COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT

to

the Insurance Committee

on the need for further harmonisation of the solvency margin

(presented by the Commission)

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1. Introduction

The third generation, life and non-life insurance directives adopted in 1992[1] completed the Community legislative framework necessary for the establishment of the single licence for EU insurance undertakings, the so-called "European passport", thereby realising the single market in the field of insurance. This single licence relies on co-ordination of essential rules concerning the prudential and financial supervision of insurance undertakings. These rules seek to ensure policyholders' protection and the stability of financial markets. Provisions concerning the solvency margin of insurance undertakings were partly updated by the third generation directives, but their essential features were already subject to especially detailed harmonisation from the outset, that is from the date of the first generation insurance directives[2].

During the Council discussions on the third directives, it was felt that the latter provisions ought to be reviewed beyond this update, but that, in order not to delay further completion of the insurance single market, the review exercise should take place at a later date. The Council, in agreement with the Commission, therefore included respective articles in the third generation directives[3] obliging the Commission to present a report to the Insurance Committee within three years of the implementation of the two directives on "the need for further harmonisation of the solvency margin".

The present report is intended to fulfil the Commission's legal obligation towards the Insurance Committee; its objective is to examine the present solvency schemes for life and non-life insurance undertakings and to assess whether changes are required in order that the solvency rules continue to fulfil their purpose in the light of today's economic and financial context. This assessment needs to be based on the experience of EU insurance supervisory authorities, since the Commission does not have a direct supervisory responsibility and therefore lacks its own empirical data. It also needs to take due account of other expertise, such as that of actuaries practising in the EU and the insurance industry itself.

At the meeting of the Insurance Committee (IC) in April 1994, the Commission discussed for the first time with IC Members this solvency review. It was agreed that the Conference of Insurance Supervisory Departments of European Community Member States ("the Conference") would be asked to establish a working group to look into solvency issues in a broad sense and to report back to the Commission by the end of 1996. This working group, established under the chairmanship of Dr. Müller of the BAV[4] (hereafter called the Müller Group), has prepared a report which was discussed and agreed by the Conference in April 1997 and, shortly afterwards, submitted to the Commission. This document has already been published by the Conference and is therefore not annexed to the present report[5,6].

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1 Non-life insurance: directive 92/49/EEC and life insurance: directive 92/96/EEC.

2 Non-life insurance: directive 73/239/EEC and life insurance: directive 79/267/EEC.

3 Article 25 in the third non-life insurance directive and article 26 in the third life insurance directive.

4 Bundesaufsichtsamt für das Versicherungswesen, the German insurance supervisory authority.

5 The Müller Group report can be obtained from the Secretariat of the Conference, care of Mrs Gougeon or Mrs Rotté-Capet: télédoc 649, Ministère de l'Economie et des Finances,

In parallel, the Commission sent a questionnaire, closely based on a questionnaire used by the Müller Group, to three European federations representing EU actuaries and the insurance industry (namely the CEA[7], ACME[7] and Groupe Consultatif des Actuaires). All three federations delivered their replies to the Commission by the end of 1996. As these replies may be obtained from the organisations concerned, they are not attached to the present report.

2. Overview of the rules aimed at ensuring the solvency of insurance undertakings.

The solvency of an insurance undertaking refers to its capacity to respect, at any time, its commitments to policyholders and, more generally, to any creditor. The measurement of solvency depends crucially on the way assets and liabilities are assessed. The two third generation insurance directives and the Insurance annual and consolidated accounts directive (directive 91/674/EEC) have harmonised, in great detail for certain items, the principles for the calculation of liabilities and for the valuation of assets of insurance undertakings. However, those rules have only been in force for a few years and it is, in the Commission's view, too early to evaluate whether they need to be reviewed. They will therefore be considered as given for the present and will not be dealt with specifically in this report. Nevertheless, should the continuing work on solvency margin suggest that the valuation rules for assets and liabilities of insurance undertakings ought to be amended or supplemented, the Commission would be prepared to take full account of such a conclusion.

The main liabilities of an insurance undertaking are its technical provisions (sometimes called mathematical provisions in life insurance) which are established in order to cover the anticipated claims and associated costs arising from the policies underwritten. They are calculated on an actuarial and statistical basis, but this cannot provide an absolute guarantee that they will always be sufficient to cover all claims and costs. Therefore, and in order to protect policyholders and to ensure the stability of financial markets, it has appeared necessary to require insurance undertakings to hold a certain amount of additional resources to act as a buffer in the event that unexpected losses and costs emerge. This buffer is called the solvency margin, and the minimum buffer which insurance undertakings must maintain is termed the solvency margin requirement.

