead supervisory authority is necessary to ensure effective supervision of the group and also reduce the regulatory burden for both the insurance companies and the supervisory authorities concerned.⁵⁰ Where the same supervisory authority is competent for all (re)insurance undertakings within a group, the task of group supervisor is exercised by that supervisory authority. In all the other cases, the Directive sets out specific criteria for the appointment of the group supervisor, depending on whether the group is headed by a (re)insurance undertaking or not. It is worth noting that in particular cases the

supervisory authorities concerned may make the joint decision to derogate from the criteria set by the Directive, where their application would be inappropriate in light of the group's structure and the relative importance of the (re)insurance undertakings' activities in different countries.⁵¹ The waiver option, where properly used, permits to appoint as group supervisor the authority that can better ensure effective and efficient group supervision, in light of the structure of the insurance group.

The group supervisor is assigned a wide range of responsibilities that involve all the essential areas of group supervision, including the review and assessment of the financial situation of the group, assessment of the group system of governance and of whether the members of the administrative, management, and supervisory body of the participating undertaking meet the group fit and proper requirements, the coordination of the gathering and dissemination of information relevant for supervisory purposes, planning and coordination of supervisory activities taking into account the specific risks of all undertakings within the group.⁵²

The group supervisor also has a significant role in the supervision of risk concentration at the group level and intra-group transactions, representing the only authority that interfaces with the insurance group. It should be noted that the regulation of intra-group transactions is more comprehensive than under the previous regime, and rules on the supervision of risk concentration have also been introduced.⁵³ Regular and at least annual reporting to the group supervisor is required for all significant intra-group transactions⁵⁴ by (re)insurance undertakings and any significant risk concentration⁵⁵ at the level of the group, whereas reporting of very significant intra-group transactions has to be made as soon as practicable. Intra-group transactions and risk concentrations are subject to supervisory review by the group supervisor that also identifies, after consulting the other authorities involved in the supervision of the group, the type of risks and intra-group transactions to be reported in all circumstances.⁵⁶

In order to facilitate the oversight of the group, cooperation, exchange of information and consultation between the group supervisor and the other supervisors involved are necessary. To this end the Directive provides

for the establishment of a college of supervisors, chaired by the group supervisor and composed of the supervisory authorities of all the member states where the subsidiary undertakings have their head office. The European Insurance and Occupational Pensions Authority (EIOPA) is also a member of the supervisory colleges, and aims at promoting their efficient, effective and consistent functioning, and the convergence of supervisory best practices.⁵⁷

Coordination arrangements between the group supervisor and the other supervisors set down the criteria for the establishment and functioning of the college of supervisors, and ensure a tailor-made supervision of the group within the limits imposed by the Directive. In fact, without prejudice to the responsibilities provided for by the Directive, the coordination arrangements may also assign additional tasks to the group supervisor, the other supervisory authorities, and EIOPA where this would increase the efficiency of the group supervision and would not impair the individual responsibilities of the members of the college of supervisors.

Recognizing the importance of cooperation and exchange of information between supervisory authorities, Solvency II prescribes that the group supervisor and the other supervisory authorities cooperate closely and promptly exchange relevant information available to them in order to permit and facilitate the exercise of their supervisory tasks. In addition, member states have to ensure that their authorities responsible for the exercise of group supervision have access to any relevant information regardless of the nature of the undertaking concerned.⁵⁸ Where a decision is of importance for the supervisory tasks of other authorities, consultation between the supervisory authorities is required, for example with respect to changes in the shareholder, organizational or management structure of (re)insurance undertakings within a group, which require the approval of the supervisory authorities, or major sanctions or exceptional measures taken by the supervisory authorities. To ensure efficient and effective group supervision, however, a supervisory authority may decide not to consult in cases of urgency or where the effectiveness of the decision may be hampered by the consultation.⁵⁹

Looking Ahead. Toward EU-Level Supervision for Systemically Significant Insurance Groups

Solvency II builds on the previous regulatory framework under the Insurance Groups Directive, the Helsinki Protocol and the CEIOPS' Guidelines for Coordination Committees to introduce a more effective and adequate system of group supervision. As discussed previously, it provides for rules on the supervision of the system of governance at the group level, as the necessary complement to the rules on the calculation of group solvency. It mandates an own-risk and solvency assessment at the group level and lays down more comprehensive rules for intra-group transactions and risk concentrations. The supervisory system rests on an organizational form of supervision that mainly revolves around the group supervisor. In particular, the Directive has moved toward a more centralized model of group supervision, institutionalizing the role of the group supervisor that provides the central impulse for group supervision. The concentration of responsibilities in the hands of the group supervisor may lead to a system of group supervision that is more efficient for both the (re)insurance undertakings subject to group supervision and the supervisory authorities involved, since the group supervisor may facilitate the coordination of group supervision. Notably, in some cases the group supervisor represents the only authority that interfaces with the insurance group.⁶⁰ Group supervision may also prove to be more effective, considering that a wide range of powers involving all the essential areas of supervision is now specifically assigned to the group supervisor. The establishment of the college of supervisors, meanwhile, ensures cooperation, exchange of information and consultation among the national supervisory authorities involved in the supervision of the group, and promotes convergence of supervisory activities. There is a clear allocation and division of powers and responsibilities between the group supervisor and the other supervisory authority, and this has certainly enhanced the accountability in the exercise of group supervision.

Yet it should be noted that the supervision of group risks is inherently complex. Understanding and controlling the interactions between risks in multi-tiered insurance groups can be demanding, and the group

supervisor and the other national authorities may not have the capacity, time and resources to identify and respond to these risks effectively.⁶¹ The question arises as to whether a different model of supervision should be contemplated for systemically significant insurance groups, whose distress or failure can have a major negative impact on the global financial system and real economy.⁶²

The common wisdom that insurance is not systemically risky⁶³ was questioned by the financial crisis of 2008. In particular the well-known and notable collapse of AIG increased the awareness of the potential of the insurance industry to generate systemic risk, especially where “non-traditional” insurance activities such as derivatives and financial guaranties are concerned.⁶⁴ Available data show that the largest European insurance groups have considerable direct exposures to other financial institutions; this can create contagion risk and have systemic implications.⁶⁵ In addition, cross-border activities of insurers in Europe have not been affected by the financial crisis and remain substantial, leading to a need for intense coordination among the national supervisory authorities.⁶⁶

Then, it appears sensible to entrust the supervision of systemically significant insurance groups to a supranational EU authority, in all probability EIOPA. If equipped with sufficient resources,⁶⁷ a supranational authority, in fact, should be comparatively well situated relative to a national group supervisor to proactively monitor and manage systemic risk in large, international insurance groups. The centralization of supervisory responsibilities at the EU level for systemically significant insurance groups should allow to better coordinate supervisory actions across jurisdictions and ensure a more efficient and effective supervision. Although appropriate cooperation with the national supervisory authorities would remain important, a supervisory model based on a global EU supervisor will facilitate the exercise of consolidated oversight of the cross-border activities of groups designated as systemically risky, and permit to overcome the coordination difficulties that are inherent in the supervisory colleges.⁶⁸

From a comparative perspective it is worth noting that also in the US systemically significant insurers warranted a different supervisory regime than other insurance groups, and are subject to consolidated supervision at the federal level as well as insurance groups controlling a depository

institution. Aside from the unquestionable peculiar features of the US insurance regulatory framework, suffice it to say that, while insurance regulation in the US has been traditionally the responsibility of the individual states, which also have authority for group supervision,⁶⁹ in Dodd-Frank, the US Congress enacted several measures to address systemic risk in insurance, expanding the role of the federal government.⁷⁰ In particular, for our purposes, it should be mentioned that Congress authorized the Federal Reserve Board to supervise insurance groups that are determined to be systemically significant by the US Financial Stability Oversight Council, thereby creating a federal system for systemic risk oversight.⁷¹

The centralization of supervisory responsibilities at the EU level for systemically significant insurance groups would certainly require to overcome both legal constraints and political resistance from member states, as it implies reallocation of authority from the national supervisors to a supranational authority.⁷² However, to the extent that there are good prudential reasons for greater supervision of systemic risk in insurance, oversight of systemically significant insurance groups appears to be an area where EU-level supervision will expand over time.

Notes

1. IAIS 2009, p. 8. *See also* Outreville 2008, p. 464.
2. *See* Houben and Teunissen 2011, pp. 246 ff.
3. OECD.Stat 2016.
4. Darlap and Mayrm 2006, pp. 96 f., 104 f.; Outreville 2008, pp. 463 f.; IAIS 2009, p. 10.
5. Manghetti 2006, pp. 311 f.; IAIS 2009, p. 10; Darlap and Mayrm 2006, pp. 99, 101 (noting that managers may engage in riskier activities because they are confident of a government's bailout).
6. Darlap and Mayrm 2006, pp. 99 f.; IAIS 2009, p. 11; Manghetti 2006, pp. 311 ff. *See* Sangiorgio 1996, p. 542; Mächler 2011, pp. 155 f.
7. IAIS 2009 Paper, p. 9 (emphasizing the possibility that contagion risk may cause systemic risk); Darlap and Mayrm 2006, p. 100 (highlighting that direct exposures, like an investment in, or a loan to, a group entity, or an obligation to provide financial support, are particularly relevant in the context of groups).

8. IAIS 2009, p. 9 (pointing out that reputational risk may also have a positive impact, depending on the circumstances of the specific cases).
9. *See* Schwarcz and Schwarcz 2016, p. 51.
10. European Parliament and Council Directive 98/78 on the supplementary supervision of insurance and reinsurance undertakings in an insurance or reinsurance group, 1998 O.J. (L78) 1 (hereinafter: Insurance Groups Directive).
11. European Parliament and Council Directive 2009/138, 2009 O.J. (L138) 1 (hereinafter: Solvency II).
12. *See* Council Directive 92/49/EEC, 1992 O.J. (L228) 1; Council Directive 92/96/EEC, 1992 O.J. (K360) 1.
13. Insurance Groups Directive, paragraphs 4, 5 of the Preamble.
14. Insurance Groups Directive, paragraph 3 of the Preamble, and Article 2. *See also* Commission of the European Communities 1995, p. 2.
15. Commission Proposal for Insurance Groups Directive, p. 4.
16. Insurance Groups Directive, paragraph 4 of the Preamble. Commission Proposal for Insurance Groups Directive, pp. 4 f.
17. Insurance Groups Directive, Article 9, and Annexes I and II.
18. Insurance Groups Directive, Article 8.
19. Insurance Groups Directive, Article 6.
20. Insurance Groups Directive, Article 5.
21. Insurance Groups Directive, Article 7.
22. Helsinki Protocol 2000.
23. CEIOPS 2005b Guidelines.
24. CEIOPS 2005a Recommendation, p. 4.
25. CEIOPS 2005a Recommendation, p. 9. The Protocol was extended to the new EEA member states in 2004.
26. The CEIOPS' Recommendation on Insurance Groups Directive notes that the coordination committee of a major insurance group typically meets face-to-face once a year and exchanges information by telephone or email during the year, while the coordination committee of a smaller group may just have one initial meeting and then exchange information by telephone or email.
27. Helsinki Protocol, pp. 8 f. (highlighting that in case of large groups it will be necessary to limit the amount of information gathered and exchanged and that a small number of key supervisors should have more intensive supervisory contacts).
28. Helsinki Protocol 2000, pp. 11 f.

29. Helsinki Protocol 2000, p. 8 (adding that, depending on the group structure, the coordination committee may decide to appoint two or more joint lead supervisors). *See also* CEIOPS 2005b Guidelines, pp. 5–6 (considering that if a lead supervisor is appointed, for reasons of good order, it should also act as key coordinator).
30. CEIOPS 2005b Guidelines, pp. 4–5.
31. *See* Helsinki Protocol 2000, p. 7.
32. *See* CEIOPS 2005a Recommendation, p. 12 (suggesting that reporting may be centralized to one supervisory authority).
33. *See* CEIOPS 2010.
34. Center for European Policy Studies 2006, p. 97 (reporting that the supervisory model based on a lead supervisor was not effective and that there was a lack of specific rules regarding the responsibilities of the national supervisory authorities); KPMG 2012, p. 20 (highlighting that the coordination committee model of supervision was relatively underdeveloped in Europe).
35. Solvency II, paragraphs 3, 93, and 95 of the Preamble. For the Solvency II regulatory framework, including the implementing rules and technical standards issued by the Commission, and the accompanying guidelines issued by EIOPA, see http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm; <https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii>.
36. Solvency II, paragraph 97 of the Preamble, and Article 213(1).
37. Solvency II, Article 215.
38. Solvency II, Article 216.
39. Solvency II, Article 217.
40. Solvency II, Recital 29.
41. Solvency II, Article 246(1). *See* Borselli 2014, pp. 50 ff.
42. Solvency II, Article Art. 41; EIOPA 2013, p. 6.
43. Solvency II, Article 246.
44. Although the responsible entity is generally the parent undertaking, depending on the structure and organization of the group, it may be another group entity.
45. EIOPA 2013, pp. 19–20.
46. Solvency II, Article 246.
47. Solvency II, Article 257; EIOPA 2013, pp. 5–7.
48. *See* Borselli 2012, pp. 36 ff.
49. Solvency II, Recital 104.

50. *See* IAIS 2015, pp. 347 ff.; IAIS 2014, pp. 88 ff.
51. Solvency II, Article 247 (2), (3).
52. Solvency II, Article 248.
53. *See* Solvency II, Articles 244, 245.
54. Intra-group transactions are considered as significant if they materially influence the solvency or liquidity position of the group or of one of the (re)insurance undertakings involved in these transactions. Commission Delegated Regulation 2015/35, 2015 O.J. (L12) 1, Article 377 (also providing a non-exhaustive list of significant intra-group transactions).
55. Risk concentrations that could threaten the solvency or liquidity position of the group are considered as significant. Commission Delegated Regulation 2015/35, 2015 O.J. (L12) 1, Article 377 (also providing a list of elements to consider when determining thresholds in a group for significant risk concentrations).
56. Solvency II, Articles 244, 245.
57. *See* Solvency II, Article 248; Article 21 of Regulation (EU) No. 1094/2010 of the European Parliament and of the Council establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L331) 48.
To permit the effective functioning of the supervisory colleges, some activities can be assigned to a reduced number of supervisory authorities. *See* KPMG 2012, p. 22 (noting that for larger supervisory colleges “core” supervisors, namely the supervisors of significant insurers in the group, are likely to convene more often).
58. Solvency II, Article 254.
59. In that case the supervisory authorities must inform the other supervisory authorities involved without delay. Solvency II, Article 250.
60. *See* above paragraph 4.
61. *See* Schwarcz 2015, p. 540 (noting that supervision of large insurance groups is a full-time job and that state insurance regulators in the US have limited incentives to devote their efforts and resources to group supervision, as the potential benefits extend beyond their states’ borders).
62. *See* IAIS 2016, p. 6. In November 2016, following consultation with the IAIS and national authorities, the Financial Stability Board identified nine insurance groups as global systemically important insurers, five of which are headquartered in the EU. *See* FSB 2016, p. 3.
63. Schwarcz and Schwarcz 2016, pp. 52 ss. (observing that this view is mainly based on limited interconnections between insurers and other

- financial institutions, the smaller size of insurance companies compared with banks, and the greater substitutability of insurance than other types of financial services). *See also* Finney 2016, pp. 36 ss.
64. *See* McCoy 2015, p. 1401; Schwarcz and Schwarcz 2016, p. 54. European Systemic Risk Board 2015, p. 2 (stating that non-traditional insurance products in the EU roughly account for at least Euro 125 billion).
 65. Alves et al. 2015, pp. 3 ss.; European Systemic Risk Board 2015, pp. 2 ss. *See also* Masciandaro and Quintyn 2011, pp. 110 f.; Houben and Teunissen 2011, pp. 252 ff.
 66. *See* Schoenmaker 2013, pp. 2 ss.; Houben and Teunissen 2011, p. 262. *See also* Van Hulle 2011, p. 307 (predicting “some sort of European supervision for all or major cross-border groups”).
 67. *See* Ferran 2012a, p. 157 (noting that elevating the powers of the European Supervisory Authorities to direct supervisory responsibilities would require an appropriate increase in their resources).
 68. *See generally* IAIS 2014, p. 2 (emphasizing the need for more coordinated supervision of internationally active insurance groups).
 69. Group supervision in the US is based on the so-called “windows-and-walls” system. “Windows”, such as reporting by insurers of financial information regarding the parent and the affiliates, are intended to allow state regulators to assess the potential impact of group activities on the regulated entities, whereas “walls” aim to protect the capital of the insurers and their ability to pay policyholders’ claims, requiring review by the state regulators of certain transactions between insurers and their affiliates. *See generally* McCoy 2015, pp. 1425 ff.; Schwarcz 2015, pp. 542 ff.
 70. *See* McCoy 2015, pp. 1411 ff., 1417 ff. (arguing that the role of the federal government in insurance is likely to grow).
 71. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 113.
 72. *See generally* Ferran 2012b, pp. 46 ff.

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Part III

Evolution of the Solvency Calculation and Reporting

10

Actuarial Improvements of Standard Formula for Non-life Underwriting Risk

Gian Paolo Clemente and Nino Savelli

Introduction

Solvency II directive (see European Commission [2009](#)) defined a new framework for a prudential regulation of insurance market in European Union (EU), with particular reference to new capital requirements. While the “Solvency I” Directive aimed at revising and updating the current EU Solvency regime, Solvency II has a much wider scope. In particular, in order to reduce the risk that an insurer would be unable to meet claims and to provide early warning to supervisors, a new capital framework based on a three-pillar approach has been defined. According to the quantitative requirements (e.g. the amount of capital an insurer should hold) described in Pillar 1, insurance companies are encouraged to implement (stochastic) internal models to assess their risks as accurately as possible. However, since the implementation of such internal models is rather expensive and

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sophisticated, the European Commission with the support of European Insurance and Occupational Pensions Authority (EIOPA) has established a standard model which all insurance companies will be allowed to use in order to approximate their capital requirements. The calibration of the standard model has been achieved with a series of Quantitative Impact Studies (QIS) in which the effects of the new capital requirements are analyzed. Commission Delegated Regulation (see European Commission 2015) provided a final version of the standard formula. As is well known, the overall risk is based on a modular structure where separate solvency capital requirements (SCRs) are computed for each sub-module. These SCRs are then aggregated under the assumption of a multivariate normal distribution with pre-specified correlation matrices to allow for diversification effects.

Most small and medium-size insurance companies are expected to rely on this model. Larger companies are also likely to adopt at least a few modules for their (partial) internal model. Hence, a reasonable implementation and calibration of the standard model is crucial in order to ensure the financial stability of the European insurance markets.

Non-life insurers are particularly exposed to underwriting risk. As main results of QIS showed, the evaluation of capital requirement for premium and reserve sub-module represents a key issue for non-life insurance companies.

To this aim, we describe the approach proposed by the standard formula for premium and reserve capital charge. We examine the adequacy of the methodology provided by emphasizing some inconsistencies of the underlying assumptions. Furthermore, we explain how we could improve it.

This paper is organized as follows. In section “[Delegated Acts Standard Formula for Premium and Reserve Risk](#)”, we provide a detailed description of Standard Formula for Premium and Reserve. The section “[Methodological Framework of Premium and Reserve Risk](#)” defines the methodological framework used in actuarial literature to describe the one-year technical result and, thus, the required capital. We emphasize main inconsistencies of standard formula in section “[Some Comments About Capital Requirement for Premium and Reserve Risk](#)” also by using some examples to evaluate the numerical impact on capital requirement. Conclusions follow.

Delegated Acts Standard Formula for Premium and Reserve Risk

We briefly summarize here main elements of the standard formula for premium and reserve risk defined by Delegated Acts (DA; see European Commission 2015). Since QIS3, a unique sub-module has been introduced for the combined valuation of both risks related to future claims arising during and after the period until the one-year time horizon (premium risk) and the risk related to an insufficient amount of the technical provisions (reserve risk). Hence, this capital charge is aggregated to lapse and catastrophic risks in order to quantify the capital requirement for non-life underwriting risk. As is well known, together with other macro-modules, it allows for obtaining basic SCR and SCR.

For simplicity's sake, we focus here only on premium and reserve risk. However, as shown by results of QIS, this module usually regards the greater portion of total capital requirement for non-life insurance companies. In this case, we have that the capital requirement SCR_{NL}^{SF} is derived from the following formula (see European Commission 2015 for details):

$$SCR_{NL}^{SF} = 3 \cdot \sigma_{NL} \cdot V_{NL}. \quad (10.1)$$

where V_{NL} is the net of reinsurance volume measure and σ_{NL} measures the volatility of non-life premium and reserve risks. In particular, σ_{NL} represents the standard deviation of the ratio of the aggregate losses due to the risk involved in the volume measure and it is then strictly related to the coefficient of variation¹ of aggregate claims amount.

Hence, Eq. (10.1) implicitly assumes to measure the distance between the VaR² at 99.5% confidence level and the mean of the probability distribution of aggregate claims amount by using a fixed multiplier of the standard deviation equal to 3. This choice has replaced the function³ used since QIS5 (see European Commission 2010) based on the assumption of a lognormal⁴ distribution of total losses. More details on the numerical effect of this replacement are given in section “[Some Comments About Capital Requirement for Premium and Reserve Risk](#)”.

The net volume measure V_{NL} is equal to the sum of net best estimate of claims reserve and net premium volume related to all non-life insur-

ance business. Premium volume is equal to the maximum between last year and next year earned premiums plus the expected present value of future premiums after one year for both existing and next-year policies⁵. Finally, in the valuation of volume measure it is allowed to take into account the geographical diversification of business held in different macro-geographical regions of the world. This diversification is quantified via a specific index and it allows, at maximum, a saving of capital equal to 25%. However, it is noteworthy that the effect of this diversification is usually almost negligible for most European companies.

As regards σ_{NL} , the overall volatility is derived from a two-step aggregation process based on an initial aggregation of the standard deviations of premium $\sigma_{\text{prem},s}$ and reserve risk $\sigma_{\text{res},s}$ of single line of business (LoB) assuming a linear correlation coefficient⁶ equal to 0.5. Furthermore, the standard deviations are aggregated between different lines of business by using a given correlation matrix C (see Annex IV of European Commission 2015 for details). In general, all the correlation coefficients provided are greater than zero in order to take into account the effect of a positive dependence between the risks involved.

In order to quantify the standard deviations of premium or reserve risk of single LoB, standard formula permits two different approaches. The first one (market-wide approach) applies fixed volatility, while the second one, whose use must be approved by supervisor authority, is based on the application of given methodologies (see Annex XVII of European Commission 2015) that take into account the specific technical data of the company (undertaking-specific approach). The differences between these approaches may be noticeable in the single-LoB volatility valuation.

Market approach regards a market-wide estimate of the standard deviation of each risk, which is placed equal to a specific volatility factor given as an input (see Table 10.1). It is noteworthy that LoBs from 1 to 9 regard both direct insurance and proportional reinsurance business, while the other three LoBs are for non-proportional (NP) reinsurance contracts.

With Solvency II being a system designed to incentivize sound risk management, undertaking-specific parameters (USP) are seen as a relevant part of such a system, which allow, in the areas identified in the standard formula, for replacing the standard formula risk parameters with undertakings' specific parameters.

Table 10.1 Market-wide volatility factor (DA premium and reserve risk; see Annex II of European Commission 2015)

LoB	σ_{prem} (%)	σ_{res} (%)
Motor vehicle liability	10	9
Other motor	8	8
Marine, aviation, and transport (MAT)	15	11
Fire and other damage to property	8	10
General liability	14	11
Credit and suretyship	12	19
Legal expenses	7	12
Assistance	9	20
Miscellaneous financial loss	13	20
Non-proportional casualty reinsurance	17	20
Non-proportional MAT reinsurance	17	20
Non-proportional property reinsurance	17	20

In particular, one approach is given for volatility factors of premium risk and two alternative methods are provided for reserve risk (see Annex XVII of European Commission 2015). Mainly, the USP for premium risk is based on the estimation of volatility of aggregate losses under the assumption of a lognormal distribution and by using a maximum likelihood methodology. For reserve risk, a similar approach is proposed in order to derive the volatility of run-off result. Alternatively, a second method allows the application of the Merz and Wüthrich (see Wüthrich and Merz 2008) formula to the run-off triangle of incremental payments.

The Solvency II system allows for risk mitigation techniques too. In order to consider the effect of risk mitigation given by in-force excess of loss (XL) reinsurance treaties, premium risk's gross volatilities $\sigma_{\text{prem},s}$ are multiplied by a fixed⁷ non-proportional factor NP_{lob} . It is not always easy to take this on board in the standard formula without adding too much unwanted complexity. To this aim, it is also allowed the use of an undertaking-specific approach (see Annex XVII of European Commission 2015) to derive an alternative estimate of NP'_{lob} based on the valuation of the effect of XL treaty on the variability coefficient of aggregate claims amount. This alternative estimate, subject to supervisor approval, allows a specific calibration on insurer data in order to better assess the specific risk profile of the company. In this case, the final NP_{lob} will be a weighted average of fixed NP_{lob} and the value NP'_{lob} estimated by data. The latter is

weighted with a fixed credibility factor, whose value increases with a longer time-series of available data⁸.

Finally, we emphasize that similar methodologies are applied to evaluate the capital requirement for non-SLT health sub-module. This sub-module considers contracts regarding health and accident insurance that are usually hold by non-life insurers.

Methodological Framework of Premium and Reserve Risk

We briefly describe here the methodological framework usually proposed in actuarial literature to evaluate the capital requirement for premium and reserve risk for a multi-line non-life insurer in order to highlight some pitfalls of Solvency II standard formula.

To assure a consistent comparison with the standard formula, we focus on the random variable⁹ (rv) one-year technical result evaluated, at the end of time t , as the difference between earned premiums of the total portfolio (with several LoBs) and total amount of claims and expenses of the year (see Clemente and Savelli 2013; Daykin et al. 1994; Gisler 2009; Savelli and Clemente 2009). For readers interested in mathematical details, we report main formulae in the Appendix.

Under some assumptions, it is possible to measure in a separate way¹⁰ the effect on the technical result of next-year contracts and unexpired risks (i.e. premium risk) and of the run-off result (i.e. reserve risk). Furthermore, it is noteworthy that gross premiums of single LoB are in practice the sum of risk premiums (equal to the expected claims amount), safety loadings, and expenses loadings (equal to the expected expenses amount).

According to the VaR risk measure at the 99.5% confidence level defined by Solvency II, the solvency capital requirement (SCR^{IM}) for premium and reserve risk can be written as:

$$SCR_{99.5\%}^{IM} = VaR_{99.5\%} \left(\tilde{X} \right) - \sum_{h=1}^L (P_{t+1,h} + BE_{t,h}) - \sum_{h=1}^L \lambda_h P_{t+1,h}. \quad (10.2)$$

In other words, the capital requirement is equal to the VaR of premium and reserve losses X less the amounts at disposal to cover future obligations. The cash inflows are the risk premiums related to all next-year contracts of the portfolio (P), the best estimates of the claims reserves (BE), and the safety loadings (λP) implicitly applied by the insurer in premium rates. As defined in Solvency II standard formula, we exclude risk margin in Eq. (10.2) in order to avoid circularity in risk margin evaluation.

Furthermore, it is noteworthy that we recognize expected profits and losses in the capital assessment by considering safety loadings as traditionally happens in actuarial literature (see Beard et al. 1984; Daykin et al. 1994). We discuss more about this point in the next section because standard formula does not regard it directly in capital requirement evaluation.

We rewrite previous formula to assure a better comparison with Eq. (10.1) provided by DA:

$$\text{SCR}_{99.5\%}^{\text{IM}} = k_{99.5\%} \sigma \left(\frac{\tilde{X}}{V} \right) V - \sum_{h=1}^L \lambda_h P_{t+1,h}. \quad (10.3)$$

The distance between the VaR at 99.5% confidence level and the mean is obtained here as the product of the standard deviation of the ratio of losses to volume measure multiplied by $k_{99.5\%}$. The value of $k_{99.5\%}$ depends on the shape of the distribution of the random variable. For example, it is well-known that $k_{99.5\%} \approx 2.58$ under the Gaussian law¹¹. Standard formula (see Eq. [10.1]) assumes instead in a simplified framework that $k_{99.5\%} = 3$. In the next section, we will show how a different choice of this value can affect in a significant way the capital requirement.

Some Comments About Capital Requirement for Premium and Reserve Risk

We provide here some comments about the Solvency II standard formula emphasizing some inconsistencies. To support our discussion, we also consider a case study based on two non-life insurance companies (OMEGA

and EPSILON) with a different dimension (their figures are summed up in Table 10.2). Furthermore, both insurers underwrite business in the same five lines of business (Accident, Motor Other Damages (MOD), Property, Motor Third-Party Liability (MTPL) and General Third-Party Liability (GTPL)) with the same mix of portfolio (rather similar to the actual proportion in the Italian insurance market). We assume that both insurers have the same characteristics except for the expected number of claims. OMEGA is ten times larger than EPSILON.

We perform a comparison between a risk-based capital, obtained from the application of a partial internal risk model, and the equivalent SCR, as provided by the Solvency II standard formula. To this end, we apply a risk theoretical simulation model in order to estimate the capital charge regarding both premium and reserve risk. The internal model exploits the collective risk model for premium risk (see Clemente and Savelli 2013) and lognormal bootstrapping (see England 2002; England and Verrall 2002) on a one-year view (see Diers 2009; Ohlsson and Lauzenings 2008) for reserve risk. Clearly, there are several methodologies provided in literature that allow to estimate future obligations and, hence, the capital requirement. However, we have chosen widely used methods in order to assure a consistent comparison between internal model and standard formula results.

Distribution of Total Losses

As shown by both Eqs. (10.1) and (10.3), capital requirement can be obtained by multiplying a value $k_{99,5\%}$ by the standard deviation of aggregate claims amount for premium and reserve risk of the total portfolio. The choice of $k_{99,5\%}$ depends on the shape of the distribution of the random variable. Theoretically, we can compare alternative values provided by internal model and by standard formula.

In particular, we have that:

- Delegated Acts (DA) assume $k_{99,5\%} = 3$ for all Insurers (see Eq. [10.1]).
- QIS5 assumes $k_{99,5\%} = \rho(\sigma_{NL})/\sigma_{NL}$ for all insurers, where $\rho(\bullet)$ function (see European Commission 2015) is calibrated according to a

Table 10.2 Premium and reserve volumes of both insurers

	OMEGA			EPSILON			Both insurers				
	B_t	B_{t+1}	FP	BE_t	B_t	B_{t+1}	FP	BE_t	$V_{prem,t}/V$ (%)	$V_{res,t}/V$ (%)	V_t/V (%)
Accident	100.0	105.0	16.4	56.6	10.0	10.5	1.6	5.7	4.99	2.33	7.32
MOD	100.0	105.0	3.9	19.6	10.0	10.5	0.4	2.0	4.48	0.81	5.28
Property	150.0	157.5	64.6	109.5	15.0	15.8	6.5	10.9	9.13	4.50	13.63
MTPL	550.0	577.5	16.9	793.3	55.0	57.8	1.7	79.3	24.43	32.61	57.04
GTPL	100.0	105.0	16.4	285.7	10.0	10.5	1.6	28.6	4.99	11.74	16.73
Total	1000.0	1050.0	118.2	1264.7	100.0	105.0	11.8	126.5	48.02	51.98	100

¹ B_t and B_{t+1} are earned gross premiums at time t and estimated next-year premiums, respectively. FP is the expected value of future premiums for multi-annual contracts, and BE_t is the best estimate of claims reserve at time t . Amounts are expressed in millions of Euros. Last three columns show the effect of premium volume, reserve volume, and total LoB volume on the overall portfolio's volume measure

lognormal distribution and it is applied to the overall volatility σ_{NL} . Under this assumption, value of $k_{99,5\%}$ depends on the skewness¹² of lognormal distribution and it increases when σ_{NL} is higher. We remind that skewness and variability coefficient of a lognormal distribution are strictly related (see Klugman et al. 2008).

- Value of $k_{99,5\%}$ depends on the shape of the full distribution provided by the developed partial internal model (see Clemente and Savelli 2013; Savelli and Clemente 2011).

From a practical point of view, DA multiplier does not take into account the skewness of the distribution with a potential underestimation of capital requirement for small insurers and an overestimation for big insurers (see Fig. 10.1). We have that the lognormal assumption (QIS5) leads to a multiplier equal to 3 only when the volatility σ_{NL} is roughly 14.47%. When higher values are observed (i.e. for small or high volatile insurers), DA leads to a lower capital requirement than QIS5.

Furthermore, we also computed for both insurers the multiplier derived from the internal model. As shown in Table 10.3, for OMEGA Company, Lognormal assumption (QIS5) is not so far from the internal model results, while in the case of EPSILON Company the lognormal assumption underestimates by far the skewness of aggregate claims obtained by simulations (0.18 against an exact skewness of 3.37), and it yields a multiplier lower than the internal model (2.77 instead of 3.11). Finally, we can see how the final version of the standard formula (DA)

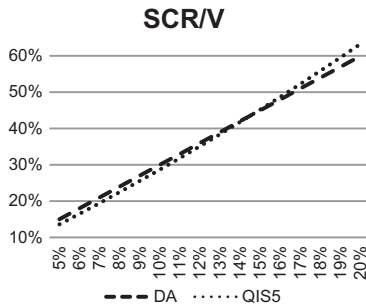


Fig. 10.1 Ratios SCR/V according to different overall volatilities σ_{NL}

Table 10.3 Multiplier $k_{99,5\%}$ according to different approaches

	OMEGA		EPSILON			
	QIS5	DA	IM	QIS5	DA	FP
Accident	2.79	3	2.84	2.87	3	2.83
MOD	2.79	3	2.81	2.81	3	2.77
Property	2.77	3	2.99	2.93	3	3.57
MTPL	2.69	3	2.69	2.74	3	2.69
GTPL	2.82	3	3.01	3.20	3	3.60
Total	2.69	3	2.74	2.77	3	3.11

tends to overestimate in a significant way for big insurer, while the underestimation of QIS5 is partially reduced when smaller or high volatile companies are considered.

