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THE CHALLENGE OF SOLVENCY II

LECTURE TO THE FACULTY OF ACTUARIES

By K. Van Hulle

[Delivered to the Faculty of Actuaries, 1 October 2007]

Introduction

The third Lecturer to the Faculty of Actuaries is Mr Karel Van Hulle. He is a lawyer by training, and is Head of Unit at the European Commission (Directorate-General 'Internal Market and Services'), which he joined in 1984, after having served for eight years with the Belgian Banking Commission.

He was subsequently Head of Unit for Accounting Standards, Head of Unit for Financial Reporting and Company Law and Head of Unit for Accounting and Auditing. In that capacity he was closely involved with harmonisation in the fields of accounting, auditing and company law, both at European Union level and internationally, and served as the Commission's observer with the International Accounting Standards Committee. He was Secretary of the High Level Group of Experts on Company Law, which prepared the Commission's 2003 Action Plan on Company Law.

Since November 2004 he has been Head of the Insurance and Pensions Unit. In this function, his main responsibility is the preparation of the new solvency regime for insurance and reinsurance companies (Solvency II).

The Lecture

I thank the Faculty of Actuaries for inviting me. I have learnt from my American colleagues that I should make a statement at the beginning of my presentation that I speak on my personal behalf, and that nothing of what I say, or will not say, can possibly be used against the European Commission.

I have been wondering why the Faculty invited me. After all, I am only a lawyer. After thinking about this, I came to the conclusion that, maybe, the reason could be that we both share something in common; the legal profession and the actuarial profession are often the subject of criticism, but also of many jokes. Indeed, I have discovered that some of these jokes are actually the same, such as when an actuary is being asked how much one plus one is. He will answer: "How much would you like it to be?" That is what they say about lawyers, too. I must add immediately, that some of the jokes

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which actuaries enjoy are more divine. I have not yet heard any of these about lawyers. Two examples are: "What is the difference between an actuary and God?" "God knows that He is not an actuary!", or: "Where do actuaries prefer to be buried?" "In Jerusalem, because the probability of resurrection is higher there than anywhere else in the world!" With that, I think that I have made it clear that we do have something in common.

No doubt Solvency II will put more emphasis on your profession. I had not had much contact with the Actuarial Profession before I joined the Insurance and Pensions Unit, but I can assure you that your future looks bright. The world needs good actuaries to make Solvency II work. That is what I will try to explain to you.

I want to talk to you about Solvency II, and mainly about the challenges of Solvency II. First of all, I consider the challenge of Solvency II as a project in itself. Solvency II is quite innovative, and the questions, therefore, are: "Will it work eventually? Will replacing Solvency I with Solvency II actually produce all the benefits which we hope that it will deliver?"

There is a challenge, also, of the process. As I will try to show you, to get from Solvency I to Solvency II is not something which happens overnight. It is an extremely complex process, and is a challenge also to all parties involved. "Can industry take greater responsibility on board?" "Do the supervisors have the right skills and experience to work in this new environment?" To the Actuarial Profession: "Will they not get lost in formulae and models?" To risk managers: "Will they be able to identify the right risks and combinations of risks?" To policyholders: "Can we explain to policyholders that things can still go wrong?" To Europe: "Will Europe be able to develop an innovative solvency regime which can stand as a model for the rest of the world?" That is what I want to talk to you about in this lecture. I will come back to these challenges as I go through my presentation.

Einstein said: "Not everything that can be counted counts — and not everything that counts can be counted." Solvency II is not all about quantitative aspects, however important they may be. There is more to it than this. Qualitative aspects are bound to become very important. That is a challenge also for your profession, a challenge which I should like to encompass in the word 'communication' — which is very important in this project.

I mentioned that the project is complicated in itself; in fact, we proposed, on 10 July 2007, a directive, which is the first step in the official process of adopting the new rules at European level. Figure L.1 shows that we have taken the existing Insurance Directives — and I know not all of you are avid readers of those directives, but I can assure you that some of them were written in the 1960s — and we have put them together in one single document. That is what we call a recast.

As I am speaking in the Royal College of Physicians, I want to use a medical example to explain how we will proceed in drafting the legislation.

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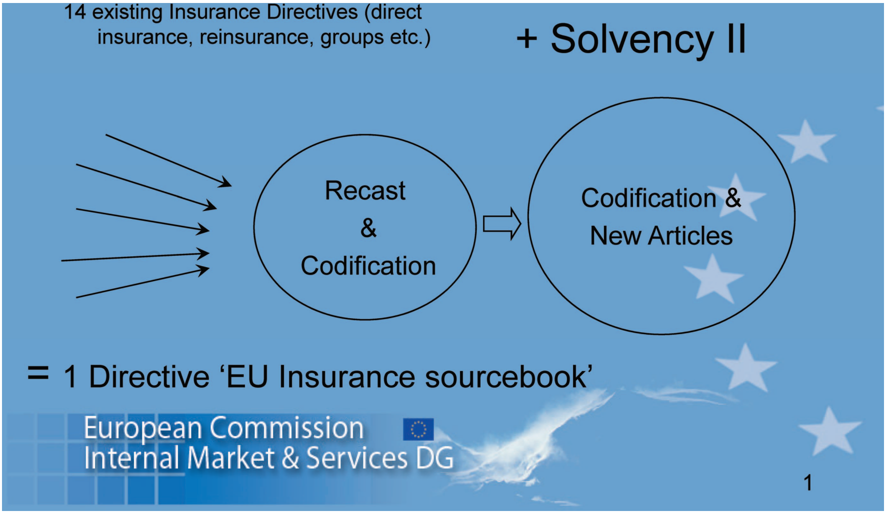

Figure L.1. Proposal for a framework directive, 10 July 2007

What we have done is to take out, very much like a surgeon, the old heart, Solvency I, and to replace it, as is done during the course of a transplantation, with the new heart, beating strongly, of Solvency II. That is the exercise. This is a very complex process, because the 'patient' sometimes shows resistance. The advantage is that what you will have in the end is a real source book, with all the relevant material on insurance regulation in one single document.

The first objective of Solvency II is to deepen the Single Market. You will say: "He comes from the internal market, so he wants to talk about the internal market." The problem, today, is that we do have various solvency regimes throughout Europe. Solvency I has evolved. Some member states already under Solvency I have decided to move to a more risk-based solvency regime. The United Kingdom is one of the member states which has developed Solvency I into what you call ICAS. However, Solvency II is not the same as ICAS, as I will point out later.

Thus, the problem is that we have, today, different solvency regimes in Europe which make the internal market disharmonised. What we are trying to achieve with Solvency II is to improve the level of harmonisation. You will probably ask me: "Why do you not go for maximum harmonisation?" We have learnt that maximum harmonisation may not be in the interest of the market, because it would lead to the adoption of the rules of those countries which are the most heavily regulated, and that is not what we want. What we are aiming at is a sufficiently high level of harmonisation.

