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**NOTE TO THE MEMBERS OF THE EUROPEAN INSURANCE AND OCCUPATIONAL  
PENSIONS COMMITTEE (EIOPC)**

**Subject:           The Impact Assessment of the Solvency II Level 1 Directive**  
**- Considerations on function and possible structure**  
**- Timing and organisation of work**

**Purpose of this note**

The purpose of this note is to describe in some detail the function and the structure of the Impact Assessment (IA) report that should accompany the Solvency II Level 1 Directive. The note presents the timing for certain milestones in the preparation of the IA report. It furthermore discusses its relationship to quantitative impact studies and suggests a streamlining of terminology.

The note takes into account comments made during a preparatory meeting on 8 July 2005 with members of the CEIOPS Financial Stability Committee's QIS taskforce.

## **1. Background on the Impact Assessment**

### *Introduction*

The revised Roadmap document (July 2005, MARKT/2505/05-rev 2<sup>1</sup>) foresees a Solvency II Directive proposal in July 2007. The Directive will combine a recast of the existing Directives and new or amended Solvency II related articles. For the Solvency II related changes, it will contain general principles in accordance with a “Lamfalussy” structure that will also include Level 2 implementing measures and Level 3 guidance.

According to Commission rules, a Directive proposal must be accompanied by an Impact Assessment (IA). Further on in the project, more detailed Quantitative Impact Studies (QIS) will have to be performed in order to determine, calibrate and back-test quantitative requirements, as indicated in the calls for advice as well as in CEIOPS documents.

### *Terminology - Purpose of an Impact Assessment – Relationship to Quantitative Impact Studies*

It may be useful to streamline the terminology used in connection with impact assessments. The Commission Services suggest using the terms with the following meanings:

- Impact Assessment: the formal analysis prepared by the Commission. In the preparation of this analysis, the Commission will use input provided by CEIOPS.

COM (2002) 276 final defines Impact Assessment as “the process of systematic analysis of the likely impacts of intervention by public authorities. It is as such an integral part of the process of designing policy proposals and making decision-makers and the public aware of the likely impacts.”<sup>2</sup>

The calculations needed for this report (see below) will be estimations, as all detailed parameters will not have been decided upon and calibrated at the time of the adoption of the Directive proposal. CEIOPS should aim, as much as possible, to perform the calculations on a representative sample of EU insurance and reinsurance companies.

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<sup>1</sup> Available at the Commission website:  
[http://europa.eu.int/comm/internal\\_market/insurance/solvency/solvency2-workpapers\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/solvency/solvency2-workpapers_en.htm)

<sup>2</sup> COM (2002) 276 final also indicates that the impact assessment “identifies the likely positive and negative impacts of proposed policy actions, enabling informed political judgements to be made about the proposal and identify trade-offs in achieving competing objectives.” “It will contribute to an effective and efficient regulatory environment”.

- **Quantitative Impact Studies:** the detailed analysis made at a stage in the project when the structure of the quantitative requirements is clear. This study is made on the basis of a sufficiently detailed methodology ensuring that the results, obtained with adequate statistical methods, are reliable and comparable; it is applied to a large and representative sample of insurance companies or even to the whole market. This was the understanding by the Commission Services. However, CEIOPS has chosen to use the term QIS for its simulations (except for the first simulation which was called “preparatory field study”) at an early stage, before having all the necessary detailed elements.

The purpose of an IA is to give background, argumentation and an assessment of the impact of the critical choices made during the preparation of the Solvency II Directive. An IA contains qualitative as well as quantitative aspects. The quantitative aspects will relate to the Solvency II changes. An IA comes early in the process of adopting an EU Directive (it must be finalized before the inter-services consultation that takes place prior to the adoption of the proposal by the College of Commissioners), and significant changes can follow during the negotiations in Council and Parliament. In the case of a Lamfalussy directive, there is an additional complexity in performing an impact assessment as all the technical details needed for the analysis may not be finally decided upon at the time of the adoption of the Commission’s Directive. In such cases, certain parameters for the calculations may need to be estimated in order to perform the analysis. Also, smaller sample sizes or even case studies may be needed to provide input to the IA.

Quantitative impact studies (as for example used in the Basle II exercise) tend to be large simulation exercises on the basis of fairly well-elaborated solutions. QIS are often used iteratively in order to calibrate quantitative requirements. We foresee that several rounds of QIS will be needed during the Solvency II project in order to assess the detailed impact of for example different solvency requirements. QIS for the Solvency II project will be initiated as soon as the details of the new solvency system will be known. The initial Impact Assessment performed in connection with the preparation of the Directive may be completed and updated through subsequent QIS.