The solvency margin requirement should be capable of absorbing -assuming the continuing operation of the insurance undertaking- the effect of non-quantified risks and the impact of an underestimation of, or unusual fluctuations in, quantified risks already covered elsewhere (typically by the technical provisions). The objective is to give undertakings and the supervisory authorities time to correct the situation once such risks have materialised.

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6 Furthermore, a first orientation debate was held in the Insurance Committee in April 1997 on the elements justifying the need for further harmonisation of the solvency margin. The present report takes full account of this debate.

7 Comité Européen des Assurances, representing EU insurance undertakings limited by shares and certain mutual insurance undertakings; Association des Assureurs Coopératifs et Mutualistes Européens, representing other EU mutual and co-operative insurance undertakings.

Finally, insurance undertakings are, like all supervised financial undertakings, subject to specific requirements concerning the suitability of shareholders and the fitness and properness of management (as in the non-life and life insurance directives) and additional requirements concerning the transparency of the corporate and group structures (directive 95/26/EC, also called the "BCCI follow-up directive").

3. Empirical data concerning the solvency margin of EU insurance undertakings

a/ Actual solvency margin

The table in the appendix presents empirical data relating to the solvency margin of EU insurance undertakings as at the end of 1995, collected from the respective supervisory authorities. At that date, the solvency margin of insurance undertakings was ECU 321 829 million, for a total solvency margin requirement of ECU 88 494 million. By way of comparison, the total investments by insurance undertakings[8] were ECU 2 120 979 million[9].

The table also shows the absolute and relative level of the different elements eligible for the solvency margin. In particular, it can be seen that own funds, in other words paid-up capital (or initial fund for mutual undertakings), reserves and profits brought forward, *plus* hidden reserves[10] (where relevant) amount to 77% of the total solvency margin for life insurance and 93% for non-life insurance[11]. Profit reserves represent 17% of the solvency margin of life insurers. On the other hand, own funds substitutes, that is to say subordinated loans, cumulative preferential shares and other securities with no specified maturity amount to 2% of the solvency margin elements of life and non-life insurance undertakings taken together (but 9% for the sole non-life mutual insurance undertakings). As regards the other elements, unpaid capital (or initial fund for mutual undertakings) amounts to 0.3% of the total solvency margin[12]; future profits constitute 4% of the solvency margin of life insurance undertakings; lastly supplementary contributions represent 11% of the solvency margin of non-life mutual insurance undertakings.

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8 Source: Eurostat.

9 This figure excludes Greece and Ireland.

10 Where they are admitted and for the purpose of this presentation, hidden reserves have been taken into account along with own funds in order to present homogeneous data irrespective of the accounting options in force in the different Member States, since whether or not hidden reserves are included in an insurance undertaking's own funds depends on the accounting option adopted.

11 Percentages in this paragraph exclude the United Kingdom (see appendix).

12 This percentage excludes Germany (see appendix).

b/ Solvency margin requirement

b - 1 - Non-life insurance

By way of a summary presentation, which is adopted here for the purpose of facilitating the understanding of the present report, the solvency margin requirement can be expressed as the higher of two results:

- 16% of the annual premiums written by the insurance undertaking (18% up to a certain premium volume) or

- 23% of the average annual claims costs incurred by the insurance undertaking (26% up to a certain claim volume).

The result is then multiplied by a reduction factor equal to the ratio of claims costs remaining for the insurance undertaking after taking account of reinsurance ceded to gross claims costs, as resulting from the last financial year (with a lower limit of 50%). The total solvency margin requirement for non-life insurance at the end of 1995 was ECU 28 098 million. The average reinsurance factor[13] was 85%.

b - 2 - Life insurance

The solvency margin requirement may be summarised as the sum of two results:

- 4% of the mathematical provisions of the insurance undertaking *plus*

- 0.3% of the capital at risk (an amount equal to the difference between the maximum payments under the policies underwritten and the mathematical provisions).

In fact, before aggregation, as in non-life insurance, each of these amounts is multiplied by a reduction factor for reinsurance, taking account of the effect of reinsurance respectively on the mathematical provisions and on the capital at risk (with lower limits respectively of 85% and 50%). The total solvency margin requirement for life insurance at the end of 1995 was ECU 60 396 million. The average reinsurance factor[13] was 97%.