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The second objective of Solvency II is to enhance policyholder protection. I need to repeat sometimes, when I have people from the insurance industry coming to see me, that it is not just for the industry that we have developed Solvency II. Solvency II has everything to do with the protection of the policyholders. For instance, following the Sharma report, we have discovered that what is failing at present in our regime is an early warning mechanism. That has led us to propose two capital requirements in the new Solvency II regime, which will allow supervisors to intervene at an early stage, and will, therefore, improve policyholder protection.

A third objective of Solvency II is to improve the competitiveness of the insurance industry. What we have tried to achieve in Solvency II is a better allocation of capital. That is in the interest of society as a whole. It is also in the interest of the industry, because those companies which manage their risks well will be rewarded.

Last, but not least, and very importantly, what we apply in Solvency II is also a process of better regulation. I know that the U.K. Government is very keen on better regulation. In Brussels we are also very keen to make sure that what we develop is not top down legislation, but bottom up legislation, developed in full transparency and consultation. Solvency II is being created with the full participation of all relevant stakeholders.

The new regime will introduce an economic risk-based approach, which will reward good risk management and will enhance policyholder protection. The recognition and the management of risk are key to Solvency II. It was one of the problems of Solvency I, which is not really a risk-based regime.

The new regime will place the emphasis on the responsibility of senior management to manage their business responsibly. It is very important to know that many insurance supervisors, today, follow a paternalistic approach. They will tell the industry how to run their businesses and how to invest, but are they the right institution to do that? Nobody knows their businesses better than the companies themselves. That is why, under Solvency II, we put the responsibility back to where it really belongs; to the management of the insurance and the reinsurance companies. There will be no more detailed investment rules, which say what percentage can be invested in particular types of assets. It is now up to the management, with good internal controls and good risk management, to take these decisions.

Lastly, the new regime fosters and demands greater supervisory convergence across the Community. That is a challenge. It is a challenge, because supervisors in Europe work with different traditions. I have been to many meetings with the supervisors. Sometimes the U.K. delegation, the Financial Services Authority (FSA) representatives, will say: "We do this and we do that", and the representatives of the German supervisor (BAFIN) will say: "But, in Germany, we cannot do this."

Under Solvency II, we want to give the same toolkit to all the supervisors, so that no supervisor can any longer say: "We cannot do this." All

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supervisors will have the same powers. That is very important if we want to achieve a true internal market for insurance services.

Solvency II, as a legislative process, will follow the so-called Lamfalussy process. Lamfalussy — a name which is very well-known in the financial services industry — is a Belgian Baron who was the chairman of a group of wise men asked by the European Commission to suggest a new way of law making in the financial services area which was different from that in other areas of Community law, because, in financial services, things move all the time. The latest financial crisis has shown how quickly things change in the financial services' area. If financial services' regulation is to serve a useful purpose, it must be possible to take account of new developments.

The Lamfalussy group of wise men suggested that financial services legislation should be developed at different levels.

At the first level, which is where we are now in Solvency II, there is principle-based legislation, developed by the co-legislators, Council and Parliament, following a Commission proposal. The proposed Solvency II Directive is a framework directive, not like the old ones, not rules based, but principle based. I hear people say: "Well, principle based is a new theory, but will it really change things?'' I believe that it is more than just a theory. It is very important that, at the European level, we try to be principle based, otherwise we will lose ourselves in details which we will need to change later on. Note that changes in legislation at the E.U. level are complex, so that there is a real risk that the legislation will soon be by-passed by events. So, level 1 consists of principle-based legislation, embodied in a framework directive.

Level 2 will comprise implementing the legislation. The implementing measures, which the Commission will issue after discussion with the supervisors of the member states, will be based on a specific mandate in the level 1 Directive. These implementing measures may well take the form of a regulation which is a legal instrument which is different from a directive. A regulation is a legal instrument which is directly applicable in all the member states, and does not need national implementing measures.

Level 3 is the convergent implementation of Community legislation, developed by close co-operation between national authorities. We, in Europe, have a natural tendency to fight each other, not a natural tendency to talk to each other. It is the same with supervisors. We need to establish a mechanism whereby they can decide, preferably, but not yet the case, on the basis of a (qualified) majority vote, how to work out the rules which we have agreed at the legislative level.

Finally, the last level, level 4, is that of rigorous enforcement by the Commission of Community law. We need to ensure that what we have agreed at the European level is actually applied in practice.

Developing legislation following this Lamfalussy approach involves many players and stakeholders. This is particularly true for the Solvency II project.

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We developed our proposal in close consultation and dialogue: with the industry, represented by various organisations at the European level (CEA, AISAM-ACME, CRO Forum, CFO Forum); with the professionals, such as the Groupe Consultatif, with which I am sure you are familiar; and with the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

The role of the CEIOPS is particularly important in the Solvency II project. It was asked by the Commission, by way of calls for advice, to answer a number of questions which we had agreed beforehand with member states' experts. On the basis of its advice, we have developed our framework proposal. The calls for advice were incorporated in three waves, each comprising a number of questions, much like the waves of the sea.

What did we get back from the CEIOPS? We received a tsunami of pages, over 1,000 pages of well-written advice to the Commission! From that we had to take out the principles, and put them into our framework proposal.

I mentioned member state experts. Do we have member state experts on solvency? That is a very good question. It is one of the problems. Because of the complexity of Solvency II, member states will include more and more supervisors in their delegations, as finance ministries do not always have enough experts who can make useful contributions to the discussion. Nevertheless, it is important to underline the role which member state experts have played, and will continue to play, in the development of the Solvency II project. The Commission relies heavily on the advice of member state experts, delivered in the context of the European Insurance and Occupational Pensions Committee (EIOPC), the so-called level 2 committee, which was instrumental in helping the Commission with the design of the solvency project, but which will be even more important in the further development of implementing measures, once the framework directive will have been adopted.

The proposal is now with the European Parliament and the Council of Ministers, which are the co-legislators. The European Parliament will have the first debate on our proposal on 2 October 2007. I will be in Brussels, presenting the proposal before the Economic and Monetary Committee of the European Parliament. The Council of Ministers has set up a working party, which has already discussed the Commission's proposal several times.

In the end, Solvency II will have to be implemented by thousands of insurers — actually there are 5,000 insurers and reinsurers, plus some 2,000 small mutuals in France. No one knows exactly how many of these mutuals still exist in France, but they say that there are about 2,000 of them. One of the big questions which is still open is how far the scope of Solvency II should go. Should it include all the small and medium sized players? There are arguments in favour (such as avoiding the creation of a second-class-type of insurer), and arguments against (such as not overburdening small operators).