## **2. A possible structure for the Impact Assessment Report**

An IA report should be readable for non-specialists as it should serve as reference material for the co-legislators<sup>3</sup>. It should not be excessively long (perhaps around 30-35 pages). It should provide a general introduction to the area in question, describe the need for legislative action, and outline the objectives for the work as well as options to reach these. It should provide qualitative as well as quantitative assessments of the impact of major alternatives. It should furthermore include stakeholders’ comments and show how these have been taken into account in the preparation.

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<sup>3</sup> For reference, please see the Impact Assessment for the Reinsurance Directive, available on the Commission website: [http://europa.eu.int/comm/internal\\_market/insurance/reinsurance\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/reinsurance_en.htm)

The report could be structured as follows:

1. Procedural issues and consultation of interested parties
2. Problem definition: why do we need a Solvency II Directive?
3. Main objectives for the Solvency II Directive
4. Main policy decisions to reach the objectives
5. Expected quantitative impacts from the different options identified
6. Comparing the options
7. How to monitor and evaluate the results and impacts of the proposal after implementation?

Parts 5 and 6 are especially linked with quantitative analysis.

*Additional considerations in the case of a Lamfalussy Level 1 Directive*

A Lamfalussy Directive should contain general principles. In a recent speech, Commissioner McCreevy strongly emphasised this orientation. In particular, most quantitative requirements may be introduced through Level 2 implementing measures.

The Council decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission (comitology) gives a general indication on the split between Level 1 and Level 2 rules. However, we must explicit how we will implement this general indication in the concrete case of Solvency II. For this, principles must be developed at an early phase of the project, as it will impact the scope of the IA.

Currently, the EU institutions are considering whether draft Level 2 implementing measures expected to have a significant economic impact should be subject to specific Impact Assessments. No decision has been taken as yet.

*Main policy issues to be analysed in the Impact Assessment*

The IA should go through the different alternatives to reach the set objectives. Theoretically all major issues should be dealt with, but a choice must be made in order to retain readability. The initial issues are of a general character, whilst some detailed matters of overall significance will have to be treated as well. This part of the report should identify the subset of alternatives that are deemed most relevant for a quantitative analysis. In annex to this note, examples of general and specific issues that could be touched upon in this part of the report are put forward.

### **3. Timing**

The revised Roadmap outlines the following tentative milestones for the preparation of the Directive and the Impact Assessment:

	<i>Level 1 Directive (incl. codification)</i>	<i>Impact Assessment</i>
<b>2005</b>		
May	Discuss outline document with Member States	
June	Document on legal approaches	Oral update
July		Preparatory discussions with CEIOPS – Background document published
September		Start writing the report <i>CEIOPS starts first round simulations</i>
October		Preparing structure of IA report
November	1 <sup>st</sup> draft codification text	Update paper
<b>2006</b>		
February	2 <sup>nd</sup> draft codification text	IA drafting <i>CEIOPS – result from first round of simulations</i>
March		<i>CEIOPS starts second round simulations</i>
April	3 <sup>rd</sup> draft codification text	Update
May	Document on new legal texts stemming from the Solvency II project	Elements of IA report discussed with Member States
July	Final codified draft text – Update on new Solvency II elements	Update
September		<i>CEIOPS – result from second round of simulations</i>
October	1 <sup>st</sup> draft of Directive	1 <sup>st</sup> draft IA report
November	Update	Update
December	2 <sup>nd</sup> draft of Directive	2 <sup>nd</sup> draft IA report

2007		
February	Final draft of Directive	Final draft IA report
March	Translations	
April	Inter-service consultation	
May	Update	Update
July	Written procedure for adoption by the Commission	

#### **4. Organisational issues – Expected input from CEIOPS – Next steps**

##### *The respective roles of the Commission and CEIOPS*

The impact assessment report is a part of the preparation process of a Directive, and is therefore the responsibility of the Commission.

However, as for all other major parts of the Solvency II work, the Commission is dependent on the work of CEIOPS for the quantitative aspects. The Commission Services will extend significant latitude to the CEIOPS Financial Stability Group and its QIS task force concerning the actual performance of the simulations.

The macro-economic aspects of the Impact Assessment (societal impact, general business, financial, environment, etc.) would be undertaken by, or under the responsibility of, the Commission Services. CEIOPS has indicated that it would concentrate on the simulation of the situation for insurance and reinsurance companies (at solo and group level) as well as impacts on the insurance markets. CEIOPS is of course welcome, on its own initiative, to also consider wider impact issues.