4. Assessment of the operation of the present solvency margin scheme

a/ The present scheme has proved satisfactory

In order to assess the operation of the present solvency margin scheme, two aspects should be examined: on the one hand, whether insolvency cases of insurance undertakings have been many or few since the harmonised scheme was introduced and, on the other hand, whether insolvency cases which occurred could have been avoided by insurance undertakings' being subject to a different scheme or supervisory authorities' having different means of intervention.

The question of whether the current solvency margin requirement might have been excessive was also examined. As regards the supervisory authorities, only two delegations in the Müller Group considered that the solvency margin requirement could be reduced, and this concerned only very specific insurance contracts. As regards

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13 This factor is calculated for the following Member States: Belgium, Denmark, Finland, France, Luxembourg and Portugal.

insurance undertakings, it was not considered that the solvency margin requirement had been excessive or had impeded the growth of EU insurance industry. Nevertheless, in advocating simplification of the solvency margin requirement for non-life insurance, the insurance industry wishes to retain only the lower coefficients contained in current Community legislation for the calculations based on premiums and claims (respectively 16% and 23%). Conversely, while all EU supervisory authorities also declared themselves favourable to such a simplification, they supported the idea that percentages at least equal to the higher coefficients should, alone, continue to be used (respectively 18% and 26%). These considerations lead to the conclusion that the current solvency margin requirement cannot be considered as excessive, and hence the present report focuses on weaknesses in the current Community solvency margin scheme.

The exercise of identifying cases and analysing the causes of deficiencies of insurance undertakings in European Economic Area countries in the past 20 years was conducted by the Müller Group. Supervisors found that there have been only a few cases of deficiencies. A significant proportion of these could be remedied through capital increase or by takeover by other insurance undertakings or holding companies[14], thus avoiding final insolvency and winding-up. These findings tend to show that the overall scheme designed to guarantee the solvency of insurance undertakings, including the adequacy of the solvency margin, has operated satisfactorily. In particular, they provide some evidence that the solvency margin satisfactorily fulfilled its function as an early warning system thus giving time to the undertakings concerned and the supervisory authorities to rectify the emerging problems

Closer examination of these cases of deficiency allows some fine-tuning of the analysis. Deficiencies could only be attributed to weaknesses in the solvency margin scheme if they were not due to dramatic lack of compliance with other requirements to which insurance undertakings are subject. However, the problems which occurred and which were not remedied were in most cases due to an accumulation of several shortcomings among the following types: inexperienced or non-professional management, inappropriate underwriting policy, imprudent investments, insufficient provisions, inadequate reinsurance policy, high losses due to rapid growth, double gearing[15] or detrimental transactions involving other entities belonging to the same group as the insurance undertaking, and of course fraud / misdemeanours. The Commission accepts and shares the analysis reflected in the Müller Group report:

"It was found that even if the solvency [margin] rules had been applied and observed more strictly, and even if they had contained stricter requirements than they do at present, a number of the economic collapses that happened could not have been prevented. The solvency margin as a rule fulfils its warning and safety function but it

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[14] Given that the analysis of past deficiencies has been carried out thoroughly in the Müller Group rep..., the present document does not undertake to present a full analysis. Rather, it relies on the findings by European supervisory authorities and presents in a synthetic manner what conclusions the Commission draws from this experience.

[15] Double gearing refers back to the fact that, where an insurance undertaking owns a participation in another one, a proportion of the solvency margin of the former is invested in the latter, and is thus engaged for the protection of the latter's policyholders. Double gearing, as well as intra-group transactions, are dealt with in a proposal for a directive ("On Insurance Undertakings which are Part of an Insurance Group") presently being discussed by the European Parliament and the Council.

does not at all replace an effective company analysis and even less a prudent establishment and coverage of the technical provisions."

b/ However, certain weaknesses have been identified in specific cases

These positive findings must not hide the fact that certain cases of deficiency have pointed to weaknesses in the solvency margin scheme. Indeed, the work of the Müller Group has shown that, in certain, well defined instances, difficulties encountered by, or failures of, insurance undertakings could have been addressed by a more accurate solvency margin regime. Such difficulties occurred more particularly in relation to long-settlement risks in non-life insurance, investment and asset-liability mismatches, rapidly growing entreprises, inadequate reinsurance taken out by an insurance undertaking, but also in relation to the legal incapacity of the supervisory authorities to intervene sufficiently in advance of the insurance undertaking's problems becoming irreversible. Possible consequences of these findings are discussed later in this report.