Size of Non-life Business

Another key issue is the analysis of volatility of each LoB and each risk. As described in section “[Delegated Acts Standard Formula for Premium and Reserve Risk](#)”, standard formula is primarily dependent on fixed risk factors (see Table 10.1). Instead, it is proven in actuarial literature that the variability coefficient of aggregate claim amount decreases for larger portfolios because of pooling effect (see Daykin et al. 1994; Gisler 2009). Market-wide approach does not consider the size of portfolio.

In this regard, Table 10.4 compares internal model’s variability coefficients to the volatility factors provided by DA standard formula. Measuring the risk profile of specific LoB and risk, internal model leads to a greater volatility for the small insurer (EPSILON). It is noteworthy that both insurers instead have the same risk factors when the standard formula is applied. After the aggregation process, we observe the same overall volatility. In other words, insurers, with the same mix of portfolio, have the same ratio between non-life underwriting risk capital requirement and volume measure when market-wide approach is applied. This choice seems not consistent with the diversification effect usually observed in practice.

Table 10.4 Variability coefficients (CV) of each LoB and the total portfolio derived from IM and DA standard formula

	OMEGA				EPSILON							
	IM		DA		IM		DA					
	Premium (%)	Reserve (%)	Total (%)	Premium (%)	Reserve (%)	Total (%)	Premium (%)	Reserve (%)	Total (%)			
Accident	9.49	6.30	7.34	8.5	14	8.90	10.52	11.26	9.41	8.5	14	8.90
MOD	8.09	6.33	7.33	8	8	7.46	8.60	7.60	7.87	8	8	7.46
Property	6.52	9.34	6.58	8	10	7.57	14.16	8.92	10.74	8	10	7.57
MTPL	7.18	2.84	4.14	10	9	8.18	7.76	4.94	5.33	10	9	8.18
GTPL	13.65	8.11	8.36	14	11	10.45	31.34	15.38	17.34	14	11	10.45
Total	5.77	3.51	3.95	7	7.59	6.35	8.12	6.03	6.06	7	7.59	6.35

Profit and Loss Attribution

Typically, in actuarial literature expected profits and losses are considered in the capital requirement evaluation (see for instance Eq. [10.3]). Safety loadings are usually taken into account when capital at risk is assessed (see Beard et al. 1984; Daykin et al. 1994). In addition, QIS2 standard formula proposed a way to modify basic solvency capital requirement (BSCR) in order to consider positive and negative margins entailed in both underwriting and reserving processes. In particular, empirical combined ratios were used to calibrate an adjustment factor to reduce (or increase) BSCR according to expected positive (or negative) safety loadings in premium rates. In a similar way, the expected portion of risk margin released during the next year was allowed to reduce BSCR for reserve profits. DA standard formula removed these solutions. This choice is probably justified by a prudential perspective, but it could underestimate capital requirement when negative profits are expected. However, it is noteworthy that the best estimate of premium reserve considers expected profits (or losses) for both unexpired business and multi-annual policies. In this way, the volume of earned premiums, used for SCR, implicitly takes also into account the expected profits (or losses) of these contracts. Furthermore, expected profits in future premiums (EPIFP) are related to own funds assessment (see EIOPA 2011).

We show in Fig. 10.2 the effect of expected safety loadings on IM capital requirements. We derived these results under the assumption of equal-

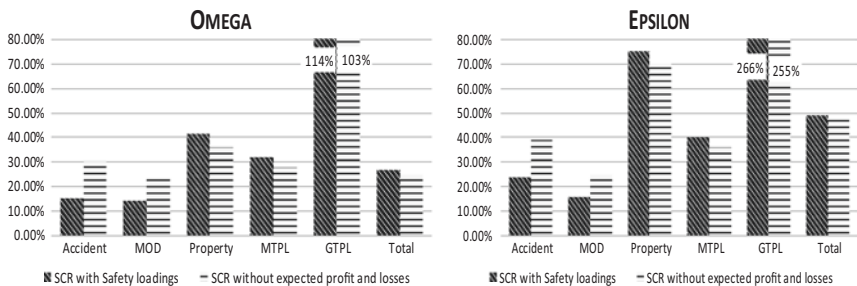


Fig. 10.2 Ratios SCR/V evaluated with or without considering expected profits and losses

ity between earned and written premiums. It is to be pointed out that safety loading coefficients are obtained mainly by Italian market combined ratios for the period 1996–2010¹³. As shown, when profits are considered, a significant saving of capital is gained (as for MOD and Accident LoBs). Nevertheless, at the same time, the choice of DA formula is not prudential for other LoBs (as Property, MTPL, and GTPL in the case study). These results emphasize how the solution provided by the standard formula could underestimate the capital requirement when a negative underwriting result is expected (as happens for the total business in Fig. 10.2).

Non-proportional Reinsurance

DA standard formula also considers the risk mitigation provided by reinsurance treaties. In particular, proportional reinsurance leads to a proportional saving of capital requirement. Eq. (10.1) is based on a net volume measure, while proportional treaties do not affect volatility.

For NP treaties, DA applies an **NP** factor to premium risk's market-wide volatilities aiming at measuring the reduction of volatility entailed by XL treaties. **NP** is a fixed value equal to 80% for MTPL, GTPL, and Property lines of business only if XL treaties are in force. It is equal to 1 for all other segments. Furthermore, standard formula gives the possibility to use an undertaking-specific approach to evaluate **NP** on the basis of insurer's available data set. This alternative value is the square root of the ratio between the second moments about zero of net and gross claim size distributions. The gross amount is estimated by data, while the net claim size is derived under a lognormal assumption, calibrated by using method of moments, taking into account the retention limit of treaty.

From our point of view, both the choice of a fixed value and the USP methodology appear as a too simplified view of XL reinsurance effect. On the one hand, it is not consistent to assume the same reduction for different insurers and different retention limits. On the other hand, USP methodology disregards the effect of parameter uncertainty on number of claims. Parameter error is instead a systematic component that is not affected by XL treaties.

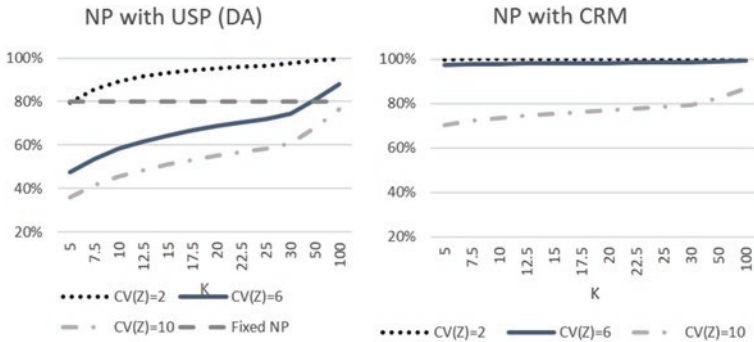


Fig. 10.3 Non-proportional (NP) values derived from both standard formula and collective risk model

To this aim, we compare (see Fig. 10.3) the *NP* value derived from the DA formula with a classical collective risk model (see Clemente and Savelli 2013; Daykin et al. 1994 for CV formula). We test different LoBs by varying the retention limit M . To assure a consistent comparison between LoBs, retention is quantified here as the average claim size plus a multiplier K of the standard deviation ($M = E(\tilde{Z}) + K\sigma(\tilde{Z})$). This analysis confirms on average an overestimation of risk mitigation effect when standard formula is applied.

However, it is noteworthy that EIOPA recently launched a project dedicated to the revision of specific items of Commission Delegated Regulation (European Commission 2015). Main goals of this process (see EIOPA 2016) are both to ensure a technically consistent supervisory regime and to look for possible simplifications in the standard formula. According to premium and reserve risk sub-module, the main items that are under discussions pertain to the calibration of volatility factors for some specific lines of businesses (as legal expenses, assistance, etc.) and the evaluation of risk mitigation. In particular, according to NP reinsurance, European Commission requested EIOPA to investigate which alternative methods could be adopted for the assessment of NP factor. Comments reported in this subsection could be a helpful insight for a potential revision of this factor.

Conclusions

We provide a brief description of the methodology provided by the Solvency II standard formula in order to quantify the capital requirement for premium and reserve risk of a non-life insurer. We show how this proposal is not fully consistent with the traditional framework used in actuarial literature and in practice to model these risks.

In particular, we emphasize how the lack of a size factor in volatility evaluation represents a critical issue leading to derive the same relative capital requirement for all insurers with the same mix of portfolio.

Furthermore, the choice of a capital requirement, obtained as a fixed multiplier of the overall volatility, seems to be too strong an approximation to describe the real shape of aggregate claims distribution. In this regard, an underestimation of capital could be observed for small insurers that will be probably more focused on the application of the standard formula.

Inclusion of expected profits/losses in SCR valuation should be an important point of discussion. Except for QIS 2, standard formula excluded this component from non-life underwriting risk capital charge. Finally, the effect of NP treaties must be properly taken into account in the valuation.

Appendix: Some Methodological Aspects of Premium and Reserve Risk

We introduce the random variable \tilde{Y}_{t+1} one-year technical result (defined in section “[Methodological Framework of Premium and Reserve Risk](#)”) of the period $(t, t + 1)$ as:

$$\begin{aligned} \tilde{Y}_{t+1} = & \sum_{h=1}^L \left(\mathbf{B}_{t+1,h}^{\text{earn}} \right) \\ & - \sum_{h=1}^L \left(\tilde{\mathbf{E}}_{t+1,h} + \tilde{\mathbf{X}}_{t+1,h}^{\text{paid,CY}} + \tilde{\mathbf{X}}_{t+1,h}^{\text{paid,PY}} + \widetilde{\text{PCO}}_{t+1,h}^{\text{CY}} + \widetilde{\text{PCO}}_{t+1,h}^{\text{PY}} - \text{PCO}_{t,h} \right) \end{aligned} \quad (10.4)$$

For the sake of simplicity, we consider only the gross of reinsurance technical result, but relations can be easily expanded in order to describe the reinsurance effect (see Clemente et al. 2015). Next year's earned premiums $B_{t+1,h}^{\text{eam}}$ are considered as cash inflows. Main cash outflows are instead the claim costs of the year, affected by both payments (X) for claims and the variation of provisions for outstanding claims ($\widetilde{\text{PCO}}_{t+1} - \text{PCO}_t$). Technical liabilities are evaluated as best estimate (BE) plus risk margin (RM) as defined by Solvency II for non-hedgeable risk. Moreover, payment for losses can be split between claims incurred during the year $t + 1$ ($\widetilde{X}^{\text{paid,CY}}$) and claims of previous years ($\widetilde{X}^{\text{paid,PY}}$), and, in the same way, technical provision $\widetilde{\text{PCO}}_{t+1}$ is the sum of the reserve for claims of current ($\widetilde{\text{PCO}}_{t+1}^{\text{CY}}$) and previous ($\widetilde{\text{PCO}}_{t+1}^{\text{PY}}$) years, always summing up best estimate and risk margin.

Disregarding both catastrophic and lapse risks, we rewrite Eq. (10.5) to point out the effect of premium and reserve components:

$$\begin{aligned} \widetilde{Y}_{t+1} = & \sum_{h=1}^L \left(P_{t+1,h} (1 + \lambda_h) + c_h \cdot B_{t+1,h} + \text{PR}_{t,h} - \widetilde{\text{PR}}_{t+1,h} \right) \\ & - \sum_{h=1}^L \left(\widetilde{E}_{t+1,h} + \widetilde{X}_{t+1,h}^{\text{paid,CY}} + \widetilde{\text{BE}}_{t+1,h}^{\text{CY}} + \widetilde{\text{RM}}_{t+1,h}^{\text{CY}} \right) \\ & + \sum_{h=1}^L \left(\text{BE}_{t,h} + \text{RM}_{t,h} - \widetilde{X}_{t+1,h}^{\text{paid,PY}} - \widetilde{\text{BE}}_{t+1,h}^{\text{PY}} - \widetilde{\text{RM}}_{t+1,h}^{\text{PY}} \right), \end{aligned} \tag{10.5}$$

where the first term describes the effect on the technical result of existing and next-year contracts not completely expired (i.e. premium risk), while the second one measures the effect of run-off result. It is noteworthy that gross premiums of single LoB h are the sum of risk premiums equal to the expected amount for claims of current year $\left(P_{t+1,h} = E \left(\widetilde{X}_{t+1,h}^{\text{paid,CY}} + \widetilde{\text{BE}}_{t+1,h}^{\text{CY}} \right) \right)$,

plus safety loading ($\lambda_h \cdot P_{t+1,h}$) and expenses loading ($c_h \cdot B_{t+1,h}$) usually equal to the expected expenses amount $\left(c_h \cdot B_{t+1,h} = E \left(\widetilde{E}_{t+1,h} \right) \right)$.

Under the simplified assumption of written premiums equal to earned premiums and neglecting expenses risk, we have:

$$\begin{aligned} \widetilde{Y}_{t+1} &= \sum_{h=1}^L \left(P_{t+1,h} (1 + \lambda_h) - \widetilde{X}_{t+1,h}^{CY} \right) + \sum_{h=1}^L \left(BE_{t,h} - \widetilde{X}_{t+1,h}^{\text{paid,PY}} - \widetilde{BE}_{t+1,h}^{PY} \right) \\ &+ \sum_{h=1}^L \left(RM_{t,h} - \widetilde{RM}_{t+1,h} \right) = \sum_{h=1}^L \left(P_{t+1,h} (1 + \lambda_h) - \widetilde{X}_{t+1,h}^{CY} \right) \\ &+ \sum_{h=1}^L \widetilde{CDR}_{t,h} + \sum_{h=1}^L \left(RM_{t,h} - \widetilde{RM}_{t+1,h} \right), \end{aligned} \quad (10.6)$$

where $\widetilde{X}_{t+1,h}^{CY} = \widetilde{X}_{t+1,h}^{\text{paid,CY}} + \widetilde{BE}_{t+1,h}^{CY}$ are current year (paid and reserved) claims and $\widetilde{CDR}_{t,h}$ is the claims development result (see Wüthrich and Merz 2008) of period $(t, t + 1)$ defined as the difference between the initial best estimate and the updated insurer obligations arising during the year $t + 1$ for claims incurred until time t . Insurer obligations are equal to the sum of payments for claims $\widetilde{X}_{t+1,h}^{\text{paid,PY}}$ and the new best estimate $\widetilde{BE}_{t+1,h}^{PY}$ at the end of the year evaluated conditionally to the additional information available during the year.

Denoting as $\widetilde{X} = \sum_{h=1}^L \widetilde{X}_{t+1,h}^{CY} + \widetilde{X}_{t+1,h}^{\text{paid,PY}} + \widetilde{BE}_{t+1,h}^{PY}$ next-year insurer obligations, it is important to assess the capital requirement as defined by Eq. (10.2) in section “[Methodological Framework of Premium and Reserve Risk](#)”.

Notes

1. Coefficient of variation (CV) is a **standardized** measure of **dispersion** of a **probability distribution**. In other words, it is a measure of relative volatility and it allows a consistent comparison between distributions with a different average value.
2. Value at risk (VaR) is a risk measure of potential losses at a given confidence level and a fixed time horizon. The VaR summarizes the **distribution** of possible losses by a **quantile**, a point with a specified probability of greater losses. A common alternative metrics is **expected shortfall**. As is well-known, Solvency II identifies a capital requirement evaluated as a VaR at a 99.5% confidence level over one year.
3. In QIS5, capital requirement is obtained as $\rho(\sigma_{NL})V_{NL}$, where the function $\rho(\sigma_{NL})$ measures the distance between 99.5% quantile and the mean of a lognormal distribution.
4. In **probability theory**, a lognormal distribution is a continuous **probability distribution** of a **random variable** whose **logarithm** is **normally distributed**. In non-life insurance, it is a widely used distribution to model aggregate claims amount.
5. Definition of volume measure is under revision (see EIOPA 2016).
6. A correlation coefficient quantifies the linear dependence, meaning statistical relationships between two random variables. Typically, in non-life insurance, we observe a positive correlation. For example, we take into account that an adverse event may have an unfavorable effect on more than one line of business.
7. It is set at 80% for Property, Motor Third-Party Liabilities (MTPL), and General Third-Party Liabilities (GTPL) and 100% for other LoBs. A justification has not been provided for these different calibrations (see European Commission 2015).
8. For all LoBs the weights are greater than zero if data of at least last five years are available and tend to be 1 with 15 years for MTPL, GTPL and Credit and Suretyship and with 10 years for other LoBs.
9. From now on, tilde over a letter will indicate a random variable.
10. See Eq. (10.6) in the Appendix for the formula.
11. The quantile of a normal distribution with mean μ and standard deviation σ is equal to $\mu + k_{\alpha}\sigma$, where k_{α} is the quantile at the α confidence level of the standard normal distribution (i.e. with $\mu = 0$ and $\sigma = 1$). If we consider $\alpha = 99.5\%$ as provided by Solvency II, then $k_{99.5\%} \approx 2.58$. If

skewed distributions are considered, the value of k_α varies according to the skewness.

12. Skewness is a measure of the asymmetry of the **probability distribution** of a **random variable** about its mean. The skewness value can be positive or negative. Usually in non-life insurance, we handle with positive skewed distribution (i.e. a fat right tail) because of a greater exposition toward extreme events.
13. Details on parameters and calibration are reported in (Clemente and Savelli 2013). A similar calibration has been computed on a previous paper (see Savelli and Clemente 2011) by using data from 1991–2005.

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11

Risk Factor Contributions and Capital Allocation in Life Insurance in the Solvency II Framework

Massimiliano Menzietti and Marco Pirra

Introduction

The initial reason for the assessment of total capital requirements is often for regulatory reporting: capital is aggregated to a company level, allowing for diversification, in order to quantify enterprise-wide risk-based capital. Subsequently, company-level capital and risk are allocated down to lower levels such as lines of business, business units, and products for a number of purposes, including pricing and performance measurement, among others. Breaking down portfolio risk into its different sources is a crucial concern in financial and insurance risk management: once a risk measure (such as the standard deviation, the value at risk [VaR], the expected shortfall, etc.) has been chosen and the total risk of a portfolio has been quantified, the analysis and comprehension of the origins of the risk follow naturally; specifically, a risk manager may be interested

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in quantifying contributions to portfolio risk of two types, on the one hand, the underlying positions (i.e. individual instruments, counterparties, and sub-portfolios) and, on the other, the risk factors (i.e. various systematic or peculiar factors affecting portfolio losses such as market risk factors, interest rates, exchange rates, equity volatilities, etc., and macro-economic, demographic, geographic, or industry factors).

The improvement of methodologies for the first kind of risk contribution has a great utility in hedging strategies, capital allocation, performance measurement, and portfolio optimization: portfolio losses can be represented as the sum of losses of individual positions (instruments, counterparties, sub-portfolios). For such sums, there is a consolidated theory for additive risk contributions based on the concept of marginal contributions, sometimes referred to as Euler allocation, as the formula for contributions to those risk measures that are homogeneous functions of degree one of the portfolio weights (standard deviation, value at risk, expected shortfall, etc.) follows directly from Euler's theorem (see Tasche 1999, 2006, 2008). Position risk contributions in general, and the Euler allocation principle in particular, have received much attention in the recent literature (see Denault 2001; Dhaene et al. 2012; Sherris 2006; Tasche 2009).

Just as significant for risk management, the study of methodologies for contributions of different risk factors to total portfolio risk has been discussed much less in literature by comparison. In this case, portfolio losses usually cannot be written as a linear function of the individual risk factors: when each position depends only on a single independent risk factor or a small subset of risk factors, not necessarily in a linear way, the problem can be addressed effectively by computing position contributions and transforming them to factor contributions. However, in many cases, several factors interacting across large parts of the portfolio drive potential losses and the standard theory for determining contributions cannot be directly applied. These factors might be systematic factors, representing macro-economic variables, indices, or financial and demographic variables. Contributions of risk factors are decisive because they facilitate an understanding of the sources of risk in a portfolio: this is particularly important for complex portfolios with many instruments, where individual instrument risk contributions may not be informative.

It is also useful in understanding the sources of risk for the liabilities of a life insurance company (not only life annuities) where the total portfolio loss is nonlinear with respect to risk factors in the portfolio. Solvency II, the most significant change for the European (re)insurance market in recent years, specifically requires the quantification of the sources of risk an entity deals with, either through simplified calculations provided by standard formulas or through the use of sophisticated internal models that may improve the simplified framework (see European Parliament and Council of the European Union 2009).

In this chapter, a life insurance company with a portfolio composed either by annuities or by term insurance contracts is considered. It is well known that such portfolios are exposed to different risk sources, but interest rates risk and mortality risk are the main ones. On the one hand, interest rates affect the value of the bonds in which the asset portfolio is usually invested, and on the other hand, they are used to determine the discounting factor in liabilities evaluation. Mortality rates influence the benefit amount paid to the policyholders.

The total portfolio loss is nonlinear with respect to risk factors. Our aim is to examine the contributions of the investment risk factor and the insurance risk factor to the future liability values under different allocation methods.

An extension of the Euler allocation principle that applies to nonlinear functions of a set of risk factors is followed: the technique is based on the ‘Hoeffding decomposition’ originally developed for statistical applications (see Tasche 1999). The idea behind the methodology is straightforward: while the total portfolio loss cannot be written as a sum of functions of individual risk factors, through the application of the ‘Hoeffding decomposition’ it can be represented as a sum of functions of all subsets of risk factors; subsequently, the standard Euler allocation principle can be applied to the new loss decomposition. A possible limitation in this procedure is that both contributions from single risk factors and the ones arising from the interaction of every possible collection of risk factors have to be considered (see Rosen and Saunders 2010; Tasche 2008).

An alternative approach to linearize the loss model in order to apply allocation methods (such as the Euler) recalls the Taylor expansion methodology, applied (Karabey 2012; Karabey et al. 2014) to a portfolio

of life annuities. Thanks to these approaches, a loss model in which total loss is linear in losses of risk factors is obtained.

Starting from the analysis reported in Karabey (2012) and Karabey et al. (2014), the work is extended, considering a different dataset, to a portfolio composed not only of life annuities but also of term life insurance contracts in order to improve the understanding of the effectiveness of various capital allocation methods for different insurance portfolio compositions and also to better appreciate the effects of diversification in portfolio composition.

The remainder of the chapter is organized as follows. First, the basic elements needed for the risk contributions assessment are reviewed. In the next section, the model used for the portfolio evaluation and the risk measurement is defined and explained. Then, the procedure is applied and numerical results are shown, and, finally, conclusions are presented in the last section.

Risk Capital Contribution and Allocation

In this section, the theory of risk contributions is concisely recalled: for an exhaustive discussion of the theory of capital allocation, see McNeil et al. (2005) and Tasche (2008).

A common way followed in literature to assess the total loss of a portfolio is the use of structured stochastic models to derive its distribution, though the total capital requirement allocation to each source of risk is hardly ever detailed. The analysis is usually limited to the variance and its decomposition: it is known that the results of this approach, based on iterated conditional expectations, depend on the choice of the sequence itself.

In life insurance models, the total risk can be usually broken down into the mortality component and the investment component. If the total loss is assumed to be a function of two random variables, the mortality risk and the investment risk, then the total variance of the loss can be expressed as the sum of two components, the average expected value of the variance of the loss conditioned by the mortality scenario and the variance of the average expected value conditioned by the mortality scenario or, in the alternative, as the sum of the average expected value of

the variance of the loss conditioned by the financial scenario and the variance of the average expected value conditioned by the financial scenario (see Eqs. (11.1) and (11.2) in Appendix for details).

Since the results are affected by the sequence of conditioning, they could be different (see Bruno et al. 2000; Parker 1997). The assessment of the risk with the variance has some limits that can be overcome through the use of other risk measures, such as VaR and expected shortfall.

As the total portfolio loss function cannot be written as a sum of functions of individual risk factors, the application of the ‘Hoeffding decomposition’ allows to express it as a sum of functions of all subsets of risk factors (see van der Vaart 1998). In statistical applications, the term ‘Hoeffding decomposition’ is usually reserved for the situation where the factors are independent. However, the general formula is valid for correlated factors as well. The price paid for this methodology is that contributions from both single risk factors and the ones arising from the interaction of every possible collection of risk factors need to be considered.

The aim is to define a measure of the contribution of the k -th factor to the total portfolio risk. Different methods of calculating risk contributions have been studied for different purposes:

- *Stand-alone contribution*: the stand-alone contribution of a factor is simply its risk if it were held as a portfolio in isolation. The distributions of all other factors are not considered, and, therefore, no diversification or hedging effects are taken into account.
- *Incremental contribution*: the incremental risk contribution of a factor is the change in total risk arising from including the factor in the portfolio; typically, incremental contributions of risk factors do not add up to the total portfolio risk.
- *Marginal contribution*: the marginal contribution according to the Euler’s theorem is the ratio between the increase in the risk measure considered due to the increase in a risk factor and the increase in the risk factor itself. The standard Euler allocation approach can be applied to the loss decomposition previously represented. A similar approach as reported in Gouiroux et al. (2000) and Tasche (2008) is followed with the application of the methods described in Pagan and Ullah (1999).

Market Consistent Evaluation

As previously stated a life insurance company with a portfolio composed either by annuities or by term insurance contracts is considered. In order to examine the contribution of different risk sources a framework to represent interest rate and mortality rate evolution and a pricing methodology must be defined.

In order to model interest rates the evolution of the instantaneous spot interest rate is assumed to be represented by the Cox-Ingersoll-Ross model (Cox et al. 1985) and in order to represent the mortality the realized mortality rate is assumed to be represented by the two-factor model for mortality proposed by the Cairns-Blake-Dowd model (Cairns et al. 2006).

Independence between market and mortality risk is assumed. The value at time T of an annuity for M years is given by the expected present value of future cash flows (including a risk adjustment) considering the information available on the interest rate and mortality levels (see Appendix for details).

More details on the value at time T of an annuity for M years and for a term life insurance with term M , considering the models chosen, are given in Appendix.

Numerical Application

For the numerical analysis, the Cairns-Blake-Dowd model is fitted on a mortality dataset coming from the population of Italy (period 1961–2009, age 35–90).

In order to get the value of the annuity and the term life insurance the market price of longevity risk is needed. However, for our purposes, the distribution of the annuity and term life insurance values is required to represent the effectiveness of a capital allocation method and not their absolute values. Therefore, in the remaining of the chapter, the price of longevity risk is assumed to be null.

In order to calculate the Euler's contributions of the risk factors, the distribution of future portfolio values under both interest rate and mortality uncertainty is analyzed.

In the first case study analyzed, a constant unitary whole life annuity is considered. The policyholder is a male, aged $x = 65$ in year 2010 ($t = 0$). The annuity value in $T = 0$ is equal to 14.40.

Our aim is to simulate the annuity value at time $T = 1$; the time horizon (12 months) has been chosen coherently with Solvency II directive. As many as 5000 simulated scenarios are generated for mortality and the same number for interest rates; when the two risk sources are considered together the scenarios are combined obtaining 25,000,000 scenarios. Once the distribution of the annuity value in $T = 1$ is obtained, the variance decomposition is then calculated, first conditioning on the demographic scenario then on financial scenario, according to Eqs. (11.1) and (11.2) shown in Appendix. The results are represented in Table 11.1.

It can be observed that in both cases the financial risk justifies nearly the 90% of the risk; moreover, the results are not influenced much by the order of conditioning.

The second analysis is performed by measuring the stand-alone contributions and the incremental contributions of both the risk sources on VaR at 99.5% confidence level. The confidence level has been chosen coherently with the Solvency II directive. The results are presented in Table 11.2. Considering the stand-alone approach, the sum of contributions exceeded the VaR while the sum of the incremental contributions decreased; therefore, the percentages for capital allocation should be rescaled in order to obtain full allocation. In this case, the weight of the demographic risk is significantly stronger.

Table 11.1 Whole life annuity variance decomposition

Total risk	Financial risk	Demographic risk	Conditioning
0.226628 (100%)	0.202638 (89.42%)	0.023965 (10.58%)	On demographic scenario
0.226628 (100%)	0.202582 (89.40%)	0.024021 (10.60%)	On financial scenario

Source: Authors' calculations

Table 11.2 Whole life annuity stand-alone (top) and incremental contributions (bottom)

	Both risks	Financial risk only	Demographic risk only
$\text{VaR}_{\alpha=99.5\%}$	0.931838	0.772186 (82.87%) (65.96%)	0.398434 (42.76%) (34.04%)
$\text{VaR}_{\alpha=99.5\%}$	0.931838	0.511753 (54.92%) (76.23%)	0.159601 (17.13%) (23.77%)

Source: Authors' calculations

Table 11.3 Whole life annuity marginal contributions

	Total	Financial risk	Demographic risk	Residual (joint) risk
$\text{VaR}_{\alpha=99.5\%}$	0.931838	0.682260 (73.22%)	0.233288 (25.04%)	0.016289 (1.75%)
$\text{ES}_{\alpha=99.5\%}$	1.009212	0.708707 (70.22%)	0.279570 (27.70%)	0.020935 (2.07%)

Source: Authors' calculations

Finally, the capital allocation through the Euler's allocation adopting the 'Hoeffding decomposition' is considered. The results obtained choosing as risk measure a VaR at 99.5% confidence level and expected shortfall at the same confidence level are reported in Table 11.3.

The results are coherent with the ones presented in Karabey et al. (2014); the weight of the demographic risk is greater than the one obtained through the incremental contribution and smaller compared to the weight obtained by the stand-alone contribution. Adopting the expected shortfall as risk measure the demographic risk slightly increases due to the tail nature of this risk respect to financial one. It can be observed that the residual risk is negligible.

In the second case study, a portfolio of term life insurance contracts with a maturity of 35 years and a death benefit of 100 monetary units is considered. The policyholder is a male, aged $x = 35$ in year 2010 ($t = 0$). The portfolio value in $T = 0$ is 5.62. The term life insurance value at time $T = 1$ is simulated following the same procedure for the annuity. The variance decomposition is computed, first conditioning on the demographic scenario then on the financial scenario. The results are shown in Table 11.4.

Table 11.4 Term life insurance variance decomposition

Total risk	Financial risk	Demographic risk	Conditioning
0.108706 (100%)	0.087762 (80.73%)	0.020944 (19.27%)	On demographic scenario
0.108706 (100%)	0.087704 (80.68%)	0.021002 (19.32%)	On financial scenario

Source: Authors' calculations

Table 11.5 Term life insurance stand-alone (top) and incremental contributions (bottom)

	Both risks	Financial risk only	Demographic risk only
$VaR_{\alpha = 99.5\%}$	0.701835	0.513551 (73.17%) (57.37%)	0.381535 (54.36%) (42.63%)
$VaR_{\alpha = 99.5\%}$	0.701835	0.321539 (45.81%) (63.02%)	0.188690 (26.89%) (36.98%)

Source: Authors' calculations

The demographic risk is more relevant in the term life insurance respect to annuity, but the financial risk still represents the major source of risk. In both cases, the financial risk justifies almost 81% of the risk.

The second analysis is performed by measuring the stand-alone contributions and the incremental contributions of both the risk sources on VaR at 99.5% confidence level. The results are presented in Table 11.5. The weight of the demographic risk is significantly stronger in this case as well.

Finally, the capital allocation through the Euler's allocation adopting the 'Hoeffding decomposition' is considered. The results obtained choosing as risk measure a VaR at 99.5% confidence level and expected shortfall at the same confidence level are presented in Table 11.6.

The results confirm the greater weight of the demographic risk on this type of contracts. Furthermore, its weight assessed through the marginal approach is greater than the one obtained via incremental contribution but smaller in respect of the weight obtained from the stand-alone contribution. It can be observed that the residual risk is still negligible even if slightly larger than in the annuity case study.

In the third case study, a mixed portfolio composed of life annuities and term life insurances with a proportion of 80% of life annuities with

Table 11.6 Term life insurance marginal contributions

	Total	Financial risk	Demographic risk	Residual (joint) risk
$\text{VaR}_{\alpha=99.5\%}$	0.701835	0.421023 (59.99%)	0.262461 (37.40%)	0.018351 (2.61%)
$\text{ES}_{\alpha=99.5\%}$	0.770082	0.439621 (57.09%)	0.307409 (39.92%)	0.023052 (2.99%)

Source: Authors' calculations

Table 11.7 Mixed portfolio variance decomposition

Total risk	Financial risk	Demographic risk	Conditioning
0.437953 (100%)	0.405765 (92.65%)	0.032189 (7.35%)	On demographic scenario
0.437953 (100%)	0.405686 (92.63%)	0.032267 (7.37%)	On financial scenario

Source: Authors' calculations

respect to the initial portfolio value is considered. The mix has been chosen coherently with a natural hedging purpose strategy, a strategy that aims to reduce the demographic risk in a life insurance portfolio combining contracts whose value is positively correlated to mortality (as the term life insurances) with contracts whose value is negatively correlated to mortality (as life annuities; see Gatzert and Wesker, 2012, for a detailed analysis of the composition of an insurance portfolio to achieve a good natural hedging). The characteristics of the policies are the same ones previously described. The portfolio value in $T = 0$ is 18.01.

First of all, the variance decomposition is calculated. The results are reported in Table 11.7.

As an effect of the natural hedging, the demographic risk is less relevant with respect to the previous cases. In both cases, the financial risk justifies almost 93% of the risk.

The second analysis is performed by measuring the stand-alone contributions and the incremental contributions of both the risk sources on VaR at 99.5% confidence level. Results are detailed in Table 11.8. Results once more give evidence of the great difference between these capital allocation methods.

