CEIOPS

Committee of European Insurance and Occupational Pensions Supervisors

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Advice to the European Commission in the Framework of the Solvency II project on Pillar II issues relevant for reinsurance

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Style convention

The following has been adopted for this document:

Advice appears in shaded (blue) boxes, headed **CEIOPS' Advice**

Descriptive headings are used (such as 'Background', 'Explanatory text' etc.) in an attempt to improve the navigability of the answers.

Introduction

1. The European Commission has requested CEIOPS to advise on the development of a new solvency regime for insurance and reinsurance undertakings in the EU.

2. CEIOPS has submitted its Advice in the form of answers to three waves of Calls for Advice from the European Commission and following public consultation[1].

3. Unless expressly stated otherwise, the advice in these three documents stands. For convenience, this paper occasionally summarises parts of the advice previously given as 'background information,' but the omission of other parts should not be viewed as a retraction.

4. CEIOPS has identified and developed principles concerning Pillar II issues relevant to reinsurance. CEIOPS' Pillar II analysis includes of:

   - Solvency II and the supervision of reinsurance undertakings;
   - supervisory co-operation between group and solo supervisors for reinsurance supervision;
   - assessing equivalence of third country supervisory regimes regarding reinsurance;
   - recent EU legislative developments regarding reinsurance.

5. CEIOPS has set out its explanations and Advice according to those headings. The Advice is to be taken together with CEIOPS' answers to the first, second and third waves of Calls for Advice as well as its subsequent Consultation Papers.

[1] Answers to the European Commission on the first wave of Calls for Advice (CEIOPS-DOC-03/05), Answers to the European Commission on the second wave of Calls for Advice (CEIOPS-DOC-07/05) and Answers to the European Commission on the third wave of Calls for Advice (CEIOPS-DOC-03/06), available at www.ceiops.org

Pillar II issues relevant for reinsurance

Explanatory text

Background

1. In its letter to CEIOPS dated 24 January 2006[2] the European Commission asked CEIOPS among other requests, for more detailed input regarding Pillar II issues relevant to reinsurance, both for direct insurers and reinsurers (EU reinsurers as well as non EU reinsurers).

2. Reinsurance allows direct insurance undertakings, by facilitating a wider distribution of risks at worldwide level, to have a higher underwriting capacity and to reduce their capital costs. Furthermore, reinsurance plays a fundamental role in financial stability, since it contributes to ensuring the financial soundness and the stability of direct insurance markets, as well as the financial system as a whole.

3. When considering the future supervisory framework for reinsurers in the Solvency II project, it is necessary to identify elements that should be taken in common with direct insurers and those elements that should be taken to reflect the same risks but are more pronounced in reinsurers.

4. The aim of this paper is to:

    a. reflect the link between the upcoming Solvency II project, from a Pillar II perspective, and the supervision of reinsurance undertakings;

    b. identify the need for an enhanced framework for co-operation in the case of reinsurance supervision between group supervisors and solo supervisors within the EU, including:

        - General guidance;
        - Information exchange;
        - Validation of internal models;
        - Groups and subsidiaries;

    c. discuss and clarify the assessment of equivalence of third country supervisory regimes with respect to reinsurance. This relates especially to:

[2] Available at: www.ceiops.org

- equivalence assessments of third country supervisory regimes for third country reinsurers to whom EU insurers cede risks;

- reliance assessments of third country supervisory regimes in the context of "advanced approaches" (i.e. internal models), both with respect to their implementation of a similar regime to Solvency II and the review validation work surrounding actual implementation;

- equivalence assessments of third country supervisory regimes for a reinsurance subsidiary based in a third country forming part of a group headed by a company in the EU;

- equivalence assessments of consolidated group supervision arrangements for groups and financial conglomerates headed by a company in a third country; and

d. take into account the recent developments from a EU legislative point of view, namely Directive 2005/68 on Reinsurance, as well as the upcoming Recast Codified Insurance Directive in which Reinsurance will be incorporated by the inclusion of a chapter on the subject, and the draft Framework Directive of the Solvency II project;

e. consider the work carried out in other fora, e.g. in the IAIS.