c/ The main existing alternative schemes have not proved their superiority to the Community approach and therefore do not need to be introduced in lieu of the current Community regime to respond to the identified weaknesses

More analytical systems have been introduced outside the European Union, notably the risk-based capital scheme as used in the United States of America[16]. Similarly, variants of the RBC approach have been used for many years by rating agencies to assess the ability of American insurance undertakings to pay their debts, and their use is also increasing, subject to some adaptations, in relation to European insurers. The superiority of such approaches, in the way they have been implemented, over the Community regulatory approach has not been demonstrated. Such models are characterised in particular by their complexity and comparatively greater arbitrariness. The European insurance industry criticises the RBC approach on a number of counts. The Commission, along with EU supervisory authorities, note that, although the short experience gained with such models does not permit their rejection, neither does it create an objective incentive at this stage to privilege them over the EU approach altogether. Nevertheless, it will be interesting to draw lessons from them where appropriate.

In addition, it is important to note that the present EU regime is soon to be complemented by the supplementary supervision of insurance undertakings which form part of a larger insurance group (see footnote 15). As a result, but subject of course to the outcome of the current legislative process, double gearing will be eliminated and intra-group transactions will now be monitored. Consequently, two of the most frequently mentioned causes (as identified above) for insolvency will be dealt with, on the basis of the existing EU scheme, by specific provisions.

The Commission therefore considers that the principles governing the operation of the present EU regime should be maintained. This does not mean of course that some more detailed arrangements cannot be adjusted and supplemented, on the basis of the present regime, in order to correct any inadequacies that have been identified (as mentioned above).

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[16] The American RBC approach is presented in the appendices to the Müller Group report.

d/ Any unnecessary additional cost for the industry should be avoided

In line with the above analysis, the Commission considers that the review exercise should not have the effect of increasing unnecessarily the general level of the regulatory burden imposed on the industry. It is important in this respect to emphasise that an unjustified increase could be expected to have the following negative effects. It would:

- cause considerable difficulty to a significant proportion of EU insurance undertakings: the comfortably high solvency ratio (effective solvency margin over solvency margin requirement) of 3.6 in average (see section 3-a) should not conceal the fact that a number of small undertakings or even medium sized or large undertakings do present a solvency ratio close to 1[17]. For those businesses, a sudden rise in the solvency margin requirement might provoke considerable financial difficulty even though, as past experience shows, their ultimate solvency may not be materially threatened;
- curb the competitiveness of the European insurance industry in terms of growth capacity, as any increase in risks provided for (life insurance) or turnover or claims costs (non life insurance) implies a corresponding increase in the solvency margin requirement;
- increase cost of taking insurance for consumers as insurers would, at least partly, pass on extra costs to the policyholders through the premiums;
- discourage investment in the insurance field as funds "blocked" in insurance undertakings would increase in relative terms;
- create (or reinforce an already existing) tendency to establish imprudent premiums and technical provisions to compensate for the rise in the solvency margin requirement, given that these parameters are components of the basis on which the requirement is calculated (see section 3-b above).

Therefore, considering the assessment of the operation of the existing scheme, a systematic increase in the solvency margin requirement would not seem to be justified.

Increases may however be desirable concerning specific risk profiles which have been identified by EU supervisory authorities as having caused cases of insolvency for insurance undertakings (as mentioned in section 4-b above). Furthermore, de facto increases may result in any case for certain individual undertakings from updating minimum monetary thresholds contained in the solvency margin regulations or from re-examining the list of solvency margin elements, as discussed later in this report. In addition, when elimination of double gearing (see section 4-c above) is generalised throughout the EU, insurance undertakings which are part of an insurance group will be subject to still further solvency margin constraints.

It might be argued that raising the solvency margin requirement, even targeted on well defined risk situations, would be an excessive response to deal with only a few cases of insolvency. However, the Commission is not convinced by this argument and would stress the following considerations:

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17 Sometimes, such undertakings can even be in a comfortable situation where their overall solvency is concerned thanks, for example, to prudently calculated tariffs and technical provisions.