##### *Expected input from CEIOPS*

A first meeting between CEIOPS and Commission experts on the preparation of the Impact Assessment was held on 8 July 2005.

CEIOPS aims at initiating simulations to measure, in particular, the confidence level in technical provisions in October 2005. Further simulations will be made concerning the solvency requirements in spring 2006. CEIOPS has indicated that the simulations would take around six months and that they should be started in early October and in the spring season after companies have prepared their financial statements.

It is crucial that the CEIOPS' simulations are designed in a way that the results are readily usable for the Impact Assessment. CEIOPS will need to give indications as to the following elements:

- Impact of Solvency II valuation principles (compatible with the probable outcome of IASB phase 2) for assets and liabilities on EU insurance and reinsurance companies' balance sheet in comparison to current methods.
- Impact of Solvency II valuation principles on EU companies' solvency ratio, using as numerator the market-consistent value of the probable future eligible elements to cover the capital requirements and as denominator the amount resulting from the current Solvency I requirement.
- Impact on EU insurance and reinsurance companies of requiring a 75% benchmark on the level of confidence of the technical provisions, valued with Solvency II principles, compared to the current situation (current level of confidence within the current accounting environment).
- Impact on EU companies of a solvency requirement targeted at ensuring that it has a ruin probability of a maximum of 0.5% (99.5% Value at risk) over a one-year time horizon, compared to the current situation (Solvency I requirement within the current accounting environment).
- Impact on EU companies of the new minimum capital requirement (MCR) compared to the current situation (Solvency I requirement within the current accounting environment).
- If CEIOPS suggests a longer time horizon is taken into account, impact of introducing this longer time horizon on EU companies' capital requirement.
- Impact on small insurance undertakings.
- Rough estimate of the cost of setting up a quality internal model, which would have a high probability of being approved by the supervisor.

We understand that CEIOPS is working in close cooperation with the insurance industry and the actuaries to carry out these simulations.

### *Next steps*

During the autumn, the Commission Services will also start preparing the structure of the Impact Assessment report. The Services will carefully follow the simulation work under way in CEIOPS.

Having received the results of CEIOPS' simulations, the Commission Services will prepare a first draft Impact Assessment report in October 2006. A final draft version should be ready in February 2007 when the official procedure to adopt the Solvency II Directive will start.

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IMPACT ASSESSMENT REPORT:

EXAMPLES OF POLICY ISSUES

General policy issues may include the items listed below. The issues and alternatives are included in this note *only for illustration purposes*, and may be changed in the final IA. The IA should give arguments for different alternatives, including quantitative impacts.

- Overall approach:
  - (1) Status quo – no changes needed to the current situation
  - (2) Update the existing Solvency I Directives
  - (3) Develop a new EU solvency framework
  - (4) Wait for an international solvency solution
- Legislative approach for the new EU solvency framework:
  - (1) Update the current (non-Lamfalussy) Directives through (non-Lamfalussy) amendments.
  - (2) Create one new Lamfalussy Directive, which recasts and codifies existing Directives (life, non-life, reinsurance and groups) and introduces simultaneously the Solvency II changes.
  - (3) Create three separate recasting Directives for life, non-life and reinsurance/groups, introducing simultaneously the Solvency II changes separately in each of the Directives (Lamfalussy type).
- Should the system contain several solvency capital requirements?
  - (1) No. One solvency requirement level is enough.
  - (2) Yes, a solvency capital level based on the economic capital that an insurance company needs, and a minimum capital level below which a company cannot continue in operation.

- What confidence level for policyholder protection should be used in the development of the solvency capital requirement?
  - (1) 99,5%
  - (2) Lower than 99,5%
  - (3) Higher than 99,5%

To a certain extent specific issues may need to be addressed in the Impact Assessment for the Directive. This does not prejudice of the fact that subsequent implementing measures with significant economic impact may have to be accompanied by specific Impact Assessments. The following issues may be addressed in the IA linked to the Level 1 Directive (*only for illustration purposes*):

- What overall approach should be used for the valuation of technical provisions?
  - (1) Prudent approach not specifying a benchmark confidence level
  - (2) Prudent approach specifying a benchmark confidence level
- What benchmark confidence level should be used for the valuation of technical provisions?
  - (1) 75%
  - (2) 90%
  - (3) Another level
- How should the solvency capital requirement be calculated?
- How should the minimum capital requirement be calculated?
- Should internal models be allowed for the calculation of the solvency capital requirement?