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# REINSURANCE DIRECTIVE - REGULATORY IMPACT ASSESSMENT

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## 1. INTRODUCTION

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1. A Regulatory Impact Assessment (RIA) is a tool used to inform policy decisions and negotiation strategies. It is an assessment of the impact of policy options in terms of their costs, benefits and risks of a proposal.
2. An RIA is an important part of the domestic scrutiny process that all European proposals must go through.
3. The purpose of this document is to set out a regulatory impact assessment for the European Commission's proposal for a Reinsurance Directive, based on the initial April 2004 proposal. It does not set out impacts of any subsequent changes to the text made by either the European Council or Parliament.
4. The Reinsurance Directive cleared the House of Commons European Scrutiny process in October 2004 and the House of Lords in November 2004.

## 2. TITLE

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5. COM (2004) 273: Proposal for a Directive of the European Parliament and of the Council on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC and Directives 98/78/EC and 2002/83/EC.
6. The Commission's proposal for a Reinsurance Directive was formally adopted on 21 April 2004.

## 3. PURPOSE AND INTENDED EFFECT OF THE MEASURE

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### (I) Objectives

7. The purpose of the proposed Directive is to harmonize the supervision of reinsurance business in the EU. A reinsurer is an insurance company that assumes liability for some part of a policy written by another insurance company. Using reinsurance helps spread out risk and limits the possible maximum loss faced by the company that wrote the original policy.
8. The Commission has three specific objectives in harmonising EU reinsurance supervision.

≠ **Objective 1: Establish a sound and prudent regime in the interest of policyholders.** Strong and well-supervised reinsurers contribute to a stronger internal market and international financial stability. This objective addresses uncertainty for direct policyholders, barriers to trade and administrative burdens. As the UK already applies a similar approach to the proposals, they should bring the EU more in line with UK practice and will therefore reduce regulatory arbitrage and benefit UK-based reinsurers. Reinsurers also benefit by not having to implement different regulatory regimes in different countries. Greater financial stability should benefit direct insurance companies and their policyholders.

- ⚡ **Objective 2: Allow mutual recognition of licensed companies so they can conduct reinsurance business all over the European Community under freedom of establishment and the freedom to provide services.** This also addresses uncertainty for direct policyholders, barriers to trade and administrative burdens, but in addition it should also be beneficial for the EU position in international trade negotiations. Like objective 1, the main beneficiaries should be reinsurers, direct insurers and their policyholders.
- ⚡ **Objective 3: Abolish systems, which require the pledging of assets to cover outstanding claims provision.** This primarily addresses barriers to trade and will help improve the EU position in international trade negotiations. This is likely to raise the level of reinsurance underwritten from the UK. For instance, UK-based reinsurers do not generally underwrite French insurers, because they will be subject to UK solvency requirements plus French collateral requirements. However with collateralisation removed it may be more efficient for reinsurers to underwrite such business from the UK. Therefore the primary beneficiaries from this are reinsurers, direct insurers and their policyholders (reaping the benefits of a more efficient reinsurance market).
9. In order to facilitate a ‘fast track’ approach to adoption and implementation of the Directive, the Commission is proposing that the regime for pure reinsurers is based on the existing regime for direct insurers, and uses similar solvency parameters (mixed insurers – i.e. firms which write both insurance and reinsurance business – are already covered by the regime for direct insurers). Thus the Directive proposals will in particular:
- ⚡ Introduce a mandatory licensing system, under which an EU reinsurer would be able to write business anywhere in the EU under the authorisation and supervision of its home state supervisors.
- ⚡ Remove collateral requirements that currently exist in some Member States and prevent new ones being imposed.
- ⚡ Set minimum non-life reinsurance solvency margins in line with those already applying in the EU to direct non-life insurance; and set minimum life reinsurance solvency margins in line with those already applying in the EU to direct life insurance.
10. The following table provides a summary of the main groups who are likely to be directly affected by the proposal.