- analysis shows that some of the insolvency cases arose as the result of risk situations which do not correspond only to isolated undertakings, but characterise risk profiles which can generally be found among the industry. In such cases, insolvency cases contributed to revealing weaknesses in the operation of the existing solvency margin scheme which should be corrected;

- it is generally considered that, due to increasing competition in the context of the opening of the markets, international industry concentration and the development of new distribution channels, the overall profit margin of insurance business, at least in its most traditional forms, has decreased and might continue to decrease. Simultaneously, certain categories of risks increase in terms of concentration and cost and new risks appear. Identifying and responding to particularly sensitive risk profiles therefore appears to be a consistent and prudential policy and, as such, desirable;

- responding to weaknesses or inadequacies of the solvency margin scheme in special cases may also take the form of a more flexible solution, consisting of giving supervisory authorities the legal means to intervene in anticipation - in other words, even if the actual solvency margin is greater than that required. This would help avoid an unjustified, systematic increase in the general level of the solvency margin requirement (discussed later in this report).

e/ Conclusion

As a global assessment of the operation of the solvency margin scheme, the current arrangements have proved to be soundly based as to principle and satisfactory as to practical results. The solvency margin has fulfilled its role as a cushion of own funds coming on top of other requirements aiming at ensuring solvency, as the small number of bankruptcies linked to an inadequate solvency margin - as well as the case study of difficulties which occurred - show. Another advantage of this scheme, also stressed by the European insurance industry, resides in its relative simplicity. The Commission considers that clarity and stability of the solvency margin regime are important features for the good operation of the industry and the ability of third parties (customers, employees, investors, financial analysts,...) to understand it; these features are also relevant in the perspective of the enlargement of the EU.

In conclusion, the Commission considers it desirable for the current Community requirements regarding the level of the solvency margin to be maintained. However, amendments could be made to correct clearly identified inadequacies. Every effort should then be made to avoid any additional cost for the industry, except in the case of specific risk situations for which the current level of the requirement proves to be inadequate.

5. Discussion on issues pointing to inadequacies of the present solvency margin scheme and thus justifying further harmonisation

In addition to the lessons to be drawn from past insolvency cases in relation to certain specific risk profiles a number of more general questions also need to be raised in order to achieve better harmonisation of the solvency margin scheme, and thus to secure the foundations of the European passport. The issues discussed in the present section are of two types: first, technical points which have arisen from the analysis of past insolvency cases and secondly, more general points which were not fully harmonised by the adoption of the third generation directives and which have also been highlighted by the supervisory authorities, notably in the Müller Group report.

The objective of this section is to set out the Commission's view that, given the experience accumulated in the past 20 years, further work should be done to improve and deepen harmonisation of the solvency margin provisions contained in the insurance directives. The following list of issues does not seek to be exhaustive; nor does it seek to provide at this stage technical solutions to the problems raised. Subject to the results of the discussion in the Insurance Committee on the basis of the present report, it is proposed that a working group of government experts chaired by the Commission's services should be set up. This group should study in detail the most appropriate responses to problems identified through the substantial work already carried out by the Müller Group and by the replies from industry and actuaries to the Commission questionnaire, as well as other issues arising from the review of the solvency margin scheme.

a/ Composition of the solvency margin

a - 1 - Re-examination of the list of solvency margin items

As provided for in the insurance directives, the solvency margin of life and non-life insurance undertakings consists of their "assets [...] free of any foreseeable liabilities, less any intangible items." An open-ended list of such assets is then given in the directives, with certain variations between life and non-life insurance. Three aspects of such a definition call for further reflection and work (see also the Müller Group report).

- The expressions "free of any foreseeable liabilities" and "intangible items" should be clarified and, probably, improved. Indeed, the third generation insurance directives introduced own funds substitutes in the list of solvency margin elements in recognition of the evolution of available forms of financial resources and of the potential role of such items for the insurance sector. Among those items, subordinated loans for example are not "free of any foreseeable liability" in the strictest sense, in spite of the numerous conditions laid down by the directives for them to be eligible for the solvency margin. In addition, it appears desirable to specify the meaning of the expression "intangible items", as certain immaterial items are indeed eligible for the solvency margin, such as supplementary contributions for mutual undertakings or future profits for life insurance undertakings.

- Without a closed list of solvency margin items, it would seem to be difficult to argue that the insurance directives offer a systematic guarantee that insurance undertakings meet comparable prudential criteria. Therefore in the interest of legal security and equivalence of prudential standards throughout the European Union, the question of closing this list should be raised, but without prejudice to the existing possibility for Member States to refuse certain elements on the closed list for the solvency margin. From a procedural viewpoint, once the list is closed and, given the necessity for insurance legislation to keep pace as much as possible with market developments - in particular in the field of funding sources, it would seem desirable to consider a simplified procedure for reviewing the list in the future.