Current situation at EU level

5. A Directive covering Reinsurance has been recently approved, as a fast track process and thus based upon direct insurance rules, by the Parliament and the Council. This Directive aims at establishing a prudential regulatory framework for reinsurance activities, being part of the body of Community legislation on insurance and therefore following that same approach.

6. The scope of application of the Directive covers reinsurance undertakings that exclusively write reinsurance business, as well as captives, but not insurance undertakings that accept reinsurance (except for certain cases, where the volume of reinsurance activities is significant and only on provisions relating to the solvency margin).

7. The solvency regime of reinsurers is based on technical provisions and solvency margin, the latter to act as a buffer, under the application of the rules of direct insurance. However, supervision is intended to cover both quantitative and qualitative elements, including internal controls, governance rules and risk management systems.

Current situation in IAIS

8. The IAIS has issued a series of documents of interest regarding the supervision of reinsurers, namely the Principles on minimum requirements for the supervision of reinsurers, the Standard on supervision of reinsurers, and the Guidance Paper on risk transfer, disclosure and analysis of finite reinsurance.

9. Two principles listed by IAIS should be quoted:

   - Principle 1: Regulation and supervision of reinsurers' technical provisions, investments and liquidity, capital requirements, and policies and procedures to ensure effective corporate governance, should reflect the characteristics of reinsurance business and be supplemented by systems for exchanging information among supervisors.

   - Principle 2: Except as stated in Principle 1, regulation and supervision of the legal forms, licensing and the possibility of withdrawing the licence, fit and proper testing, changes in control, group relations, supervision of the entire business, on–site inspections, sanctions, internal controls and audit, and accounting rules applicable to reinsurers, should be the same as that of primary insurers.

Main differences between direct insurers and reinsurers

10. CEIOPS has analysed the main qualitative requirements in order to get an overview as to whether the future Solvency II Directive should contain the same references to qualitative requirements for direct insurers and for reinsurers.

11. The detailed analysis comprises the Pillar II aspects of the following issues:

    - Governance;

    - Fit and Proper;

    - Risk management and internal control;

    - Management of technical provisions;

    - Investment policy (including asset/liability management, Limits on eligible assets/Prudent Person Plus Principle, liquidity risk, currency risk);

    - Retrocession;

    - Validation of internal models for reinsurance undertakings (only the qualitative requirements for the "use test");

- SRP (General);
- Solvency Control Levels;
- Capital add-ons;
- Supervision of non EU reinsurers.

12. Products and markets vary quite considerably. Insurance products may be short term or long term, simple or more complex with guarantees and embedded options, fairly stable and predictable (high frequency low impact) or more volatile (low frequency high impact), retail or commercial line. Products are offered by smaller local companies or by companies that are part of globally operating groups. It is recognised that reinsurers tend to operate on the more global and complex side of the spectrum. References could be made in the Directive to emphasise that Pillar II issues relevant for reinsurers should reflect this complexity. Nonetheless, at this stage of development, no decision has been taken as to whether the standard formula to be developed should be applied to reinsurers as well, in the future. Some differences between insurance and reinsurance business are mentioned below:

    - While the direct insurer has a direct obligation to the policyholder, the reinsurer has an obligation solely to the direct insurer;
    - While the direct insurer assesses directly the risks that it is going to underwrite, the reinsurer relies on data and information supplied by the direct insurer, on the basis of "utmost good faith";
    - The establishment of technical provisions by the reinsurer is strongly conditioned by the timing and quality of the claims information received by the cedants; it implies a particular focus on IBNR provisions;
    - Reinsurance operating results are potentially more volatile than those of direct insurers;
    - Reinsurance is generally an international business, and this has important practical implications (e.g. most of these companies are listed, rating agencies play an important role in terms of internal capital held);
    - Reinsurers may potentially use internal models rather than the SCR standard formula;
    - Generally, internationally active reinsurers are assessed by at least one rating agency; supervisors should seek to benefit from information by rating agencies.