Group	Reason
Reinsurance firms	Pure reinsurance firms across the EU will have to apply a new regulatory regime for their business. The proposals are very similar to the regime currently applied in the UK. The licensing system will also provide easier access to other markets and could also lead to competitive efficiencies.
Insurance firms	It should become easier for direct insurance companies to evaluate the financial soundness of different reinsurers. Life insurance firms may experience increased reinsurance costs on the basis of the Commission’s proposals for life reinsurance solvency margins.
Policy holders of insurance firms	One of the objectives of the Directive is to establish a

	sound and prudent regime in the interest of policyholders. However, customers of life insurance firms may experience an increase in premiums.
Financial Services Authority	The FSA will have to make a number of modest adjustments to the current UK supervision of reinsurers to align it with the new Directive.

## (II) Interactions with other Directives

11. The Commission are planning that their Solvency II project will update the whole system of solvency requirements for the insurance industry, including reinsurance, taking account of structural changes in the financial market, such as the use of derivatives, new insurance products and new risk management techniques. These plans are still at the formative stage, and on the Commission's timetable Solvency II will not be implemented until 2008 at the very earliest. However, the Commission and the majority of Member States and industry organisations believe that there is a need for more rapid action to achieve tangible results in the reinsurance sector in the short to medium term (to reduce uncertainty for direct insurance companies and their policyholders to remove barriers to entry, reduce administrative burdens and strengthen EU position in international trade negotiations – see section on background).
12. Consequential amendments to existing Insurance Directives (see title) will be made to ensure authorisation of reinsurers and recognition of reinsurance contracts (73/239/EEC and 92/49/EEC) and for the recognition of reinsurance in-group structures (98/78/EC and 2002/83/EC).

## (III) The background

13. The global reinsurance market has been growing steadily over the last 20-30 years. According to a study by Swiss Re, reinsurance business is split 83% non-life and 17% life and health. The global reinsurance market is dominated by US, German and UK-based reinsurance firms. Within the EU, German and UK-based reinsurers account for 82% of the total reinsurance business<sup>1</sup>.
14. The UK reinsurance market is dominated by a few firms, with the top 5 and top 8 reinsurers accounting for 52% and 74% of premiums written respectively (excluding Lloyds of London). This dominance partly reflects a wave of acquisitions by major providers during the 1990s, and also insurers undertaking a flight to quality and migrating their reinsurance business towards the larger, more highly-rated reinsurers.
15. Within the EU German-based reinsurers account for 65 per cent of the EU market, while UK-based firms account for 17 per cent. Most of the UK-based firms are subsidiaries of Swiss, German or US-owned organisations.
16. Currently there are no EU-level regulations for the supervision of pure reinsurers. Instead Member State supervisors have adopted different national approaches to supervising reinsurance. This has resulted in significant

<sup>1</sup> See European Commission, "Study into the methodologies for prudential supervision of reinsurance with a view to the possible establishment of an EU framework", 31 January 2002, KPMG.

differences in the level and type of reinsurance supervision undertaken in Europe 2.

17. Domestic professional reinsurers are not subject to any reinsurance supervision in Belgium and Greece. Ireland has started tightening up its supervision. Although reinsurance companies are not at present subject to a formal solvency supervision regime, the Irish financial services regulator has the power to order a reinsurance company to cease writing business if it is not satisfied with the manner in which it is conducting its business. A formal reinsurance regulatory regime will be introduced in the near future and will be informed by current deliberations at European and international level.
18. Germany (although Germany intends to legislate to subject reinsurers to supervision in future, in order to meet a recommendation from the IMF), France and the Netherlands apply elements of their direct insurance supervisory regime to reinsurers. A reduced licensing regime exists in Austria, Italy, Spain and Sweden, but only the latter two impose solvency margins.
19. Only in the UK, Denmark, Finland and Portugal are reinsurers subject to similar comprehensive regulation and supervision as is applied to direct insurers under the single market regime, including licensing and thorough ongoing financial supervision.
20. The Commission suggests the different national rules have created:

⚠ **Uncertainty for direct insurance companies (and their policy holders):** Different national rules create difficulties for direct insurers in choosing reinsurers in a prudent and cost-efficient way.

⚠ **Barriers to trade within the internal market:** Some Member States require reinsurers to pledge assets as collateral to cover outstanding claims provisions. Such systems restrict a reinsurer's choice of investment by making firms set up parallel investment strategies and systems for different Member State jurisdictions, and reduce the incentive for portfolio diversification, making reinsurance cover more expensive. These systems constitute a significant barrier to free trade in reinsurance; in practice, UK-based firms do little business in these jurisdictions.