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The question whether and how many players should be exempted from Solvency II is still under discussion.

Very important in the development of Solvency II are the quantitative impact studies (QIS). Some of you have participated in this exercise. It is part of the impact assessment, a key element of better regulation. Impact assessment means that we try to find out what could possibly be the consequences of the things which we are proposing. We have organised three quantitative impact studies which were carried out by the CEIOPS. Each of them was a formidable exercise involving many people and a lot of work.

QIS 3 was rolled out in June 2007. The results will be known in November 2007. We will then put the results to discussion with all the stakeholders. The Council working party will examine QIS 3 on 26 November, and the European Parliament plans a public hearing on 18 December. On the basis of the findings of QIS 3, we will prepare the specifications for QIS 4, and we will amend what we proposed in July, if necessary, following the results of QIS 3.

QIS 4 will then be organised in 2008. The specifications will be prepared by the CEIOPS, and will be delivered to the Commission on 20 December 2007. QIS 4, unlike QIS 3, will be organised by the Commission under its political responsibility. It will be carried out by the CEIOPS, as in the past, but this time the Commission will consult directly with the market, to make sure that we have the full recognition and co-operation of all market forces and that we can answer all the political questions which might arise.

The timetable for Solvency II is 2012. Does this mean that we can now relax and go home? Not quite; 2012 is not tomorrow, but it is the day after tomorrow. We were criticised when the proposal came out in July that we were moving Solvency II to 2012. Several journalists were asking Commissioner Charlie McCreevy, the Commissioner responsible for this exercise, why the Commission had decided to postpone Solvency II. The question was raised because we had been talking in the past about a timeline of 2010 and 2011.

As you can see from Figure L.2, it cannot possibly be earlier than that, because the implementing measures needed in order to make the system work will still have to be prepared. The final negotiation of the framework directive will finish, we hope, by the end of 2008. The CEIOPS has already been asked by the Commission to start work on the implementing measures by developing advice in those areas where we foresee the need for such measures. Following the advice by the CEIOPS, the Commission will then draft the implementing measures during the course of 2009 and 2010. The measures will be adopted in the course of 2010. Then we need at least 18 months for the industry to prepare itself for the new solvency regime. So, 2012 is indeed not too soon. It is not too late. I believe that we might just get there.

I am sure that many of you are very familiar with the key elements of

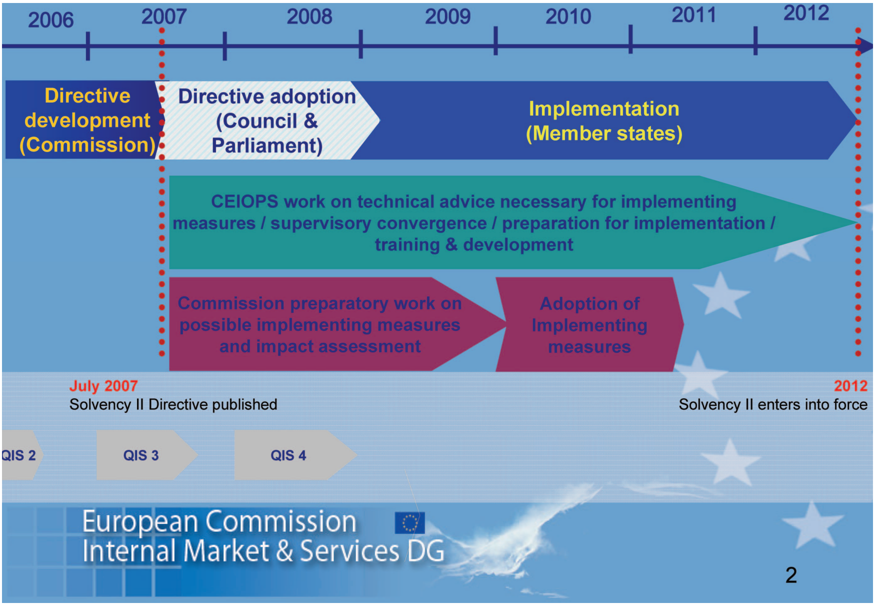

Figure L.2. Solvency II timetable for 2007 to 2012

Solvency II, as shown in Figure L.3. We follow the three pillar approach, which you also find in Basel II. We also took on board much of the experience learnt from Basel II, because we want to achieve a cross-sectoral convergence between insurance and banking. However, one of the first things which we heard when we were saying that we would follow the Basel II approach was that insurance is different from banking.

Although Mr Paul Sharma is present, and I know that he disagrees with me, I still say that I think that insurance is more sophisticated than banking. Therefore, we will need to make some changes to what we have done in Basel II. Basel II, clearly, as we discovered recently, is not perfect.

So, we have the three pillars structure, which we have taken over from the banking area. This means that we have the quantitative Pillar I, the qualitative Pillar II, and then the market discipline and disclosure, Pillar III. I will come back to that in a minute.

From Solvency I to Solvency II, the balance sheet rules change slightly. We have two capital requirements, as shown in Figure L.4. Although we used to have some kind of required capital also under Solvency I, the capital requirements under Solvency II are more sophisticated, and they are risk based.

Very important, also, is that we now move to a market-consistent

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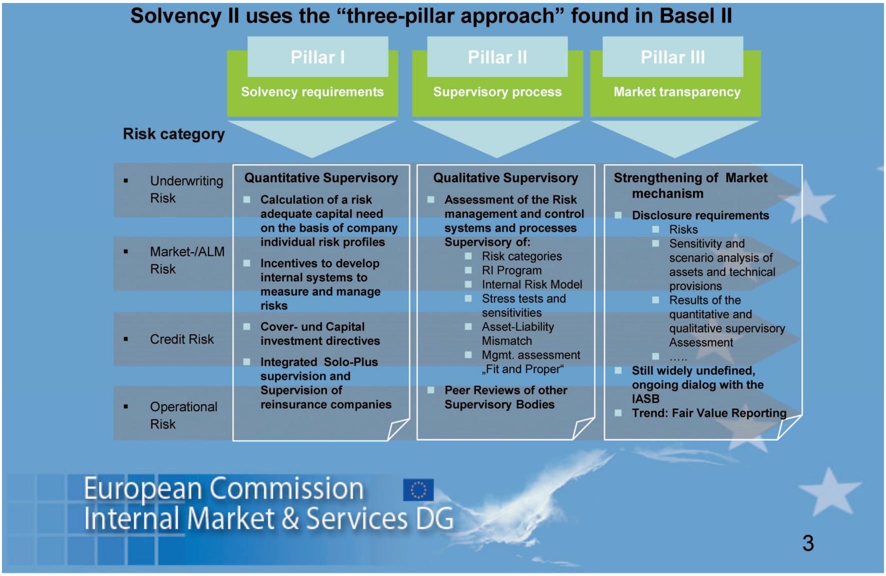