- The eligible items in the open-ended solvency margin lists in the directives should themselves be carefully re-examined. For example, while the legitimacy of admitting paid-up share capital and reserves as elements eligible for the solvency margin is unanimously accepted by supervisory authorities, views differ concerning the opportunity to admit non paid-up share capital. Similarly, supervisory authorities have different views concerning the opportunity to admit future profits of life insurance undertakings. The Commission's view is that only actual resources of an insurance undertaking should be accepted as solvency margin elements and in that respect considers that the elements more particularly mentioned in this indent deserve proper scrutiny in the course of revising the solvency margin scheme.

a - 2 - Quality of the items representing the guarantee fund

Life insurance directives provide that at least half of the guarantee fund[18] of life insurance undertakings must be made up of items belonging to a closed sub-list of the list of solvency margin elements, considered as being of higher quality. The minimum guarantee fund[18] must be made up totally of such higher quality items. This provision gives rise to the following two remarks:

- The sub-list of items composing at least half of the guarantee fund and the total minimum guarantee fund should undergo further scrutiny. Among other issues, it should be discussed whether it is appropriate to include in it, as is now the case, unpaid share capital, as the latter does not appear to be as financially secure as other solvency margin items.

- It seems necessary to assess whether a similar sub-list of higher quality solvency margin items should be introduced in non-life insurance.

b/ Calculation of the solvency margin requirement

b - 1 - Long-term risks in the non-life insurance field

Long-term business in the non-life insurance sector has been identified by the Müller Group as posing particular problems associated with increased risks in a number of respects: under-tarification, under-estimation of technical provisions, deviation (significant variations in claims frequency or cost with respect to the assumptions governing the calculation of the technical provisions), operating expenses and even reinsurance. One of the EU insurance industry federations also stressed the appropriateness of studying this issue further. However, the present Community regulations governing the solvency margin do not take specific account of such non-life long-term risks.

Insofar as (see section 4 above) the present solvency margin scheme is to be maintained to the greatest possible extent while correcting its weaknesses in relation to well identified, specific risk profiles, there appears to be two possible ways of dealing with long-settlement risk in calculating the solvency margin requirement: either by introducing a third alternative index (in complement to the premiums index and the claims index) based on technical provisions, or by adding a given proportion of the technical provisions to the result given by the present scheme. Without taking a definitive position at this stage, the Commission takes note of the fact that, as reported by the Müller Group, a majority of EU supervisory authorities is in favour of the first solution. In approaching a solution in the course of future work, the Commission shall seek that which proves the least disruptive to the present scheme, the most specifically focused on the sole long-term business in terms of cost for the industry, and the most apt to avoid or minimise undesirable effects such as encouraging insurance undertakings to adjust the

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18 The guarantee fund is equal to the higher of one third of the solvency margin requirement or a fixed amount called the minimum guarantee fund.

level of technical provisions in order to lower the cost of the solvency margin requirement.

b - 2 - Investment risk

EU supervisory authorities have stressed that, "with reference to past difficulties, insufficient account had been taken of investment risk until now". Indeed, the analysis of insolvency cases of insurance undertakings in the EU in the past 20 years shows that a number of cases arose out of, or were aggravated by, inappropriate investments and in particular concentration of investments on poorly performing assets or assets of low security.

While life insurance solvency margin regulation contains an element covering investment risk, this risk is not, as such, taken into account in the solvency margin requirement of non-life insurance undertakings. The Commission considers that further reflection should be devoted to possible ways of dealing with the investment risk of insurance undertakings, more particularly in the non-life insurance sector. In future work on this issue, two aspects should be borne in mind:

- There are already a number of rules concerning the investments of insurance undertakings covering technical provisions, so that the interplay between these rules and any possible solution further dealing with investment risk would need to be carefully assessed.

- The investment risk is especially relevant for long term business.

b - 3 - Excessive costs / Rapid growth risks

The Commission takes good note of the reference by EU supervisory authorities to the significance of risks linked to excessive costs in cases of rapid and uncoordinated growth. As these risks are not dealt with in the present solvency margin scheme, further reflection should be devoted to this issue.

b - 4 - Reinsurance transfers

As explained in section 3-b above, reinsurance transfers are taken into account in order to reduce the solvency margin requirement of the ceding insurance undertaking. EU supervisory authorities have stressed that certain occurrences of financial difficulties of insurers had been caused by failure of reinsurance cover to work properly. Suggestions have been made to allow supervisory authorities to have more flexibility to act upon inappropriate reinsurance cover, more particularly in the non-life insurance sector. At present, insurance directives provide for flat-rate calculation arrangements which do not vary according to the nature of the reinsurance agreements or the quality of the reinsurers.