Finally, the capital allocation through the Euler's allocation adopting the 'Hoeffding decomposition' is considered. The results obtained

Table 11.8 Mixed-portfolio stand-alone (top) and incremental contributions (bottom)

	Both risks	Financial risk only	Demographic risk only
$\text{VaR}_{\alpha = 99.5\%}$	1.262697	1.098183 (86.97%) (70.95%)	0.449723 (35.62%) (29.05%)
$\text{VaR}_{\alpha = 99.5\%}$	1.262697	0.797732 (63.18%) (82.89%)	0.164722 (13.05%) (17.11%)

Source: Authors' calculations

Table 11.9 Mixed-portfolio marginal contributions

	Total	Financial risk	Demographic risk	Residual (joint) risk
$\text{VaR}_{\alpha = 99.5\%}$	1.262697	1.001604 (79.32%)	0.243224 (19.26%)	0.017869 (1.42%)
$\text{ES}_{\alpha = 99.5\%}$	1.359354	1.037379 (76.31%)	0.298546 (21.96%)	0.023429 (1.72%)

Source: Authors' calculations

choosing as risk measure a VaR at 99.5% confidence level and expected shortfall at the same confidence level are reported in Table 11.9.

The results obtained allow to appreciate the effectiveness of a natural hedging strategy. It can be observed that there is a demographic risk reduction in terms of risk proportion though it is not perfect. However, the financial risk remains at a similar absolute level and assumes a greater proportion on the overall portfolio risk.

Further studies could be performed to identify the optimal proportion of term life insurance contracts in the portfolio composition in order to get the greatest risk reduction. Nevertheless, this type of analysis goes beyond the goals of this chapter, whose objective is to show the effectiveness of allocation methods in representing the effects of risk reduction strategies and verify the proportion of single risk sources on the total amount.

Conclusions

The Solvency II directive introduced capital requirements that necessitate the proper evaluation of the risks, according to a “going-concern” regime, in order to correctly assess the risk margin not only for past business but

also for the new business to be acquired. The present study contributes to the understanding of how a firm could quantify different risk factors and combine different products in order to possibly mitigate the risks and the cost of capital. This is not only important in order to meet requirements of Pillar I but also for those described in Pillar II: as the own risk and solvency assessment (ORSA) procedure is intended to serve as a tool to enhance the understanding of the interrelationships between the risk profile and capital needs an entity could invest considerable effort to develop an advanced methodology to assess a specific complex risk which is believed to give a competitive advantage in the market and allow for improved capital allocation.

The allocation of an aggregate capital to various risk factors can be carried out in numerous ways and the optimal method is still to be identified. It is clear that different capital allocations must in some sense correspond to various questions that can rise from a risk management context.

In this chapter, the quantification of the main risk sources in life insurance portfolios is analyzed, coherently with the Solvency II framework, testing the sensitivity of the assessment on different insurance contracts and portfolio mixtures. The analysis verifies how the allocation varies as the approach followed changes.

Specifically, the demographic risk has a greater influence on a portfolio composed by term life insurances than on a portfolio composed by whole life annuities. The mixed portfolio shows a reduction of the demographic risk as a consequence of the natural hedging between products that can be measured more effectively, thanks to the capital allocation procedure. As expected, in the mixed portfolio the capital allocated to the financial risk is not reduced with respect to the other cases and its weight on the allocation increases.

Furthermore, the chapter observes a different capital allocation as the risk measure chosen varies. The demographic risk has a smaller impact on those risk measures that are less influenced by the tail of the distribution. As a result, the capital allocated to this risk is lower when the variance is adopted as a risk measure and increases when either VaR or expected shortfall are chosen.

The co-movements between the risk sources have nonlinear effects that could be investigated even if the dimension of the proportion on the portfolio is negligible.

Further research could concentrate on possible extensions of the work, regarding on the one hand the assessment of the optimal mixture of contracts in the portfolio composition in order to get efficient hedging strategies. On the other hand, the decomposition of the total portfolio loss, which is nonlinear with respect to risk factors in the portfolio itself, could be examined through other alternatives, considering that the assumption of linearity is meant to simplify the assessment of Solvency II capital requirements through the use of standard formulas while the development of internal models is recommended by the directive to reflect specific risk profiles.

Appendix

If the total loss L is assumed to be a function of two random variables, $L = g(F_1, F_2)$, F_1 being the mortality risk and F_2 the investment risk, then the total variance of the loss can be expressed as the sum of two components, the average expected value of the variance of the loss conditioned by the mortality scenario, $E[Var[L|F_1]]$, and the variance of the average expected value conditioned by the mortality scenario, $Var[E[L|F_1]]$:

$$Var[L] = E[Var[L|F_1]] + Var[E[L|F_1]]. \quad (11.1)$$

As an alternative it can be considered as the sum of the average expected value of the variance of the loss conditioned by the financial scenario, $E[Var[L|F_2]]$, and the variance of the average expected value conditioned by the financial scenario, $Var[E[L|F_2]]$:

$$Var[L] = E[Var[L|F_2]] + Var[E[L|F_2]]. \quad (11.2)$$

The value at time T of an annuity for M years is given by the following formula:

$$V_{\mathbb{Q}}^M(T) = \sum_{i=1}^M P(T, T+i) \mathbb{E}_{\mathbb{Q}} [S(T+i, x) | \mathcal{M}_T] \quad (11.3)$$

where $P(T, T+i)$ is the price at time T of a zero-coupon bond with maturity $T+i$ conditional on the information in T on the term structure of interest rate and $\mathbb{E}_{\mathbb{Q}} [S(T+i, x) | \mathcal{M}_T]$ is the risk-adjusted expectation of the survivor index at time $T+i$ of a cohort aged x at time T conditional on the information available in T on the term structure of mortality.

Considering the models chosen the value at time T of an annuity for M years is given by the following formula:

$$V_{\mathbb{Q}}^M(T) = \sum_{i=1}^M P(T, T+i, r(t)) \mathbb{E}_{\mathbb{Q}} [S(T+i, x) | k(t)] \quad (11.4)$$

where $P(T, T+i, r(t))$ is the price at time T of a zero-coupon bond with maturity $T+i$ conditional on the value assumed by the spot interest rate $r(t)$ in T and $\mathbb{E}_{\mathbb{Q}} [S(T+i, x) | k(T)]$ is the risk-adjusted expectation of the survivor index at time $T+i$ of a cohort aged x at time T conditional on the value assumed in T by the mortality trend $k(t)$ of the Cairns-Blake-Dowd model.

In a similar way, the value at time T for a term life insurance with term M is given by:

$$W_{\mathbb{Q}}^M(T) = \sum_{i=1}^M P(T, T+i, r(T)) \left(\mathbb{E}_{\mathbb{Q}} [S(T+i, x) | k(T)] - \mathbb{E}_{\mathbb{Q}} [S(T+i-1, x) | k(T)] \right) \quad (11.5)$$

where the difference $\mathbb{E}_{\mathbb{Q}}[S(T+i,x)|k(T)] - \mathbb{E}_{\mathbb{Q}}[S(T+i-1,x)|k(T)]$ represents the risk-adjusted expectation of the mortality at time $T+i$ of a cohort aged x at time T conditional on the value assumed by $k(t)$ in T .

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12

Solvency II: The Supervisory Reporting and Market Disclosure

Alberto Floreani

Introduction

The two key innovations of Solvency II, the new pan-European prudential regime for insurance and reinsurance undertakings, regard:

- Harmonization of the prudential regulation and supervision across EU member-states;
- The introduction of a risk-based approach which provides incentives for insurance and reinsurance undertakings to properly measure and manage their risks.

The regulatory harmonization has been reached through the Lamfalussy approach which introduces different levels of regulation. At the first level, there is the directive 2009/138/EC of the European Parliament and of the Council which set the general framework of the system and is transposed

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into National Law of the European Union (EU) member-states. At the second level, there are the Commission Delegated Regulation 2015/35 and the Regulatory and Implementing Technical Standards which are proposed by European Insurance and Occupational Pensions Authority (EIOPA) and adopted by the Commission. The second-level regulation gives additional technical specifications about some subject delegated by the directive (among others, the detailed specification of standard formula and the reporting content of supervisory and market disclosure) and is directly applicable in each member-state. The EIOPA Guidelines stand at the third level of the Solvency II regulatory framework. These Guidelines are not legally binding, but companies or supervisors not complying must present justification for non-compliance (comply or explain principle). On the one hand, the Solvency II regulatory framework provides to EU member-states with very limited regulatory responsibilities. On the other hand, Solvency II grants to national authorities the power for supervision of insurance and reinsurance undertakings. The supervisory harmonization is mainly realized through the coordination of EIOPA and for multinational insurance groups through the system of Colleges of Supervisors.

The proper incentives for insurers to measure and manage their risks are reached by the three-pillar system of Solvency II: a well-structured quantitative model to measure value and risks (Pillar 1), governance and risk management requirements (Pillar 2), and supervisory reporting and public disclosure (Pillar 3).

The measurement of assets and liabilities (i.e. investments, technical provisions, and own funds) according to coherent and homogeneous financial economics principles (the full fair value approach) and, similarly, the risk measurement system based on a single quantitative measure (the value at risk [VaR] with a 99.5% confidence level over a one-year time horizon) gives to insurance and reinsurance undertakings the right incentive to use this modern measurement system for internal managerial activities (i.e. product pricing, product profit testing, supporting decision-making, capital allocation between products and business units, measuring value creation through risk-adjusted measures). Furthermore,

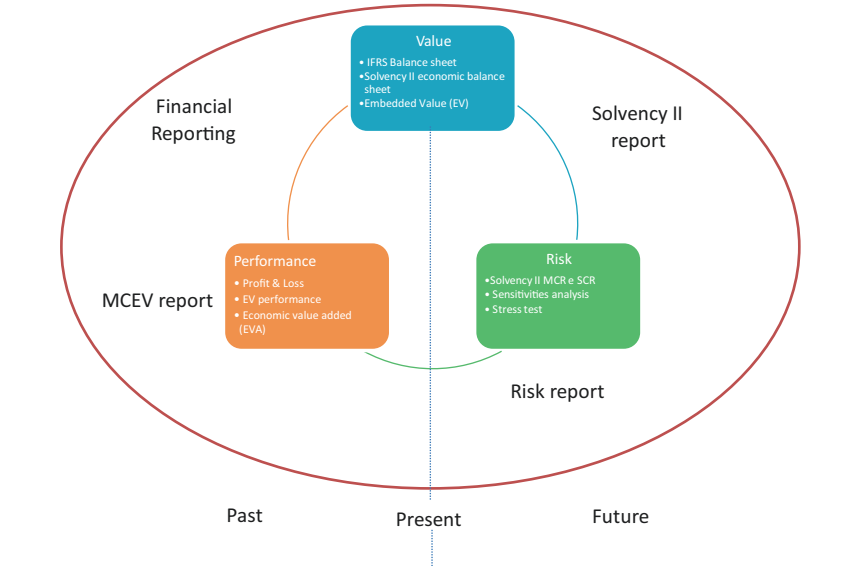


Fig. 12.1 Value, risk, and performance in insurance undertaking reporting

the mandatory system of reporting to supervisory authorities and to the public facilitates the creation of a system of internal reporting supporting corporate planning, programming, and control.

The Solvency II reporting system integrates the two traditional dimensions of the reporting—value and performance—with the third one—the risk (see Fig. 12.1).

Insurance companies have an opportunity to create value from the Solvency II investments by improving their management processes. The insurance companies' ability to integrate the Solvency II framework in their managerial processes and systems of reporting may provide some competitive advantage over the insurers which incur investment and maintenance costs of Solvency II only to be compliant with the regulation.

This chapter focuses on the third pillar of Solvency II. The technical aspects are only sketchy, and a more detailed discussion focuses on most critical aspects of the regulation, especially on market disclosure.

Reporting to the Supervisory Authority

The information to be received by the supervisory authority could be divided into the following (art. 35.2.a Solvency II directive) items:

- Regular supervisory reporting;
- Upon occurrence of predefined events, such as the non-compliance with solvency capital requirement (SCR) or minimum capital requirement (MCR);
- During enquires regarding the situation of an undertaking.

Supervisory reporting allows national authorities and EIOPA to perform their supervisory duties. In particular, “to assess the system of governance applied by the undertakings, the business they are pursuing, the valuation principles applied for solvency purposes, the risks faced and the risk-management systems, and their capital structure, needs and management” and “to make any appropriate decisions resulting from the exercise of their supervisory rights and duties” (art. 35.1.b Solvency II directive).

The regular supervisory reporting consists of the following:

- *Regular Supervisory Report (RSR)*. The content of this report is regulated by the articles 304.2 and 307–311 of the Delegated Regulation 2015/35. The RSR structure is rigid and set by the Annex XX of DR 2015/35.¹ It consists of a Summary and five sections (Business and Performance, System of Governance, Risk Profile, Valuation for Solvency Purposes, Capital Management), and each is further divided into specific paragraphs. It should be produced by insurance undertakings at least every three years, no later than 14 weeks after the undertaking’s financial year in question ends, with a transitional period with longer deadlines (20, 18, 16 weeks for 2016/17/18 financial years). Material changes in the RSR information should be submitted annually.
- *Quantitative Report Templates (QRTs)*. These are the core of regular supervisory reporting and consist of a set of QRTs that should be produced annually (some selected information should be produced quarterly). The rigid and uniform content of the templates is set by the Commission Implementing Regulation 2015/2450, a 1123-page document, which

provides quantitative information about Pillar 1 items (economic balance sheet, including investments and technical provisions, solvency capital requirement, minimum capital requirement, and own funds). QRTs should be produced annually within the same deadlines set for RSR and quarterly, no later than 5 weeks after the end of the quarter, with a transitional period with longer deadlines (8, 7, and 6 weeks for 2016/17/18).

- *Reporting for Financial Stability Purposes.* Additional QRTs are required for financial stability purposes² on annual, semi-annual, and quarterly bases within 7 weeks after the end of the reference period with the usual transitional period with longer deadlines for 2016/17/18. Among others, information about own funds, SCR, and MCR should be produced on a quarterly basis, even if provisional data are admitted and the SCR “*may be updated only with the more volatile elements (i.e. market risks), while extrapolation of yearly figures is acceptable for other SCR elements.*”
- *Own Risk and Solvency Assessment Report (ORSA supervisory report).* The ORSA³ supervisory report should be submitted annually within 2 weeks after concluding the assessment and its minimal content is set by art. 306 DR 2015/35 and by EIOPA “Guidelines on own risk and solvency assessment.”

The aforementioned reporting should be produced either at a single-entity or at a group level. The RSR and QRTs at group level benefit from a six-week extension of the prescribed deadlines.

Solvency II RSR leads to a remarkable increase in the content of information that insurance companies and groups should provide to supervisors and realize a pan-European convergence of supervisory reporting. Insurance undertakings face a challenging task from different points of view, and among others, data quality, the required time to produce QRTs, and the possibility of additional supervisory reporting required by national supervisory authorities.

Even if most of the third-pillar resources are absorbed by regular supervisory reporting (market disclosure is an almost perfect subsample of regular supervisory reporting), Solvency II does not innovate in the principles of supervisory reporting. Solvency II requires that “*Member States shall*

ensure that supervisory authorities have the power to require all information necessary to conduct supervision in accordance with Article 35” (art. 34.3 Solvency II directive), but previous directives also have similar prescriptions (e.g. according to art. 13.3 Directive 2002/83, “*Every Member State shall take all steps necessary to ensure that the competent authorities have the powers and means necessary for the supervision of the business of assurance undertakings...*”). The innovation in Solvency II supervisory reporting regards the content and the quantity of information that insurers should submit, but supervisory reporting is just a technical and compliance matter, without particular strategic issues.

Market Disclosure

The Content of Market Disclosure

Market disclosure is the most innovative part of the Solvency II Pillar 3. Some information about insurance undertakings’ solvency were disclosed also under the Solvency I regime. However, the quantity and the quality of information required to be disclosed by the Solvency II regime are much more extensive and structured and could have a broader impact.

Each insurance undertaking should publish the *Solvency and Financial Condition Report* on its website annually. The document includes information about the system of governance, risks, assets, technical provisions, own funds, and internal model (if any) and “*the amount of any non-compliance with the Minimum Capital Requirement or any significant non-compliance with the Solvency Capital Requirement during the reporting period, even if subsequently resolved, with an explanation of its origin and consequences as well as any remedial measures taken*” (Art. 51.1 Solvency II directive). The structure and the content of the SFCR are set out in art. 290–303 of Delegated Acts, and a rigid and highly comparable structure is also set out in Annex XX, which is similar to the structure of the RSR. The document is redacted separately⁴ for each single entity and at group level. The document should be published at the latest within 14 weeks from the financial year end with a transitional period with longer deadlines (20, 18,

and 16 weeks for 2016/2017 and 2018 reports). The group report has a six-week extension subsequent to the single entities deadline.

The SFCR is supplemented by quantitative information (*public QRTs*) set by the Commission Implementing Regulation 2015/2452 (ITS). The public QRTs include among other information on the economic balance sheet, the SCR, and its macro components, and the own funds quality (tiering). Clearly, public QRTs are just a subsample of QRTs required for supervisory reporting purposes.⁵ The two key information items are:

- The Solvency Ratios, that is, the ratio between total eligible own funds to meet the SCR and the MCR, and the SCR and MCR, respectively;
- The total basic own funds (BoF), that is, the adjusted difference between the fair value of assets and liabilities, including the technical provisions.

The rationale of the market disclosure is *market discipline*,⁶ that is, the ex-ante inducement to a more prudent management approach in order to raise the solvency ratio and avoid releasing to the public any information that could have a negative impact on insurance companies.

The debate on the effectiveness of market discipline is ongoing, especially for banks that introduced a structured Pillar 3 public disclosure some time ago.⁷ Even though the results about the effectiveness of market discipline for banks appear mixed, the Solvency II regime seems to be much better structured, and this will probably make market discipline more effective and relevant. The two key concepts of the Solvency II regime that are historically lacking in the banking prudential regulation are comparability⁸ and a common metric approach to measure value (BoF) and risks (SCR).

The rigid structure of the SFCR and the Public QRTs makes the comparative information, even internationally, easily accessible to anyone who needs it.

BoF is measured using a full fair value approach and is a (quite) precise measure of the intrinsic value of the insurance company, that is, its embedded value. The SCR is measured using a value-at-risk approach and is a rather precise measure of the insurance company risks (even in the

standard formula). Common metrics to measure value and risks of insurance companies already exist, for example, the market consistent embedded value⁹ or the economic capital using an internal model. However, European embedded value (EEV) and economic capital are usually only used by large listed insurance groups and only for a part of the insurance business (i.e. life insurance). In addition, the EEV and economic capital calculations use different risk measures (i.e. VaR vs. Tail VaR) or different parameter specifications (i.e. different costs of capital in EEV, different levels of confidence, or time horizons in the economic capital). Solvency II extends this calculation to all insurance companies and requires the use of the same risk measure (i.e. the VaR with 99.5% confidence over a time horizon of one year) and methodology (standard formula, with the use of internal models subject to the approval of the supervisory authority only if, among others, it is possible to demonstrate that the internal model measures the risks better than the standard formula). As a consequence, the Solvency II BoF is a measure of the intrinsic value of the company that is more informative than the equity in traditional or International Financial Reporting Standards (IFRS) financial reporting, and the solvency ratio is a measure of the financial strength of the insurer that properly accounts for the measurable risks of the insurance undertaking.

Market disclosure is expected to have several effects on insurance companies. More specifically, it could affect the market value of listed insurance companies, as well as the rating; the cost of issue equity or quasi-equity, that is, subordinated debt; and the commercial position of both listed and unlisted insurance companies.

The Effects of Market Disclosure on Listed Insurance Companies

Many listed insurance companies started to disclose their solvency ratio according to Solvency II (usually named as economic solvency ratio) before the official start of the Solvency II regime. However, this preliminary information was disclosed on a voluntary basis and was computed using a partial or full internal model not yet approved by regulators. It was expected that from 2016 listed insurance companies may disclose key

solvency information on a quarterly basis, even if the regulation makes this disclosure mandatory only annually. This could imply a more direct link between the market value of insurance companies, own funds, and the solvency ratio.

In line with the market discipline hypothesis, listed companies are expected to anticipate the effect of public disclosure. They are expected to have a more prudent approach in order to raise the solvency ratio and to reduce the volatility of own funds. This probably concerns especially the investment side of insurance activities. The equity investments and, more generally, the investments in asset classes that absorb more SCR and induce BoF volatility should be evaluated with more attention with respect to the previous regime. This is the positive effect of market disclosure.

However, Solvency II disclosure could induce side effects.

On the one hand, there are calibration misalignments of Solvency II metrics with respect to a perfect economic approach. The Solvency II principles are based on a very well-structured economic approach. However, the detailed regulation is also influenced by political negotiations or rigid rules, which distances the practical implementation of Solvency II from a perfect economic approach.¹⁰ Clearly, the main issue is the treatment of EU government bonds in the spread and concentration risk submodules. This favourable treatment could induce an overinvestment in (relatively) high-spread risk in EU government bonds, especially in local government bonds, if the national authority avoids the use of capital add-on for local government bond investments or approves internal models with favourable calibrations for local government bond investments. The volatility adjustment of risk-free term structure used for technical provision valuation also mitigates the BoF volatility induced by an investment in (relatively) high-spread EU government bonds. Other misalignments could be observed in standard formula calibrations—which necessarily use, in order to avoid excessive complexity, fixed parameters—or in BoF measurement.

The practical effect of such misalignments should not be overestimated. The improvement in value and risk measurement of Solvency II with respect to the Solvency I regime is in any case exceptional, though perfection is unattainable. EIOPA and the national authorities should detect the calibration misalignments that induce relevant distortions in the insurers' behaviour and should try to remove them in a coordinated manner.

On the other hand, Solvency II reporting is a point-in-time disclosure (quarterly to the supervisory authorities or voluntary disclosure, annually to the mandatory public disclosure). This could induce window dressing, that is, a de-risking strategy just before the quarterly and/or financial year end. This is a well-known strategy in financial accounting disclosure or mutual fund portfolio management in order to avoid disclosing information that could overshadow the managerial skills of the monitored company.¹¹ Here, the window-dressing strategy is more material. Selling assets with high SCR absorption (i.e. equity) just before the public disclosure reporting date and acquiring assets with low SCR absorption (i.e. high-grade corporate bonds or government bonds) could reduce substantially the SCR and improve the solvency ratio. This policy could be reverted immediately after the reporting date by acquiring risky assets and selling safer ones. In the Solvency II regulation, the window-dressing problem is relevant only when the solvency ratio is close to 1, that is, the compliance with the SCR is at risk. In fact, the regulation introduces the concept of compliance with capital requirements on a continuous basis (art. 45.1 Solvency II directive). However, the problem of window dressing for listed, well-capitalized insurance companies is not addressed at all. The regulation allows the use of derivatives for hedging purposes and has no restriction regarding changes in asset allocation as long as this does not imply problems of compliance with capital requirements. For instance, a listed company could operate most of the time with a 200% solvency ratio and with a 225% solvency ratio just before each end of the quarter, using an appropriate derivatives hedging strategy. This window-dressing practice could provide the public with incorrect information about the true financial and solvency condition of a listed insurance company. In addition, if systematically used by listed insurance companies, this practice could also affect financial market prices and financial market volatility. Here, the empirical expectation is of a negative effect on risky asset prices and of a positive effect on low-risk asset prices before the reporting date, followed by an opposite effect after the reporting date. Clearly, the existence and the relevance of such window-dressing behaviour are so far uncertain.¹² However, EIOPA and national authorities should monitor the existence of window-dressing policies and, if they are judged relevant, suggest some improvement in the regulation in order to offset this negative impact on public disclosure and/or market price and volatility.

The Effects of Market Disclosure on Listed and Unlisted Insurance Companies

Two other important consequences of public disclosure could be detected: first, the effects on insurance company rating and, consequently, on the cost of raising equity and quasi-equity, that is, subordinated debt, and second, the impact of public disclosure on the insurer's competitive position.

A very high correlation can be expected to exist between the solvency ratio and the rating of insurance companies. At the same time, the cost of financing is expected to be inversely related to the solvency ratio. This also could improve market discipline. An insurance company could be induced to bring forward the strength of its financial and solvency position by issuing new equity or subordinated debt at the time the solvency conditions are sufficiently strong in order to prevent downgrading or a rising cost of financing. For example, an insurance company that anticipates a drop in the solvency ratio, say from 140 to 110%, could be induced to issue new BoF elements (equity or subordinated debt) immediately and not wait for the solvency ratio drop.

Also a commercial impact of public disclosure is possible. The effect of public disclosure on reinsurance business is clear. The public disclosure of solvency and financial conditions directly affects the rating of the reinsurer and this impacts on the credit capital charge of the reinsured insurance company. Some simple simulations¹³ demonstrate that the SCR absorbed by counterparty risk in reinsurance operations with a BB rated reinsurer offsets, almost completely, the underwriting SCR liberated by the reinsurance operation.

Also the direct insurance business could be affected by public disclosure. Here, the impact is more uncertain and may depend on the characteristics of the insurance market segment in which the insurance undertaking operates. A greater impact of public disclosure on the commercial position of insurance undertaking is expected for:

- Long-term contracts (i.e. traditional life insurance), in which the solvency and financial strength is very important in order to fulfill long-term insurance obligations;

- Market segments such as banking distribution with independent insurance company or corporate insurance, where the selection of the insurance company partner could be also based on the solvency ratio;
- Market segments where the competition and customer mobility is higher (i.e. auto insurance).

The SFCR and the public QRTs should be disclosed at solo and group levels, irrespective of whether the insurance (or reinsurance) undertaking is listed or not. Even if the proportionality principle applies also to the Solvency II third pillar, an unlisted medium-sized insurance company should disclose to the public the same information that a listed insurance group does. In addition, the same disclosure should be provided also by single unlisted entities belonging to an insurance group. This gives an evident incentive to restructuring the group organization in order to eliminate unnecessary insurance entities and to avoid the release of unnecessary information to the public. Anyway, for an unlisted company that belongs to an insurance group, the impact of public disclosure is expected to be lower than either for listed companies or unlisted independent companies. The rating and the external cost of raising funds depends principally on the financial and solvency strength of the group rather than the financial and solvency condition of the single entity. Also, the commercial position of the single entity is usually affected by the groups' strength. In addition, a single insurance entity belonging to a financial group usually distributes its products through group distribution channels (e.g. the group bank). This makes the commercial position of the insurance company less affected by public disclosure, especially if the ultimate customer has a low level of financial culture.

Solvency II Market Disclosure and Financial Reporting

The Solvency II SFCR is only a part of insurance company market disclosure. Financial consolidated reporting based on IFRS introduces different metrics. In some countries, such as Italy, the single entity financial reporting is still based on local GAAP,¹⁴ very far from the full-value approach of Solvency II.

More than one metric could generate confusion in market disclosure and avoidable administrative costs. In addition, the management has to control the accounting impact of operations regarding all adopted metrics.

There will be a partial convergence between the Solvency II economic balance sheet and the IFRS financial statement. For financial instruments, the IAS 39 will be replaced by the IFRS 9 in 2018.¹⁵ The new standard introduces the fair value measurement as the default approach (the amortized cost could be used only in specific circumstances and only for plain vanilla debt instruments) and a forward-looking impairment model for expected credit loss conceptually in line with the Solvency II approach. For insurance contracts, the tentative and incomplete IFRS 4 will be replaced by the definitive and complete new insurance contract principle in 2021 (IFRS 17). This new principle introduces criteria for measuring technical provisions not far from the Solvency II approach.

However, many differences between the IFRSs and Solvency II framework still persist.¹⁶

The economic balance sheet adopts a full fair value approach, while in the financial statement, each item has its measurement standard and the fair value is just one of the measurement criteria used.

The IFRSs are principle based, while Solvency II adopts a rule-based approach. This implies that even if the same measurement principles are stated in IFRS and Solvency II framework, different values could emerge. For example, in the technical provisions estimates, the IFRS 17 fulfillment value is conceptually very close to the current exit value established by Solvency II and both are based on the sum of the best estimate and the risk margin. However, Solvency II specifies the discount rate and the methodology and the parameters for the risk margin estimation. The IFRS 17 approach only sets the principles for discounting and risk adjustment, which are compatible with the Solvency II framework, but it grants the insurance company more freedom.

Essentially, the financial statement looks at the financial position (equity) and at the performance (profit/loss). The Solvency II framework looks at the financial position (own funds) and at the risks (SCR). Moreover, this could lead to different measurement approaches. For instance, according to the new insurance contract standard, technical provisions also consider

a contractual service margin (CSM) in addition to the fulfillment value, in order to spread the underwriting result over the contractual life of the contract. In the Solvency II framework, the technical provision is equal to the current exit value and the CSM is not considered.

More generally, the different objective of the financial reporting, that is, “*to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers,*” and the economic balance sheet of Solvency II, that is, to compute the own funds that are eligible to absorb future unexpected losses, introduce differences in the two sets of market disclosures that should be understood in advance by the users of the market disclosure.

Conclusion

The third pillar is the Cinderella of Solvency II. In the third pillar, insurers invest a large part of resources in their supervisory reporting system, in order to provide timely, consistent, and accurate data to authorities, to comply with regulations. Market disclosure has so far not been taken properly into account, since it is an almost perfect subsample of supervisory reporting. Actually, everything changes if one looks at the impact on insurance business and behaviour of insurance companies.

The supervisory reporting (and all work behind the first and the second pillars) produces no more than a green (fully compliant), yellow (partially compliant), or red (not compliant) light, and it is expected that the vast majority of the market will have the green light. The real impact for insurance companies is on market disclosure. With market disclosure, each insurance company has its specific, highly comparable solvency and financial position, and it could have 1000 shades of green, yellow, and red. This is one of the most innovative aspects in the Solvency II framework and could lead to a more transparent market and positive market discipline.

Even if the overall judgement on Solvency II market disclosure is positive, in this chapter, some potential side effects of market disclosure have been identified and some possible measures to reduce them were suggested.

Firstly, the point-in-time disclosure of solvency ratio could induce insurance companies to window-dressing practices with evident negative

effects on the transparency and volatility of financial markets. At the preliminary level, the EIOPA and the national authorities should evaluate if, as far as we will have the first market disclosure, such window-dressing practices exist and, effectively, whether they have a negative impact on insurance and financial markets. If so, some adjustments in market disclosure should be studied, for example, to disclose the average solvency ratio of the period and not only the point-in-time solvency ratio.

Secondly, the Financial and Solvency Condition Report is a new and very informative report that is added to the IFRS financial report and other public information realized by insurance companies. In different reports, some equivalent accounting quantities are measured with different metrics (i.e. the financial reporting “equity,” the Solvency II “basic own funds,” and the “market consistent embedded value”). Here, more than one metric could generate confusion in market disclosure and avoidable administrative costs. In addition, management has to control the accounting impact of operations with respect to all adopted metrics. Here, the EU regulator and the standard-setters have to converge to a coordinated measurement approach in order to minimize the differences. This has been done in the past (i.e. Solvency II requires to use IFRS to measure assets and liabilities different to technical provisions, if the IFRS is in coherence with the fair value approach stated in art. 75 Solvency II directive) and improvements are expected for the future (the new IFRS 17 on insurance contract measures technical provisions with an approach similar, but not identical to Solvency II). However, some differences still persist since different reports have different objectives.

In this perspective, the key word is *integrated reporting*. Insurance companies should introduce a coordinated system of reporting in order to clarify disclosure to the public, avoid duplication of costs, avoid inconsistencies in the reporting system, and define the organizational structure, the role, the responsibilities, and the processes of the new integrated reporting system.

This is a hard task and one of the major challenges in the future. The search for best practices could improve substantially the content of market disclosure of insurance companies, providing comparable, timely, and understandable information about the three relevant dimensions of reporting: value, risk, and performance.

Notes

1. See also the EIOPA “Guidelines on reporting and public disclosure.”
2. See the EIOPA “Guidelines on reporting for financial stability purposes.”
3. According to art. 45 of Solvency II directive, every undertaking “*shall conduct its own risk and solvency assessment,*” which include at least: “(a) *the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;* (b) *the compliance, on a continuous basis, with the capital requirements, and with the requirements regarding technical provisions;* (c) *the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement.*”
4. According to art. 256, Solvency II directive, a single report, containing all prescribed information either at the group level or the single entity level, it is also possible even if the agreement of the group supervisor is required.
5. The 2015/2452 ITS on public QRTs consists of only 196 pages versus the 1223 pages of the 2015/2450 on supervisory QRTs.
6. See Flannery (2001).
7. See, among others, Nissen-Ruenzi et al. (2015) and Goldstein and Sapra (2014), for banks, and Castagnolo and Ferro (2013), for insurers.
8. See European Banking Authority (2015).
9. See CFO Forum (2009).
10. See, among others, Doff (2016), Cole and McCullough (2014), and Floreani (2013).
11. See, among others, Lakonishok et al. (1991), Morey and O'Neal (2006), and Allen and Saunders (1992).
12. The transitional measures regarding equity SCR (a lower capital charge is loaded for equities acquired before 21/12/2015 and holds after this date) could reduce the impact of window-dressing policies for early application of the Solvency II regime.
13. Ehrlich et al. (2010).
14. In Italy only in 2018, the IFRS will be extended also to the single entity financial report.
15. For insurance companies, the application of IFRS 9 in 2018 before the application of the new insurance contract standard (expected in 2021) could amplify the accounting mismatch problem. Therefore insurance companies are entitled to defer the application of the IFRS 9 to 2021.

See, the IASB's IFRS Standard “*Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4)*” issued in September 2016.

16. See Visser and McEneaney (2015).

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13

How the New Accounting Standards Cross Solvency II

Alessandro Di Lorenzo and Lucia Magenta

The Current Regulatory Landscape for Solvency and Accounting Standards for (Re)insurance Undertakings

Different principles and rules in accounting and regulatory standards in the European Economic Area (EEA) led to divergent perspectives in performance and solvency assessment of (re)insurance undertakings vis-à-vis external stakeholders.