Figure L.3. Solvency II — content and targets

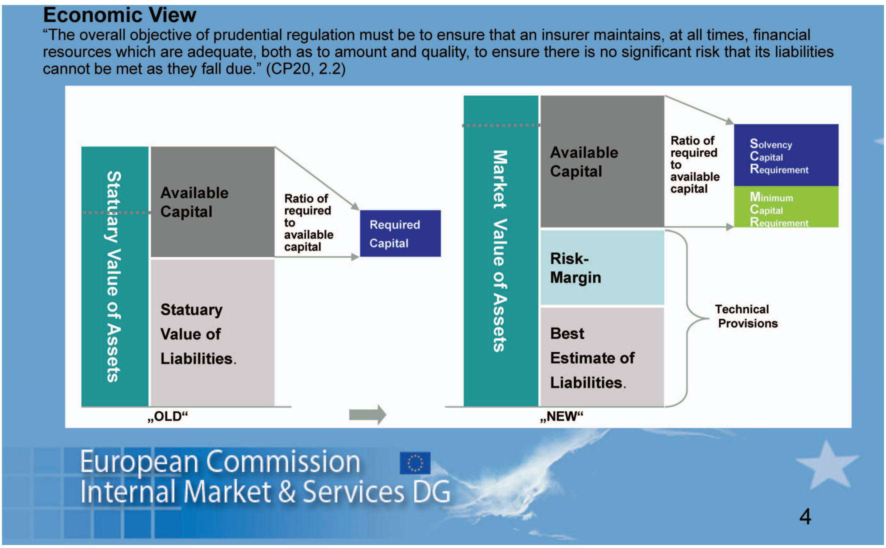

Figure L.4. From Solvency I to a Solvency II balance sheet

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valuation of assets and liabilities. That is one of the key elements of the new solvency regime. We also have an agreed position on how to value technical provisions. That was very difficult, because we have not managed to agree on this over the last 30 years. It is very unclear, today, how technical provisions are calculated in member states. We do not really know.

Some people say: "Put your finger up in the air, add some grease to it, and everybody is happy." Supervisors are indeed happy when technical provisions are calculated very prudently and the amounts are possibly very high, and the industry is happy to come up with high amounts in technical provisions when these amounts are tax deductible. In the future, we will have a much clearer picture on how technical provisions are calculated. For the first time we will have a harmonised regime.

To arrive at such a situation was not easy. I remember the CEIOPS members' meeting in Frankfurt. We started the whole Solvency II process on the basis of a framework for consultation, agreed between member states. The CEIOPS was asked to deliver its advice, taking account of the principles included in the framework for consultation. The framework for consultation says that we want a market-consistent valuation of assets and liabilities. When the CEIOPS had to come up with advice on how to calculate technical provisions, it proved impossible for supervisors to agree, because at least one of the supervisors asked: "Does a market-consistent valuation of liabilities mean that we have to discount technical provisions?"

This proved to be a difficult question to answer. As the Commission's observer at the meeting, I was then asked by the Chairman of the CEIOPS to clarify the meaning of the framework for consultation, as the framework was apparently not sufficiently clear on this issue. My immediate reaction was that I could not see any interpretation other than that a market consistent valuation indeed meant discounting. I promised the CEIOPS that we would change the framework for consultation, in order to put this into the text clearly, and that is what finally happened. Once the framework had been amended, all parties concerned agreed and the matter was settled. That is the way we resolved it.

I now turn to some particular challenges of Solvency II. First of all there is Pillar I. The introduction of a market-consistent valuation of assets and liabilities and of economically-based capital requirements will require insurers to assess accurately their current financial position using modern financial mathematical and actuarial techniques, and to manage better their asset-liability mis-match risk. These words comprise a lot of substance.

A first question to the industry is whether the current IT systems and data processes are capable of delivering that.

A second question to the industry is whether it fully understands the economic effects of the risk mitigation techniques which it uses, such as reinsurance, securitisation and derivatives. This is particularly important, because, under Solvency II, we want to increase the capacity of the industry

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to take on more risks by giving full recognition to risk mitigation techniques, which is presently not the case.

It goes without saying that the calculation of technical provisions on a market consistent basis is another major challenge. The calculation may be complex, and we need to consider also the difficulties of many insurance companies which may not have all the relevant know-how on board. I am thinking, particularly, about small and medium-sized companies, for which we have asked the CEIOPS to develop simplifications for the calculation of the technical provisions, but also for the calculation of the solvency capital requirement (SCR).

Secondly, there is Pillar II. The introduction of qualitative risk management standards covering all risks, not just those captured by the Pillar I requirements, will require insurers to ensure that risk assessment and risk management play a central role in their system of governance. That is where it all starts. Good governance is a key element of this reform. That is where the industry should start now. Unless that is in place, the rest will not follow.

What we also make quite clear in Pillar II is that Solvency II is not just a question of sticking to the formula, the SCR, but it is also important that the company is required to look, once in a while, into the mirror, in order to proceed with a critical self-examination. This is what we call the own risk and solvency assessment (ORSA), which is not another capital requirement, but should allow the company to see whether the capital requirements which are in place correspond with reality.

In all three pillars, but particularly in Pillar II, we attach a great deal of importance to the so-called proportionality principle. The governance system introduced under Pillar II comprises a number of functions, which must be in place within the company (risk management, internal control, internal audit, actuarial function). However, the application of the proportionality principle means that not all companies have to organise themselves in the same way. The functions, which we identify under Pillar II, may, for instance, be outsourced under certain conditions. They may also be combined (with the exception of the internal audit function, which must be independent), depending on the size and the complexity of the business. The development of the system of governance must be carried out in time, so that supervisors, when they discuss with an insurance undertaking the use of internal models, must be satisfied that the system runs well internally. That is very important in the Pillar II exercise.

Of course, you expect me to speak more specifically about the actuarial function. We have identified the actuarial function as one of the key functions of the governance system under Solvency II. Considering the complexity of Solvency II, the presence of an actuarial function seems evident, and I would have been shocked if it had not been there. However, things are not that simple. We had an extensive debate with the member

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states about the question of whether we should identify a separate actuarial function. Some people argued that it would be enough just to mention, somewhere in the text, the importance of the presence of actuarial skills, without turning this into a separate function. There was a fear that we would overburden the large majority of small and medium-sized insurers and that there would not be enough actuaries. Some people were also afraid that the recognition of an actuarial function would give a monopoly to the actuarial profession. It is in this context that one should understand the text of our proposal. We believe that it is important to have an actuarial function.