13. The often international nature of reinsurance activity and its supervision, demands under the Supervisory Review Process that cooperation and information systems among supervisors need to be fostered, and harmonisation should be a core objective.

14. CEIOPS believes that at the current stage of development, in the future Solvency II Directive the high level principles for governance, fit and proper testing, risk management and internal controls, management of technical provisions, investment policy, retrocession, validation of internal models, solvency control levels and capital add-ons for reinsurance undertakings, should be the same as the qualitative requirements already recommended in CEIOPS' previous answers to the European Commission for direct insurers.

15. Recapitulating, for most of the subjects, no need for a different treatment between direct insurers and reinsurers could be determined or justified.

Enhanced Framework for Co-operation between Group Supervisors and Solo Supervisors with respect to reinsurance

16. As reinsurers mostly belong to large groups, it seems very important to emphasize the need for an enhanced framework for co-operation in the case of reinsurance supervision between group supervisors and solo supervisors within the EU, including:

- information exchange on a going concern basis and in emergency situations;
- co-operation in relation to the validation of internal models;
- verification of information regarding subsidiaries of groups in other Member States.

This framework should be completely in line with the requirements relating to groups, already determined by CEIOPS in its answer to CfA 20.

Prudent person plus principle - Limits on eligible assets for reinsurers

17. It is recognised that with respect to the desirability or otherwise of any limits on assets, there are some differences between the Reinsurance Directive (RID) and the current Life and Non-Life Directives. CEIOPS has discussed this issue in more detail in another Consultation Paper.[3]

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[3] Consultation Paper 19, now CEIOPS Advice to the European Commission in the Framework of the Solvency II Project on Safety Measures (Limits on Assets), CEIOPS-DOC-07/07, for further details see website: http://www.ceiops.org/content/view/17/21/

Equivalence requirements of non EU reinsurers

18. The RID (art. 49) provides that reinsurance undertakings whose head office is situated outside the EU Community and which conduct reinsurance business in the EU Community, must not be subject to provisions which result in treatment more favourable than that provided to reinsurance undertakings having their head office in a Member State.

19. In order to take account of the international aspects of reinsurance, the RID also encourages the conclusion of international bilateral agreements between the EU Commission and a third country, aimed at defining the means of supervision over reinsurance entities which conduct business in the territory of each contracting party.

20. These bilateral agreements should make it possible to assess prudential equivalence with third countries on a Community basis, so as to improve liberalisation of reinsurance services in third countries, whether through establishment or cross-border provision of services.

21. It should be noted that regarding the Solvency Capital Requirement, QIS 2 already distinguishes reinsurers in the calculation of the credit risk capital charge. The rated reinsurers are treated equally according to the individual rating. Only the unrated reinsurers have a different treatment, depending on whether they are subject to the requirements of the RID or not. This would mean that the bilateral agreements will have a direct impact in the SCR calculation of the insurance undertakings.

22. There is a parallel or precedent for this ratings line in the banking sector. The Banking Consolidation Directive (BCD) Annex 6 allows counterparty weightings for exposures of banks to banks (and other financial institutions) to be based on ratings from External Credit Assessment Institutions (ECAIs). However it should be noted that, while the BCD does not specially distinguish the cases where the bank counterparty is located in the EEA or a third country for the purpose of assessing credit risks, the equivalence requirement of the BCD (and of the RID), could prevent a third country undertaking from entering into contracts with EEA counterparties in the first place unless it obtains EU authorisation.

23. Nonetheless, from a technical point of view with respect to Pillar II qualitative requirements, CEIOPS considers that it is clearly desirable to avoid multiple equivalence assessments applying to individual third countries. This may arise either because:

    - equivalence assessment are performed for a variety of different reasons; or

- the same equivalence process is conducted by different Member States.