Over the last few years the International Accounting Standard Board (IASB)—the independent standard-setter of the International Financial Reporting Standards (IFRS) Foundation—and the European Insurance and Occupational Pensions Authority (EIOPA)—the European Supervisory Authority for the insurance and occupational pension sector acting as independent advisory body to the European Parliament, the

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Council of the European Union, and the European Commission—have been working, each within its own field, to ensure greater comparability and transparency in their specific reporting standards to markets, consolidating local practices present in the various European countries.

The two bodies are not directly connected or coordinated: IASB defines and issues accounting standards that are assessed by the European Financial Reporting Advisory Group (EFRAG) throughout the IFRS assessments process, providing advice to the European Commission to check compliance of IAS Regulation with endorsement criteria for drawing up financial reporting in the European Union (EU).

On matters of common interest between Solvency II and IFRS standards, EIOPA may express its opinion and comments to EFRAG based on IABS draft documentation to ensure general consistency with Solvency II and avoid any divergences between the two regulations.

In this context, it is interesting to explore the main features of the two regulations, their common features, differences, and how insurers can best face their challenging implementation.

The underlying idea for both frameworks is a more accurate measurement and evaluation of insurance undertakings in line with common standards with focus on fair value of the balance sheet and the risk capital required for running business for EIOPA and on fair-value balance sheet and economic performance for IASB.

On the one hand, IASB aims at defining understandable, commonly accepted and globally applicable accounting principles to enhance transparency and comparability of corporate financial statements.

The accounting principles for insurers, which will be effective in the near future, set criteria for the classification and measurement of the investments (IFRS 9 effective from January 2018, with specific option to defer the application for insurance entities until 2021) and for the definition of the insurance contracts and their measurement (IFRS 17 with an effective date in 2021). There were different reasons and common objectives for issuing the new standards, namely increasing transparency and comparability,¹ of financial statements.

On the financial instruments side, IASB's objective in issuing IFRS 9 was to develop new, principle-based less complex standards compared with the current one (IAS 39), whose requirements were difficult to

understand, interpret and implement. Most especially, the key issues with IAS 39 relate to the following:

- Multiple ways of measuring financial instruments (at fair value with impact on profit and loss, at fair value with impact on other comprehensive incomes at amortized cost),
- Accounting rules for derivatives, especially those for hedging accounting (fair-value hedge, cash flow hedge and hedges on net investment in foreign transactions),
- When financial assets should be considered as sold and when financial liabilities should be considered as settled,
- How to distinguish between liability and equity instruments.

Finally, the recent economic scenario has proved these standards to be inadequate in assessing financial instruments in case of a financial crisis: IFRS 9 is the IASB's response to the financial crisis and represents a fundamental review of accounting principles for financial instruments.

On the insurance contracts side, the new Standard, actually in draft, aims at providing a fundamental reassessment of accounting for insurance contracts. In fact, current IFRS 4 was intended as an interim measure, and, consequently, it has allowed insurers to retain their existing accounting practices, including also a "temporary exemption" from other Standards and from the requirement of considering the conceptual framework in selecting their accounting policies. Currently, substantial differences are present between jurisdictions in the models implemented for insurance contract accounting and they will be overcome with the new standard.

On the other hand, EIOPA, with Solvency II, which has entered into force on January 1, 2016, inspired by principles of stronger policyholders' protection and greater stability of financial markets through stricter capital requirements, intends to set a single regulatory framework with more comprehensive and sophisticated rules to calculate solvency, to implement a robust risk governance framework and to disclose standard sets of information to the authorities and to the public (Swain and Swallow 2015).

Previous simplified and inconsistent European frameworks on capital requirements, governance systems, and internal/external regulatory

reporting have been coexisting, making it difficult to immediately compare insurers operating in different European countries. This intervention of standardization and greater sophistication in the light of a wider range of risks (e.g. financial risks), also in line with recent developments in the banking sector through Basel II/III, was necessary to guarantee a leveled playing field, at least in Europe.

Solvency II harmonizes the rules for calculating capital requirements around Europe, giving insurers the option to adopt, if approved by the regulator, their internal models to better reflect their own risk profile, but it also sets new principles for assessing technical provisions and, more generally, balance sheet as a whole, with impacts on available own funds. In parallel with the reinforcement of capital structure, insurers are required to strengthen their governance system, to self-assess their actual capital needs in a forward-looking perspective and to produce a standard set of information for the regulator and the public.

The timeline for the new accounting rules is not aligned with the introduction of Solvency II: on the liabilities side, the new standard for insurance contracts standard, the IFRS 17, has been issued in May 2017 with effective date 2021. This time mismatch allowed IASB to fine-tune open technical issues gaining experience from Solvency II, in order to consider the expectations of investors, analysts, rating agencies, regulators, accounting firms and standard-setters for simplification and alignment with Solvency II requirements.

Despite the absence of specific requirements to ensure coherence and consistency between the two reporting approaches, it is not difficult to see that there are several overlapping items in Solvency II and IFRS 17 regarding measurement and disclosure, even if they differ in their main goal of providing information: capital adequacy for Solvency II versus profitability and performance in the IFRS.

There are many common areas, from data of the balance sheet and of risk margin (Pillar 1 of Solvency II) to profit and loss attribution (Pillar 2 in the case of internal models) versus IFRS income standards, to financial and insurance risks disclosure (Pillar 3): they need a clear reconciliation of the data they produce to allow the public to understand the risk position of insurers and their performance and enabling them

to compare all European undertakings with data and information calculated on a common basis.

Nevertheless, there are differences which refer to treatment of liabilities and expenses: IFRS 17, for example, uses a contract service margin (CSM) to spread profits over contract duration, while with Solvency II profits are recognized immediately. Similarly, acquisition costs are included in the cash flows under IFRS 17, and implicitly deferred, while under Solvency II they are recognized immediately to profit and loss. In addition, differences may arise in the discount rates to be applied and in the level of aggregation of the contracts.

To avoid misunderstandings with investors and rating agencies, communication, transparency, and a clear explanation and reconciliation of figures will pose an important challenge to insurers: external communication should be exhaustive and complete and consider that this more realistic representation of fair value, with its details, and risk-based solvency may lead to higher volatility in these dimensions.

Data quality will be one of the red-hot topics for companies in the next few years as they will have to guarantee sound and reliable figures in their internal management decisions and to meet investors' requirements of data transparency and completeness.

Even if Solvency II is now in force, implementation efforts for full compliance are not over: regulators are finalizing local rules to transpose Solvency II according to their intention to comply (or not) with EIOPA's guidelines in their own jurisdictions.

In this context, the significant efforts required by the two frameworks, which have been partially already undertaken for Solvency II, will prompt insurers to optimize financial, human and technological resources, especially in overlapping areas, implementing joint projects, sharing teams, competences and experiences, even if the dates when they enter into force are not aligned.

On the assets side, Solvency II and IFRS 9 could be aligned if insurers decide to measure all financial assets using the fair-value model under IFRS 9. However, an insurer may elect to use the amortized-cost approach under IFRS 9 for assets backing those components under IFRS 17 that match with change in the fair value of those assets. This needs to be

measured against the cost and effort of having the same assets measured at fair value under Solvency II.

Solvency II: The New European Solvency Directive

Solvency II Directive² has entered into force in EU member-states on January 1, 2016, conforming previously existing local regulations on capital requirements, systems of governance and internal control systems, current and forward-looking risk assessment, disclosure to the public and to the regulators.

The key priorities for the authorities were an overall harmonization and convergence of supervisory practices for granting a leveled playing field for all insurances within the EU, trying to limit local specificities and avoiding discrimination of policyholders across borders.

The EU legal process leading to approve the Directive in November 2009 has been long, complex, articulated and not without obstacles that, at certain points in time, have jeopardized its actual implementation, with repeated deferrals (from the initial October 2012 to the final date of January 1, 2016).

European undertakings started implementing Solvency II projects some years before the original deadline, but uncertainty about the date when Solvency II would enter into force at that time slowed down pressure toward compliance.

Omnibus II,³ which amended the Directive deadline to January 1, 2016, and EIOPA guidelines on Pillar 2 and Pillar 3, issued in late November 2013, gave new impetus to local regulators for preliminary implementation (the so-called interim measures phase,⁴ covering the period 2014–2015) on such pillars, while Pillar 1 required at that time further technical discussions within the industry, EIOPA and regulators.

Specifically, Omnibus II allows a certain level of flexibility in Solvency II implementation timing, with a set of transitional measures on the following topics:

- Information to supervisory authorities: to be sent within 20 weeks after financial year end 2016, reduced by two weeks per year for the following four years;
- Own funds: basic own fund items that only met the requirements in Solvency I on December 31, 2015 are included in Tier 1 or Tier 2 basic own funds of Solvency II up to ten years;
- Market risk: gradual implementation of capital charges for equity, concentration and spread risk submodules;
- Noncompliance with SCR: allowed until end of 2017 only if undertakings comply with Solvency I requirements;
- Partial internal group models: under certain criteria, they can be applied only to a part of a group until March 31, 2022.

This gave more time to undertakings to adopting all necessary initiatives to attain compliance with Solvency II requirements.

The various levels of “Lamfalussy” approval process have been progressively approved by the members of the so-called Trilogue: the European Commission, the European Parliament and the European Council: specifically the Directive (Level 1) and EIOPA guidelines (Level 3), which provide indications to national regulators on homogeneous and consistent implementation at country level based on a “comply or explain” approach, require a local approval, while Level 2 implementation measures (Delegated Acts⁵ and Implementing Technical Standards) are directly applicable to local countries without any needs for local transposition.

Like the provisions adopted in the banking sector with Basel II, Solvency II is structured in three pillars and defines new quantitative, qualitative, and external disclosure requirements (Fig 13.1).

Specifically, *Pillar 1* defines calculation rules for economic balance sheet (assets, best estimates, risk margin and own funds), minimum capital requirement (MCR) and solvency capital requirement (SCR).

The economic balance sheet requires an assessment of assets and liabilities at fair value; major changes are expected on the liabilities side where technical provisions require a calculation of best estimates (the expected value of future cash flows) and risk margin that reflects uncertainty in the estimation of the best estimates and is based on the cost of capital at risk arising over the time horizon of the best estimates on cash outflows.

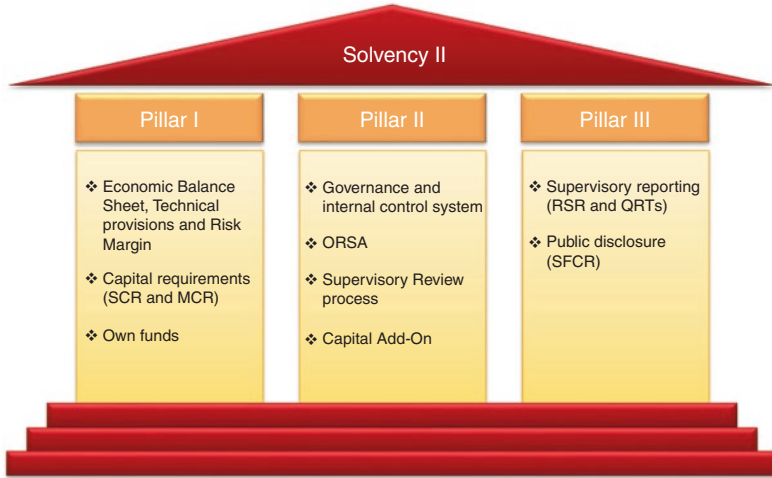


Fig. 13.1 Solvency three pillars structure

Own funds, calculated as the difference between assets and liabilities, are classified into tiers (1–3) with respect to the eligibility of the funds of an undertaking, and they have to be sufficient to cover the SCR and the MCR. Specific limits in terms of tier composition are provided by Solvency II, as for example a minimum of 50% of Tier 1 on the overall available funds to cover the SCR.

The SCR calculation is based on a total balance sheet approach; that is, it quantifies the required level of own funds to cover unexpected losses due to a range of quantitative risks the overall financial statement of the undertaking is exposed to, according to a standard taxonomy, with a level of confidence of 99.5% within a period of one year: technical risks (life, non-life, and health), financial risk, default risk, and operational risk.

The last three risk factors are substantially new compared with Solvency I paradigm, opening up internal discussions among insurers on capital allocation and risk-return remuneration for the various business units, products and lines of business (LoB) (Matten 1996). Furthermore, the correlations among risks are considered as a mitigation effect in the overall capital requirements. A further element of adjustment is represented by the effect of deferred taxes and management actions.

According to the latest capital simulations for most of European insurers, the financial risk represents the main source of risk in terms of economic capital and it will impact very strongly on the asset allocation⁶ of insurers in the future, as they may privilege asset classes with lower capital requirements or better risk-return profiles according to their own individual criteria of selection and capital optimization.⁷

As a main principle, insurance undertakings invest all their assets according to the principle of the prudent person, being able to properly identify, measure, monitor, manage, control, and report risks, appropriately considered in the assessment of the overall solvency needs, in selecting their assets they must ensure portfolio security, quality, liquidity,⁸ and profitability, taking into consideration the nature and duration of their liabilities and the interest of all policyholders and beneficiaries.

In calculating the SCR for financial risk for managed funds, great relevance is given to the look-through approach, which requires a calculation of the SCR according to the actual internal composition at the date of evaluation in order to avoid useless capital requirements that can be applied in case of lack of transparency using the highest capital charge for equity classified as “Other.”

EIOPA allows different calculation approaches for the SCR, which ranges from the standard formula, according fixed rules for computing the SCR, to the adoption of the full or partial internal model, which requires modeling of all (or some of) the risk factors by the undertaking, using external market data and insurers internal ones.

The use of the internal model to quantify the SCR is subject to the approval of the regulator according to stringent requirements such as use test,⁹ statistical quality standards, calibration standards, integration of partial internal models, profit and loss attribution, validation standards, documentation standards and external models and data.

An approach with an intermediate level of sophistication is represented by the undertaking-specific parameters (or USP),¹⁰ which allow tailoring the risk weight parameters in the standard formula for technical risks (life, non-life, and health risks), using the insurer’s own data according to specific data quality requirements: it implies approval by the regulator but is less cumbersome than the ones required in case of an internal model.

The objective of USP or internal models is a better measurement of the company's risk profile compared with the standard formula which is calibrated on European-wide market data.

For (re)insurance groups operating in different countries, in case of internal model's approval request, competent supervisors will join a working group led by the home regulator to define a consistent approach to cross-border validation according to EIOPA's guidelines.

Pillar 2 requires from companies a system of governance which is the basis to manage all risks faced by undertakings through detailed responsibilities of the board, a risk strategy and a risk appetite framework (RAF), governance and risk policies, key control functions, a process of risk self-assessment, the so-called ORSA (Own Risk and Solvency Assessment) process. On the regulators' side, Pillar 2 pushes for convergence and harmonization of the supervisory review process (SRP), especially in case of group oversight, with a key role of the group supervisor acting in coordination with other local authorities involved in the supervision within the so-called college of supervisors.

The requirements for the governance system, whose level of sophistication is proportional to the nature, scale and complexity of undertakings, will lead to greater responsibilities of the board and its members, now in line with the "fit and proper" requirements, as they are in charge of approving the risk appetite and risk strategy of the insurer.

The directives of the board directed to the top management in implementing the overall risk governance translate into a set of governance and risk policies prescribed by Solvency II and cover all risks and governance items: process and procedures shall consequently be harmonized.

The role of key control functions becomes even more crucial and relevant in case of internal model adoption, both in the application phase and in the business-as-usual time, where the use test shall be submitted to the regulator at least for risk management systems, decision-making, capital evaluation and capital allocation processes.

Since Solvency II is applicable to insurers of all sizes, proportionality is a concept that must be carefully considered according to the impact on the effectiveness of undertaking governance, on the potential increase in operational risk, on the ability of the regulator to monitor compliance of

the undertaking or on the ability to respect the obligations with the policyholders.

One of the key challenges of Pillar 2 lies in setting up the ORSA process, which involves different internal functions (CFO, CRO, top management etc.) in gathering data, performing simulations on the evolution of the economic balance sheet and the related risks (overall solvency needs [OSN]), in a current and forward-looking perspective over the planning time horizon (with a minimum of three years and in line with the business plan), quantified with methodologies consistent with the risk profile of the undertaking.¹¹ ORSA's main objective is verifying the adequacy of the insurers' own funds with respect to the OSN over such time horizon, as tested also in stressed scenarios.¹²

In quantifying the OSN, insurers can use approaches that differ from the ones adopted for SCR if these ones do not fit their effective risk profile: in such case, an explanation for deviations must be provided to the regulator.¹³

ORSA ends with a final report, approved by the board and addressed both internally and externally to the regulator: it is the basis for strategic decisions of the undertaking, performed at least annually and whenever there is a material change in the risk profile of the company.

When ORSA evidence indicates inadequacy of the system of governance due to the complexity of the insurer or to modeling and covering risks in the OSN with respect to the actual risk profile of the insurer, the regulator can decide whether to apply specific capital add-ons until these gaps are not removed.

In the interim measures period, according to EIOPA guidelines, the authorities might have requested from companies a FLAOR exercise (Forward-Looking Assessment of Own Risks, that is, the interim and partially simplified version of ORSA) in order to gain confidence with ORSA as a core process connected with the company business strategy. Yet many implementations are still expected in the business-as-usual period of companies whose boards have recently started to discuss with regulators about their risk strategies with reference to their business plans.

A specific mention is due to data quality, one of the most ambitious challenges that companies are facing also in terms of data governance and

IT implementation, not only in case of internal model or USP application (irrespective of the approach for calculating the SCR, a minimum standard of data quality is required for technical provisions).

Pillar 3 defines external disclosure requirements, toward the public and the authority, according quantitative reporting templates (QRTs) and narrative documents, the RSR (Regular Supervision Report) for the regulator and the SFCR (Solvency and Financial Condition Report) for the public, to be released by certain deadlines.¹⁴

Additional disclosure requirements are for financial stability purposes and apply to undertakings with total assets higher than 12 billion Euros and intended for the European Central Bank (ECB) for systemic undertakings, asking for statistical data on the insurance market for monetary, financial and economic stability: even if requested data do not imply specific new processing, a minimum of data gathering, controlling and validating is needed.

These data and information calculated with the same homogeneous standards and minimum details and released for public disclosure will influence the way the undertakings will be assessed by the financial markets that will pay higher attention to return on invested capital, to risk sensitivities and reinsurance strategies, being able to perform comparisons among different companies, even across European countries: Pillar 3 information can be used as an official source to build up risk and performance indicators and compare fairly competitors established in different countries.

If on the one hand Pillar 3 disclosure¹⁵ will allow everybody interested in assessing the solvency position of a company to run any kind of risk and performance analysis with the same set of data around Europe, on the other hand this raises issues on the public data coming from official financial statements and balance sheets, where publicly available, which are based, for the time being, on different accounting rules, waiting for new IFRS principles to be in place.

Locally regulators are allowed to add new country-specific data requirements, also to maintain consistency with data controls done in the past, but this translates into an additional workload for companies.

The huge amount of new data and information required by Solvency II pushed the undertakings to adjust their IT systems, internal processes, and responsibilities to comply with reporting deadlines and grant

adequate level of data quality. For the data needed for disclosures on investments, an important role will be played by asset managers,¹⁶ who shall have to provide the right data set required for Pillar 3 (and also Pillar 1) on time with specific deadlines.

In addition to plan development, gathering, storage, extraction, control of data and validation of the models and IT systems used for risk calculations, new processes and organizational functions (i.e. actuarial function for some countries) that will be necessary to update and/or implement internal and external reporting, another really big challenge for insurers will lie in reaping the benefit of the above in the business-as-usual, as a strategic driver to change the company and manage it within a risk-based framework.

One interesting open topic is the requirement on Pillar 3 external audit: for the time being there are no European minimum standards, even if EIOPA with its document “Need for high quality public disclosure: Solvency II’s report on solvency and financial condition and the potential role of the external audit,”¹⁷ published in July 2015, allows each local regulator to define the scope of application of assurance for the economic balance sheet, own funds and SCR.

The need for assurance on public Pillar 3’s data is supported by different stakeholders¹⁸: boards, rating agencies, investors and financial analysts, who expect a level of assurance on Solvency II figures comparable with the one adopted for local balance sheets audits; furthermore, they will compare and take into consideration the level of external assurance offered by different undertakings in their analysis.

Starting from 2016, the great challenge in the transition from the project implementation phase to the business-as-usual one will impact on the industrialization processes to produce Pillar 3 information with adequate levels of data quality in terms of availability, quality, granularity and audit-trail capability, governance, organization, and IT support systems.

Technological requirements on data automation and their related controls are expected to grow significantly also because of the introduction of new accounting principles.

With such expectations, undertakings will have to be time-efficient (in order to respect the regulatory due date not only for Pillar 3 but also for ORSA report), disclosure-efficient (Solvency II reporting has to be

aligned and reconciled with current IFRS and local GAAP reports), cost-efficient (capitalizing and optimizing data gathering, IT systems, skills and resources for producing Solvency II and accounting data) and governance-efficient (clear roles and responsibilities in production, validation and final sign-off of disclosed data).

Only Solvency II disclosed figures are under the lens of external stakeholders who, having at their own disposal data useful to compare homogeneously companies in the various member states, can reconcile them with the output according to the new accounting principles to have all elements for an exhaustive evaluation of insurers.

The New Accounting Standards for (Re)insurers

In July 2014, the IASB issued the completed version of IFRS 9, replacing “IAS 39 Financial Instruments: Recognition and Measurement”; its date of effect is January 1, 2018 with early application allowed but also with deferral option allowed in order to align the effective date with IFRS 17 which has date of effect January 1, 2021. Both standards will be relevant for insurers, raising many concerns by stakeholders about the different dates of entering into force. To address these concerns, the IASB allows all entities that issue contracts within the scope of current IFRS 4 to reclassify from profit or loss to other comprehensive incomes some of the items (incomes or expenses) arising from designated financial assets that are measured at fair value through profit or loss in their entirety applying IFRS 9 but would not have been the same if measured applying IAS 39 (“overlay approach”). In addition, IASB gives undertakings whose activities are predominantly connected with insurance contracts an optional “temporary exemption” from applying IFRS 9 until 2021.

To assess if activities are predominantly connected with insurance contracts, an undertaking considers whether the carrying amount of its liabilities arising from contracts within IFRS 4’s scope, compared to the total carrying amount of all of its liabilities, is significant (higher than 90%, or in a range of 80–90% if the company is not engaged in a significant activity unconnected with insurance business).

The entities that defer the application of IFRS 9 will continue to apply the existing financial instruments standard IAS 39.

On the liability side, the current standard for insurance contracts, the current IFRS 4, represents a compromise, where a mixture of different and not comparable local approaches to the liabilities' measurement coexist. One of the main objectives of the new IFRS 4 Phase II model is guaranteeing a wider degree of comparability and transparency overall,¹⁹ even the long time of the consolidation's process showed the difficulties existing in the complex business of the insurance sector.

The scope and definition of insurance contract for the IFRS 17²⁰ are unchanged from current IFRS 4. In terms of accounting model, this new standard introduces three approaches to be applied according to the features of insurance contracts and introduce requirements that any non-distinct investment components, not separated from the insurance contract (the "deposit component," which represents the cash flows the insurer estimates; insurer will be obliged to pay to policyholders or their beneficiaries regardless of whether an insured event occurs), are excluded from revenues and claims in the statement of comprehensive income.

The General IFRS 17 Model is based on a discounted cash flow model with an allowance for risk and deferral of up-front profits (through the contractual service margin [CSM]).

The General Model is based on the building blocks of a current, discounted, and probability-weighted average of future cash flows expected to arise as the insurer fulfills the contract; an explicit risk adjustment and a contractual service margin (previously called "residual margin") represent unearned contract profits (Fig 13.2).

The cash flows are calculated as the difference between an explicit, unbiased, and probability-weighted estimate of future cash outflows and future cash inflows that will arise as the insurer fulfills the insurance contract using a level of aggregation for measurement (e.g. portfolio or individual contracts) that should not affect the expected present values of these cash flows. This level of aggregation, however, is one of the main open points still under discussion and expected to be clarified in the operational point of view before the effective date. The IASB, in fact, decided to create a Transitional Resource Group with the aim to facilitate the application of the new Standard.

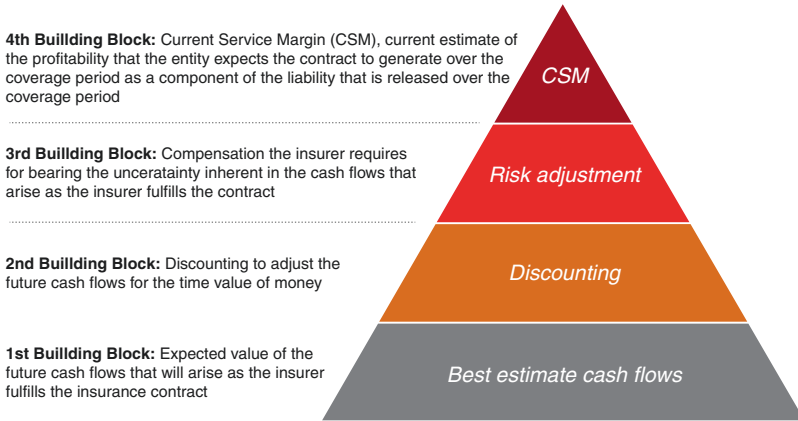


Fig. 13.2 General Model

This expected value (or statistical mean) is determined considering a number of scenarios that reflect the full range of possible outcomes. Each scenario specifies the amount and timing of cash flows for the specific outcome and estimated probability of that specific outcome. The relevant cash flows from each outcome are discounted and weighted by the probability factor to drive the expected present value.

The cash flows reflect the entity's perspective, and they should not contradict observable market prices for market variables and incorporate all available information about the amount, timing, and uncertainty in an unbiased way.

For non-market variables (e.g. demographic features of a life portfolio or probability of occurrence of an earthquake in a given period), an entity will have to consider non-market external and internal data and attribute a weight to the more compelling evidence. These demographic features for life insurers may differ from those of the national population, and, therefore, an entity may decide to use its internal data. Entities will have to use current estimates representing the conditions at the end of the reporting period and their changes.

Directly attributable acquisition costs are included in expected cash flows if they can be allocated to a portfolio on a rational and consistent basis. These costs include costs of selling, underwriting, and initiating an insurance contract. Fixed and variable overheads (such as the costs for

accounting, human resources, IT and administration, building depreciation, rentals, maintenance and utilities), that are directly attributable to manage the portfolio that contains an insurance contract, are also included in cash flows.

Expected cash flows are discounted to reflect the time value of money in the insurance contract liabilities: the discount rate reflects the characteristics of the relevant cash flows.

Risk adjustment measures the compensation that an entity has because of the uncertain amount and timing of cash flows as the entity fulfills its insurance contract. Risk adjustment measures the compensation so that for an entity there is no difference between:

- fulfilling an insurance contract that has a range of possible outcomes and
- fulfilling an insurance contract with fixed cash flows with the same expected present value.

Risk adjustment is explicit, separated from cash flows and discount rate, and recorded as profit or loss as it is released from risk in both coverage and settlement periods.

The CSM is the unearned profit in an insurance contract, and it is amortized over the coverage period in a systemic way that best reflects the residual services provided under the contract based on the “coverage units” which are determined by considering for each contract the quantity of benefits provided under a contract and its expected coverage duration. The CSM is adjusted for changes in cash flows relating to future services but not to current and past coverage. Hence, the pattern of services is an important element in the recognition of profit resulting from insurance contracts.²¹

However, due to the complexity of General Model, the IASB has also provided relief for companies issuing short-term contracts, particularly those with a duration of one year or less. This relief comes in form of a simplified model (premium allocation approach [PAA]) that can be used if specified criteria relating to contract duration and variability of expected future cash flows are met. Applying the PAA to the pre-claim period, the model may prove similar to accounting based on unearned premiums as currently applied under many GAAPs²² (Fig 13.3).

- Optional simplified model for future cover based on the unearned premium.
- Permitted for short duration contracts (period of cover <= 1 year) or where a 'reasonable approximation' or where a 'reasonable approximation' of BBA.
- Reasonable approximation' does not apply when entity expects significant variability in cash flows – No further guidance on what this means.
- Incurred claims liability (including IBNR) calculated in the same way as for the BBA approach.

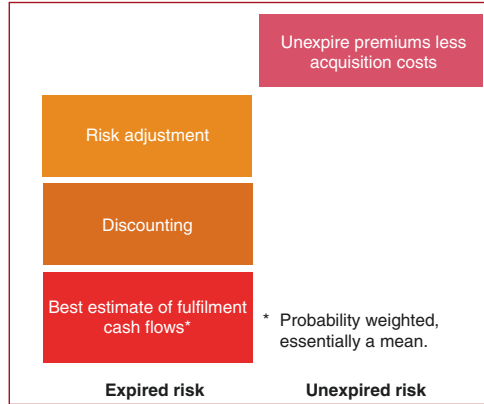
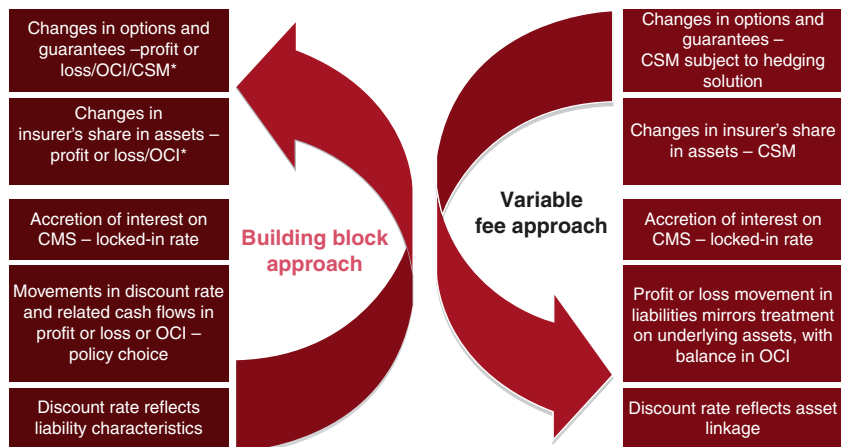


Fig. 13.3 *Premium allocation approach—optional model for short-term contracts*

Under the PAA, the liabilities for incurred claims are recognized according to the General Model; however, they do not have to be discounted if cash flows are expected to occur within a year after a claim has been incurred. A General Model approach with discounting of expected claim payments will be still required for incurred claims unless it is expected that amounts will be settled within a year (a further simplification is allowed in this case). In addition, if the PAA is used, an entity may elect to recognize as an expense directly attributable costs if the coverage period is one year or less.

Finally, the IASB staff proposed a measurement model for participating contracts where changes in estimated future fees that an entity expects to earn from policyholders of the participating contracts are adjusted against the CSM (“variable fee approach” [VFA]). This fee, at inception, includes the entity expected share of returns on the underlying items to which the participating contracts have a participation right minus any expected cash flows that do not vary directly with underlying items (e.g. guaranteed minimum benefits and expenses). Changes in estimated future fees that an entity expects to earn from policyholders are adjusted against the CSM (Fig 13.4).

The General Model and the VFA are significantly far from the current accounting framework in most European countries: like Solvency II, its



*Depends: market (Profit and Loss or Other Comprehensive income depending on accounting policy election), non-market (CSM)

Fig. 13.4 Participating contract—variable fee approach: mechanics

implementation will require a deep transformation of the accounting and reporting infrastructure, of actuarial modeling, data requirements, IT systems, processes, and controls.

The crossroad between the IFRS and Solvency II is represented by common activities already carried out on by the finance and the actuarial teams on Pillar 3 implementation.

On the asset side, special attention is to be given to IFRS 9,²³ which is applicable from 2018 (with specific options for exemptions available to insurers as mentioned above) and will involve significant changes in asset evaluation in terms of classification, measurement, impairment, and hedge accounting compared to the current IAS 39.

“Classification and measurement” (or “C&M”) required by IFRS 9 for financial assets needs new tests/criteria to be met to classify financial instruments at fair value through other comprehensive income compared to IAS 39. As a consequence, the C&M requirements are likely to result in more financial instruments being held at fair value through profit and loss (FVTPL) than under IAS 39. Insurers who currently hold amortized-cost assets and make large use of the available-for-sale (AFS) category under IAS 39 are likely to have the biggest impact: debt instruments that fail the solely payment of principal and interest (SPPI) criteria and

most equity instruments are now expected to be classified in the residual FVTPL category, including put instruments on mutual funds.

The process of setting up classification and the measurement of balance sheet items would require an in-depth look into corporate portfolios to classify each asset properly, taking into account the interrelations with IFRS 4, and IFRS 17 starting from 2021, and avoiding any accounting mismatches.

The impairment model introduced by IFRS 9 is based on expected credit losses rather than incurred losses used under IAS 39²⁴; consequently, the expected result is an earlier recognition of credit losses. Insurers who are likely to hold significant volumes of amortized-cost assets, such as loan books or “Fair value through other comprehensive income” (or “FV-OCI”) debt instruments, will face the biggest impact, particularly during the transition phase. The new accounting framework requires a significant shift from an incurred model to an expected loss one, performing both a forward-looking and an historical analysis. A key factor of success will be the development of a robust expected-loss model, which needs to include issuer’s specific parameters such as probability of default, loss given default or exposure to default (Fig 13.5).