In order to take account of the concerns expressed, we state, in the text, that the actuarial function shall be carried out by persons with sufficient knowledge of actuarial and financial mathematics, who are able, where appropriate, to demonstrate their relevant experience and expertise, with applicable professional and other standards. As to the contents of the function, the text states that the actuarial function is:

— to coordinate the calculation of technical provisions;
— to ensure the appropriateness of the methodologies and underlying models used, as well as the assumptions made in the calculation of technical provisions;
— to assess the sufficiency and the quality of the data used in the calculation of the technical provisions;
— to compare best estimates against the experience;
— to inform the administrative or management body of the reliability and adequacy of the calculation of the technical provisions;
— to oversee the calculation of the technical provisions;
— to express an opinion on the overall underwriting policy;
— to express an opinion on the adequacy of the reinsurance arrangements; and
— to contribute to the effective implementation of the risk management system.

These are what the function is about.

We discussed this matter with the Groupe Consultatif, and invited its members to come up with some wording which we could use in the text. The description of the actuarial function is more detailed than that of the other functions. We have tried to give full recognition to what the profession is actually doing, and to what we believe that it is also capable of doing.

The actuarial function may be outsourced. The same is true for the other functions which are identified, like the risk-management function, the internal control function, and so on, because it is important that small and medium-sized companies can actually operate under conditions which are not too burdensome.

Pillar III is new for many member states. Disclosure requirements are not so much developed. We believe that, through appropriate disclosures, we can strengthen the system by building on market discipline. Insurers should explain to shareholders, rating agencies and analysts, clearly and accurately, how their risk profile and risk appetite fit in with their overall business strategy. That is very important. Companies will be obliged to publish what we call a report on solvency and the financial condition, which explains how a company is working within the new solvency requirements. We hope that the rating agencies will actually follow what we have developed in Solvency II, and not develop an alternative model, which would make things more complex. Without wanting to diminish, in any way, the important role which rating agencies play in the financial services sector, it would be a pity if the important reform which will take place under Solvency II would not be recognised fully by them. I am sure that rating agencies, which, these days, do not enjoy much popularity — at least, not with the political authorities — will understand this message perfectly.

Also, insurers will be required to explain to external stakeholders how they assess and manage risk, particularly those insurers using an internal model to calculate capital requirements. That is also very important, because it will inform the users as to what extent they can rely on the capital requirements developed on the basis of an internal model. We will also provide, under Pillar III, for the separate disclosure of capital add-ons. We believe that it is important that there is an appropriate disclosure of capital add-ons which might be imposed by the supervisory authorities. Of course, we knew, from the beginning, that this would be difficult. There will have to be a transitional period, so that people get used to the idea that a company might be required by its supervisor to add on more capital, without this information leading to a disturbance in the market. For the Commission and for a number of member states, the disclosure of capital add-ons is important, because capital add-ons should be exceptional, and should not be the rule. How can we know that supervisors are not consistently second-guessing what companies are doing? We can only do so if we have appropriate disclosures about the number of capital add-ons which supervisors are imposing. That is why we will ask the CEIOPS to make appropriate disclosures about the number of capital add-ons imposed in the different markets, and the reasons why they have been imposed. Not only will this contribute to more transparency on the issue, but it will also add further convergence between supervisory practices.

One of the key elements of Solvency II is the new rules on group supervision. It is very interesting that we speak today exclusively about solo supervision. Solo supervision is the basic principle of supervision; each entity is looked at as a separate entity, even when the entity is part of a group. When an entity is part of a group, there will also be additional group supervision. However, no supervisor is actually looking at the group as such. We do not give full recognition to the group as an economic entity. This no longer corresponds with the way in which many groups are being managed today. We want to bring supervision closer to the way in which groups are

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managed in actual practice. That is why we say, in our proposal, that groups must appoint a group supervisor with real powers. There is no requirement today to appoint a group supervisor. There is, however, a requirement to appoint a group co-ordinator, who chairs the so-called coordinating committee. Until recently most groups did not organise a coordinating committee, and those which have done so come to us and say that it does not work, because it is just a talking shop. Nothing happens, as nobody is in the lead. We want a group supervisor with real powers; a group supervisor who will decide on the internal model for the group; a group supervisor who will also be responsible for the SCR of the group. The local supervisors will only work with a notional SCR, not with a real SCR. They will not have the powers of intervention which supervisors normally have under Pillar II. Their actions will have to be co-ordinated with that of the group supervisor, who will be in the lead.

The proposal also contains a regime of group support. A parent undertaking may apply, with the group supervisor, for the group support regime, under which the parent offers support to build up the solvency capital requirements in the subsidiaries. This is a tricky issue, and the regime will only apply if the parent undertaking satisfies a number of conditions, including that of a legally enforceable commitment to provide capital support to the subsidiaries included in the regime. Important questions, however, remain. What happens if something goes wrong? Will the parent be able to deliver the capital in time to back up the subsidiary? Is that technically and legally possible? Will the parent transfer capital in a crisis situation? Can we force the parent to do that? These are some of the questions which we are still discussing. Also, the full recognition of diversification effects within the group will be very positive for groups. It is, however, resisted by those companies which are not part of a group, and which believe that, therefore, they have a competitive disadvantage, as they will have to provide the full amount of capital and will be in competition with companies which are part of a group, and which are, therefore, operating with lower capital requirements in the same market.

A system of group supervision can only function when supervisors work together. Co-operation between supervisors is not evident. There are a number of barriers. One of them is the language barrier. Past experience (Equitable Life) has clearly shown that communication between, for instance, the FSA and the BAFIN is not evident. It may already start at the switchboard. There is a language barrier and there is also a barrier that the people involved are not always used to cross-border co-operation. In order to make the system work, we also need trust between supervisors. That is difficult, because local supervisors fear that they will still keep their responsibilities while their powers are transferred to the group supervisor.

What we are trying to do now is to find mechanisms to assure the supervisors that, although there is a group supervisor with specific powers,

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the solo supervisors still have a role to play, because, without co-operation, the system cannot work. In the end, it is in nobody's interest that no supervisor is actually looking at the situation of the group, which might generate its own risks.

The system cannot work, either, if companies do not organise themselves so as to be able to show how they manage a system of group support and how they manage the diversification effects. That is something which was disappointing for us in the QIS 3 exercise. Only very few groups have delivered data which allow us to see, for instance, what the diversification effects are within a group. We need to have that information in order to calculate the potential impact of our proposal. This subject will be important under QIS 4, which will focus particularly on group issues.

To conclude, Solvency II is all about improving risk management and rewarding already existing good practice. Updating risk management processes and practices in any company takes time. We have time now until 2012. We should use this time to get prepared for Solvency II. It is important in the U.K. to say that ICAS makes the transition easier for the insurance industry, because the philosophy and the mentality are already there. However, ICAS is not Solvency II, and Solvency II is not ICAS. There will be changes. It is important that you are aware of that, and that you work towards what is going to be the system of the future.