24. Bearing this in mind there are four key questions that need to be addressed in the design of Solvency II:

a. What, if any, equivalence assessments process should be applied in respect of third country reinsurers seeking to conduct business with EU insurers on a cross-border services basis (either the current RID approach or something different such as a ratings-based approach)?

- **Equivalence assessments of third country supervisory regimes for third country reinsurers to whom EU insurers cede risks.**

25. Article 49 of the RID introduced a requirement that third country reinsurers which conduct reinsurance business in the EU or on a cross-border basis must not be subject to provisions which result in treatment more favourable than that provided to EU reinsurers. In order to take account of the international aspects of reinsurance, the RID also encourages the conclusion of international bilateral agreements between the EU Commission and a third country aimed at defining the means of supervision over reinsurance entities which conduct business in the territory of each contracting party.

26. The requirement in Article 49 of the RID is similar to the position under the BCD[4]. In short, the RID could be deemed to require that a third country institution wishing to conduct banking or reinsurance business in the EU must either be subject to equivalent regulatory regimes (as stated in Article 50 of the RID) in their home states or obtain authorisation in one of the EU states[5].

27. While recognising the intentions behind these provisions in the RID in terms of the liberalisation of reinsurance services, it is difficult to see how they can be implemented in practice in respect of major third country markets, where insurance supervision is for example a State prerogative. Nevertheless, the European Commission has produced draft guidance that equivalence assessments - and compensating measures where sub-equivalence is found – are required for third country reinsurance that has been sold even on a cross-border services basis.

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[4] Article 38 of the Banking Consolidation Directive 2006/48/EC.

[5] It is worth noting that the Markets in Financial Instruments Directive (MiFID) may diverge from the current BCD position and move closer to insurance directives in that any party wishing to undertake MiFID activities in the EU may need to obtain relevant authorisation in one of the EU states.

b. What equivalence procedure should apply in relation to group supervision in the situations described in paragraph 4c above, second and third bullet point?

28. Whatever is incorporated in Solvency II bearing on group supervision should be consistent with the approaches in the Financial Conglomerates Directive (FCD) and the Capital Requirements Directive (CRD). In this respect, CEBS and the Interim Working Committee on Financial Conglomerates (IWCFC) have set up a joint working group to consider equivalence. Since many of the issues are likely to be the same (and the treatment of reinsurers should, in principle, be identical to that of insurers), relevant CEIOPS Members might provide input to the debate in the expectation of a common approach being adopted.

- **Equivalence assessments of third country regulatory regimes for third country-based subsidiaries of EU groups in respect of their inclusion in group capital adequacy calculations.**

29. Article 129 of the BCD sets out the requirement for assessing whether third country regulators' rules are broadly equivalent to those in the CRD for the standardised rules for market risk, credit risk and operational risk. The BCD does not specify exactly how the assessment should be performed, leaving a degree of discretion to competent authorities. Where a third country regulator's rules are deemed equivalent as a result of an assessment, it is possible to rely on the third country regulator's rules to calculate the capital requirements for subsidiaries supervised in that third country, when calculating group capital resources requirements. This is instead of requiring the group to re-calculate the third country subsidiaries' capital resources requirements using the EU rules.

30. The Insurance Groups Directive (IGD) Annex I 2.4 has a similar provision to the CRD in respect of third country insurers and reinsurers. If a third country is deemed to have equivalent solvency requirements to those that are required under the insurance and reinsurance directives, the use of local rules would be allowed to calculate third country subsidiaries' solvency requirements to be included in the insurance group calculation.

31. The FCD 'sits' on top of sectoral rules, so if a financial conglomerate's members include third country subsidiaries, the CRD and IGD assessments on these third country rules would be considered valid for the financial conglomerate calculations.

- **Equivalence assessments of third country consolidated group supervision arrangements for banking groups and financial conglomerates.**

32. Article 143 of the BCD sets out the requirement for assessing whether a group whose ultimate parent is located in a third country, is subject to consolidated group supervision by the regulator of that third country, which is equivalent to what is required under the CRD[6]. Article 18 of the FCD has a similar provision in respect of financial conglomerates whose ultimate parents are located in third countries. These assessments must be performed on each third country group or financial conglomerate, and are ongoing obligations.