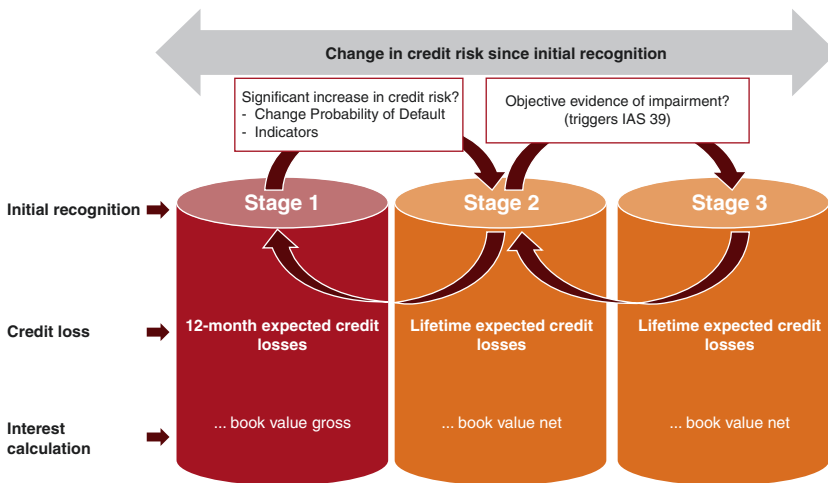


Fig. 13.5 Impairment: a general approach

Finally, IFRS 9 hedge accounting criteria are intended to facilitate the use of hedge accounting even if macro-hedging proposals are still under discussion.

Hedge accounting prompts a convergence of risk management techniques and accounting ones, with an improvement in some basic requirements like effectiveness testing or the introduction of several new options like a wider range of hedging instruments which can provide interesting opportunities to insurers to manage potential accounting mismatches.

Crossroads Between New Accounting Standards and Solvency II

Besides the significant differences between Solvency II and the new IFRS 17 concerning the evaluation of insurance contracts and financial instruments, there are several similarities between the two frameworks relating to the field of corporate assessment and their current and forward-looking performance.

Financial instruments, measured at fair value under Solvency II, could be measured at fair value or at amortized cost under IFRS 9, depending on the business model adopted by the insurer. Insurance liabilities are measured using a similar model under IFRS 17 and Solvency II with the exception of future profits from current business and acquisition expenses that are spread over the life of contracts under IFRS 17 and recognized immediately under Solvency II.

To become Solvency II-compliant, insurance undertakings have faced, and are likely to face, significant investments also for Pillar 3 adequacy, for example, for data collection, modeling systems, reporting lines, and so on: these noticeable efforts can be used as a starting point for implementing IFRS 17. The same can apply to the new financial instrument standards (IFRS 9).

The new accounting standard applies to all contracts that meet the definition of “insurance contract,” which depends on whether significant insurance risk is transferred to the insurer, largely unchanged from current IFRS 4, while Solvency II is applicable to all contracts issued by insurers, thus creating a potential accounting mismatch with IFRS for

contracts that are subject to IAS 39 (now) or IFRS 9, when it comes into force (i.e. financial contracts).

The liabilities are quantified as the amount necessary to execute the contract over its lifetime, with a series of items that are used for measurement in both frameworks (Solvency II is based on an exit price value, rather than on a fulfillment concept).

Among these elements, one can highlight cash flows, how cash flows are discounted and risk adjustment.

Specifically, it is necessary to estimate future cash flows needed to fulfill a contract: Solvency II requirements are more prescriptive than the IFRS; hence, there is less room for interpretation. There are, for example, no deferred acquisition costs under Solvency II, while certain overhead expenses might be excluded under IFRS.

These cash flows need to be discounted reflecting the time value of the money: for Solvency II risk-free rates, volatility adjustment and significant components of matching adjustment are prescribed by EIOPA, whereas IFRS 17 would allow two options: a bottom-up (allowed only when cash flows do not vary with underlying items) or a top-down approach that reflects the entity-specific features. Conceptually, the top-down is similar to Solvency II through application of the matching adjustment approach. However, the required IFRS 17 criteria to reflect the characteristics of the liabilities and the calibration of the adjustments to risk-free rates might be different.

Furthermore, the risk adjustment is the component that is included to reflect the compensation the insurer requires for bearing uncertainty. In Solvency II, the requirements are highly prescriptive with a cost-of-capital approach, detailing the technique to apply the risk factors included, the calibration adopted, and the level of diversification benefit, while IFRS 17 does not provide a specific method.

Finally the CSM, which under IFRS 17 represents future unearned profits from a contract to be recognized in the income statement over contract duration, eliminates any day 1 gain on the contract by deferring the recognition to future periods: day 1 losses are recognized immediately in profit or loss. There is no comparable technical provisions component in Solvency II balance sheet.

Another element to point out is that IFRS 17 requires a granular evaluation of each insurance contract, allowing companies to aggregate if this

fits the goal, with no possibility of offsetting profit-making and loss-making contracts at initial recognition.

In terms of reporting, Solvency II's figures are based on LoBs, while IFRS 17 will require more granularity, involving potentially greater complexity of accounting, remembering that Solvency II does not have an income statement as required for accounting purposes.

Despite the differences between Solvency II and IFRS 17, the two reporting regimes should communicate on a constant basis for managing corporate business and for an external evaluation by financial analysts and investors, from the risk exposure point of view for Solvency II and from the accounting point of view for IFRS.

In this multifaceted scenario, insurers shall leverage on all synergies between the two frameworks, especially on the common elements such as data input, systems, processes, and valuation of the three main elements in IFRS 17 measurement model (cash flow, discount factor, risk adjustment).

In terms of common data input, a key challenge will be to set up a common database for reporting systems, granting adequate, greater granularity in IFRS 17, than in Solvency II, in order to increase efficiency in data recording and enhance data quality; thus decisions and disclosures will rest upon consistent information.

Common systems and processes for the two frameworks will allow not only to improve efficiency and return on investments but also to amplify the “one reality”, engaging many of the same stakeholders in both IFRS and Pillar 3 reporting.

In terms of resources, Solvency II implementation teams should take part in IFRS 17 projects, facilitating the collaboration of risk, actuarial, finance and accounting departments, while common functionalities for systems and processes should be identified in order to avoid duplications.

Conclusions

The significant requirements posed by Solvency II in terms of capital requirements, system of governance and new reporting standards are hardly impacting on insurance companies which are still busy in a process

of adjustment that shall end up with a real business-as-usual phase. In addition, the not-far-away introduction of new accounting principles is adding a further burden on the shoulders of insurers who are asking for the maximum possible convergence between the two frameworks joining the efforts for common data requirements, IT systems, methodologies, resources, and competences.

The different implementation deadlines for the two regulations can allow sequential transposition of their common aspects in order to ensure consistency and avoid misleading, not fully comparable representations of the insurer's performance and solvency.²⁵

In a context of scarcity of specialized resources for implementing these regulatory projects, with significant investments, mostly completed for Solvency II, now starting for IFRS 17, regarding IT systems, processes and procedures, insurers will have to demonstrate their ability and flexibility to capitalize on past and present efforts and expenses for implementing the new accounting framework.

On the methodology side, the industry expects the maximum possible convergence of the two frameworks, most especially in terms of assessment models in order to facilitate the reconciliation process of figures to be disclosed to markets (rating agencies, financial analysts, investors, regulators, insurers versus insurers). Simplicity is necessary to ensure real understanding of publicly released information on the accounting side and on the regulatory one.

The different metrics and sets of information deriving from the two frameworks might confront not only insurers but also investors and rating agencies with a dilemma: which information is most reliable for a specific purpose?

In field of investments, IFRS 9 asset classification may prompt insurers to select those instruments that can offer more "benefits" than others, while in Solvency II the lack of asset classification in terms of evaluation criteria (fair value is a "must") in conjunction with capital charge for financial risk drives insurers to make decisions on asset allocation²⁶ that cannot be reconciled with accounting suggestions.

In the field of liabilities, the issue arising from differences between IFRS 17 and Solvency II regime will probably not be addressed by IASB and EIOPA in a short time horizon; this will increase complexity for

insurers in terms of flexibility, capacity, performance, data control, and management to support IFRS 17 alongside with Solvency II. In addition, different information given to the market will require further effort in reconciliation and communication.

Pricing will be influenced by the cost of Solvency II risk capital, and, as a consequence, product offering will be revised as well; on the other hand, the new accounting principles may lead to a revised product offering inspired by profit maximization under new accounting rules.

All these new regulatory and accounting requirements are hugely affecting insurers that are engaged in implementation activities to be compliant and, where possible, to gain advantage for business-as-usual in a more regulated and more precisely measured world.

What's Next?

Although it has just come into force, Solvency II already shows the first signs of aging that are also linked to the long gestation period while financial markets and other regulations, such as the banking or the accounting organizations, have been evolving significantly.

The new solvency framework has made a giant leap forward compared with the previous one, requiring from companies substantial implementation efforts which are still under way: the transition to business-as-usual through a target operating model in line with Solvency II has not been completed yet.

Of course, Omnibus II gives each EU member-state local flexibility in implementing some requirements that can be burdensome for companies (consider, for example, the timing for reporting to regulators that will gradually be reduced from 20 weeks to 14 weeks in the next four years).

In terms of capital charge, on the one hand higher capital requirements than in the past are prompting companies to pay more attention to capital management and to explore solutions of aggregations to strengthen the capital structure to cover the risk capital.

On the other hand, the legal framework is the object of potential evolutions that are anyway bound to the banking sector, so that it's not possible to rule out that Solvency II will follow an evolutionary path similar

to Basel II, also in terms of requirements that can be better calibrated over time.

A subject under debate in the banking system is a better representation of the credit risk for EU government bonds which to date, as with Solvency II, does not require specific capital charge for the spread and concentration risks. It is therefore reasonable to assume that, for reasons of homogeneity, similar considerations can be transposed also to the insurance sector: companies had better start considering this scenario.

While in EU member-states regulations for insurers rest upon Solvency II, on a global basis several other policymakers, such as the International Association of Insurance Supervisors, the Financial Stability Board, G-20 and European Commission, are working on a host of other directives and initiatives with a potential impact on the global insurance market to foster harmonization and convergence of international regulations.

On the accounting side, the next awaited step will be, for the liabilities side, the endorsement by EFRAG of the IFRS 17 for which a specific working group has been created with the aim to carefully evaluate the operational implications of the new standard by the insurers.

For assets side, the IASB has to issue a standard on the macro hedge, not covered by IFRS 9: the IASB acknowledged that any solution should consider the information needs of constituents concerning dynamic risk management activities and that its approach should envisage disclosures, recognition and measurement to develop a consistent set of proposals addressing those needs²⁷; the discussion is anyway still ongoing.

The scenario that lies in front of companies is complex, challenging, and evolving because of the connections and parallels with the banking sector and of the interactions with global policymakers.

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Part IV

Scenario Analysis and Market Trends

14

Solvency II: Reasonable Expectations

Karel Van Hulle

Introductory Comments

The introduction of a risk-based solvency capital regime in the European Union (EU) constitutes the most important regulatory reform in insurance since the last 30 years. Although some member states had upgraded their solvency regime since it was introduced in the 1970s, it is fair to say that the impact of the new solvency rules will be considerable in all member states.

The adoption of Solvency II took more time than expected. The implementation was initially planned for 1 November 2012. It was subsequently postponed until 1 January 2014, then to 1 January 2015 and finally to 1 January 2016. The main reason for the postponement was the financial crisis.

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The low-interest-rate environment following from the financial crisis created volatility in the calculation of technical provisions and own funds. This became clear when the results of the last quantitative impact study (QIS 5) were released by the European Insurance and Occupational Pensions Authority (EIOPA)¹ at the beginning of 2011. This volatility had not been foreseen when Solvency II was developed. It made it necessary to provide for special rules reducing the volatility in the case of long-term guarantee products. Furthermore, the low-interest-rate environment put additional strain on insurers that had provided long-term guarantees at interest rates which were well above the new market interest rate. Transitional rules were therefore necessary in order to smooth the transition from Solvency I to Solvency II, as it was believed that insurers should not be blamed for having contracted “unreasonably high guarantees” under a different regulatory framework.

It took about 15 years to develop Solvency II. The idea was to develop a principles-based regulatory regime based upon a framework directive which would be further implemented by the European Commission (EC) and by the national competent authorities in the context of EIOPA (the successor of the Committee of European Insurance and Occupational Pensions Supervisors [CEIOPS²]). This Lamfalussy approach with three levels of regulation³ was subsequently changed through Omnibus II which implemented the regulatory approach introduced by the Lisbon Treaty. As a result, there are now four levels of regulation: the Solvency II Framework Directive,⁴ which was substantially modified by Omnibus II⁵; the Commission Delegated Regulation (Delegated Act)⁶; Commission Implementing Regulations introducing Implementing Technical Standards or laying down technical information developed by EIOPA⁷; and Guidelines from EIOPA.⁸

Furthermore, four Commission Delegated Decisions were adopted, dealing with the equivalence or the provisional equivalence of the solvency regime for insurance and reinsurance undertakings in a number of third countries.⁹

It is fair to say that the regulatory regime that became applicable from 1 January 2016 is complex and that it is difficult to argue that it is still principles based. This is regrettable. An important reason for the added complexity is the lack of trust between member states and between supervisors and industry.

The insurance industry wanted to have clarity about the application of the principles in the Framework Directive so as to be protected in the case of disputes with supervisory authorities. Insurance supervisors from their side favoured more detailed rules so as to avoid needless arguments with insurance undertakings.

Member states wanted to ensure that the new solvency regime would include specific measures that would allow their national insurance industry to continue providing long-term guarantee products under the new low-interest-rate environment. They therefore insisted during the Omnibus II negotiations that the long-term guarantee package would include their national products, that specific rules to that effect would be included in the Solvency II Framework Directive and that no member state would be given a preferential treatment.

And EIOPA finally wanted to have detailed rules in order to promote supervisory convergence and to avoid national gold plating.

Why Do We Need Solvency II?

The reasons for the introduction of a risk-based solvency capital regime can be found in the EC's impact assessment that accompanies the proposal introduced on 10 July 2007.¹⁰

Solvency I as designed in the 1970s is not sufficiently risk based. It mainly deals with underwriting risk and ignores other risks, such as operational risk, market risk, credit risk, liquidity risk as well as the interconnectedness between these risks. This has allowed insurers to live in a dream world with solvency margins that are more generous than justified.

Solvency I does not encourage insurers to better manage their risks. By ignoring a number of important risks, Solvency I does not incentivise insurers to improve their risk management. As a result, life insurers in some member states were able to continue offering long-term guarantees which were well above the new market rates.

Solvency I attached a great deal of importance to the quantitative aspects of supervision. It did not sufficiently focus on the qualitative aspects of supervision. Experience has shown that when insurers fail, it is more often due to a lack of proper management than to a lack of capital.

Solvency I does not include an early warning signal. This made proper supervision difficult. Supervisors did not have the data that would allow them to intervene at an early stage in order to prevent situations from deteriorating further. This must have been a nightmare during the financial crisis. It must have felt like driving at a speed of 150 km an hour on a motorway in complete fog.

Finally, Solvency I does not attach sufficient importance to group supervision. In fact, the authors of Solvency I can hardly be blamed for this. Group supervision is definitely one of the most difficult areas of supervision involving complex legal, political, cultural and economic aspects. As the development of Solvency II has shown, the move from supplementary group supervision to group supervision in its own right only came about with great difficulty.

Objectives of Solvency II

The main objective of Solvency II is the protection of policyholders and beneficiaries. Solvency II should ensure that insurers do not make promises on which they cannot deliver. The protection is not absolute. The agreed confidence level is 99.5% value at risk (VaR) over a one-year time horizon. The EC was criticised during the negotiations of Solvency II for having introduced a confidence level that was considered by some experts as too low (the equivalent of a triple B rating). Later developments have shown that the confidence level is actually not that low, and criticism was voiced against the high capital levels resulting from Solvency II.

There is no magic behind the confidence level adopted by Solvency II. The EC “borrowed” this from Australia, which was one of the first countries in the world to introduce a risk-based solvency regime for the insurance industry.

In an ideal world, the definition of the confidence level should be set in the context of an overall approach towards protection of policyholders. The introduction of a risk-based solvency regime should thus be linked with the introduction of a system of insurance guarantee schemes. The confidence level should then be set at a level that is not so high as to impose an unreasonable capital buffer and that takes account of the additional protection offered by an insurance guarantee scheme.

The protection offered under Solvency II is delivered by linking the capital required with the risks to which an insurer is exposed. By following a total balance sheet approach, the regime ensures that—to the extent possible—all risks (including those that cannot be quantified) are taken into account.

After the financial crisis, the EC's proposal was amended to include a second objective, that is, financial stability. A new Article 28 was added to the Solvency II Framework Directive, which states:

Without prejudice to the main objective of supervision as set out in Article 27, Member States shall ensure that, in the exercise of their general duties, supervisory authorities shall duly consider the potential impact of their decisions on the stability of the financial systems concerned in the European Union, in particular in emergency situations, taking into account the information available at the relevant time.

In times of exceptional movements in financial markets, supervisory authorities shall take into account the potential pro-cyclical effects of their actions.

Although financial stability is another objective of Solvency II, this objective should not undermine the main objective, which remains policyholder protection. In most instances, policyholder protection and financial stability go hand in hand.

There are however cases whereby regulators or supervisors in the EU have imposed or recommended actions which were aiming at ensuring financial stability, thereby limiting the rights of policyholders. Examples are the imposition by the legislator of a specific reserve to compensate for the low-interest-rate environment (Germany) or the recommendation by the supervisory authority to reserve part of the profits (and thereby limiting dividends to shareholders and profit participation by policyholders) in order to deal with the consequences of the low-interest-rate environment (Belgium). In both cases, the short-term benefits of policyholders were subordinated to the long-term sustainability of the undertaking and the confidence in the market (financial stability).

Another tool that has been used by legislators in a number of countries for financial stability purposes was the reduction of the maximum guaranteed interest rate (for future business). It should be observed that

supervisory authorities in the EU usually cannot undertake actions aimed at reducing policyholders' benefits or reducing maximum guarantees for existing business, which would affect policyholders in a negative way. This would be contrary to the objective of policyholder protection. Nothing prevents however the legislator from doing so for financial stability purposes. Supervisory authorities can of course as part of the supervisory review process recommend individual insurance undertakings to take action so as to be in a better position to survive in a low-interest-rate environment. Such action could include profit reserving.¹¹

Deepening the single market is also an important objective of Solvency II. This objective is ensured by introducing uniform rules, by reducing member state options and by preventing gold plating by member states and national supervisory authorities through the introduction of a Single European Rulebook. An important consequence of Solvency II is that for the first time in European history, insurers and insurance supervisors will be able to discuss common issues, using the same terminology and following the same approach. This should ultimately further cross-border business and improve supervisory cooperation.

Solvency II should also improve the (international) competitiveness of EU insurers. As the amount of capital needed under Solvency II is linked to the quality of risk management, insurers are able to run their business with the optimal amount of capital. They may even use an internal model approved by the supervisor to calculate the capital buffer. Efficient allocation of capital is important as capital is expensive, and it would not be justified to block too much capital by imposing a capital buffer that does not reflect the true risk position of the insurer.

It is within that logic that the EC also proposed the introduction of a regime of group support which would have allowed a parent undertaking to replace the capital of a subsidiary by a promise to deliver that capital when needed. This proposal was not retained in the Solvency II Framework Directive because of the opposition by a blocking minority of host member states (i.e. member states that do not have headquarters of insurance groups) in the Council. The European Parliament (EP) had supported the EC in this economic approach to group supervision. In accordance with Article 242 (2) of the Solvency II Framework Directive, this issue will be reviewed by 2018 when the EC must deliver an assessment

of “*the benefit of enhancing group supervision and capital management within a group of insurance or reinsurance undertakings including a reference to COM (2008) 0119 and the report of the Committee on Economic and Monetary Affairs of the European Parliament on this proposal of 16 October 2008 (A6-0413/2008)*”.

The insistence on an improvement of the (international) competitiveness of EU insurers was criticised by the banking industry, which felt that it was being discriminated (no full internal models, no group support),¹² and by the United States which believed that the EU was introducing a regime that was considered too liberal.¹³

Finally, an important objective of Solvency II was also better regulation. As part of better regulation, all stakeholders were consulted at all stages in the process. The consultation was so intense that it became difficult for people to respond to the consultations in time as they could no longer read all the consultation papers that were published by the EC or by CEIOPS/EIOPA. The Commission services also invited a sample of small and medium-sized insurers to Brussels to explain to them their concerns and worries about the new solvency regime. This resulted in the introduction of the proportionality principle which required that all measures used under Solvency II must take account of the size, the nature and the complexity of an insurance undertaking. This applies not only to all regulatory measures (at each level) but also to the measures taken by supervisory authorities.

Better regulation was also furthered by a thorough impact assessment and by a principles-based approach: more than 1000 pages of advice from CEIOPS were reduced to 60 articles in the Solvency II Framework Directive. As indicated above, this approach was changed during the negotiation of the final package that now constitutes Solvency II, which now comprises well over 2000 pages.

If I Had a Dream?

Solvency II is not just about capital. It follows the three-pillar approach of Basel II. The three pillars are of equal importance and they are interlinked. Pillar 1 deals with the quantitative aspects of the solvency

regime, including the capital requirements, the requirements on own funds and the valuation rules for assets and liabilities in the solvency balance sheet; Pillar 2 contains the qualitative requirements, including the requirements on governance, on risk management and on the supervisory review process; Pillar 3 deals with public disclosure and supervisory reporting.

This approach can be represented as follows (Fig. 14.1):

If Solvency II were to be applied as intended:

- Risk management would play a central part in decision-making at all levels, based upon an Own Risk and Solvency Assessment (ORSA) carried out regularly ensuring that an insurance undertaking does not engage in activities for which it does not have the right level of capital;
- Insurers would be fully aware of the linkage between risk and capital and would only offer products on which they can deliver;

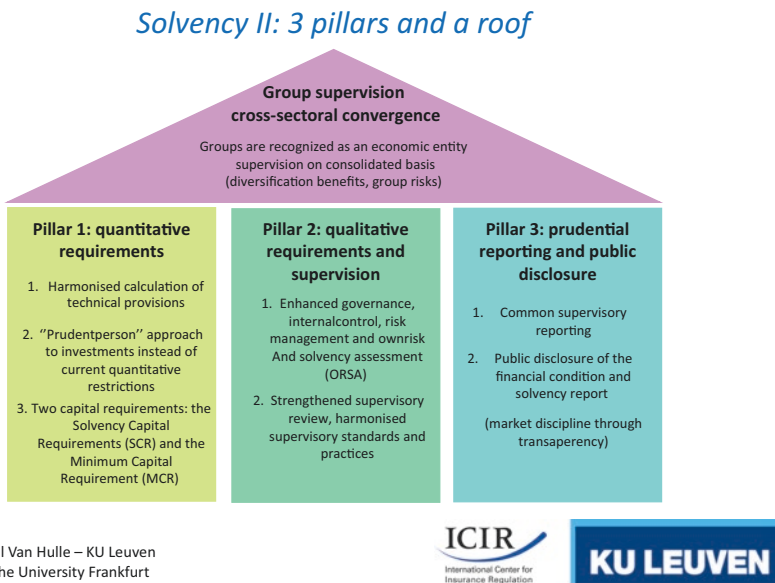


Fig. 14.1 The three-pillar approach of Solvency II

- Insurers would not stop insuring but would be creative in the production of new products because they fully understand the risks associated with these products;
- Insurance groups would be managed as groups and the national competent authorities responsible for the different parts of the group would cooperate in full transparency with the group supervisor in the college of supervisors so that groups are effectively supervised as a group;
- Insurers entertain an open dialogue with their supervisory authority, and supervisory authorities would be truly interested in the insurance undertaking which they supervise so that problems can be resolved before they arise and that insurers look at their supervisory authority as their friend;
- Insurers and their supervisory authorities follow a principle-based approach, look at the substance rather than at the letter of the regulation and do not fall into the trap of a tick-the-box approach;
- Third-country insurers would be jealous about the sophistication of Solvency II and would urge their supervisory authority to adopt a similar approach.

Lessons Learnt from the Past

Unfortunately, paradise is not of this world. It is not evident to translate good intentions into daily practice. Before trying to assess what one can reasonably expect in terms of the implementation of Solvency II, it is important to look back at the origins of Solvency II and the negotiation process.

It may be important to remember that all stakeholders were quite happy with the Solvency II proposal presented by the EC in July 2007. All member states were in favour of the new solvency regime. The insurance industry was enthusiastic. Consumer organisations were pleased to see a reform that was long overdue. Equally so, supervisors were very happy that they would at last be able to obtain relevant and comparable data and that they would receive the necessary supervisory tools.

Much enthusiasm was expressed for the EC's proposal on group supervision. The introduction of group support was considered the perfect translation of how groups were managing their capital in practice. This proposal did not however survive the negotiations. A lack of trust between national competent authorities made it difficult to introduce group support. If a European authority had been put in charge, the situation might have been different. The idea that a group supervisor could take decisions that could have a real impact in another member state was clearly a bridge too far. Similarly, it was difficult for some member states to accept that sub-group supervision was no longer necessary. The compromise which was finally achieved differed very much from the economic approach proposed by the EC in its initial proposal. Many issues remain to be resolved before such an approach will become possible. In accordance with Article 242 (2) of the Solvency II Framework Directive, the EC is expected to present a report by 31 December 2018 which should assess possible measures to enhance a sound cross-border management of insurance groups, notably of risks and asset management, which should take into account new developments and progress in the following areas:

- A harmonised framework on early intervention;
- Practices in centralised group risk management and functioning of group internal models, including stress testing;
- Intra-group transactions and risk concentrations;
- The behaviour of diversification and concentration effects over time;
- A legally binding framework for the mediation of supervisory disputes;
- A harmonised framework on asset transferability, insolvency and winding-up procedures which eliminates the relevant national company or corporate law barriers to asset transferability;
- An equivalent level of protection of policyholders and beneficiaries of the undertakings of the same group particularly in crisis situations;
- A harmonised and adequately funded EU-wide solution for insurance guarantee schemes;
- A harmonised and legally binding framework between competent authorities, central banks and ministries of finance concerning crisis management, resolution and fiscal burden-sharing which aligns supervisory powers with fiscal responsibilities.

Although some progress has meanwhile been achieved in some of these areas, the long list of issues to be considered already shows that it is not very likely that major changes will be possible in the near future.

Capital charges were another major bone of contention. The calibration of the risks in the standard formula has been the subject of a lot of debate. It is based upon extensive work carried out by CEIOPS/EIOPA under difficult conditions as no detailed data were often available for all member states. A lot of pressure was exercised on the EC to change (i.e. to lower) the calibration proposed by CEIOPS/EIOPA. This was already the case in the context of QIS 5, and it has continued afterwards when the EC was preparing the Delegated Regulation. It should be remembered that the calibration in the standard formula had always been mentioned as an important example why the Solvency II Framework Directive should remain principles based: it should be possible to amend the calibration in the standard formula based upon experience and to do so in a manner which would not imply a full renegotiation of the Directive. This is the reason why the details are included in a Delegated Act which the EC can amend. A first amendment has already taken place for certain investments in infrastructure projects as part of the Capital Markets Union Action Plan.¹⁴ This amendment became applicable as of 2 April 2016. In Recital 150 preceding the Omnibus II Directive, the EC is asked to review the methods, assumptions and standard perimeters used when calculating the SCR with the standard formula before December 2018, “*using the experience gained by insurance and reinsurance undertakings during the transitional period and the first year of application of these delegated acts*”. The review will be based upon work carried out by EIOPA, which has included such a review in its work programme.

The philosophy underlying Solvency II is rather simple. However, the negotiation showed that it takes sometimes many words to express simple ideas in regulation. The complexity of the regime has increased tremendously, and it is fair to say that it will not be possible to ensure full compliance with all the details of the new regime. That may indeed not even be necessary. It is important to concentrate on the principles. As indicated before, the complexity results from a combination of factors. It is important to give full recognition to the principle of proportionality. The intention cannot be to unnecessarily overburden the insurance industry with rules and regulations where they are not strictly necessary.

It took a long time to negotiate Omnibus II. Nobody could have predicted this. It was an ugly negotiation which showed a revival of nationalism and a power struggle between the European institutions. At the end of 2012, few people still believed that Solvency II would ever see the light of the day. EIOPA became so worried that it adopted a number of preparatory guidelines which sent a strong message to its members that they—and the insurance industry which they supervised—needed to continue their preparation for Solvency II. The long-term guarantees package adopted under Omnibus II adds enormous complexity to the regime. Although one can understand the nervousness of the insurance industry, which was required to adopt a risk-based solvency regime under economic circumstances (low-interest-rate environment with resulting volatility in the markets) that were disastrous for the insurance business model, it is doubtful whether the many compromises included in the text send the right message: it is no longer possible to continue the old business model because the world has changed. This is not the result of Solvency II but of changes in macro-economic and monetary policy. Life would be great if one could ignore market risk!

The Rapporteur of Omnibus II, Burkhard Balz, admitted that as a result of the financial crisis a more comprehensive adaptation of the Solvency II Framework Directive became unavoidable. He believes that *“the move away from a principles based approach towards a more rules based approach is likely to increase the legal certainty for the requirements set in the basic legislation. This should help to enhance the democratic accountability and provides a clearer guidance to the Commission for the work on the technical specifications”*.¹⁵ This trend towards a more rules-based system is present also in other financial services legislation, for instance, in the banking regulation.

There is no doubt that the delays in the adoption of Solvency II have had a very negative impact on the perception of the new regime. People who had been ardent supporters of Solvency II from the very beginning suddenly became strong opponents. A lack of clear direction from the political authorities was partly responsible for this. In the end, nobody knew anymore whether the EC, the Council or the EP really wanted Solvency II. Without the leadership shown by EIOPA, it is uncertain whether Solvency II would ever have been adopted.

What Can We Reasonably Expect?

Let us first look at some issues that are likely to happen from a negative point of view; that is, it would be nice if they would not happen.

Not all member states will be ready in time with the transposition of Solvency II into national law. Implementation had to take place by 31 April 2015. It is unclear whether even after the entry into force of the new regime on 1 January 2016 there are still member states that have not yet implemented the Solvency II Framework Directive and/or Omnibus II. The last information published by the EC in a press release dated 10 December 2015 referred to Cyprus which had not yet implemented Solvency II at that time. An earlier EC press release on 19 November 2015 mentioned five other member states that had at that time not yet implemented Solvency II: Bulgaria, Greece, Luxemburg, Slovenia and Sweden. It is interesting that the EC's press release of 19 November 2015 did not include either Cyprus, which clearly had not implemented Solvency II by that time, or Belgium, which only implemented Solvency II on 13 March 2016.¹⁶ There is no further information published by the EC on the state of implementation of Solvency II since the last press release of 19 November 2015.

It is not unlikely that several member states will have added supplementary rules to the Solvency II package. This can be done directly by national law or indirectly by the supervisory authorities. It is very difficult to rule out this "gold plating" practice. It is therefore important that the implementation at national level is carefully monitored.

In terms of the implementing legislation, this is first of all a role for the EC. The EC must see to it that member states have correctly transposed Solvency II and that they have not re-nationalised rules, which were meant to be uniform. For the EC, this will not be an easy exercise as many member states have used the transposition of Solvency II to fundamentally rewrite their national insurance legislation. It would be interesting to hear from the EC how it intends to deal with this and which measures will be taken to check the transposition by member states.

In terms of supervisory action, EIOPA must see to it that national competent authorities have not overstepped their mark and that they

respect the supervisory guidance which they have agreed. It is important to remember that EIOPA has received specific powers in cases of breaches of EU law by national competent authorities.¹⁷

However, it is also important that the industry comes forward when it sees areas where member states or national competent authorities have added an additional burden to an already complex regime. In a press release dated 15 December 2015, Insurance Europe referred to a survey carried out in November 2015, covering companies that account for 92% of European insurance premiums, which showed that over two-thirds of respondents (68%) indicated that Solvency II had been gold-plated in their market “as supervisors impose additional last minute requirements”. Reference was also made to an increase in “conservative interpretation” of the Solvency II rules by supervisors. It is difficult to interpret these comments without specific examples. One could easily qualify as “conservative” any interpretation which one does not like. Nevertheless, industry should be encouraged to closely monitor the implementation of Solvency II both in law and in practice.

In the end, all stakeholders have an interest in ensuring that the Solvency II reform is carried out as intended. If the new regime is adding too much “bureaucracy”, consumers will pay for it through higher premiums or through the disappearance of insurance products. This cannot be the intention. The Insurance and Reinsurance Stakeholder Group which has been set up by the EIOPA Regulation¹⁸ should therefore assist in monitoring the practical implementation of Solvency II.

There is a risk that political authorities and the insurance industry will exercise pressure for rapid change of the new solvency regime.

Recital 60 in the Preamble to Omnibus II states the following concerning the review of Solvency II: “*In order to ensure that the Union’s objective of long-term sustainable growth and the objectives of Directive 2009/138/EC of primarily protecting policyholders and also ensuring financial stability, continue to be met, the Commission should review the appropriateness of the methods, assumptions and standard parameters used when calculating the standard formula for the SCR within five years of the application of Directive 2009/138/EC*”.

Not even one year later, Recital 60 in the Preamble to the EC’s Delegated Regulation states that the review of the standard formula

should take place before December 2018, that is, *two years* after the application of Solvency II. The EC justifies this early review by referring to “*the experience gained by insurance and reinsurance undertakings during the transitional period and the first years of application of these delegated acts*”.

On 18 July 2016, the EC sent a formal request to EIOPA for technical advice on possible amendments of the implementing measures of Solvency II.¹⁹ The request takes into account the feedback received by the EC on its call for evidence on the EU regulatory framework for financial services, launched on 30 September 2015. The areas which EIOPA should look into and on which it is asked to report back to the EC by 31 October 2017 include: proportionate and simplified application of the requirements, removal of unintended technical inconsistencies and removal of unjustified constraints to financing. The EC lists a series of specific issues which EIOPA has to look at for the first two areas. As for unjustified constraints to financing, the EC is still in the process of conducting an in-depth assessment of investment classes that merit further investigation. The idea is to identify those investments which create growth and jobs and that offer sufficient transparency and credit quality to justify a lower calibration in the standard formula. The EC might request EIOPA’s technical support for this at a later stage.