Among the special features which need to be looked at is the case of financial reinsurance, whereby exclusively or mainly financial risk, rather than underwriting risk, is transferred from the insurer to the reinsurer. Although financial reinsurance has not been identified as a cause for insolvency cases of insurance undertakings by the supervisory authorities' reports to the Müller Group, this technique, which has been developing rapidly, has been singled out by supervisors as deserving particular attention.

b - 5 - Minimum guarantee fund

The amounts laid down for the minimum guarantee fund have not been amended since the various directives were negotiated (most of the amounts date from the first generation directives, in other words from 1973 and 1979 for non-life and life insurance respectively; however, amounts for tourist assistance were fixed in 1984 and for credit and suretyship insurance in 1987). An adjustment of levels in line with past inflation[19] would now have the effect of multiplying these nominal amounts by a factor of between 1.8 and 5.3 according to the date on which they were fixed. The Commission considers such an adjustment as being necessary in order to maintain the economic and prudential significance of the minimum guarantee fund, which is to ensure that every insurance undertaking has the necessary financial guarantee, which would not be the case if the solvency margin requirement were allowed to fall below a certain level. That level, which varies according to the insurance classes underwritten by an insurance undertaking, is the minimum guarantee fund.

A similar development, which the Müller Group advocates should take place in parallel with the adjustment in line with inflation, would consist in aligning the level of the minimum guarantee fund of different insurance classes. For instance, a majority of EU supervisory authorities in the Müller Group considered that the level of the minimum guarantee fund required for liability insurance should be increased to the same level as that required for credit insurance. The Commission agrees that further thought must be devoted to this issue, as well as to other possible adjustments, in order to acknowledge the fact that technological and legal developments have increased the cost and volatility of certain risks.

However, in adjusting the level of the minimum guarantee fund, it appears necessary to take due account of the situation of already existing small undertakings, which would have difficulty in respecting significantly increased levels of own funds requirements. There appears to be a number of ways of dealing with this question, the possible consequences of which will require further study. Two of them are: (1) to provide for a minimum guarantee fund which would depend on the volume of activity of the insurance undertaking, thus making smaller undertakings subject to a lesser requirement than larger undertakings (with, however, a fixed absolute minimum amount), or (2) to allow a sufficient amount of time for small undertakings to progressively increase their own funds base so as to reach the new level of the minimum guarantee fund.

In any case, all new insurance undertakings would need to respect the updated standards from the outset.

c/ Investments as cover for the solvency margin

The current directives prohibit Member States[20] from imposing any restriction whatsoever on investments covering the solvency margin. This remark highlights another aspect of the above mentioned issue of dealing with the investment risk. The discussion here should focus not, as discussed above, on measuring the investment risk and reflecting it in the solvency margin requirement, but on the appropriateness of laying

[19] Based on European consumer price indices EUR 12 and EUR 15. Source: Eurostat.

[20] Articles 18 and 21 respectively of the first non-life and life insurance directives, as amended.

down supplementary rules concerning the asset side of an insurance undertaking's balance sheet. The justification of such an approach would be to ensure that all or part of the assets counterpart of the solvency margin follow rules which contribute to limit counterparty risk as well as interest rate risk and other market risks. In any event, all investigations in the area of dealing with investment risk should be conducted in parallel and should not introduce unnecessary constraints on the investment policy of insurance undertakings.

d/ Measures available to the supervisory authorities

The current directives specifically provide for supervisory authorities to act where technical provisions are not calculated satisfactorily, where technical provisions are not covered by assets meeting the currency matching and location rules, where the solvency margin requirement is not met, or where the solvency margin is lower than the minimum guarantee fund.

However, one of the causes identified by EU supervisory authorities for the insolvency of insurance undertakings resides in their incapacity to intervene in an adequately preventive manner, in other words, in situations where the different triggering criteria in the directives for supervisory intervention were not met, although objective elements, permitting the forecast of serious financial difficulties, existed. For this reason some Member States have implemented in their national legislation measures enabling supervisory authorities to intervene with a certain degree of flexibility. Even so, there have there been examples of financial difficulties occurring despite objectively based presumptions of threatening insolvency.