⚠ **Administrative burden and costs:** The lack of harmonization of EU reinsurance regulation could lead to duplication of work and raise administrative burdens for reinsurance companies operating in more than one Member State.

⚠ **Weakening the EU position in international trade negotiations:** The lack of harmonisation of EU reinsurance supervision has proved to be an obstacle to third country reinsurers. This is particularly the case in ongoing discussions with the US in relation to reinsurance collateral requirements.

#### (IV) Risk assessment

21. The proposals are intended to ensure reinsurers are adequately capitalised to meet the demands of insurance firms (and hence to ultimately protect their policy holders). Should a major insurance claim be made where an insurer has

<sup>2</sup> See footnote 1, annex 1 and "Draft Directive on reinsurance company supervision. The belt and braces approach", 2004, Aequi-libria Associates SA.

purchased reinsurance cover, then the reinsured part of the claim will be passed on to the reinsurer. If the reinsurer lacks sufficient capital to meet this claim (i.e. becomes insolvent), then the burden would revert to the insurer. This could lead to the insurer itself becoming insolvent, which would prevent it meeting its obligation to policyholders. This could feed through to other insurers and sectors of the economy (UK and EU), with potential impacts on economic growth and financial stability<sup>3</sup>.

22. In addition, the proposals also aim to address the problems already highlighted with the current EU regime (uncertainty for direct insurance companies and their policyholders barriers to entry, administrative burdens and weakening EU position in international trade negotiations). Furthermore the lack of harmonisation of rules will also encourage regulatory arbitrage<sup>4</sup>. Firms who relocate to take advantage of lower regulatory burdens may not have adequate, systems, solvency margins, management and rules in place to commensurate for the risk they undertake.
23. The Commission intends that Solvency II will introduce a proper risk-based system in the medium term, but a significant number of other Member States feel that the current problems affecting the EU reinsurance market should be addressed in advance of Solvency II. This is why the Reinsurance Directive has been introduced under a “fast-track” approach (basing reinsurance supervision on existing supervision of direct insurance).

#### 4. OPTIONS

24. The UK faces three broad options; either to oppose the Directive, to support it, or to support it subject to seeking specific amendments on life reinsurance solvency requirements. The Commission’s proposals will also introduce a single passport system, and remove collateral requirements. The cost and benefits of each of these elements are considered in the analysis below.
25. If the Directive is not implemented then:
- ⚡ The EU will continue to have inconsistent supervision of reinsurers. Some countries will continue to not subject their reinsurance organisations to comprehensive supervision, while others (including the UK) will.
  - ⚡ Current UK solvency requirements will continue to apply to UK-based reinsurers.
  - ⚡ The reinsurance reduction factor will remain at 50%. UK reinsurers who transfer part of the risk on their books to another reinsurance company (this is known as ‘retrocession’) or to their parent company or another part of the group, will be allowed continue to reduce solvency requirements by up to 50%.
  - ⚡ The current UK minimum guarantee fund (the minimum capital required to do business) will remain at €3 million for UK-based reinsurers.

<sup>3</sup> The financial sector could be particularly affected, but with insurers covering a whole array of firms and industries the impact would also be much broader. See “Reinsurance – a systemic risk”, Swiss Re, 2003 and International Monetary Fund, “Global Stability Report”, June 2002.

<sup>4</sup> Whereby differences in regulation and treatment of the reinsurance business in different Member States lead to firms seeking to do business in the least regulated market, or the one that leaves them least comparatively disadvantaged.

- ⊘ While the UK does not have collateral requirements, UK-based reinsurers will continue to be subject to collateral requirements when doing business in some other Member States.