As indicated before, the first amendment of the Delegated Regulation already took place on 2 April 2016. There are always good reasons to have a second go at a legal text. Even though one cannot possibly argue that Solvency II has not been properly prepared and consulted about, there are always new developments which make people look differently at what has been agreed. In a low-interest-rate environment, insurers have difficulties in finding good investment opportunities. On the other hand, governments are interested in finding institutional investors who are prepared to invest in infrastructure projects particularly at times when interest rates are low and economic growth must be stimulated. The amendment of the Delegated Regulation therefore introduces a new investment category “qualifying infrastructure investments” with an adapted calibration. Following the advice from EIOPA,²⁰ using this investment category requires insurers to apply specific risk management measures. Although this makes the standard formula more complicated, a more granular approach can certainly be justified if the risks are properly calculated.

However, there is a risk of “regulatory capture”. Quick changes in a carefully prepared legislative reform are rarely contributing to the consistency of the regime. Although the changes are based upon advice delivered by EIOPA, one can read between the lines that EIOPA is not exactly “excited” about the pressure under which it has to operate in providing this advice to the political masters.²¹ Experience from the past should urge us to be prudent. One cannot induce insurers to become “imprudent” in their investments, to the detriment of policyholders. There is a fine line here that should not be crossed.

There is no doubt that the calibration of the risks in the standard formula can be improved. This should however be based on careful examination and experience gathered with the application of Solvency II. Without proper data, no serious work is possible. Furthermore, it is important to ensure stability so as to allow insurers to conform with the new regulatory regime.

A regular dialogue between the supervisory authority and the supervised entity is a key feature of Solvency II. A dialogue is by definition interactive and should not be a combination of two monologues. The dialogue should be based on a relationship of trust between the supervisory authority and the supervised entity. This is very different from Solvency I. Both parties will have to learn to communicate with each other and do so in full transparency. It would be an illusion for supervisory authorities to believe that the new regulatory regime can be applied in practice without an intense dialogue with the supervised entities. One of the essential innovations brought about by Solvency II is the large amount of freedom attributed to insurance undertakings. It is their responsibility to organise their risk management, to decide on their investment strategy and to ensure that their capital position reflects their true risk position. It is no longer for the supervisory authority to dictate everything. As a result, both sides need to talk to each other. That will not come about easily, as this is new: insurers will have to get used to talk to their supervisor and supervisors will have to learn to understand business reality. This will no doubt not happen from day one.

Compliance with the new (complex) regulatory regime should not be considered more important than innovation. The insurance industry needs to be more responsive to the demand of consumers. Solvency II

allows them to do so because of the greater amount of freedom which they will enjoy under the new regime. New products should emerge and should replace old products which no longer serve a useful purpose or whose risks have not been properly calculated in the past. Supervisory authorities should encourage insurers to use this opportunity and not burden them with compliance exercises: substance over form should be the guiding principle.

Here again, it would be an illusion to believe that things will change from day one. There will still be control exercises carried out by supervisory authorities which will make insurers go back to a tick-the-box exercise. Similarly, insurers might be inclined to formally comply with the rules without looking at the rationale behind the rules.

It is also important that sufficient recognition is given to the application in practice of the proportionality principle.

Some Achievements Already Made

Let us now look at some positive developments.

One of the advantages of the long negotiation of Solvency II is that both insurers and supervisory authorities have had ample time to prepare themselves for the reform. Of course, it is unfortunate that many detailed provisions—for instance the reporting templates—were only finalised at the very last moment, which must definitely have created practical problems for many insurers. However, the success of the reform will to a large extent depend on compliance with the new philosophy, that is, the introduction of a risk-based solvency regime which links capital requirements with the risks to which insurers are exposed.

A key element in a risk-based solvency capital regime is risk management. Solvency II deals extensively with risk management in the Pillar 2 requirements. There is no doubt that the quality of risk management in the insurance industry has improved a lot in the past years mainly as a result of the preparation for Solvency II and the intense collaboration between insurance undertakings and insurance supervisors during the quantitative impact studies in which a large part of the industry has participated.

Similarly, there has been a serious increase in professionalism in the discussions between supervisors and insurance undertakings. The preparatory guidelines issued by EIOPA in 2013 have contributed a lot in clarifying what is expected from both sides in terms of implementing the new solvency regime. Particularly, the Own Risk and Solvency Assessment report (called Forward-Looking Assessment of Own Risks under the preparatory guidelines) has been instrumental in this respect.

Although the reporting requirements are no doubt burdensome, the advantage of having detailed and comparable data about the insurance industry at regular intervals cannot be overestimated. It will be the first time in European history that relevant data on the European insurance industry will become readily available. Supervisors will already dispose of detailed information during the course of 2016. The public at large will see the first Solvency II data from 2017 onwards. Many (large) insurance undertakings are already coming forward with data in 2016 because they are publicly listed or because the market expects them to release relevant data about their solvency position. Markets will have to learn to understand these data and to put them into the right context. A comparison between the solvency margins under Solvency I and the Solvency Capital Requirement (SCR) under Solvency II is not possible. Insurance undertakings will have to explain this in terms that can be easily understood, which is not evident.

Supervisory reporting is crucial for national competent authorities. They will need the data in order to see to what extent insurers and reinsurers have complied with the new requirements. Public disclosure is important not only from a policy holder protection perspective but also for market discipline. Much of the information will be centralised by EIOPA. The wealth of data that will become available should for the first time allow academics to carry out research using real market data.

As a result of Solvency II, insurance and insurance supervision and regulation will be taken more seriously. This is and will always be a challenge. Insurance is complex and few people from outside the insurance industry understand the insurance business model. In many member states, the insurance industry is now supervised by central banks. The introduction of a risk-based solvency capital regime makes it easier to compare the supervisory approach for banking and insurance. Banking

supervisors will see that insurance regulation is now at least as sophisticated as banking regulation. That should ultimately be beneficial for the insurance sector.

Although group support did not survive the negotiations, the provisions on group supervision in the Framework Directive will still have an important impact in practice. Colleges of supervisors are now in place in all 108 European cross-border groups. The dialogue between the group supervisor and the other national competent authorities represented in the college will considerably improve now that all parties around the table will use the same solvency framework. The representation of EIOPA in each college will further contribute to the development of a single European rulebook.

Essential Role for EIOPA

Through Omnibus II, the powers of EIOPA have been considerably strengthened. In terms of Solvency II, EIOPA's actions in the coming years will now focus on supervision rather than on regulation.

As indicated before, EIOPA's interventions in the regulatory debate were very important: although EIOPA did not sit at the negotiation table, it was consulted at each step in the process and was invited to deliver its expert opinion whenever the co-legislators could no longer agree on a way forward. This was particularly the case in the context of Omnibus II where it was to large extent EIOPA's expert opinion through an assessment of the long-term guarantees package that made the ultimate compromise between the co-legislators possible. EIOPA also delivered the draft text for 17 Commission Implementing Regulations as well as the final text for the 29 Guidelines.

Supervisory convergence is a key priority in EIOPA's work programme for the coming years.²² Supervisory convergence is important because it helps to achieve three fundamental objectives:

- Ensure the application of EU regulation;
- Guarantee a level-playing field and prevent regulatory arbitrage in the internal market;

- Safeguard a similar level of protection to all policyholders and beneficiaries in the EU.

The ultimate goal is to bring about a European supervisory culture, described as a risk-based culture that:

- aims to ensure strong but fair supervision;
- is based on a forward-looking approach to risks;
- prioritises the dialogue with market participants to better understand their business models, strategies and underlying risks;
- promotes early-enough awareness and supervisory action in order to protect policyholders and mitigate possible disruptions in the market.

In order to bring about this European supervisory culture, EIOPA is developing a Supervisory Handbook that should assist national competent authorities in their supervisory task.

Considering the current differences in supervisory culture and practice, the development of a common European supervisory culture is quite a challenge.

In order to make this a success, four messages are important:

- Supervisory convergence should not lead to maximum harmonisation, that is, the highest common denominator, and should respect the European motto: unity in diversity;
- Supervisory convergence should concentrate on substance and not on form;
- Supervisory convergence should promote best practice and not lead to the development of new rules and procedures;
- Supervisory convergence should be realistic and proceed gradually (“*festina lente*”²³).

Concluding Observations

Because of the low-interest-rate environment, not all insurance undertakings will be able to meet their solvency requirements in 2016.²⁴ This became already apparent from EIOPA’s 2014 stress test.²⁵ For some of

these undertakings, the transitional measures will provide a solution.²⁶ For other undertakings, run-off might be the only way out, if they cannot find more capital or link up with another undertaking. In order to provide an appropriate solution for insurance undertakings that have become insolvent, it is important for the EU to develop a suitable framework for recovery and resolution in the insurance sector, as has already been done in the banking sector. Run-off will become more common in member states. This procedure will by itself create new business for undertakings that want to take over a run-off portfolio or undertakings that have been put into run-off.

Monitoring of Solvency II implementation and application is crucial and should be organised. It would be helpful if both the EC and EIOPA would regularly report on the state of play in member states. The Insurance and Reinsurance Stakeholder Group can assist EIOPA in carrying out its monitoring task.

Now that the regulatory framework for banks and insurance undertakings has been finalised, consideration should be given to look for commonalities in insurance and banking regulation and supervision. Both sectors can learn from each other's experience, and there is no obvious reason why the same issues should be regulated differently.

Regulatory stability must be a key objective after more than ten years intense work in delivering Solvency II. It cannot be in the interest of all parties concerned to continuously amend the Delegated Regulation. The official revision of the Delegated Regulation is foreseen for 2018. This should be properly prepared and EIOPA has been asked to develop some ideas in this respect, at the request of the EC.²⁷

It is too early to assess the impact of Solvency II. Although the insurance industry was asked to respond to the EC's Call for Evidence on the EU regulatory framework for financial services, dated 30 September 2015, it is obvious that the comments gathered at this stage (the call was closed on 31 January 2016) can only be of limited relevance for a review of the Solvency II Framework Directive, whose official review is planned for 2020.

A distinction must indeed be made between the Solvency II Framework Directive and its implementing measures. It was always the intention to make the new solvency regime flexible. This means that the implementing measures should be amended when experience shows that they can

be improved. As for the Framework Directive, this is more challenging: amending the basic principles of Solvency II should only be done after very careful examination. The low-interest-rate environment raises a number of tricky questions concerning the market-consistent valuation of insurance liabilities. A satisfactory answer to these questions is not evident, and any amendment in this area should be thoroughly prepared and tested.

Notes

1. European Insurance and Occupational Pensions Authority.
2. Committee of European Insurance and Occupational Pensions Supervisors.
3. See, Final Report of the Committee of wise men on the regulation of European securities markets, Brussels, 15 February 2001, p. 117.
4. Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (recast), *OJ L* 335, 17.12.2009, p. 1. For a coordinated version of the Directive, including all subsequent amendments and for all implementing measures and the EIOPA Guidelines, see Lowet, L., European Solvency II law, *Knopsbooks*, Antwerp, 2016, 937 p.
5. Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No. 1060/2009, (EU) No. 1094/2010 and (EU) No. 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority), *OJ L* 12, 17.1.2015, p. 1.
6. Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), *OJ L* 12, 17.1.2015, p. 1, amended by Commission Delegated Regulation of 30 September 2015 amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets

held by insurance and reinsurance undertakings, *OJ* L 85, 1.4.2016, p. 6.

7. 23 Commission Implementing Regulations on Solvency II have so far been adopted.
8. 29 Guidelines on Solvency II have been issued so far by EIOPA.
9. Commission Delegated Decision (EU) 2015/1602 of 5 June 2015 on the equivalence of the solvency and prudential regime for insurance and reinsurance undertakings in force in Switzerland based on Articles 172(2), 227(4) and 260(3) of Directive 2009/138/EC of the European Parliament and of the Council, *OJ* L248, 24.9.2015, p. 95; Commission Delegated Decision (EU) 2015/2290 of 12 June 2015 on the provisional equivalence of the solvency regimes in force in Australia, Bermuda, Brazil, Canada, Mexico and the United States and applicable to insurance and reinsurance undertakings with head offices in those countries, *OJ* L323, 9.12.2015, p. 22; Commission Delegated Decision (EU) 2016/309 of 26 November 2015 on the equivalence of the supervisory regime for insurance and reinsurance undertakings in force in Bermuda to the regime laid down in Directive 2009/138/EC of the European Parliament and of the Council and amending Commission Delegated Decision (EU) 2015/2290, *OJ* L58, 4.3.2016, p. 58; Commission Delegated Decision (EU) 2016/310 of 26 November 2015 on the equivalence of the solvency regime for insurance and reinsurance undertakings in force in Japan to the regime laid down in Directive 2009/138/EC of the European Parliament and of the Council, *OJ* L58, 4.3.2016, p. 55.
10. The impact assessment as well as all other official documents referred to in this contribution can be found on the website of the European Commission: http://ec.europa.eu/finance/insurance/solvency/index_en.htm
11. See, for instance, Recommendation 1 addressed by EIOPA to national competent authorities after the 2016 Insurance Stress Test, “EIOPA’s Insurance Stress Test 2016: Recommendations”, EIOPA 16/297, 15 December 2016, p. 3.
12. See, for instance, European Banking Federation: *Review of the Lamfalussy Process: A success to be further improved*, Press Release, Brussels, 3 December 2007.
13. See, for instance, Zolkos, R., The song of solvency, *Business Insurance*, 16 September 2007, p. 2.

14. Commission Delegated Regulation (EU) 2016/467 of 30 September 2015 amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings, *OJ L* 85, 1.4.2016, p. 6.
15. Balz, B., Lessons learnt from Solvency II more rules than principles, in *Eurofi Newsletter*, 2014, March 31–April 1, p. 20.
16. Law of 13 March 2016 on the status and the supervision of insurance and reinsurance undertakings, *Moniteur belge, first edition*, 23 March 2016, p. 204.
17. Article 17 of Regulation (EU) No. 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/79/EC, *OJ L* 331, 15.12.2010, p. 48.
18. Article 37 of Regulation (EU) No. 1094/2010.
19. The letter to EIOPA including an attachment with specific requests for advice is published on the EC's website referred to under endnote 10.
20. EIOPA, Final Report on Consultation Paper No. 15/004 on the Call for Advice from the EC on the identification and calibration of infrastructure investment risk categories, *EIOPA-BoS-15-223*, 29 September 2015, 194 p.
21. See for instance, Bernardino, G., Infrastructure projects—Improved data is needed to support the reassessment of risk, in *Eurofi Newsletter*, 2014, March 31–April 1, p. 13 and Montalvo, C., The (re-)calibration dilemma, in *Eurofi Newsletter*, 2014, March 31–April 1, p. 21.
22. Bernardino, G., *EIOPA and supervisory convergence—The beginning of a new journey*, Speech delivered at the 5th Annual Conference of EIOPA in Frankfurt on 18 November 2015.
23. “Hurry slowly”.
24. This was confirmed in the last stress test carried out by EIOPA: 2016 EIOPA Insurance Stress Test Report, EIOPA 16/302, 15 December 2016, 74 p.
25. EIOPA, 2014 EIOPA Insurance Stress Test Report, EIOPA-BoS-14-203, 28 November 2014, 244 p.
26. EIOPA, Report on long-term guarantees measures and measures on equity risk 2016, EIOPA BoS-16/279, 16 December 2016, p. 145.
27. EIOPA, Discussion Paper on the review of specific items in the Solvency II Delegated Regulation, EIOPA-CP-16/008, 5 December 2016, p. 118.

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15

Why Insurance Regulation Is Crucial for Long-Term Investment and Economic Growth

Dario Focarelli

Insurance and Economic Growth

There is a broad consensus in economic literature on the positive correlation between financial development and economic growth (see among others King and Levine 1993; Levine and Zervos 1998). In particular, a causal nexus running from financial development to economic growth has been highlighted by Rajan and Zingales (1998). More recently, however, Cecchetti and Kharroubi (2012) have argued, on the basis of a sample of advanced and emerging economies, that the level of financial development is a positive factor only up to a certain point, beyond which it actually becomes an obstacle to growth.

The literature on the relationship between insurance development and growth is less extensive. In general, the insurance sector tends to be larger in mature economies, but there is no clear, unidirectional causation (ESRB 2015). There is ample evidence that the ratio of insurance

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premiums to GDP and per capita premium payments are higher in the affluent countries (see, most recently, Outreville 2013). In fact, these economies show a premium/GDP ratio ten times as high as the other economies and per capita premium payments a hundred times as large as those in poor countries.

Recent works have made some advances in seeking to establish the causal nexus between insurance and economic growth. Ward and Zurbruegg (2000) study the correlation between GDP and the growth of the insurance industry in nine OECD countries (Australia, Austria, Canada, France, Italy, Japan, Switzerland, the UK and the USA), concluding that insurance is a cause (as defined by Granger) of GDP only in some countries (of which Italy is one). Arena (2008) maintains that both life and non-life insurance have a positive causal impact on economic growth. But while for life insurance this result obtains only in the developed countries, for non-life insurance the relationship holds for both high-income and developing countries.

As regards life insurance, Lee et al. (2013) show evidence consistent with the hypothesis of co-integration of GDP and life premiums. They find that a 10% increase in life insurance premiums in real terms is correlated with real GDP growth of 0.6%.

Apart from the empirical evidence, there is a broad consensus that insurance contributes significantly to economic growth and development in a variety of ways:

- It facilitates economic transactions thanks to risk transfer and indemnification.
- It encourages risk management and the promotion of safe practices.
- It encourages stable and sustainable saving and pension provisions.
- It promotes financial stability through long-term investment.

This chapter focuses on the very last point, namely the role of insurers as providers of funds for long-term investment in the real economy, with an examination of the European market. The thesis is that financial regulation, and prudential insurance regulation in particular, crucially affects insurers' investment behaviour and therefore their contribution to financial stability and economic growth, which for many reasons will

hopefully be increasing in the near future. Accordingly, careful assessment of the effects of Solvency II on the insurance industry is required, bearing in mind the regulatory reviews planned for 2018 and 2020.

More specifically, the second section of this chapter details the size and composition of European insurance investment, the short-term outlook and the allocational choices that insurers are called on to make, in a period marked by the intention of European policy makers to increase the flow of long-term investment. The third section reviews the literature to determine whether insurance companies' investment helps to foster financial market stability and hence economic growth. The fourth section covers the effects of accounting standards and supervisory rules on insurers' asset allocation, with special reference to investment in equities. In conclusion, I propose some considerations relating to the revisions of the Solvency II prudential regime that went into force in January after 15 years of discussion and negotiation.

The Magnitude of Insurance Investment and Its Potential to Foster Economic Growth in Europe

Insurance companies are the largest institutional investors in the European economy, with €10 trillion worth of assets under management (see Fig. 15.1) ("Key Facts", Insurance Europe 2015).

Investment Portfolio of European Insurers

The investment portfolio of EU insurers is equivalent to around 60% of the Union's GDP and accounts for over half of all institutional investment in Europe, including 24% of government debt and 21% of corporate bonds, not mention a vast array of other investments across the continent. The largest component in insurers' investment portfolio is bonds (52.4%); the other main asset classes are shares and equity participations (16.3%), loans and mortgages (13.6%), and investment funds (13%) (see Fig. 15.2).

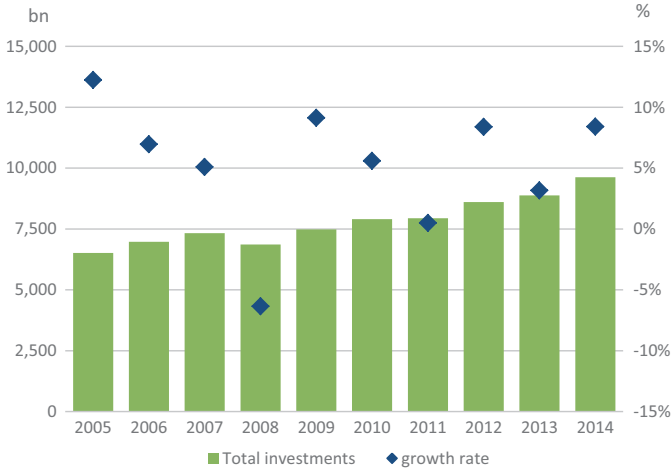


Fig. 15.1 Evolution of insurers' investment portfolio (at constant exchange rates)—2005–2014 (€ bn). Source: Author's calculations on Insurance Europe data, European insurance industry database

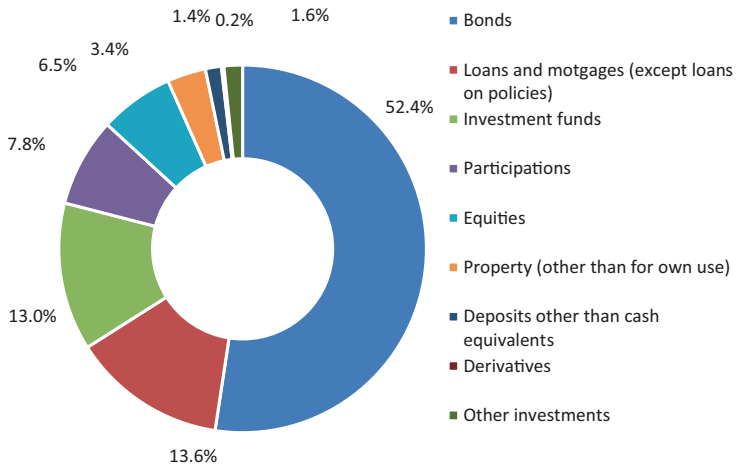


Fig. 15.2 Breakdown of insurers' investment portfolio—2013. Source: Author's calculations on Insurance Europe data

However, according to ESRB (2015) the non-financial sector (households and non-financial corporations) represents a marginal portion of insurers' total assets (7%) (see Fig. 15.3).

Over the past ten years, the volume of investment has grown by around 50%, notwithstanding the financial crisis. More important, since the crisis insurers' assets have grown steadily, filling some of the vacuum left by deleveraging banks (ESRB 2015).

Maintaining the flow of premium income is crucial for insurance companies' investment capacity. Premium growth in the life insurance sector is expected to remain fairly solid in the advanced economies in 2015 and to accelerate in the emerging markets. The outlook for non-life insurance business in the advanced markets is less encouraging. In spite of significant recent growth, the evidence is that there is still a very substantial protection gap in many countries. For example, total global underinsurance of property risks is estimated at \$221 billion (Swiss Re 2015),

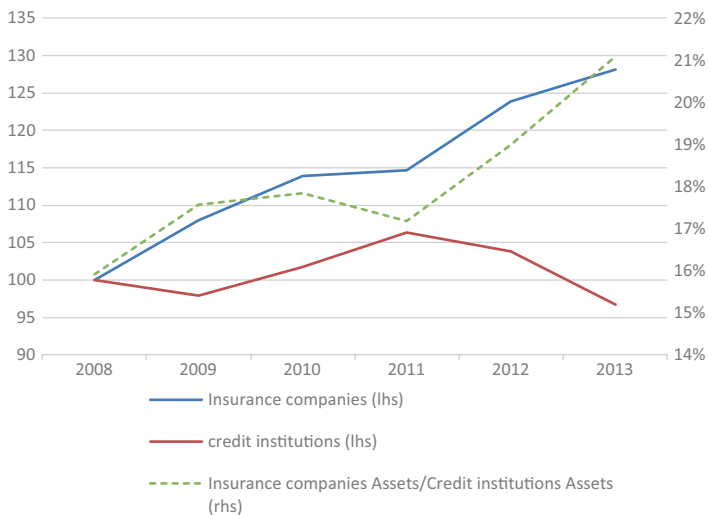


Fig. 15.3 Growth of total assets of insurers compared with banks in the euro area (2008 indexed at 100). Source: Author's calculations on European Central Bank, Statistical Data Warehouse

and the global protection gap in life insurance protection at \$86 trillion, or 116% of world GDP (Geneva Association 2014). Thus, there is enormous potential for the further expansion of insurance markets, which are far from saturated, especially in the emerging economies. If the insurance industry is to continue to grow, insurers must succeed in narrowing these protection shortfalls.

The insurance industry, especially in Europe, has a very significant investment potential, which needs to be matched with suitable long-term assets. At the same time, Europe's current unsatisfactory growth performance points to the need for long-term investments that can foster economic recovery. A number of initiatives have been undertaken in recent years to encourage long-term investment in the real economy. The year following the release of the European Commission's Green Paper in 2013, the ambitious Juncker Plan for investment and the European Fund for Strategic Investments (EFSI) were launched (European Commission 2013, 2014, 2015).

These initiatives have helped to spur the interest of insurance companies in new investment instruments. The interest of insurers stems from their need for greater diversification of asset allocation, higher returns in the persistent low-interest-rate environment, and a better match of assets with long-term liabilities. The European insurance industry is accordingly interested in asset classes that can have an immediate impact on growth, such as infrastructure (debt, equity), securitizations, and credit.

Converting the industry's potential capacity into actual investments will require a combination of measures and actions. First and most important, it is vital that the regulatory framework be consistent with insurers' "natural" propensity for investment with a long-term horizon. I will discuss this issue in the next sections. However, it is useful to anticipate here that a number of corrections to the Solvency II regulations would seem both desirable and feasible in the short term. In particular:

(a) *Treatment of securitizations*

The final version of the Delegated Regulation on Solvency II (Delegated Regulation (EU) 2015/35, of the Commission, of 1 October 2014) made significant improvements, such as by lowering

the calibration for “high quality” securitizations (Type I) by comparison with previous drafts. Further, the EC Proposal for simple, transparent and standardized securitizations (STS) contains a number of additional positive elements (e.g. the inclusion of junior tranches within the scope of STS). However, the current Solvency II calibrations still need to be reduced further in order to reflect the true risks (e.g. capital charges against securitizations of residential loans must be capped at the level charged to the underlying loan pool).

(b) *Treatment of infrastructures*

No specific treatment for infrastructures was envisaged in Delegated Regulation (EU) 2015/35. However, the new Capital Markets Union Action Plan provides for several amendments to the Delegated Regulation implementing Solvency II. According to the Plan a new asset category, namely “Qualifying infrastructure investments”, has been introduced. It would institute specific treatment for the calculation of the solvency capital requirement (reduced charges for both equity and bonds) and it would modify the risk management requirements. However, the criteria used by EIOPA should prove to be effective in a real-world scenario.

Finally, the European Commission has asked EIOPA for further advice on the treatment of infrastructure corporates; EIOPA then published a consultation paper (EIOPA 2016) to identify and calibrate other infrastructure investment risk categories (i.e. infrastructure corporates). Strong concerns about EIOPA’s approach to the calibration of the capital requirements remain, as it could fail to capture the whole market spectrum, thus not reflecting the real risks characterizing these investments (Insurance Europe 2016).

More broadly, it is essential to improve both the supply of and access to suitable assets, insofar as insurers must have available a sufficient supply of products that match the risk/return criteria of their liabilities. In particular, insurers are attracted to instruments characterized by high issuer quality, returns that can enable them to meet their obligations to policyholders, an adequate guarantee framework, and product standardization and portfolio transparency.

Insurers are interested in infrastructure investments, for example, for such features as long duration, low correlation with other asset classes, higher returns than “traditional” investments and their particular source of default risk (primarily physical/technical factors). In particular, they are interested in infrastructure investments with stable and predictable cash flows and low correlation with financial market movements.

In the medium and long term, the appetite for private credit instruments will be fueled substantially by decreasing exposure to sovereign bonds and increasing insurance industry liabilities. However, lending on a large scale is a radically different business from insurance, so it is crucial that a more efficient market for private credit risk be established.

Do Insurers’ Investments Stabilize Financial Markets and the Economy?

For insurers, investing is an integral part of the business model. It is driven by the nature of insurance liabilities and the need to match them on the asset side. Insurers—life insurers in particular—are a prime source of long-term investment because the amount of payments they will have to make to policyholders over any given period of time can be estimated with reasonable accuracy. What is more, even during economic downturns most policyholders continue to pay their premiums. This regular flow of premium income enables insurers to buy undervalued assets at a time when many other market players are forced to sell. That is, insurers are able to keep investing when others withdraw from the market, so that they may have a counter-cyclical and stabilizing effect on financial markets and the economy.

Recent evidence from the 2008 financial crisis supports this hypothesis. Manconi et al. (2016), in an examination of the US corporate bond market, find that at the onset of the financial crisis insurance companies traded relatively little and were modest net purchasers. Also, they acted as strategic liquidity providers, offsetting the bond sales of mutual funds.

In another study, based on a unique, confidential security-level dataset provided by Deutsche Bundesbank, Timmer (2016) finds that from 2005 to 2014 insurance companies and pension funds bought debt

securities that were trading at a discount and sold securities that were trading at a premium, stabilizing the market by responding counter-cyclically to price changes.¹ This result reinforces the tentative evidence of Paulson and Rosen (2016), on the basis of US data from the 2008 financial crisis, that life insurers absorbed liquidity risk by purchasing less liquid bonds. However, this study did not find any increase in bond purchases by insurers during the crisis.

On the other hand, ESRB (2015) finds some evidence, admittedly limited to just a couple of studies, of procyclical investment behaviour by insurers. The first study cited is Bank of England (2014), which finds some “evidence of procyclical shifts in asset allocation in the UK following the [dot.com](#) crash of the early 2000s, and to a lesser extent during the recent financial crisis”. But this conclusion has to be qualified in view of the “important structural shifts in asset allocation [that occurred] during this period, which make identifying procyclical behaviour more difficult”. In particular, the study finds that British insurance companies “have undertaken a structural shift in asset allocation over the past 15 or so years, reducing their holdings of UK equities, largely in favour of fixed income instruments. This process, widely considered ‘de-risking’, has at least in part been a response to a variety of regulatory, valuation and accounting changes that have happened during this period”.

The second study cited is Bijlsma and Vermeulen (2015). These authors find that at the height of the European sovereign debt crisis Dutch insurance companies engaged in procyclical investment, disposing of southern and subsequently investing in northern European (not Dutch) assets. However, the authors also note that “the effect disappears after ECB Chairman Draghi’s mid-2012 speech”, an observation suggesting that this period was characterized by a very special risk—namely the break-up of the euro area.

All in all, then, a review of the literature reveals basic consensus on insurers’ ability to work a stabilizing effect on financial markets and the economy, albeit with two important qualifications. One, mentioned in IMF (2016), among other studies, relates to the current, prolonged period of low interest rates, which represents a serious challenge to life insurers’ business model in the major advanced economies, threatening to touch off a “search for yield” as the guaranteed rates of return

on insurers’ long-term liabilities exceed the yields of the available “safe” assets.² The second qualification, interrelated with the macroeconomic contest, reflects the decisive importance of the regulatory framework in conjunction with accounting rules in shaping the behaviour of insurance companies. Since both Solvency II and IFRS Phase II are dramatically altering the playing field for European insurers, closer analysis of their indirect effects on financial stability and the economy is vital. A helpful watchword could well be that it is crucial that the regulatory framework not be an impediment to insurers’ investing for the long term. With no claim to exhaustiveness, given the complexity of the issue, the following section is intended to shed light on this point.

How Does Insurance Regulation Affect Investment Decisions and the Economy?

Good regulation is important for a healthy industry (Insurance Europe and Oliver Wyman 2013). Insurers’ investment strategies and behaviour are now liable to be affected by a series of regulatory changes, notably involving prudential rules (Solvency II), accounting standards (IFRS 9 and IFRS 4) and the treatment of derivatives (EMIR) (see Figs. 15.4–15.6).

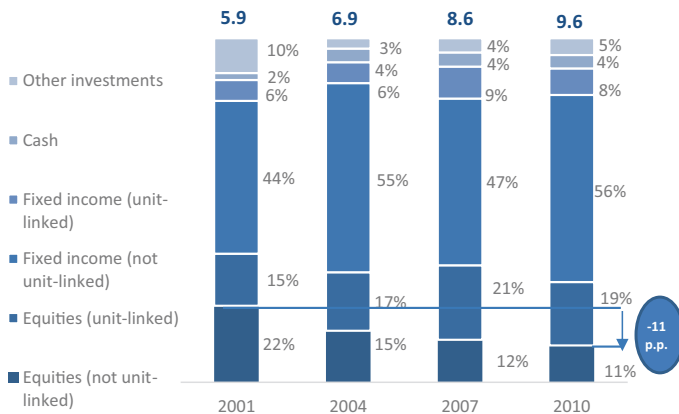


Fig. 15.4 Western European insurers’ financial assets (% , USD trillion, 2010 exchange rates). Source: Author’s calculations on Group of Thirty data

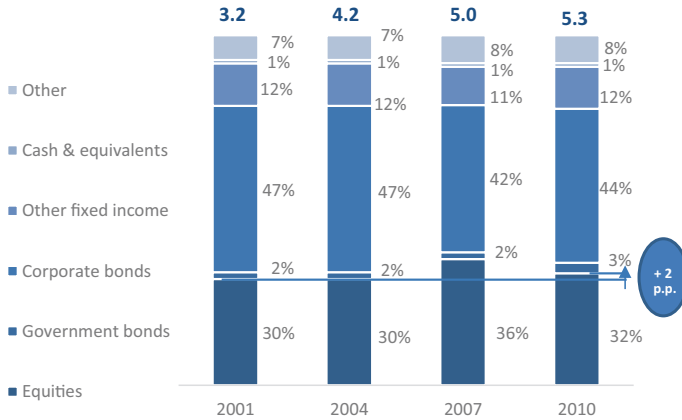


Fig. 15.5 US insurers’ financial assets (% , USD trillion). Source: Author’s calculations on Group of Thirty data

A very simple case can show how insurance regulations are crucial. According to the Group of Thirty (2013), the proportion of equity investment in total assets fell dramatically for both European pension funds and insurance companies between 2001 and 2010. There were a variety of causal factors, but one was regulatory developments that may have discouraged riskier, long-term investments.