Insurers need to start preparing now, if they do not want to be caught out when Solvency II comes into force. Also, of course, it goes without saying that the future belongs to those who prepare for it today.

We will not get it right from the outset, but I hope that I can count on you, on the Faculty, to help us to introduce an innovative, new solvency regime, which, in the end, as I have tried to show, is in the interests of us all.

Questions of the Lecturer

The President (Mr J. S. R. Ritchie, O.B.E., F.F.A.): Thank you very much for that very lucid lecture on a very difficult technical subject. Most of us will have learnt quite a bit from it — I certainly have.

Professor R. S. Clarkson, F.F.A.: I very much enjoyed the presentation. The idea of a three-legged stool, Pillar 1, 2 and 3, appeals to me. Towards the end of your remarks you said that you hoped that we could count. Your introductory quotation from Einstein was: "Not everything that can be counted counts ... ."

One of the philosophic difficulties which I see with Pillar I, which is quantitative, is that there has to be no significant risk that the liabilities fall short of the assets. The problem is how one defines 'significant'. I should be very interested to know what debate went on about this. Is it a 5% margin, like our conventional statistical test; is it one in 1,000; is it one in a million; or what is it?

Mr Van Hulle: I think that the sentence which I quoted referred to two issues. First of all, there is the issue that the SCR will deal with an identified number of risks which have been specified also in the Directive, and we also work on the basis of a ruin probability which is defined in the Directive, and which has been chosen at 0.5% over a one-year time horizon, which corresponds with a 99.5% confidence level over a one-year time horizon.

Some people are questioning that, but you have to start somewhere. Most people seem to agree now with the confidence level which we have set in the definition of the SCR. However, there is not only Pillar I. It is important that Pillar II helps us to take on board all the other elements which are not included in the SCR, these are all the other (particularly qualitative) risks which are specific to the enterprise. It is for the industry to show how they deal with those risks which are not taken into account in the standard formula.

Of course, we cannot foresee everything. The fact that we have a ruin probability, as defined, means that we presume that something might go wrong, but, at least, we should pick up everything which is significant.

The President (Mr J. S. R. Ritchie, O.B.E., F.F.A.): As we move through this process from conception to getting Solvency II applicable in 2012, what are the risks that politicians might take it away from the concept which the technical people have developed? Is there a risk of that? If so, how can that be managed?

Mr Van Hulle: That is also my risk! I have carried out my own risk assessment in that respect. First of all, let me say that today no member state of the European Union, and we are 27, is opposed to Solvency II. You might think that this is evident. It is not! It is very rare that the Commission comes up with a proposal where there is no member state from the outset saying: "I do not like this." There is no member state at present which fundamentally puts into question the principles underlying Solvency II, or the need to move to a risk-based solvency regime.

Secondly, industry, in general, has welcomed the Commission's proposal. You can read it in a number of press statements which were published after the adoption of the proposal in July 2007. Of course, we will get some more submissions as we go along this year. Industry has welcomed the proposal, because industry was involved in the development of this project from the very beginning.

I have not fully identified all the stakeholders which we have consulted at the European level, but I can assure you that the list is impressive. You can see and read some more of that in the impact assessment report which precedes the Commission's proposal, and which explains what we have done in terms of consultations. I and my (small) team have received numerous representatives of individual insurers in our office. We even organised interviews with small and medium-sized insurers, which might not have participated in the official consultation exercises, asking them what their fears were about Solvency II, and what we could do to help to accommodate their concerns. That has been very much appreciated by the industry. The fact that we were open, that we were transparent, and that we discussed our draft proposal with stakeholders and with member states, until as late as two weeks before the Commission actually adopted the proposal, has been an important reason to explain the large degree of support which we now enjoy. People saw the text beforehand. They were not surprised when they saw the final version of the text, as issued.

However, that does not mean that there are no risks; we do have risks. From where do the risks come? The risks come from a traditional tendency, which we see in some of the larger member states, towards perfectionism. I received a submission from the U.K. of over 150 pages, with detailed comments on how the Commission's proposal could be improved. These comments did not only relate to the English version, but also to some substantive points of the proposal. We can always improve a text, but when a proposal has been thoroughly discussed beforehand and has been modified after those discussions in order to take account of the various comments, I am not saying that these later comments are not relevant, but I am afraid that the French might now come up with 200 pages, because, if the British come up with 150 pages, the French have to come up with 200 pages, and the Germans have to come up with 500 pages! That is the

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risk. If there is no self-restraint in coming up with amendments and drafting suggestions, we might never finish the negotiation. After all, we have 27 member states, which could each come up with valid points.

We need to concentrate on the essentials. That is the message which I try to pass on in the negotiations in the Council working party, reminding the member states to be reasonable, and not to go over the top. However, the project can also go wrong, when companies, individually, try to get a quick fix to serve their own specific needs and concerns. Industry should come up as one insurance industry. I cannot possibly negotiate with 5,000 insurance companies; neither can the European Parliament, nor can the Council. These are the risks; perfectionism and disorganised lobbying. However, as I have said before, this is the first project with which I have been involved, during my 23 years at the Commission, which is so deeply shared by most of the people to whom I have talked, because people believe that what we are proposing is basically the right thing.

Mr C. Barnard, F.I.A. (in a written contribution which was read to the meeting)**:** These comments are mainly from the point of view of a European-based insurer's subsidiaries in emerging markets:

(1) *There will be a greater emphasis on risk management*
With a greater linkage of capital requirements to risk management, local management will place more emphasis on risk management activities. With Solvency I, risk management was not crucial, as it does not impact the bottom line immediately. With Solvency II, this will change the mindset of the management of insurance companies. Local management will be forced to understand the risk drivers more carefully, and to take actions to align their risk position with their desired risk appetite. This will have implications in areas like business planning, investment strategy (e.g. more active asset liability management), performance measurement, product design, reinsurance, etc.

(2) *Market-based approach*
With Solvency II, the valuation will be conducted using a market-based approach. For some small companies this will present a problem, given the lack of breath and depth of their bond market. Markets in some bonds are so illiquid that the listed price may not be a true reflection of the market value. On the same theme, valuing the liabilities at market values could prove to be a challenge.

(3) *Technical expertise/resources*
Solvency II requires much complex modelling and high levels of technical skills to implement, maintain and interpret the results. Hiring and keeping skilled resources will prove to be a great challenge for some companies, due to the limited supply. Moving from Solvency I to Solvency II will prove challenging, as it represents a big shift in the methodology and thinking approach (from a rule-based to a principle-based approach). In addition, generating stochastic economic scenarios for the Solvency II calculations will prove to be extremely challenging for many countries, due to a lack of reliable data. Finally, local companies and international group centres need to ensure that their systems and their processes are robust enough for auditing and, e.g., SOX compliance, but flexible enough to give an integrated solution, including other regulatory and financial (e.g. IFRS) reporting needs.