26. However if the proposal is adopted then:

- ⊘ The mandatory licensing system will provide easier access to other EU markets for UK reinsurers.
- ⊘ Solvency requirements for non-life reinsurance will mirror the EU requirements for non-life insurance. This means they will remain unchanged from their current levels in the UK. (However, through comitology, the non-life solvency margin on non-liability business could be raised by up to 50%, if further analysis of risks of different business lines suggested that was appropriate<sup>5</sup>).
- ⊘ Solvency requirements for life reinsurance will mirror the EU requirements for life insurance. This means pure life reinsurance in the UK will potentially face significantly higher solvency requirements, as FSA solvency requirements for pure life reinsurers are currently considerably lighter than the Commission's proposal. The Association of British Insurers (ABI) estimate solvency requirements will increase by an average of 140 per cent<sup>6</sup>.
- ⊘ For life reinsurance business, reinsurers will be only allowed to reduce solvency requirements by 15% under retrocession, rather than by 50% as now.
- ⊘ The minimum guarantee fund will be set to €3 million (for an industrial or commercial captive reinsurance firm - an autonomous and licensed subsidiary established to cover part or all of the risks of its parent – the requirement will be €1 million). Currently there is no EU-wide minimum guarantee requirement but some Member States do currently set a minimum requirement of €2 million.
- ⊘ The proposals will remove collateral requirements (the UK has no collateral requirements). Some Member States require reinsurers to pledge assets to cover outstanding claims provisions.

27. The following table highlights some of the key differences between the EU proposal and current UK regime.

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<sup>5</sup> This increase could only be done after:

(i) detailed analysis by CEIOPS (Committee of European Insurance and Occupational Pension Insurance Supervisors – the new Level 3 committee for insurance) and extensive consultation with interested parties, including the European Parliament; and then

(ii) through a comitology vote on any proposed changes by the new Level 2 Insurance Committee.

<sup>6</sup> See the Association of British Insurers May 2004 publication, "Reinsurance Directive Commentary on Proposal Life Reinsurance Solvency Capital Requirements". The estimate is based on the difference between solvency requirements for life reinsurance for the 8 largest UK-based reinsurers under the current UK regime and the proposal by the Commission (ie the 3 per mille ratio being introduced instead of the current UK 1 per mille ratio).

Some key differences between the current UK reinsurance regime and the Commission's proposal (as currently drafted).		
	Do nothing (Directive not implemented)	Apply Commission's proposal
Life solvency requirements	About 33% of net in force premiums.	About 79% of net in force premiums.
Non- life solvency requirements	About 25% of gross premium written for all business (ignoring the retrocession reduction) <sup>7</sup> .	Under the proposals it would be 25%, rising to 30% if CEIOPS exercised all the options to increase requirements.
Collateral requirements	Collateral requirements vary between countries. UK does not have collateral requirements but some other Member States do.	Removes the collateral requirements existing in some Member States and prevents new ones being imposed.
Reinsurance reduction factor	Under retrocession all reinsurers are allowed to reduce solvency requirements by up to 50%.	The Commission's proposal will only permit life reinsurers to benefit by up to 15%. (Non-life reinsurers will continue to benefit from a 50% reduction.)
Minimum guarantee Fund (MGF)	The current MGF level varies with the type of business. It is €3 million for life reinsurance, €2 million for non life reinsurance, rising to €3 million if any part of the non life reinsurance is liability or credit (there are reductions for mutuals)	€3 million for all reinsurance.
Licensing	The license to do reinsurance business has to be obtained from each Member State in which a firm wants to do business in.	Once a license has been obtained from one Member State, a firm is free to do business in other Member States.

## 5. BENEFITS AND COSTS

### Economic

28. The table in annex 2 provides full details of the direct and indirect economic costs and benefits of the options. In summary:

- ⚡ **Compliance costs:** The Commission's proposals are similar to current UK supervision of reinsurers by the FSA. Therefore additional compliance and administrative costs are likely to be marginal.
- ⚡ **A new EU-wide regime:** The introduction of a new EU-wide mandatory licensing system under the Commission's proposal will provide easier access for UK-based reinsurers to other Member State markets under the Single Market "passport". Increased market access should feed through to higher profits for UK-based reinsurers if they are competitive.

<sup>7</sup> This was based on the assumption that about half of reinsurance business is liability business. We are therefore looking at a requirement in the order of 20% for non-liability business and 30% for liability business.