- Qualitative group supervision;
- Quantitative group supervision;
- Supervisory co-operation and information sharing; and
- Enforcement.

33. Typically, a failure in relation to one of the above to meet the standards set out in the FCD would result in non-equivalence. If a third country's consolidated supervisory arrangements are deemed non-equivalent, competent authorities are required to consider other methods being imposed. Other methods may involve establishing a European holding company or ring-fencing European entities.

c. What assessment procedures should apply in relation to reliance assessment in respect of third countries' equivalence to Solvency II (especially if Solvency II is to use an internal model based approach) – or is there any need for this?

- **Reliance assessments of third country regulatory regimes in respect of their implementation of Basel II.**

34. Under the CRD, reliance is assessed in order to establish whether it is appropriate to rely on a third country regulator's implementation of the Basel II and review/validation work for the advanced approaches (i.e. internal models) to market, credit and operational risk. The decision to rely on the work of a non-EEA regulator is based on an assessment that its:

- general regulatory environment and ability or willingness to share information is adequate; and
- proposed implementation of Basel II is independent, adequately resourced and of a sufficiently high standard, to give confidence that it is justified to take comfort from the work third country regulators have done, because its quality will be equivalent to that undertaken by the EEA supervisor and any decisions taken are likely to be robust.

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6 The BCD and the CRD 2006/49/EC.

35. If it is possible to rely on the non-EEA regulator's implementation of Basel II and on the undertaking-specific work it is to carry out as home or host supervisor, then it becomes possible to reduce the amount of work necessary when, for example, reviewing internal model approvals. The use of reliance is a key component in making the home-host concepts set out in the CRD work in practice.

d. Which body, or bodies, should provide advice on equivalence of third country supervisory regimes to avoid multiple and/or divergent equivalence assessments?

In order to guarantee consistency, it would be preferable if a high-level multi-national body (e.g. CEIOPS) could provide advice on equivalence of third country supervisory regimes.

e. Possible conclusions taken from question a. to d.

36. The European Commission, supported by Member States, clearly leads on the overall issues that impact on market access and relations to stakeholders outside the legal framework of the EU. From that perspective, it seems likely that the European Commission will wish to incorporate provisions in Solvency II that reflect those in the RID and the CRD regarding the negotiation of international agreements.

37. In parallel, it seems sensible for CEIOPS to adopt at Level 3 a formal procedure to enable any of its Members to request that CEIOPS initiates a supervisory assessment procedure, under which the equivalence of third country regimes as operated in practice and the reliance which can therefore be placed on them, would be assessed (liaising with CEBS, the IWCFC and IAIS where necessary). If, on a qualified majority decision, CEIOPS decided to initiate such an assessment, it would advise the European Commission at that time, and subsequently inform the European Commission of the results. The European Commission should agree a mechanism for taking such advice into account.

38. As this issue needs further discussion with the European Commission, CEIOPS will only give a preliminary advice on the treatment of third country reinsurers.

A rating approach - in accordance with the SCR credit matrix approach - should at first be taken into account for calculating the credit counterparty risk when assessing non-EU reinsurers. Both, the results of a rating approach and the results of the supervisory assessment procedure, mentioned in paragraph 37 can lead to the following four alternatives:

- If the result of the supervisory assessment procedure is positive, and the reinsurer has a rating of more than BBB (or

equivalent), it will be treated in the same way as an EU reinsurer;

- If the result of the supervisory assessment procedure is negative, but the reinsurer has a rating of more than BBB (or equivalent), it could be treated in the same way as an EU reinsurer. However please note paragraph 39 still applies;

- If the third country reinsurer has a rating below BBB (or equivalent) or is unrated, but the supervisory assessment procedure is positive, it will be treated the same way as an EU reinsurer in the same circumstances;

- If the third country reinsurer has a rating below BBB (or equivalent) or is unrated, and the supervisory assessment procedure is negative, the supervisory authority will ask the direct insurer to justify placing reliance on this reinsurance in its Internal Risk and Capital Assessment (IRCA).