EU supervisory authorities gave particular emphasis to this issue in the Müller Group report. It is the Commission's view that, the facility to intervene early should be given to supervisors in situations where converging pieces of evidence support the presumption that the financial position of an insurance undertaking is at risk, even though the different individual quantitative thresholds (i.e. solvency margin requirement, minimum guarantee fund, etc.) may well be fully respected. Such evidence can only be examined on a case by case basis, particularly in well identified situations, such as rapidly growing enterprises or cases of very specific business conditions.

e/ Level of harmonisation

The recitals to the third insurance directives state that "certain provisions [...] define minimum standards"[21] but fail to specify what these are. This situation should be reviewed in order to establish clearly which provisions should be based on strict harmonisation and which on minimum harmonisation. The Commission notes the diverging opinions of EU supervisory authorities: some request that solvency margin provisions should be considered as being minimum requirement, as is the case with Community legislation in other financial areas (credit institutions, investment firms), while others advocate stricter co-ordination. The Commission also takes note of the European insurance industry's opinion that, for the sake of fair competition within the EU, harmonisation of solvency margin regulation should be regarded as strict. With regard to future discussions on this issue, the Commission stresses that the advantages of giving national legislators flexibility to lay down stricter rules, with the objective of

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[21] The 8th recital of directive 92/49/EEC and the 9th recital of directive 92/96/EEC.

improving consumer protection, need to be balanced against the necessity to ensure co-ordinated operation of the insurance single market, with as few regulatory, competitive and other barriers as possible remaining.

6. Conclusion

Examination of insolvency cases and, more generally, financial difficulties of insurance undertakings within the European Union in the past twenty years leads to the conclusion that the current solvency margin scheme not only has proved to be soundly based as to principle, but also has produced satisfactory results in practice. The Commission therefore considers it desirable for the current Community arrangements regarding the solvency margin to be maintained. However, detailed analysis identifies a number of weaknesses in the existing arrangements where very specific risk profiles are concerned. Adjustments and improvements should therefore be made to remedy the identified weaknesses.

It is therefore intended to set up a working group of government experts, chaired by the Commission, to study ways of bringing relevant improvements to the current Community solvency margin scheme. This working group should take into account all past contributions to the debate on the merits of the existing scheme and in particular the comments expressed in the substantial report prepared by the Müller Group of EU supervisory authorities. This working group should seek to avoid any additional cost for the industry, except in the case of specific risk situations for which the current level of the requirement has proved to be inadequate. Finally, it should seek to assess the impact on the insurance industry in the EU of any new measures proposed.

The outcome of this group's work is expected to be twofold:

- some amendments to current directives might be required;
- other specific areas of the legal regime aiming at ensuring the solvency of insurance undertakings might be identified as requiring further work.

Finally, it is believed that close monitoring of Community solvency legislation for insurance undertakings should continue in the future, considering the economic impact of such legislation and its central role in the insurance single market.

APPENDIX

Data concerning the Solvency Margin of EU Insurance Undertakings

Million ECUs [1]		Life insurance		Non life insurance	
		Limited companies	Other (mutuals,...)	Limited companies	Other (mutuals,...)
Number of entities [2]		952	198	1569	630
Solvency margin	Paid-up capital + reserves + profits brought forward [3,4]	63 543	16 094	50 342	21 267
	Profit reserves (life insurance)	18 563	5 908		
	Hidden reserves	19 534	9 049	7 478	4 939
	Unpaid capital (or unpaid initial fund) [3]	347	59	243	15
	Future profits (life insurance)	4 791	1 015		
	Supplementary contributions (mutual undertakings)				3 674
	Subordinated loans and Cumulative preferential shares	801	150	640	2 956
	Other (Zillmerisation difference, etc...) [4]	568	20	-1 231	193
	Total [5]	149 198	67 665	70 297	34 669
Solvency margin requirement		46 246	14 150	22 361	5 737

(1) Source: EU insurance supervisory authorities.

(2) Composite insurance undertakings are counted both under life and non-life insurance. The solvency margin elements and requirement respectively corresponding to their life and non-life insurance business are broken down in the relevant columns. However, for Greece and the United Kingdom, all data concerning composite insurers are counted under life insurance.

(3) For Germany, unpaid capital is counted in the row "Paid-up capital + reserves + profits brought forward".

(4) Certain Member States have counted the negative amounts corresponding to intangible assets in the row "Other", while other Member States have counted it in the row "Paid-up capital + reserves + profits brought forward".

(5) The total in each column is greater than the sum of the different solvency margin elements as they appear in the breakdown in the corresponding column, as the breakdowns are not available for the United Kingdom.

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