It is particularly striking to see that over this period European insurers cut their allocation to equities by 11 percentage points (equivalent to more than €1 trillion in current value, given that total assets currently amount to almost €10 trillion). A very simple question arises: why, in these same years, did the portion of equities in US insurance portfolios hold almost constant at about the same level registered in Europe at the beginning of the century?

The “de-risking” in Europe began as an internal risk management approach—encouraged and to some extent forced by regulations—after the collapse, in 2000, of Equitable Life, a UK company that had accumulated a disproportionate amount of equities in respect of guaranteed fixed returns to policyholders and was unable to cope with the bursting of the dot.com bubble. The trend culminated with the adoption of both the fair value (market price) accounting approach and a one-year value-at-risk (VAR) horizon for assessing the capital requirements under Solvency

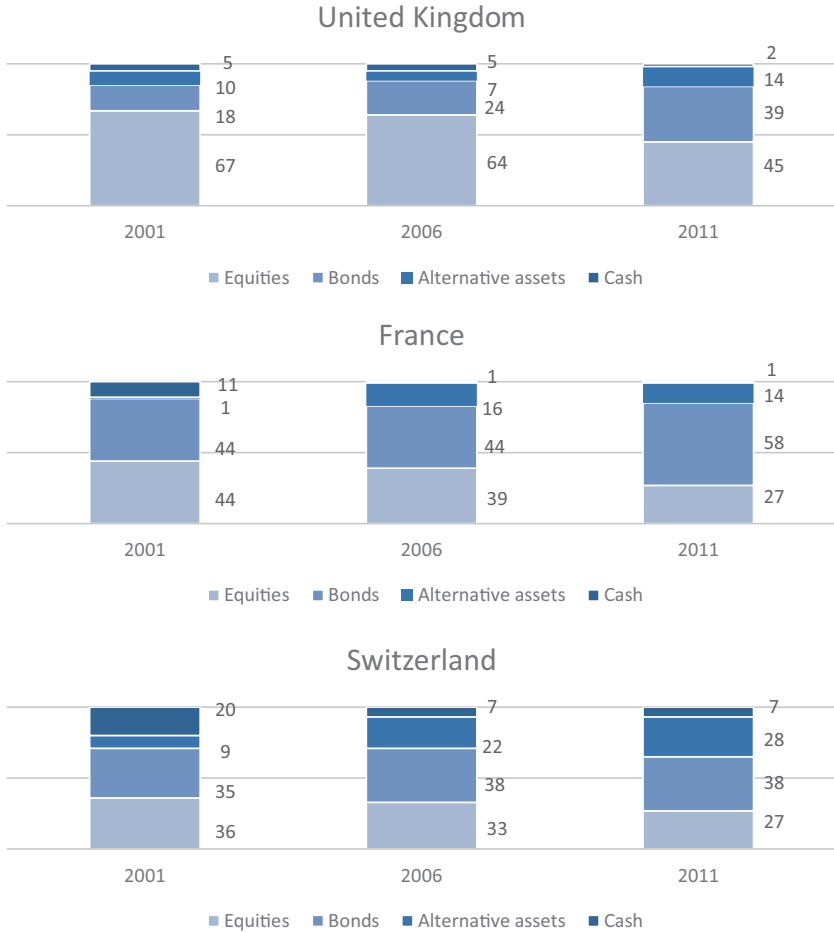


Fig. 15.6 European pension funds asset allocation (% of portfolio). Source: Author’s calculations on Group of Thirty data

II, the new regulatory framework for the solvency requirements for all European insurers. Solvency II came into force officially in 2016, but European insurance companies have been incorporating it in their asset allocation decisions at least since 2005. On the other side of the Atlantic, the prevailing accounting standard is still historical cost (book value), while the prudential system can safely be described as a lighter risk-based system that has undergone only minor modifications in recent years.

Careful research would be required in order to quantify the actual impact of the changing regulatory framework on European insurers' investment strategies. In any case, though, there is no neglecting the hypothesis that the change played a role in the divergent propensities for equity investment of US and European companies.³

Looking ahead, a still more important consideration is this: "Because equity does a better job than debt of sharing risk between borrowers and lenders, and—because it is perpetual—is better able to support long-term investment projects, this transition away from equity holding by ICPFs—insurance companies and pension funds—may leave the system as a whole with poorer risk-sharing and weaker long-term investment. More broadly, it is possible that the combination of factors that drive the asset allocation decisions of ICPFs may lead to outcomes that are suboptimal from the perspective of financial stability (through procyclicality) and long-term investment and economic growth (through an unwillingness to bear risk). Ultimately this may lead to worse outcomes for individual policyholders as well" (Bank of England 2014).

The implications of these issues are enormously far-reaching, and policy prescription will obviously have to be founded on high quality research. The next section is devoted to one specific point: how we should prepare for the 2018 Solvency II review, bearing in mind that this complex regulatory system, though it went operational only months ago, has already begun to spur important changes in the market.

Solvency II: Some Thoughts for the 2018–20 Reviews

Support for the move to the risk-based framework for solvency capital requirements continues to be strong in Europe, and rightly so. There is broad consensus on its advantages: transparency, the general alignment with internal risk management, and the ability to capture the impact both of embedded options and guarantees and of asset/liability mismatch. On the other hand, there are concerns that the market-value approach, coupled with the one-year VAR horizon, may result in an overestimation of the market risk that insurers face, especially in relation to long-term business.

Specifically, it is argued that this regulatory framework may jeopardize European insurers' capacity for long-term investment, thereby undercutting their ability to avoid procyclical conduct (Persaud 2015). This is because using market values to assess available capital may overstate the companies' balance-sheet exposure to short-term market volatility and so create a disincentive for illiquid, long-term, risky assets such as equity, property, infrastructure, securitizations and bonds.⁴

In addition, there is concern over the potentially excessive capital burden on long-term life insurance products with smoothing, yield guarantees and profit sharing. Such products have constituted the largest part of the industry's total balance sheet and have been very popular throughout Europe, providing millions of policyholders with access to balanced funds (often including a mix of government bonds, corporate bonds, shares and property) that can yield more than the inflation rate over the long term while still protecting them from the risks of timing mismatch inherent in the market.

From a purely methodological point of view, these concerns dovetail with a point made in discussions in the USA, namely that a risk-based regulatory framework might well induce procyclical behaviour (fire sales and extraordinary pricing) in the insurance industry. In particular, Ellul et al. (2011) find that the insurance companies that are relatively more constrained by regulation are, on average, more likely to sell off downgraded bonds. In addition, Merrill et al. (2014) show that during the crisis the insurance companies that were more capital-constrained owing to operating losses (uncorrelated with the credit quality of their residential mortgage-backed securities) recognized greater fair value losses and sold off comparable RMBS at much lower prices than other insurers. In short, this evidence jibes with the hypothesis that risk-sensitive capital requirements and mark-to-market accounting, jointly, can prompt fire sales of distressed securities by capital-constrained financial institutions. Finally, Koijen and Yogo (2015) find that during the financial crisis life insurers sold long-term policies at deep discounts relative to their actuarial value. This extraordinary pricing behaviour was a response to financial and product market frictions, interacting with the statutory reserve regulation

permitting them to post far less than one dollar in reserves for each dollar of future insurance liability.

At the same time, however, return to the standard of historical cost is no panacea, not only because that standard does not incentivate sound risk management but also because “to improve their capital positions, insurers using the historical cost accounting disproportionately resort to gains trading, selectively selling their corporate and government bond holdings with the highest unrealized gains. This trading behaviour transmits shocks across otherwise unrelated markets” (Ellul et al. 2015).

In finalizing the draft of Solvency II, a number of corrections were made in order to enable the market-value approach to better reflect the long-term nature of insurance business and allow insurers to continue to offer long-term guarantees backed by maturity-matched investments. These corrections include provision for matching adjustments to the risk-free rate for discounting long-term liabilities with no surrounding option, adjustment to the risk-free rate to discount liabilities in a situation of financial market distress (known as a “volatility adjustment”), and the possibility of an extension of the recovery deadline for undertakings that breach the solvency capital requirement.

The design of these corrections was the product of significant political discussion and compromise, and the proposed adjustments are piecemeal in structure and subject to severe uncertainties over calibration. Therefore, the concerns over their effectiveness have hardly been alleviated. Some observers see the adjustments not as legitimate improvements to better reflect the true risks and economics of the business but as aberrations, deviations from the ideal pure market approach (Ayadi et al. 2012). But the “purity” of the market approach is now being seriously questioned, and not only by practitioners. When markets are illiquid and trading friction is substantial, financial assets may temporarily trade well below fundamental values (Duffie 2010). More generally, in one analyst’s words, “Previously, we thought returns were unpredictable... [Now the evidence shows that] high prices, relative to dividends, have reliably preceded many years of poor returns. Low prices have preceded high returns.This pattern of predictability is

pervasive across markets... For bonds, much variation in credit spreads over time and across firms or categories signals returns, not default probabilities. ...Incorporating discount-rate variation affects finance applications, including portfolio theory, accounting, cost of capital, capital structure, compensation, and macroeconomics” (Cochrane 2011).

Looking ahead to the review of Solvency II that will be conducted in 2018, and possibly in an even longer-term perspective, to my mind it is indispensable to consider how these advances in the theory of finance can be incorporated into prudential supervisory rules. The objective has been well stated by the Bank of England: “Industry, policymakers and consumer groups all have a role in ensuring that long-term savings products provide the combination of security, affordability, risk-sharing and flexibility that is appropriate to the long-term interests of individuals” (Bank of England 2014).

Methodologically, as I see it there are two principal areas for consideration and analysis. First, the existence of mean reversion in financial variables requires serious reconsideration of the choice of the one-year horizon for VAR calibration. In particular, there is substantial evidence that asset risk for equity and property investments diminishes as the holding period lengthens: “equity returns show more volatility and tail risk at short horizons than at long horizons” (Mladina 2014).

Second, and more generally, it is essential to find a way to take proper account of the fact that insurance companies are in a position to tolerate moments of extreme volatility, as is shown by the evidence set out in the Section “Do Insurers’ Investments Stabilize Financial Markets and the Economy?”. This is because investment decisions in insurance are driven by the liability structure. The main insight of the asset–liability management (ALM) school is that investment risk in the insurance sector can be managed only when liabilities are factored in. What is more, insurance companies draw on a range of sources of liquidity (cash flow from new premiums, dividends, rent and interest payments, redemption of maturing bonds, cash reserves, and property rentals). This means that even when liabilities mature, insurers enjoy some flexibility in deciding whether or not to sell the countervailing assets, if they can pay claims in cash. More substantial intertemporal smoothing of the variables used in

calculating the capital requirements would appear to be indispensable, starting with the so-called equity dampener, which in the view of many analysts simply does not work. In any case, it should at least have to be shown, using real-world cases, that the corrections made with a view to improving the regulations are functional.

Conclusions

The issue of the regulatory impact on long-term investment by institutional investors deserves continuing attention. Our understanding of the matter would benefit substantially from academic research and discussion, hopefully helping policymakers not only to avoid introducing fresh obstacles but also to institute rules that facilitate investment in equity and other long-term assets. Additional academic input is needed to enhance the general awareness of how effective the long-term business model of the insurance industry can be in reducing market risk, and hence the extent to which the current mark-to-market regulations may be overestimating the market risks bearing on insurers. Input is also needed on ways to enable the market-consistent framework to better capture and measure true risk exposures and, consequently, the related solvency requirements.

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Notes

1. Timmer also finds that unlike insurance companies and pension funds, investment funds and banks may accentuate price dynamics. This result confirms previous evidence. For example, using data on cross-border lending both Cetorelli and Goldberg (2011) and De Haas and Van Horen (2013) report a sharp contraction in cross-border lending during the financial crisis, while mutual funds generated large procyclical asset reallocations (Raddatz and Schmukler, 2012) as a result of net redemptions of investors' units.

2. The impact of persistently low interest rates on insurance investment and financial conditions has become a burning issue for managers and insurance supervisors alike (Antolin et al. 2011; Kablau and Weiß 2011; Swiss Re 2012; Berends et al. 2013; EIOPA 2013; Berdin and Gründl 2014).
3. Bank of England (2014) made a similar argument: “In the longer term, UK insurance companies and pension funds have undertaken a structural shift in asset allocation over the past 15 or so years, reducing their holdings of UK equities, largely in favour of fixed income instruments. This process, widely considered ‘de-risking’, has at least in part been a response to a variety of regulatory, valuation and accounting changes that have happened during this period.”
4. Blackrock (2012); Horing (2012); J.P. Morgan Asset management (2010); Sverinson and Yermo (2012).

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16

Life Insurance and *Bancassurance* After Solvency II: A Market and Management Perspective

Andrea Battista and Andrea Paltrinieri

Introduction

This chapter examines the dynamics of life insurance and *bancassurance* business on the European market over the next few years, within the new Solvency 2 (S2) regulatory framework, from a company's management point of view.

The chapter is structured as follows. In section “Trends in Life Insurance” we describe and assess the general trends of life insurance in Europe, considering their impact on insurance companies' management. In section “The Framework of Solvency I” we provide a brief analysis of the Solvency 1 (S1) framework. This regime is very important to analyze the change in environment following S2. “Insurance companies' management” will assess every day the new framework comparing it with the old one. Section “The Financial Scenario and Its Impact on Solvency

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II” gives a brief overview of the relevant macro scenario, where S2 has been developed. This is necessary considering the direct impact of this scenario on S2 capital. Section “The New Competitive Scenario” goes deep inside the demand and the supply side of the S2 micro business dynamics. From the demand side, global uncertainty and scarcity of low risk performing assets for retail investors will create a positive environment in the foreseeable future. From the supply side, the main focus will be on products, investment and distribution, the core of the insurance company management. This view will be integrated highlighting how supply side will be affected by the new conduct of business regulation (Insurance Distributive Directive, IDD), to shine the spotlight on the possible regulatory scenario evolution while S2 will be further consolidated. The last section proposes and discusses some generally acceptable management guidelines for life insurance companies in Europe.

Trends in Life Insurance

This section analyses major current trends in European life insurance and their impacts in shaping the competitive scenario and management challenges. For a senior executive, the main challenges facing the European insurance industry today are (1) the implementation/evolution of the new Solvency 2 (S2) regime; (2) the technological and digital revolution (the so-called *fintech* or *instech*); (3) the structurally low interest rate environment. Everyday business and strategy obviously have to deal with other challenges and issues, like financial market volatility, micro regulations or specific trends affecting different insurance business segments—for instance, pension systems evolution, motor insurance or health insurance. All these issues, in an extremely fragmented and articulated business like insurance, become rather relevant.

These mega trends are the macro drivers with the deepest transformational impact on insurance management. In structural terms, all other factors are less relevant in shaping this scenario.

These three trends are structurally European, including the regulatory trend. Every specific local market obviously has its own relevant features

and moves from different “sticky” situations. From the regulator approach to the digital customers’ culture and the specific spread paid by bond issuers, every local context will remain quite different from the others for a long time. This is the huge legacy of the past, not the trend of the future. All new emerging trends look much more alike in different EU Member States. An implicit assumption behind is that Europe is bound to move on toward integration. From a methodological point of view, this implies that most of our observations, analyses and conclusions refer to the European market as a whole.

In this essay, we argue that the main challenge for life insurance business and its management is neither the first, nor the second or the third trend. It is a combination of the first and third one—S2 and low interest rates—in the context of the second one—the *fintech* revolution and potential digitalization of any business relationship. Combination in fact means that putting together all these challenges is different from the mere sum of the two, because in any combination the “*superadditivity*” factor becomes part of the equation and plays a key role in shaping market dynamics. Combined with others, every driver has a different impact on business dynamics.

The new Insurance Distribution Directive IDD regulation, that is, the insurance version of investors’ protection regulation, also comes into play. Furthermore, this gives rise to a second order of regulations and to new combination effects, as S2 goes forward. The overall combined impact could be “secular” for *bancassurance*, more than for other life distribution channels. On the other trend, *fintech* trends and digital phenomena appear in the short term operationally key for general insurance more than for life insurance. For example, the Internet of Things (IOT) is a breakthrough change for non-financial business. In life business, in particular in protection products—non-financial life insurance—IOT already appears to be a promising driver of change in the short run.

Moreover, “Robo-advisors” might certainly be a fascinating theme but it is advisable to leave it out from short-term impact analysis, at least as far as life insurance is concerned. In addition, *fintech* does not “combine” with S2 or low interest rates in a direct way, creating direct second-order effects, which are often the deepest ones.

There are two big caveats within this approach: (1) all customers—irrespective of the channel they prefer—will become more and more digital, mobile and social; (2) all players have to manage the digital revolution at the same time as compliance and business rules change, because late adopters in technological revolution can be the real losers. This could create binding issues of resource allocation and managerial focus for many small players. Compliance and S2 challenges cannot be taken as an alibi to avoid coping with the digital challenge. For these two reasons, we can consider the *fintech* driver as a “boundary” in the short term, which should be optimized in dealing with the S2 and low interest rates challenge.

After the analysis of the three main trends in life insurance, we are going to define the starting point of S2, the old regime of Solvency 1 (S1).

The Framework of Solvency I

Solvency 1 is not in force anymore, but, for a long time, will continue to be the natural benchmark for business people to understand and assess the new S2 framework. We try therefore to assess S1 key features from a market perspective, with a particular focus on the European Insurance Market. From the management perspective, we can derive the following characteristics of S1: (1) well-known system; (2) predictable and often “not biting” regime; (3) local regime, at the end of the game and with a few drivers impacting on Solvency level; (4) Integrated with local balance sheet; (5) “living together” with S2.

S1 was a well-known and fully tested system, based on a longstanding experience, thoroughly developed and accepted operational rules (e.g. the buffer above the minimum level). S1 was even a bit boring for management: too simple, too deterministic and essentially the same for many years; for most people since the beginning of their working activity. At normal times, S1 looked like not a very “biting” regime. Therefore, capital was a marginal issue: many players realized the existence of capital constraints only during the financial crisis peaks. At normal times, S1

figures were rather predictable, volatile just in extreme cases and essentially for the interest rates, due to their spread or free risk levels. S1 was rather fragmented in Europe: while deriving from common directives and with obvious common features, no real integration was pursued and reached in the implementation and evolution over time.

Few things had an impact on S1 capital: bond value, growth, nature of business (life/non-life, guaranteed/non-guaranteed), and dividend policy. As a consequence, management actions had a limited scope and room on capital. S1 considered only yearly net income within the capital available; therefore, self-financing growth was a real challenge. In addition, it was feasible, especially for big companies, a bit less for smaller ones: higher absolute levels of growth had more impact on S1 ratios of small companies. In brief, value was not capital. The S1 regulatory system was integrated and consistent with local financial statements and accounts. Therefore, local accounts could be the foundation for any supervisory activity and for the simple capital management required. S1 rules existed together with the S2 regime in the last period. In recent years, both regimes coexisted in business and this—albeit unavoidable—created ambiguity and additional unconstructive complexity for management activity. In brief, S1 was a relatively simple framework for a complex world.

From the above dissertation, preliminary implications emerge. The first one is that one single regime is now in place and is here to stay (S2) and the probability that the insurance industry may go back to very simple rules (S1) is close to zero. The second point is that capital becomes a key managerial issue, not for the reason that capital is more stringent under S2 but because capital is less predictable, more complex to be managed—due to the granularity of risks considered—and the leeway for managerial actions structurally and substantially increases. The third implication is that several variables are relevant in S2 framework, including external scenarios; therefore, even the relationship between these different variables can be of fundamental importance. The fourth point is that European rules now have a real impact on the insurance industry and are bound to become ever more important. Only sudden European political failure could cause a halt or reversal of this insurance integration trend.

Since in these paragraphs we have identified the S1 framework, the implications of its difference from the new S2 regime, and some challenges for management activity, the next step is to define the current financial scenario in which the new regime begins to work.

The Financial Scenario and Its Impact on Solvency II

Exogenous economic and financial variables are key in S2. Therefore it is essential: (1) to identify and understand the macro financial scenario in which S2 has become the official regime; (2) the impacts of this scenario on S2 approach. Adopting a common framework and consensus view, the current financial scenario could be defined as the world of secular stagnation (Summers 2016), underpinning volatility and low interest rates. This is the *new normal* or new neutral of life insurance. This is totally unprecedented for any European market. *Secular stagnation* is the “quasi standard” current macroeconomic framework: in brief, savings higher than investment opportunities create fewer growth opportunities. This is one of the foundations of ultra-expansionary monetary policies. Volatility may be considered an indirect consequence of the monetary policy: huge liquidity shifts from one side of the market to another and financial prices reflect these flows. Volatility is an issue per se, because financial reporting is a continuing activity and duty for the management, and noises are never welcome in this area. Low interest rates can be observed in the swap rates forward curve (see Table 16.1). Furthermore, the debate on the Ultimate Forward Rate (UFR) concept and measure is gaining the stage. UFR stands currently at 4.2% annually. A downward trend in this rate is expected in the course of the following months. The financial regime, where long-term interest rates are likely to be lower than 4.2%, is a world of structurally low interest rates.

The reason for the high importance attached to defining the exogenous scenario is twofold: (1) S2 is highly and granularly dependent on the financial and economic scenario—unlike the previous regime; (2) in terms of persistence across time, this scenario—actually a liquidity trap—appears

Table 16.1 Forward rates matrix

	1 year	2 year	3 year	4 year	5 year	6 year	7 year	8 year	9 year	10 year
30/03/2017	-0.21	-0.13	-0.04	0.07	0.19	0.31	0.43	0.56	0.67	0.77
30/09/2017	-0.12	-0.04	0.06	0.18	0.30	0.42	0.55	0.66	0.78	0.88
30/03/2018	-0.07	0.05	0.16	0.28	0.41	0.54	0.66	0.78	0.88	0.98
30/09/2018	0.03	0.16	0.28	0.40	0.53	0.66	0.78	0.89	0.99	1.08
30/03/2019	0.16	0.28	0.40	0.53	0.66	0.78	0.90	1.01	1.10	1.18
30/09/2019	0.28	0.40	0.53	0.66	0.78	0.90	1.01	1.11	1.20	1.26
30/03/2020	0.40	0.52	0.66	0.79	0.91	1.03	1.13	1.22	1.30	1.35
30/09/2020	0.52	0.65	0.78	0.91	1.03	1.14	1.24	1.32	1.38	1.43
30/03/2021	0.65	0.79	0.92	1.05	1.16	1.26	1.35	1.42	1.47	1.52
30/09/2021	0.78	0.92	1.05	1.16	1.27	1.36	1.44	1.50	1.54	1.59
30/03/2022	0.92	1.06	1.18	1.29	1.38	1.47	1.53	1.57	1.62	1.66
30/09/2022	1.05	1.18	1.29	1.39	1.48	1.55	1.60	1.64	1.69	1.71
30/03/2023	1.19	1.31	1.41	1.50	1.58	1.64	1.67	1.71	1.75	1.75
30/09/2023	1.31	1.42	1.51	1.59	1.66	1.70	1.73	1.77	1.79	1.79
30/03/2024	1.42	1.53	1.61	1.68	1.73	1.76	1.79	1.83	1.82	1.82
30/09/2024	1.53	1.62	1.69	1.75	1.78	1.81	1.84	1.86	1.85	1.85
30/03/2025	1.63	1.70	1.77	1.81	1.83	1.86	1.89	1.88	1.87	1.87
30/09/2025	1.71	1.77	1.82	1.85	1.87	1.90	1.91	1.89	1.89	1.89
30/03/2026	1.78	1.84	1.88	1.88	1.90	1.94	1.91	1.90	1.90	1.90
30/09/2026	1.84	1.88	1.90	1.91	1.94	1.94	1.92	1.91	1.91	1.92
30/03/2027	1.90	1.93	1.91	1.94	1.97	1.94	1.92	1.92	1.92	1.92
30/09/2027	1.93	1.93	1.94	1.97	1.96	1.94	1.93	1.92	1.93	1.92
30/03/2028	1.96	1.93	1.95	1.99	1.95	1.93	1.92	1.92	1.93	1.90
30/09/2028	1.93	1.94	1.98	1.97	1.94	1.93	1.92	1.93	1.91	1.89
30/03/2029	1.89	1.95	2.00	1.95	1.92	1.92	1.92	1.92	1.89	1.87
30/09/2029	1.95	2.00	1.99	1.94	1.92	1.92	1.92	1.91	1.88	1.86
30/03/2030	2.01	2.06	1.97	1.93	1.92	1.92	1.93	1.89	1.87	1.85
30/09/2030	2.06	2.01	1.94	1.92	1.91	1.92	1.91	1.87	1.85	1.83
30/03/2031	2.11	1.95	1.91	1.90	1.91	1.91	1.88	1.85	1.83	1.81
30/09/2031	1.96	1.88	1.87	1.88	1.89	1.88	1.84	1.82	1.81	1.79

Source: Bloomberg

to be as “structural” as the new regulatory regime. Both will adjust but also they will not probably change their nature neither in the medium nor in the long term.

An immediate impact of this dynamics is on strategic planning. In S2, strategic planning is a core activity and a key function. If company capital position depends on future and predictable evolution, companies have to invest a lot in making the future predictable as much as possible.

Supervision will have to be very focused on it. The interest rate scenario that has been designed is the only reasonable choice for the planning exercise of every European insurance company, even though different calibrations and specific choices can be made.

Therefore, today the financial scenario is already having a deep impact on business choices, which are linked with strategic planning and derive from it. S2 strongly reacts to these variables, interest rates in particular, much more than S1 would have done in any case. This will happen due to the fundamental reason that S2 is a total balance sheet fair market value system.

Market value is by definition the actual value and it reacts in a non-linear and exponential way to interest rate level dynamics. Every number in the S2 balance sheet is heavily influenced by the level and dynamics of interest rates. A simple example will finally prove this statement.

In the average historical scenario, a standard life insurance company would have probably showed an “amazing” S2 ratio and overall excellent conditions. It should be reminded that over the last decade several Quantitative Impact Exercises (QIS) showed on average a very high solvency ratio. At present, any simulation on life companies’ balance sheet with higher interest rates would give excellent results in terms of capital ratios—across time, after absorbing the immediate capital loss coming from interest rate increases. The reason is always in the total balance sheet fair market value mechanism: all the assets have higher value if they produce higher returns, while all the liabilities have lower values if interest rates (swap values) are higher. This is obviously a very stylized and simple evidence.

Anyway, the conclusion is that S2 on average in higher interest rates environment would look like a different regime for business terms.

The New Competitive Scenario

Moving into micro trends, we adopt a demand and supply side approach to understand high level business dynamics. In this section, customer approach from the demand side will be analyzed, while from the supply side products, distribution and investments will be the focus.

The Demand Side

The abundant liquidity, propensity for savings and risk aversion are the drivers of abundant demand for long-term low-risk savings. This is the effect of global uncertainty and of scarcity of reasonable low risk assets for retail investors. Also, the fact that people need to save more to get their results—a certain amount of whole life pension, for example—could have a long-term impact on the absolute level of savings and life products demand.

This picture is not at all a short-term trend, given the financial and economic environment that has been described. Exogenous factors that might endanger this trend are not easy to find. In any industry with relevant—and increasing—fixed costs, good and stable demand is a very important positive driver. This factor must be calibrated and managed in this context through product design, revenues budgeting and network and customer management. Therefore, if demand is “given” in this way, the final market “equilibrium” will be defined by supply.

The Supply Side

In the S2 regime, product offer is relevant, from two different viewpoints. From a single product point of view, micro design is relevant because specific features, such as minimum guarantee, duration, penalties, upfront fees and commissions, have an impact on liabilities. The reason is that product design has an impact on cash flows and so on best estimate liabilities. Some features are more relevant, others less but each of them has an impact on the evolution of liabilities and therefore on the company’s capital position. From a portfolio point of view, in any real business situation they are combined together, creating a portfolio mix. This mix also has an explicit impact on capital, through diversification effects or benefits. From a management perspective this is one of the key brand new S2 concepts/tools. Diversification is at the heart of insurance and financial management but for the first time it is rewarded in such an explicit and formal way. Management mechanisms will have to be developed (the allocation of these benefits among different business lines). Diversification benefits can

impact several percentage points, from 10 to 30% of SCR. Problems in first-time application are expected, in particular for monoline insurers.

Ceteris paribus, reducing the S2 world to issuing a less capital intensive product—for example, Class III business versus I—would be too simplistic and even wrong. In fact all new products are (must be) less capital intensive. This is feasible, because guaranteed product also can generate meaningful value for the company if the amount of expected cash flow is robustly higher than the value of best estimate liability. This is possible if guaranteed products pricing is sustainable and “correct” and if options and specific features—absorbing capital but often not so appreciated and relevant for the customers—are limited or avoided. Every single product and the overall book of business must be optimized in detail, not only the overall mix of guaranteed products/non-guaranteed products, which was the simple S1 rule of thumb.

But the growth is the real key and leeway for action in considering the new business value as capital. Good business generates capital in S2. This source of capital could be defined as “operating” capital. It is certainly quite (too) volatile, not cash based and therefore not distributable capital; but it is anyway full tier 1 capital in S2 regime.

There are also reasons not to grow in S2: the main one is not to invest the liquidity collected at low interest rates. This issue should be addressed through investment diversification and proper risk appetite. Overall, growth will be the most important issue under S2 for the life business. Reference is obviously made to good growth, where positive value creation takes place. In addition, it should be reminded that the new business value concept is especially relevant for life business and much less obvious for general insurance.

If low interest rates reduce margins, increasing risks (Berdin and Grundl 2015; Niedrig 2015), and complexity management increases costs, *ceteris paribus*, growth would have no alternative. If diversification benefits are relevant, balanced growth can generate more benefits than any downsizing strategy. Correlation of growth with innovation is less deterministic and—in the insurance sector—possible, but it may be assumed to be obvious in the economic and social context. In general, growing systems feature a high degree of innovation, because innovation investments can be rewarded within this environment. Where there is no

growth, managerial efforts are focused on restructuring and downsizing, rather than on development and innovation. On the other hand, innovation generates growth, as standard macroeconomic theory (Romer 1986). This envisaged S2 correlation with innovation is probably a bit surprising to some people but it is an unexpected positive feature of this new regime. It is another evidence that compliance is only a part of the picture.

Conduct of Business Regulation and Product Oversight Governance

Overlapping and the need for coordinated management with IDD regulation on products look straightforward. Customer is not part of S2 design and therefore it is difficult to embed it as an endogenous variable. At the most, it can be stated that every optimization must take “customer needs and constraints” into account. This additional IDD regulation is the architecture where this optimization must be pursued. Customers must sit at the value distribution table. This is the key role played by IDD in combination with S2. As mentioned earlier, European regulations on business conduct will soon be introduced (MIFID2, IDD, PRIPS regulation). Many details are still not clear but several markets are moving toward this method of enhanced consumer protection. Different features are impacted, from commission to incentives and to product governance. In this framework, for example, it is interesting to see how IDD and S2 create a combination that will generate a new impact on the system. If S2 focuses mainly on the manufacturing process and the stability of the production system, IDD is customer-centric. If the former regulation deals more with shareholders’ value creation, the latter affects the distribution of this value. Hence, the combination of two regulations deeply affects the whole value chain.

A specific brand new point of the incoming regulation is the Product governance regime, in particular the product oversight governance (Financial Conduct Authority 2015). This is a relevant topic both for banks and insurance companies. Product oversight governance can be defined as “the arrangements that set out appropriate measures and procedures aimed at designing, monitoring, reviewing and distributing

products for customers” (Marano 2016). This should imply a bigger involvement of the insurance company in dealing with customer issues—for instance, through the core activity of target definition. This should happen through more “integration” with distribution networks both at product definition level and then in bilateral information flows to monitor the evolution of quality of sales, in comparison with that planned. At this stage, it is difficult to say what the long-term impact will be, in particular, if this, *ceteris paribus*, will allow for more or less vertical integration between distribution and manufacturing. But manufacturing issues are likely to become less obvious and more relevant to deal with, affecting anyway the distribution networks relationship management also.

It will be therefore another driver affecting the balance of influence of insurance companies versus their distribution.

Investments

Under S2 regime there is a general agreement that government bonds and private debt are going to be overweight, while equity/infrastructure will be underweight. For example, the relative outlook of private debt is attractive in S2 due to different features—also looking at diversification. The risk return profile looks attractive, together with the stability and predictability of cash flows. In any case, there is no doubt that the whole asset profile will be redefined.

Distribution and Agreements

An important part of *bancassurance* management is the agreements infrastructure through which the *bancassurance* business is developed. For this dynamics capital regime is key, even though it is not the only factor, since agreements have differentiated operational and business impacts. To better understand this feature, the ‘twin regime’ for the banking system, Basel 3 should also be considered. The S1 and Basel 1 framework was generally simple. Strong incentives for integration were given to the banking system, due to limited absorption of the insurance stakes in the consolidated banking situation. In addition, S1 was easy to understand

and manage from an average banker's point of view. Basel 3 already substantially changed the *bancassurance* agreements profile, stressing toward 100% the absorption of any relevant insurance stakes.

S2 introduces an important change: the solvency absorption is much more complex to understand, less stable and more volatile, more specialized and 'vertical', because it is linked to the granular dynamics and inner details of the business.

This is a potential downside of the new regime and must be carefully managed, for example in the relation with investors in listed insurance equity, which could be discouraged to allocate capital to the sector due to the complexities of numbers and rules. It is true that investing in insurance business creates diversification per se but this is not recognized as a quantitative benefit in the consolidated position of the banking Group. In any case, it would be difficult to figure out an investment in an 'unknown' sector to capture these benefits. One complex capital regulation to be managed should be enough. Insurance will not be the situation where any banker is at the top of his comfort, particularly in a situation of overall stress and many areas to be focused on. Another impact will be long term in the relative value of distribution. S2 is focused on capital and capital is the main 'manufacturing' resource. If S2 has a deep impact, as already argued, the relative 'manufacturing' value toward distribution could increase over time.