(4) *Product pricing/competitiveness*
Since Solvency II is still very much Euro-centric, pricing products on Solvency II for Asian companies may lead to less competitive products, as compared to some of the local or U.S. based companies, which are priced on Solvency I type requirements. Furthermore, it is likely that, with Solvency II, companies will be pushed towards the direction of shorter-term products to reduce mis-matching risk (due to the lack of long-term bonds in the market). Furthermore, companies will also look towards reinsurers or investment banks to lay off some of their risks. We have started to see this already, as companies are looking actively to hedge out some of their market risk, e.g. with hedged variable annuity products, certificate and other structured products.

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(5) *Capital management*
Overall, Solvency II is a good approach, whereby it forces companies to manage their capital better and to deploy it to operations where it can be used most efficiently. It would be interesting to see if, under Solvency II, some of the spare capital in some companies will be deployed to other operations where it is needed more. This will also place more responsibility on local management to manage their companies better to reduce capital requirements under Solvency II.

(6) *Transition results*
Actuaries and risk managers must be able to explain the change in the capital position, due to the move from Solvency I to Solvency II, adequately. In some companies there will be a sharp fall in solvency, and some companies may be insolvent under Solvency II. We need to manage the expectations of senior management in these situations.

Mr Van Hulle: I think that what Mr Barnard clearly indicates is that we should be careful not to overload the smaller and medium-sized players in Europe with very complex calculation requirements. That is why I indicated that we have asked the CEIOPS, specifically, to develop simplified methods for the calculation of the best estimate.

This is also the subject of debate, although we might allow for such simplifications. These simplified methods are not perfect, but this should not be a problem in the beginning, because one has to start somewhere. When people get more familiar with the new way of calculating the technical provisions and when they have more experience, they will develop other techniques and will get used to the more complex ways of calculation.

The pricing element is important. In our impact assessment we analyse the potential impact of Solvency II on products and markets. Indeed, to the extent that, today, insurers bring products onto the market which are not correctly priced, because the risk assessment was not correct, they may want, or indeed may have, to change their practice. Either they have to put up more capital, or they have to find other ways, such as reinsurance, to reflect their individual risk profiles.

Whether Solvency II will lead to a consolidation in the markets is something which cannot be said at this stage. There is, however, no doubt that individual insurers will have to look at themselves, to look at whether they want to continue to operate in risky areas, or to move to products which are less risky.

Lastly is the question of how solvency is going to be dealt with in other markets, such as in the U.S.A. and in Asia. I did not develop this in my presentation, but it is a fact that the risk-based solvency regime which we will introduce through Solvency II is also part of an international move towards risk-based solvency requirements. The International Association of Insurance Supervisors (IAIS) is the international organisation where all the supervisors of the world co-operate. It is developing a new guidance on solvency, which is perfectly in line with Solvency II. In fact, Solvency II might well be the first application of the new international guidance.

In October 2007 we will have the annual meeting of the IAIS in the U.S.A., and I will have the pleasure of organising, together with the European insurance industry, a workshop which will explain to supervisors from all over the world and, particularly, also to the American supervisors, what a more advanced solvency system can look like. Particularly in the U.S.A., there is much concern that their own solvency regime might be outdated and be by-passed by a more sophisticated system in the E.U., which could be a competitive disadvantage for American insurers and reinsurers.

Asia, Japan, China and South Korea are also looking very closely at what we are doing, and plan to go in the direction of a more risk-based approach.

Professor A. D. Wilkie, C.B.E., F.F.A., F.I.A.: I have three questions. First, Figure L.4, showing the old system and the new system with the technical statutory basis on the left side and the best estimate plus margins on the right side, seems to me to be very like what is actually in the Third Life Directive, which defines the valuation as a valuation of the market value of the

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assets and the market value of the liabilities, with a best estimate and some margin for adverse deviation.

It does not seem to me that the new system which you have is so different from the principles on which the Third Life Directive was based. However, there were many qualifications in that. You could approximate the market valuation by using net premium valuations, and so on. If you wanted to, you could use a gross premium valuation with everything allowed for, and discounted, of course, since we are talking about life assurance, you could have used the new system under the Third Life Directive.

I am reasonably sure of that, because I was responsible within the Groupe Consultatif for writing the first drafts of that, and some of my sentences still survived in the Third Life Directive. I do not think that they still survive in Solvency II.

Secondly, a point was raised that there were problems for small companies. In fact, if a company has a small range of products and not very many policies, it might be easier to do the calculations than with a very large company with a very large range of products and with many complications about it, provided that the small company issues simple enough products. If it issues extremely complicated products which are difficult to assess, then that is a different matter.

Also, increased policyholder protection was mentioned, and is important. I wonder whether, in any of the consultations, representatives of policyholders were consulted. We might all, ourselves, be policyholders, but very few of the people replying to your questions would be saying: "From the point of view of the policyholder, what is the right thing which we want?" There will almost certainly be a reply on behalf of the insurer or the Actuarial Profession or somebody else.

It seems to me that, just as the Royal College of Physicians in Scotland has a lay advisory group which advises their council about how to do things, taking patients into account, it might be a good idea for supervisors, for yourselves and the companies, to have groups which explicitly take policyholders' views into account, where the groups are responsible only for looking at the views of policyholders.

In principle, of course, directors are responsible, particularly directors of mutual companies, if there are any left anywhere, for policyholders. However, they do not think in terms of what the view of the policyholder is. They think in terms of how they manage the company, not the view of the policyholder.

Mr Van Hulle: I think that those are valid points. On the first point, the fact that the U.K. developed ICAS means that the present regime already allows a development from the present regime to a more risk-based one. This is the quantitative aspect. We also need to look at Pillar II and Pillar III.

Regarding small companies, you are quite right. That is the reason why I would not agree with people who would say that Solvency II is only there to benefit the large companies. A small company which knows its risks very well can possibly operate under Solvency II with lower capital requirements than it does today, if it operates in a market which it knows well.

We consulted the policyholders. That is not easy, because, in the financial services sector, there is no clearly identifiable group which represents the users. This is the reason why the Commission has set up a group for the whole financial services area which is called FINUSE. It is the group of users with representatives of the consumers. They have also provided their comments on our proposed Solvency II approach. You will find their report as an annex to our impact assessment report.