39. Notwithstanding this procedure, if at any time there are reliable indications that a particular reinsurer is in financial difficulty or CEIOPS has formally determined that the regime is not equivalently regulated, supervisory authorities may take other supervisory measures in respect of any direct insurer with exposure to the reinsurer in question, including the imposition of a capital add-on.

CEIOPS' Advice

General Remarks

40. CEIOPS believes that at the current stage of development, in the future Solvency II Directive the high level principles for governance, fit and proper testing, risk management and internal controls, management of technical provisions, investment policy, retrocession, validation of internal models, solvency control levels and capital add-ons for reinsurance undertakings should be the same as the qualitative requirements already recommended in CEIOPS' previous answers to the European Commission for direct insurers. Referring to the SRP a demand for closer cooperation and information systems among supervisors should be emphasized as a core objective due to the often international nature of reinsurance activities and its supervision.

Prudent person plus principle – Limits on eligible assets for reinsurers

41. It is recognised that with respect to the desirability or otherwise of any limits on assets there are some differences between the Reinsurance Directive and the current Life and Non-Life Directives. CEIOPS has discussed this issue in more detail in another Consultation Paper[7].

Advice on third country reinsurer

42. The EU Commission, supported by Member States, clearly leads on the overall issues that impact on market access and relations to stakeholders outside the legal framework of the EU. From that perspective, it seems likely that the European Commission will wish to incorporate provisions in Solvency II that reflect those in the Reinsurance Directive and the CRD regarding the negotiation of international agreements.

43. In parallel, it seems sensible for CEIOPS to adopt at Level 3 a formal procedure to enable any of its Members to request that CEIOPS initiates a supervisory assessment procedure under which the equivalence of third country regimes as operated in practice and the reliance which can therefore be placed on them would be assessed (liaising with CEBS, the IWCFC and IAIS where necessary). If, on a qualified majority decision, CEIOPS decided to initiate such an assessment it would advise the European Commission at that time, and subsequently inform the European Commission of the results. The European Commission should agree a mechanism for taking such advice into account.

[7] Consultation Paper 19, now CEIOPS Advice to the European Commission in the Framework of the Solvency II Project on Safety Measures (Limits on Assets), CEIOPS-DOC-07/07, for further details see website: http://www.ceiops.org/content/view/17/21/

44. As this issue needs further discussion with the European Commission, CEIOPS will only give a preliminary advice on the treatment of third country reinsurers. The following procedure has been identified as a possible beneficial solution for both undertakings and supervisors:

A rating approach - in accordance with the SCR credit matrix approach - should at first be taken into account for calculating the credit counterparty risk when assessing non-EU reinsurers. Both the results of a rating approach and the results of a supervisory assessment procedure mentioned in paragraph 37 can lead to the following four alternatives:

- If the results of the supervisory assessment procedure is positive, and the reinsurer has a rating of more than BBB (or equivalent), it will be treated in the same way as an EU reinsurer;

- If the supervisory assessment procedure is negative, but the reinsurer has a rating of more than BBB (or equivalent), it could be treated in the same way as an EU reinsurer. However please note paragraph 45 still applies;

- If the third country reinsurer has a rating below BBB (or equivalent) or is unrated, but the supervisory assessment procedure is positive, it will be treated the same way as an EU reinsurer in the same circumstances;

- If the third country reinsurer has a rating below BBB (or equivalent) or is unrated, and the supervisory assessment procedure is negative, the supervisory authority will ask the direct insurer to justify placing reliance on this reinsurance in its Internal Risk and Capital Assessment (IRCA).

45. Notwithstanding this procedure, if at any time there are reliable indications that a particular reinsurer is in financial difficulty or CEIOPS has formally determined that the regime is not equivalently regulated, supervisory authorities may take other supervisory measures in respect of any direct insurer with exposure to the reinsurer in question, including the imposition of a capital add-on.