In this section, it has been argued that many business drivers are at work under the S2 new framework: overall good demand stance, different business mix, new product design approach, bias toward different investment approach, overlapping with customer protection rules and distribution dynamics.

This implies that management rules of conduct will be affected in the new regime.

Management Guidelines

In this last section, on the basis of the above analysis, we propose management guidelines, both for top and other insurance executives. In a similar kind of environment, some Japanese companies in the era of long

deflation have developed and created successful business models, with good returns, while global insurance groups have generally stayed in Japan. Therefore, we will provide some management implications.

Management approach must be holistic. One should not search for the single easy solution or the killer application. Management should look not only at any single variable, as such, but at the combination between several variables. S2 has many drivers and management levers.

Management must learn, familiarize and use all levers. This must happen at top management level and not only in the risk/technical function. There is a huge cultural step ahead to be made and a new approach is needed in management. Use test will be a big challenge for top and middle management.

Internal or external growth is imperative (Stoyanova and Grundl, 2015). Only growth generates capital and may allow, under certain strict conditions, self-financing development. Good growth is not obvious and does not come easily. But an alternative is difficult to sustain and not excusable any more since investment risk is not avoidable at all, given the zero world interest rates. Risk appetite framework and capital absorption approach, typical S2 tools, are the right way to tackle it. Mismatch risk is not a shortcut and is dangerous. Management cannot hope for interest rates to rise soon, because every fact provides the opposite signal as discussed. Mismatch capital charges in S2 are very high. German companies provide a direct live experience on this.

Product mix must be balanced. Careful redesign of every single product has been the first step. The second one is to look at the overall set of products. Idiosyncratic strategy will be looser, except for big specialized players with a track record on this. It is not only a matter of diversification benefits. Capital guaranteed product can be fearful in this context but it is also the specialization and distinction of insurers. At the same time, protection business must find a wider room in most markets and financial products (unit-linked) must be regarded as part of the mission. In addition, 'backbook' and new business should be considered different. They must be managed as two different divisions of the same company, because the skills needed and actions required are completely different.

Increase S2 ratios, whenever market conditions allow. Everybody should try to be humble and recognize that at the moment nobody knows which

is the right, optimal and satisfactory level from different stakeholder perspectives. S2 regime is new and volatile. Companies with higher S2 ratios could be more valuable in this new environment. A sudden and fast increase in interest rates is a key factor to be considered. As already pointed out, high interest rates would make things different and easier. But sudden rates or spread increase would create a shock to own funds and therefore huge short-term issues. Searching for resilience and dealing with this volatility ex ante as much as possible will be (a difficult) imperative too.

Perspectives

The analysis performed has shown both clear issues and relevant potential for the growth of the European insurance system. As insurance companies are already experiencing, volatility is a big issue and a great challenge, probably the biggest problem inside the S2 approach. This will be dealt with only when regulation review is performed and this is recognized as a problem which could impair the value of the regime. This is key to the success of the new rules for life insurance. We believe that technical solutions can be identified within the current paradigm, such as review of volatility and matching adjustment (EIOPA 2015) but this topic is clearly beyond the scope of our essay. From the positive side, the cultural gradual evolution of insurance management will allow companies to exploit the potential which is within the new regulatory approach. Therefore, implementing the rules and adapting them could be the proper mix to reinforce the positive side and cope with the negative ones of the new regime.

Conclusions

In this chapter, our departing point was the analysis of the external macro trends and scenario, the old S1 regime and the competitive sector dynamics. This has allowed to finally examine the wide impact that the new S2 regime is going to create in life insurance for top management activities. There are examples of business success in deflationary environments, as briefly argued here for the last 25 years of Japanese experience.

A pessimistic approach is not a proper way to achieve success and it is not totally well grounded. A clear vision of the world and deep knowledge of the challenge is the only way forward. Historical heritage, deep structural change and management actions together will define the outcomes in any specific local market in the immediate future. Therefore, vision and knowledge are what management really needs to successfully deal with this new challenge.

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Embracing Change: The Regulatory Evolution of Captive Insurance Companies

Angele Galea St. John

Introduction

Insurance is a dynamic industry operating in a world of risk and uniquely exposed to uncertainty. Consumer needs continually change, financial products are developed and financial markets evolve and innovate. As financial markets adjust, so too must regulatory systems which oversee them. Regulation must interface with innovation in a mutual and dynamic relationship in order to enhance the positive regulatory effects on innovation.

Regulatory change is altering the face of insurance regulation. The Solvency II Project originated some 15 years ago and was implemented in January 2016 with the aim to introduce a risk-based framework which captures the economic reality of the asset liability position of

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insurers and to bring capital closer to the insurers' risk profile. The framework promotes a strong risk culture embedded in the insurers' organisation and will develop strong risk management capabilities. This is a steep shift from the fragmented and outdated approach of the rules-based Solvency I.

Solvency II will fundamentally review the way insurance and reinsurance undertakings (including captives) across Europe are supervised. The overarching aim is to establish a harmonised European solvency system better matched to the individual risk profile of the insurer supporting a strong, efficient and competitive market with the ultimate purpose of increasing protection for policyholders.

The captive concept—in its most basic form—is that of forming an insurance company to insure the risks of its owners. In most cases, a captive insurer's owner and the ultimate insureds are one and the same. Accordingly, when the insured is the owner of the company, policyholder protection as a key principle of regulation may take a different emphasis.

This chapter will first give a background to some basic concepts applicable to captives, including the role of the captive insurance market, both from a micro- as well as a macroeconomic perspective. It will then analyse the challenges, lessons being learnt and opportunities which are afforded to captives under the three Pillars of Solvency II going forward.

What Is a Captive?

According to the International Association of Insurance Supervisors (IAIS) which represents insurance regulators and supervisors of more than 200 jurisdictions in nearly 140 countries, there are many potential definitions of a captive and a single definition remains a challenge both to the regulator and the industry.

The IAIS (2006) Issues Paper on the Regulation and Supervision of Captives adopted the following definition for captives:

An insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide insurance or reinsurance cover for risks of

the entity or entities to which it belongs, or for entities connected to the entities and only a small part, if any, of its risk exposure is related to providing insurance or reinsurance cover to other parties.

The definition given to a captive under the Solvency II Directive¹ is somewhat narrower, excluding risk exposure to related parties:

‘Captive insurance undertaking’ means an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c) or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.

This essentially means that under the Solvency II Directive, captives can only write business belonging to the entities to which they belong and are restricted from underwriting third-party liability risks—an issue which Collins (2015) states that the European Captive Insurance and Reinsurance Owners Association (ECIROA) says still needs to be resolved.

From a regulatory perspective therefore, the level of risk inherent to undertakings falling under the classification under the Solvency II Directive definition can vary substantially from those risks inherent to a commercial insurer taking into account the ownership structure, policyholders and beneficiaries as well as the nature, scale and complexity of business underwritten.

Drivers to Establish a Captive

Captives can operate anywhere in an insurance structure—from direct writers to reinsurers. Most captive vehicles are owned and used by commercial and industrial companies which are looking for *stable and economic premia*, an *increased retention in quantifiable and manageable risks* of the entity or *secure cover where there is little capacity* available in the insurance market. The Federation of European Risk Management Associations

(FERMA) represents the interest of around 4,700 European Risk and Insurance Managers, of which a number work in organisations which use a captive insurance company to cover some risks of their operations. In its Position Paper - FERMA's views on Captive Insurance Companies - FERMA (2016) affirms that Captives are an integral part of the global insurance and reinsurance market and contribute to the resilience of businesses and consequently to economic growth. The establishment of a captive by its parent accordingly signifies a management awareness and heightened appreciation of risk management practices. Indeed, a captive is in itself an integral part of its parent's Enterprise Risk Management where the ownership of risk and its management plays a key role in the efficiency and profitability of the business. Here the captive will also gain from the group's risk prevention and management measures. Additionally, a captive is able to retain the return on its own funds—this return is lost when premiums are paid to a commercial insurer.

Other drivers used to establish a captive include the *reduction or stabilisation of insurance prices* at group level through a decrease in marketing and personnel costs, lower underwriting expenses and possibly the willingness by captive owners to accept a minimal underwriting profit. A captive enables its owners to protect the benefits of its underwriting policy. A parent can retain risks with a good loss ratio in its captive on the one hand and on the other, by having a captive, the parent's insurance premium will be based on its own loss experience and will not be impacted by the loss experience of other insured parties. In addition, a key benefit of captive insurance is the *ability to access a wholesale reinsurance market* which can reduce the cost of reinsurance to the parent. Captives offer improved risk management and loss restriction by the parent which has a better understanding and control of risk. Indeed reinsurers appreciate that the insured is itself financially involved in the risk through its captive. Furthermore, particular risks such as environmental impairment or sensitive product liability risks are very often *difficult to place in a traditional market* regardless of the claims history. In these circumstances the establishment of a captive presents an ideal solution and optimises financial cash flows linked to risk management.

On a broader level, captives can also be a source of increased financial strength and competitiveness to their parent companies. Indeed, the establishment of captives has put risk management on a higher level in

many multinational companies through focusing the interest and support of company Boards on reviewing and managing all risks, including those risks that the company consciously decided to retain.

The concept of forming an insurance captive to insure the risks of its owners goes back to the late eighteenth century with the modern concept of captive insurance companies developing in the 1950s. Throughout these years, the captive market has developed an outstanding track record to adapt to challenges and benefit from opportunities. Through innovation, captives have been catalysts for new approaches in relation to the ownership, scrutiny and control of risk. They have also served to optimise positive discrimination in risk rating to attract higher quality risks and for the development of products and classes of insurance which have expanded the insurance market.

Having said this, the establishment of a captive insurance company by its parent presents various challenges. Captives require substantial initial outlay in capital, alongside the commitment of time and resources by relevant internal personnel, which will in turn contribute to additional costs of the captive. These outlays will reduce the premium savings expected in comparison to conventional insurance companies. In addition, a significant degree of expertise is required to secure quality third-party service providers such as professional insurance managers and, once these are selected, they need to be afforded varying degrees of delegation and partnership, which may be alien to the culture of the parent. Another challenge to consider is that insurance is based on the concept of pooling of risk. In a captive arrangement, the scope for the spread of risk may be restricted and as a consequence of this costs may fluctuate year in and year out. The entry point in the market for a captive is a challenge in itself due to rigorous regulatory authorisation requirements and, in the event of a change in the parent company's business plan, the captive may no longer be required as an effective risk management tool. In these cases, the only exit route may be to place the captive in run-off which will trigger expenses which do not produce any economic benefit.

In addition to these challenges to set up a captive, the use of captives for illicit purposes in the wider insurance and reinsurance market is also quoted in the literature. Some examples of this misuse—which is not exclusive to captives but can also be prevalent in captives' commercial counterparts—include money laundering, fraud and tax evasion and can

occur in small captive jurisdictions as well as wider insurance markets. With a view to mitigate the potential for this, regulators can impose ad-hoc licence conditions such as stronger governance through the inclusion of a majority of independent non-executive directors in the Board mix as well as the appointment of an anti-money laundering reporting officer, amongst others. Captives are typically managed by regulated insurance managers and regulators also maintain a close supervisory eye on these entities through their insurance managers.

The Insurance Regulatory Regime

The underlying rationale of insurance regulation is to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability (IAIS 2015). The ultimate purpose of regulation is indeed to protect policyholders. In the case of captives these are the same as the shareholders who are considered to be knowledgeable and professional parties. Baldwin et al. (2012) explain that regulation takes the form of tools to ensure that companies operate in accordance with acceptable standards of corporate governance, have adequate financial strength and exercise appropriate market conduct, which in turn all encourage growth and competition in the sector.

When applying these principles to the captive market, there is a need to recognise and appreciate the specific nature of the insurer and the risks applicable (IAIS 2008). The adoption of a risk-based as well as a proportionate approach is key and the insurance regulatory and supervisory regime is there to ensure that policyholders, beneficiaries and parties having an interest in the policy are protected and financial stability is maintained through a level of regulation which has regard for the nature, scale and complexity of the risk involved and the efficiency of the market.

Solvency II

The application of Solvency II to captives has been a hotly debated topic with the ECIROA taking the lead and issuing a position paper on the subject in 2012. The three broad EU objectives of the Solvency II

Regime—to improve protection of policyholders and beneficiaries, to improve international competitiveness of EU insurers and to deepen the integration of the EU insurance market—have been argued to have limited applicability to captives. The main arguments which have been aired in international fora include that although the nature of risks of the captive may be similar to those of a commercial insurer or reinsurer, the degree and diversity of exposure vary substantially. This is because captives do not have a varied portfolio of different policyholders but instead have a limited number of policies per line of insurance business to optimise the risk transfer plan of the parent. In this context the prevention of systemic risk also has restricted applicability in the case of captives since the downfall of a single captive or group of captives will have limited effect on the global insurance system. In response to the objective of solidifying international competitiveness and integration in the EU insurance market, it was argued that captives do not compete for a market share on the open insurance market and indeed, while disclosures to regulators do not pose problems, public disclosures may sometimes be harmful to the parent or to the captive itself and produce no value added to the public interest since interested parties have ready access to the information from group financial statements.

Accordingly, initially, captive owners viewed Solvency II requirements as an onerous burden also quoting additional regulatory cost issues. In this context, it is also fair to say that the chairman of ECIROA has recently aired his view that Solvency II will introduce a regime which is more professional than preceding regulatory regimes and that captives are in the main prepared for the implementation of the regime (Drose 2015). Indeed, even at the preparatory stage, many European captives have embraced Solvency II's increased regulatory requirements to focus more closely on their own risk management and are using the information they have gathered to meet Solvency II's qualitative and reporting requirements as an opportunity to review and challenge their own business models.

The principle of proportionality is threaded through the Solvency II Directive and is indeed identified as a fundamental concept in all three Pillars of Solvency II, applicable to small- and medium-sized undertakings

including captives. How the principle of proportionality is applied by supervisors as they transpose the Solvency II requirements in national law and aim towards supervisory convergence is key.

The underlying rationale behind the principle of proportionality stems from the Treaty on the European Union² which emphasises that “the use of Union competences is governed by the principles of subsidiarity and proportionality” and moreover that “under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties.”

Recital 10 of the Solvency II Directive states that “reference in this Directive to insurance or reinsurance undertakings should include captive insurance and captive reinsurance undertakings, except where specific provision is made for those undertakings.” Recital 21 further amplifies “This Directive should also take account of the specific nature of captive insurance and captive reinsurance undertakings. As those undertakings only cover risks associated with the industrial or commercial group to which they belong, appropriate approaches should thus be provided in line with the principle of proportionality to reflect the nature, scale and complexity of their business.”

It is therefore acknowledged that the regulatory risks inherent in a captive insurer can vary substantially from those of its commercial counterparts, and consequently the level of supervision that is necessary will vary accordingly (IAIS 2015).

The Solvency II framework is structured through three separate but complementary pillars—setting out respectively quantitative requirements (Pillar I), governance and supervisory activity (Pillar II) and supervisory reporting and public disclosure (Pillar III). All three pillars are applicable to captives and reinsurance captives in like manner as they are applicable to insurance and reinsurance undertakings.

Pillar I

Pillar I lays out the quantitative element of the solvency assessment, which consists of assets, liabilities (including technical provisions) and available capital or own funds. Essentially, these requirements are intended to ensure that insurers can absorb significant unforeseen losses.

There are two capital requirements—the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR)—assuring a risk-based calculation but also a more robust and simpler floor designed for ultimate supervisory action, whilst also providing for varying degrees of supervisory intervention. The MCR for captive insurers must have an absolute floor of between 2,500,000 euro and 3,700,000 euro depending on classes of insurance business which they write and must be no less than for 1,200,000 euro for captive reinsurers.

The aim here is to capture the insurer's quantifiable risks attaching to both assets and liabilities. Solvency II factors in proportionality through allowing undertakings to choose and apply a valuation method which is not more sophisticated than is needed in order to achieve the Solvency II objective and to remain within its market-consistent approach to valuation. The application of a market-consistent valuation to assets and liabilities identifies existing gaps between national Generally Accepted Accounting Practices (GAAPs) and the International Financial Reporting Standards (IFRSs), and solvency valuation principles across 28 member states need to be managed for the concrete application of economic valuation in Solvency II.

The Solvency Capital Requirement

The SCR can be calculated in a manner which allows captives to choose a method that is proportionate to the nature, scale and complexity of their risk profile. Undertakings can choose to use a full internal model, the standard formula together with a partial internal model, the standard formula with undertaking-specific parameters and the standard formula as a stand-alone method. The standard formula is intended to capture most of the quantifiable risks that insurance undertakings face in general and has the main advantage of being less complex and less time consuming. Nevertheless, it may neither cover adequately all the risks that a particular undertaking is facing nor cover the risks in a proportionate manner. The SCR was designed as a standard formula applicable to all the different players in the market, and therefore it may not correctly reflect a perfect picture of the undertaking's risk. Relevant and material categories of risk which distinguish captives

from their commercial counterparts include underwriting risk where captives have relatively unsophisticated premium setting methods. Here, however, captives have an advantage over their counterparts in accuracy of claim reporting also because parent companies can quickly report significant incidents. Operational risk is also particular in the case of captives and may be more appropriately addressed on a qualitative rather than quantitative basis. Captives rarely have their own staff or premises and are largely reliant on the business continuity arrangements of their insurance manager. Legal risk is negligible as the probability of the captive being sued by the policyholder (its owner) is very low. Often the captives' insurance portfolios are limited to a few lines of business, which triggers the potential for claims volatility. As opposed to their commercial counterparts, captives do not have stable portfolios or homogeneous risks. The results of actuarial computations whose basis are limited portfolios and a low level of transactions may not give reliable results. In addition, the lack of diversification in the asset base as well as in significant counterparties is prevalent in captives and this in turn impacts both market and credit risk.

Notwithstanding the above, largely for cost reasons, most captives will still use the standard formula which treats their limited diversification harshly as it was developed for a 'one size fits all' model. Zaniboni (2015) argues that the logic behind the importance of diversification in the calculation of economic capital is linked with the idea that, by including uncorrelated risks within the same portfolio, the loss volatility of the same portfolio decreases sensibly. This is one of the ways in which Solvency II has been a contributor to captives coming under pressure to justify their existence—with the pragmatic response as a mitigating factor to the cost (and reporting) strain being the transfer of risks to one captive for parents for economic efficiencies. The SCR under the standard formula will often be demanding on insurers that do not generate a large enough level of diversification benefit in the calculation, and accordingly parent companies may also find themselves assessing and reviewing the acceptance of new risks in existing captives to increase diversification—a captive that is able to accept different risks would ultimately be of increased benefit to its parent. There are many possible ways of achieving risk diversification in a portfolio, and one of the most effective is the

business lines diversification to increase efficacy due to a low stochastic correlation between the respective losses. Employee benefits are frequently being quoted as ideal for risk diversification particularly for a portfolio of Property and Casualty (P&C) industrial risks as the likely size of any single claim in Employee Benefit cover is usually a fraction of a typical P&C industrial claim and this generates a much lower volatility of the loss ratio of the portfolio. Another important aspect is the likely stochastic independence of the Employee Benefit risk among the employees themselves as well as from the corporate P&C risks. In addition, Zaniboni (2015) advocates that captives may also intrinsically benefit from differentiating their loss experience from those of their peers, therefore allowing the captive to benefit from an advantageous claim experience and reduced exposure to catastrophic risks. Accordingly, this is actually being seen as a plus of Solvency II for captives since they are now being motivated to revisit their levels of risk awareness and look at risks with a new level of attention. A further factor which can be considered is that through utilising fronting insurers, reinsurance captives are in effect placing the onus of complying with Solvency II firmly on the fronting insurer. Under Solvency II, the credit risk charge is comparatively high if an insurer cedes business to a non-rated or a low-rated entity with a potential to impact fronting arrangements—captives will be looking towards restricting this effect as this will consequentially positively impact the collateral amount which needs to be put forward by the captive.

Asset Allocations

Traditionally, the invested assets of the captive have often been linked to the parent, either through loan-backs, holding parent bond issues or in a somewhat looser sense by being invested in sovereign bonds in the parent's country of domicile. Under Solvency II captives will now need to understand their portfolio position where liabilities match with assets and document their risk appetite including the risks they have chosen as an integral part of their portfolio (such as currency mismatching, portfolio credit rating profile, portfolio volatility etc.). This will indeed trigger changes in terms of captives' asset allocations. Increasing numbers of captives now

outsource their investment management to third-party specialists in order to achieve portfolio optimisation (Essen 2015). This is reflected in asset reallocations in order to achieve more diversification and by new exposure limits to reduce concentration and hence lower capital requirements.

Pillar II

A great deal of energy and resources have been allocated to Pillar I issues. Quantitative measures, although important, cannot be seen in isolation and Solvency II puts a great deal of emphasis on the responsibility of insurers and reinsurers, including captives, identifying and measuring their own risks. The empirical study published in the Report - Prudential Supervision of Insurance Undertakings (Conference of Insurance Supervisory Services of the Member States of the European Union 2002) identifies that inappropriate risk decisions due to incompetence or operating outside areas of expertise, the lack of integrity or conflicting objectives were obvious reasons for failures. Capital adequacy, though vital, will not make up for weak governance. Pillar II therefore mandates accountability through a robust system of governance including a number of key functions.

The aim of a robust system of governance is to provide for sound and prudent management and oversight of an insurer's business and should adequately recognise and protect the interests of policyholders. The principle of proportionality is also applicable here. Governance issues specifically relevant to captives include related party transactions and perceived or actual conflict of interest (IAIS 2015). Solvency II raises issues for the Board of Directors which, on an individual as well as collective basis, has to gain and demonstrate a detailed understanding of the risk profile of the captive. The Board of Directors remain responsible for the governance of the captive despite having, in some cases, outsourced its management. The following are specific areas of governance which have heightened relevance to captives.

Although some of the functions of the captive may be outsourced either to insurance managers, investment managers, specialist claims administrators or other outsourced service providers, the *ownership of and responsibility for these functions remain that of the Board of Directors of the captive* and therefore the Board, as a collective organ as well as on an

individual director basis, has to include the appropriate mix of skills and experience necessary to effectively oversee and challenge any outsourced functions (IAIS 2015). Captives are also subject to the outsourcing provisions set out in article 49 of the Solvency II Directive, and therefore, outsourced functions should, as a minimum, be given the same degree of oversight and accountability as that applied to activities and functions carried out by the entity itself.

As in the case of small insurance companies, captives need to ensure that there is adequate separation of the oversight function from the actual management of the key function since this may be subject to overlap. In addition, the need to formalise arrangements between captive owners, directors and insurance managers to ensure effective governance is key.

In view of the relationship between the owner and the captive, the captive's Board of Directors should put in place appropriate controls so that transactions, payments or charges on assets initiated by the owner (dividends, reinsurance agreements with related entities, loans, expenses and guarantees) do not financially impair the captive's ability to meet its obligations. In this context, the Board of Directors must be able to ensure that any related parties' transactions are scrutinised and carried out at arm's length, in the same way as other transactions with third parties.

Key functions specified in the Solvency II Directive include risk management, compliance, and actuarial and internal audit. In so far as the risk management function is concerned, captives are an intrinsic part of their parent's enterprise risk management function with the Chief Risk Officer of the parent often being appointed on the captive's Board. Accordingly, the captive's attitude to risk will be heavily biased by its parent—emphasising the importance of having the whole Board engaged with an appropriate mix of independent non-executive directors to be able to challenge the parent if needed.

In a captive, some key functions may also be outsourced to insurance managers or other professional service providers and here too the outsourcing rules prevail.

Directors responsible for a captive must also demonstrate that the prudent person principle has been applied. Accordingly, captives must be able to demonstrate that their assets were invested in a prudent manner and that any reserves have been invested in the best interests of

policyholders. As indicated in the previous section, traditionally, the asset portfolios of captives were largely linked to their parent, either through loan-backs or holding parental bond issues. It could be argued here that parental loans are not necessarily the most prudent form of investments or in the interest of policyholders. Indeed, Dalziel (2015) argues that prudent investors would avoid adding to enterprise risk and would not invest in the business that is itself a source of risk that the captive underwrites. This issue is still being debated and requires detailed discussion and understanding. On the other hand, if captives have a high level of capital which the parent requires to be loaned back, Silverman and Langowski (2015) state that it would make more business sense for the captive to be domiciled outside the Solvency II hold.

The importance of Pillar II also centres around the Own Risk and Solvency Assessment (ORSA), the objectives of which are to promote a better understanding of the company's overall solvency needs, to disclose sufficient and clear information on the company's risk profile and to enhance the Board responsibility not to take on more risks than the capital base is allowing. Here again the principle of proportionality applies. As a means to assess their level of preparedness for Solvency II, and as a run-up to the requirement for the ORSA, captives (alongside their commercial (re)insurance undertakings) were required to submit to their regulators their Forward-Looking Assessment of Own Risks (FLAOR). A key advantage in completing this process is that it mandates captive owners to think strategically and take a 'clean slate' approach to analysing their captive operations. It could mean that a company is reviewing retention options through the use of data and analytics, where the results will optimise its insurance programme and, ultimately, reduce its insurance costs. In its Captive Solutions Benchmarking Report, *The world of Captives: Growth and Opportunities Without Borders*, Marsh (2015) affirms that certainty and understanding around Solvency II have had a very positive effect on captive growth in the EU.

Pillar III

One of the fundamental elements which will ultimately allow supervisors to effect part of their supervisory functions is the supervisory reporting

requirements which will enable supervisors to carry out informed supervisory review of undertakings. Pillar III involves both supervisory reporting and public disclosure requirements. Improved public disclosure requirements should provide interested stakeholders with insight into the risks of the undertakings. The timely and accurate submission of information gains importance in a risk-based supervisory approach.

In the particular case of captives, Pillar III has been one of the most sensitive and hotly debated issues. One of the goals of Solvency II is to move towards a more transparent regulatory regime. In the case of captives, because of the inherent factor that the policyholder is the informed owner of the captive, distinction needs to be made between disclosure to regulators and disclosure to the public. ECIROA (2012) argued that while in the captive arena disclosure to the regulators will not be of issue, public disclosure could be harmful to the parent group and to the captive itself. Such cases include if a captive had to disclose it has a liability insurance in force or its loss reserves could be identified by claimants or third parties or else disclosure in case the parent has a kidnap and ransom cover in its captive. Indeed this separate disclosure would not be required if the risk was insured directly with a commercial insurer. In this context, captives argue that there is no public interest for or value added through disclosure and transparency towards the market as the stakeholders belong to the same group and would therefore already have ready access to the information through other channels. The policyholder—in the capacity of owner—also has access to the information from the risk management strategy normally disclosed in the annual financial reports and requiring additional disclosure will implicate a duplication of effort.

The transparency which is being aspired for under Solvency II will be achieved through standardised reporting across the industry and an emphasis on consistent data. Directors of captives are responsible for ensuring that any data they provide their supervisor is of the required standard, even though the captive relies on third parties for that information. Directors are responsible for ensuring that data provided is accurate and this may add further operational complexity to the business.

Furthermore, the reporting timeframes have also been tightened under Solvency II. Accordingly, captives must be able to produce data accurately and in a timely manner, in various formats for multiple reporting

deadlines. Since captives broadly rely on third-party service providers, Dalziel (2015) argues that this will translate into providing multiple stakeholders with access to the same set of data so that the required reports can reconcile with one another. Here accuracy, granularity and security of data become business critical.

In like manner to commercial (re) insurers, under Solvency II captives are required to provide the regulator with three types of reports—their Own Risk and Solvency Assessment, the Solvency Reporting Templates and the Solvency and Financial Condition Report which is to be disclosed publicly on an annual basis. The information which the captive submits to the regulator must reflect the nature, scale and complexity of the business of the captive concerned, and in particular the risks inherent in that business; be accessible, complete in all material respects, comparable and consistent over time; and be relevant, reliable and comprehensible.

When Solvency II was initially rolled out, there was the fear that captives may just view the reporting requirements as a box ticking exercise. Captives have however taken the opportunity to use the information they are required to report on to improve their risk management and mitigate their financial and reporting strain. Indeed Nicol (2015) emphasises that the long-term advantages of an educated, data-driven risk management can lead to cost savings in captives, which can in turn offset the burden of initial investment and reporting.

The Protected Cell Company

As insurers respond to the new developments, they are faced with strategic and operational challenges. As captives adjust, they innovate and look for opportunity in change.

Some captives are established using the Protected Cell Company (PCC) structure as an insurance vehicle in jurisdictions which allow the use of PCCs. A PCC is a single legal entity consisting of a core and an indefinite number of cells (IAIS 2008). The structure enables different risks to be written in separate cells. The creation by the PCC of

a new cell will not create a separate legal entity. Each protected cell holds its own separate assets and liabilities attributed to it under the PCC legislation. The assets of one cell cannot be called upon to support the liabilities of another cell, or of the undertaking as a whole. The assets of the core (non cellular assets) may be available to meet the PCC's liabilities as a whole and, may, in some cases, be relied on to support an individual cell provided that the assets attributable to the relevant cell have been exhausted (IAIS 2015).

Insurance undertakings established as PCCs in a European jurisdiction are subject to a regulatory framework which transposes the requirements of all three Pillars of Solvency II.

Under Pillar I, the MCR is calculated for the PCC as a whole whereas a notional SCR is calculated for each cell as well as the core, in the same manner as if they were all separate undertakings. On the one hand, through a more efficient use of capital, protected cells within PCCs can therefore offer an alternative to small captives, which may otherwise struggle to comply with Solvency II capital requirements. On the other hand, this potential benefit for captives highlights the importance for supervisors to consider the adequacy of the capital within a PCC in both the core and the individual cells. Accordingly, where a PCC is established with individual cells being created and offered to clients to operate as captives, supervisors need to consider the funding of each cell separately as well as the PCC as a whole (IAIS 2015).

A PCC can create and issue shares in respect of any of its cells but being a single legal entity a PCC has one Board of Directors which is responsible for the proper governance and management of the core and the cells. Directors have regular statutory duties but in addition must ensure that core and cellular assets and liabilities are kept separate.

Protected cells cannot appoint directors but it is possible that a number of persons may be advising in some capacity on individual cells through cell committees. The members of this committee are appointed by the Board of Directors of the PCC and report to the Board of Directors. Captives operating through cells within a PCC structure can access a common pool of knowledge and expertise, including key functions under Pillar II, within the common management system at the core of the PCC.

The Board of a PCC has overall responsibility for all aspects of its business, including actions taken by the owners and management of cells. Specific risks attributable to PCCs include risks of cells that are unrelated to the core, a wide geographical spread of cell owners and a diverse range of business written across different cells - all of which may lead to an increased risk that the Board may be unable to adequately monitor and control all of the business activities of the PCC. To mitigate this risk supervisors need to ensure that the Board has a sufficient mix of skills and experience and has put in place suitable corporate governance procedures to ensure that potential conflicts of interest that may exist between the owners/management of the PCC and that of its cells can be identified and managed.

PCCs as a whole are also subject to regular Pillar III reporting requirements reflecting a consolidated submission identifying separately the core and its cells. The reporting is carried out by the PCC as a whole and not by each individual cell. The majority of the information, data, templates and documents that have to be submitted to the regulator (and public) may be done through the Board of directors, which is responsible for compiling, verifying and submitting the information to the regulator (and public).

PCC structures may therefore be seen as offering a proportionate facility to cell owners through efficient use of capital and cost sharing with respect to governance and reporting requirements while being fully compliant with Solvency II requirements. Against this backdrop, the supervision of PCCs comes with its own regulatory challenges, and the creation of each cell within a PCC which can be used for captive business is subject to separate regulatory approval. Solvency is assessed both on a consolidated level as well as for each cell individually, and supervisors need to be satisfied that the Board has a sufficient mix of competencies and has in place adequate systems and controls to allow it to exercise proper control over all aspects of the business. Public disclosure is reported on a consolidated basis as a single entity whereas supervisory reporting is still granular for each cell as well as for the PCC as a whole (IAIS 2015).

Conclusion

As Insurance markets change and adjust, so too must regulatory systems which oversee them (UNECE 2012). Over the past 50 years, notwithstanding volatility in the financial sector, changing global economies and the emergence of new risks, the steady growth of captives has remained a stable factor. In the midst of the changing face of insurance regulation, Bernardino (2015) inspirationally describes Solvency II as intelligent and effective regulation which does not stifle innovation. Already at the preparatory stage and now beyond January 2016, European captives are embracing Solvency II's regulatory requirements and continuing to focus on their own risk management (Captive Review 2016). Indeed, despite challenges and burdens of higher capital charges and compliance costs, European captives are increasingly appreciating the opportunities which are afforded through better governance, improved risk management and use of intellectual capital under Solvency II. Captives continue to evolve and flourish (Marsh 2016), providing affirmation of their efficacy, flexibility and stability. On a going forward basis, coping with the challenges associated with a change in regulatory culture, mind-set and skill set have been identified as the main lessons being learnt.

Regulation is complex, multifaceted and dynamic. The role which regulatory risk management plays in creating a synergy between risk management and regulation is focal, and the continued development of regulatory approaches to attune the logic of holistic risk management to the complex problems and dynamics of regulation is of relevance in this evolving field.

The challenge is to find an appropriate balance between preserving the safety and soundness of the system and allowing undertakings and markets the flexibility to perform their intended functions through fostering sustainable business growth. This is the opportunity of regulatory innovation.

Notes

1. The Solvency II Directive (Directive 2009/138/EC [recast]) was adopted in November 2009 and amended by Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 (the so-called Omnibus II Directive).

2. European Union, Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, 13 December 2007, Official Journal of the European Union C 306/01.

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