What they would like to see coming along with Solvency II is a harmonised system of guarantee schemes, a system which protects the consumers in case things go wrong. That is something which is quite complex. The Commission has mandated a consulting firm to carry out a study on insurance guarantee schemes, which will lead to a report to be delivered by the end of November 2007. On the basis of this report, we will have to decide on a way forward. Although these matters are, strictly speaking, not linked, it is a fair point, and one which is often put forward by people representing the users.

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Mr P. Guijarro, F.F.A.: I should be interested in how the Solvency II project will interact with the phase 2 of IFRS.

Mr Van Hulle: I was hoping that I would not be asked that question! With my background in accounting, it keeps hounding me! We were quite keen to come forward with an economic approach to the valuation of assets and liabilities. We were very keen to do that, because we believed that, if we were to follow such an approach, it would be a formidable challenge for the IASB to come up with something else, because such an approach is usually also followed by the IASB, which tends to be very conceptual in its thinking.

If you adopt an economic approach, it is difficult to argue against that approach, because it allows for a consistent treatment of assets and liabilities, which means that we do away with the present mis-match in the balance sheets of insurers, whereby most assets are valued at fair value, whilst most liabilities are valued at cost. However, it is possible that there will still be differences between the solvency treatment and the accounting treatment. I believe that this is not disastrous, as long as both approaches remain largely consistent. I think that financial reporting serves different objectives than solvency does. Therefore, I could very well imagine that, for financial reporting purposes, there could be slight differences.

I give you one of them, which is well known. When you apply a market valuation to liabilities, under the IASB standards you would have to take account in the valuation of those liabilities of your own credit risk. That, of course, is clearly unacceptable for supervisors. Just try to explain to supervisors that the worse the financial situation of an insurer becomes, the more profits he can show. Supervisors (in banking or insurance) will never accept that. Therefore, it would not be a surprise if some divergences remain between Phase II (Insurance Contracts) and what we will have under Solvency II.

Different parties in Europe will respond to the consultative document published by the IASB. I am optimistic that we will move, in the end, in a direction where we will have a large degree of consistency. There is much debate concerning the valuation of technical provisions, where insurers are questioning whether, when you apply an exit value model, you should pick up profits at inception, or whether you should include these profits in the equity, or should have a separate caption, somewhere under the liabilities. That is a discussion which is still ongoing, and the insurance industry in Europe has not yet come up with a final agreed position. However, again I am optimistic that we will probably move in the same direction.

On the other hand, it is very important for the IASB that the Solvency II proposal has now been tabled, because the valuation approach adopted in this proposal strengthens some of the thinking which underpins its own ideas.

Dr D. J. P. Hare, F.F.A.: I have one remark and two questions. The remark is to pay tribute to the amount of consultation which Mr Van Hulle and his colleagues have carried out on Solvency II. It is an unprecedented exercise, and the amount of work which the CEIOPS, Mr Sharma and the Commission have done to involve the industry and the Profession is something which we appreciate very much, and we look forward to it continuing.

Turning to the two questions, one is to do with the use of internal models. The importance of this cannot be over-emphasised. The step change is going to be for regulators across Europe. It is to be hoped that it will be important for companies.

My question is: “How difficult is it going to be to achieve the appropriate incentives for firms to go down the internal model route, when, at the moment, the Directive requires the internal model to cover all quantifiable risks, but what is being formulated for the standard approach does not include everything, and, in particular, does not include what we would call non-linearity, the effect of two risks happening simultaneously, and the effect then being worse than is allowed for in the single risk component?”

At the moment, it would seem that you are almost bound to get a larger answer if you use an internal model than if you use the standard approach. I am not quite sure where the incentives are, other than just trusting management to want to do the right thing.

The other question concerns a topic which is dear to the hearts of some people in this room,

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that is pension schemes. Of course pension schemes are not the same as life offices, but I think that there have been various murmurings, from time to time, as to whether there should be a similar regime introduced for pensions.

Would it be possible to say a few words on that, and where you see that debate going at the European level?

Mr Van Hulle: First of all, on the point of consultation, I can assure you that, for the implementing measures, we will apply a similar regime of consultation.

On internal models, the CEIOPS is now working on the implementing measure which will deal with the approval of internal models, and the criteria which will have to be met before supervisors will approve these internal models.

I can assure you that the views here are also divergent from member state to member state. Under Solvency II, we will allow the use of a full internal model as well as partial internal models. Some supervisors are very keen that they should be able to allow the use of these models already from day one. This is still ongoing work.

I would certainly belong to those who argue that there need to be incentives for companies to develop internal models. Ideally, all companies should have internal models, because standard formulae are only proxies for the real situation in which each company finds itself.

Regarding pensions, one of the things which I have learnt about pensions, and it is only two years since I have been dealing with this issue, is that when people talk about pensions, rarely are they talking about the same thing. We have three pillars in Solvency II and we also have three pillars in the area of pensions, but what is Pillar I to one member state is Pillar II to another member state. What is Pillar III to one member state is Pillar I for another member state.

So, the first thing which you have to start to do is to clarify what we are talking about. Pension funds are not included in the scope of the application of Solvency II, under the present proposal. Does that mean that pension funds will continue to be governed, when they offer guarantees, by the Solvency I requirements? There is, indeed, a linkage with the Life Directive in the Pension Fund Directive. We have announced that we will officially ask the CEIOPS, in 2008, to examine whether and how a solvency regime for pension funds can be developed, which is equivalent to that which will apply to insurance companies under Solvency II. All these words are important.

I was one of those in the Commission who refused to accept requests from some member states to include pension funds in the scope of the application of the Solvency II Directive. I was opposed to that, because I knew that people were not talking about the same subject. To do so without prior impact assessment would have been quite dangerous.

We need the help of the CEIOPS to prepare the grounds for a more thorough debate. Therefore, we have asked it to carry out a fact finding exercise, which is to examine how the present solvency regimes for pension funds operate in member states. This fact finding exercise will lead to a report to be published early in 2008. It will allow us to look at the potential future solvency regime for pension funds, on the basis of a clear analysis of how this matter is presently dealt with in the member states. This is, for the moment, a black hole.

Why is the regime the way it is? What other guarantees exist than just capital requirements? That is the fact finding exercise which is absolutely crucial. It does not yet exist.

Only when we know what exists will we be in a position to define what we can improve and in which direction we will move. So, there will be fact finding first, and then new ideas about legislation. On the other hand, we cannot escape dealing with this issue. Not only is there a reference in the Pension Funds Directive to the present Solvency I regime in the Life Directive, but we must also avoid a distortion of competition between insurers and pension funds, particularly in those member states where pension funds are actually run by insurance companies.

The President (Mr J. S. R. Ritchie, O.B.E., F.F.A.): I am sure that you will join with me in thanking Mr Van Hulle for, not only a most illuminating lecture, but also for the very helpful and open way in which he has addressed questions concerning a wide range of topics.