- €# The proposals will lead to more **consistent and effective supervision** of reinsurers in other EU Member States, and reduce the administrative burden of compliance for those firms doing business in more than one Member State. This should lead to increased competition within the EU and pressure on prices to fall. Furthermore, greater certainty for direct insurance companies will put pressure on premiums to fall. Both of these outcomes will benefit policyholders.
- €# The proposals should **strengthen the EU's hand in trade negotiations** with third countries. It may lead to a more competitive position in relation to the US, where collateralisation applies.
- €# It will also **help to complete a single market in financial services** as set in the Financial Services Action Plan (FSAP). Since current UK supervision of reinsurers is similar to the proposals, the UK is unlikely to benefit from the Directive to the same extent as other Member States that do not currently have as comprehensive supervision of their reinsurance industry. However, the adjustment costs to the new proposals for the UK are likely to be proportionately less than for other countries.
- €# **Capital requirements:** Changes in capital requirements are one of the drivers of firms' costs and benefits. There are three key issues regarding capital requirements and the Directive proposals – solvency margins, regulatory versus economic capital and collateralisation.

### Solvency Margins

29. Solvency margins are set to reduce the risk of reinsurance failures. They help to reduce systemic risk and provide a buffer against unexpected shocks. Their aim is to create greater stability in the market place. Solvency margins should be set having regard to probability of default. Setting requirements too low could introduce instability, but setting them too high will impose higher costs, such as the opportunity cost of holding additional capital and lead to a lower supply of reinsurance.
30. The solvency requirements for non-life reinsurance under the proposals are to remain similar to current UK requirements. However, the margins for life reinsurance are raised under the proposals. The current UK solvency margin for life reinsurance is 1 per mille (0.1%) of the capital at risk<sup>8</sup>. The Commission's proposal raises it to 3 per mille (0.3%).
31. The following table shows rating agency and regulatory models for assessing appropriate levels of solvency capital in the life insurance market. Rating agency assessments of the credit worthiness are important factors for insurers to take into account when selecting reinsurers. The table shows that reinsurers are awarded good credit ratings (which are indicators of probability of default) with solvency requirements of 0.5 to 1.0 per mille. These rates would actually be more in line with the current UK requirement.

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<sup>8</sup> Capital at risk = sum assured – reserve. Reinsurers hold a reserve to ensure that it can meet a claim when it falls due (for instance a policy holder might die during the term of a life protection policy).

	Model	Capital at risk component
<b>Rating agency models for life reinsurance</b>	Standard and Poor's (S&P) EU model for BBB (good)-rated entities	0.8 per mille
	S&P UK model for non-linked-business BBB	0.8 per mille
	S&P UK model for linked-business BBB	1.0 per mille
	AM Best model for individual business B (Fair)	0.6 per mille
	AM Best model for group business B	0.5 per mille
<b>Regulatory models for life reinsurance</b>	UK Regulatory framework for direct life offices	Ranges from 3 per mille for guaranteed business, reducing to 1 per mille for short term contracts
	UK regulatory framework for pure reinsurers	1 per mille
	US regulatory model for individual business	0.9 per mille
	US regulatory model for group business.	0.8 per mille

Source: Reinsurance Directive Commentary on Proposed Life Reinsurance Solvency Capital Requirements, Association of British Insurers, May 2004.

32. The rise in solvency margins for life reinsurance proposed by the Commission does not appear justified.
33. The Directive also needs to set solvency margins with an eye to the global nature of reinsurance business, otherwise there is a risk that business will simply be driven out of the EU. Furthermore, life reinsurance capital requirements should be different from direct life capital requirements. Requirements for the latter were set about 30 years ago. Improvements in health since then have meant changes in mortality rates and hence the risk firms are exposed to.
34. Under the Commission's proposals the reinsurance reduction factor for retrocession will also be reduced from 50% to 15% for life reinsurance. Industry estimates that with increased solvency margins for life reinsurers and reduced reduction factor, there would be a requirement to hold approximately an additional £700 million<sup>9</sup> of capital. The opportunity cost of this extra capital adds about a further £24.5 million<sup>10</sup> to total costs (these are ongoing costs but will depend on factors such as level of risk and quantity of business underwritten). With most life reinsurers underwriting life reinsurance only, this is likely to exclusively impact the life reinsurance market. The changes that we are seeking to make to the Commission's proposals will bring the Directive in line with current UK requirements for life reinsurance so that the increase in capital requirements and the associated costs are minimal.

<sup>9</sup> Based on firm results as at 31 December 2003. Including the impact on retrocession.

<sup>10</sup> If firms face increased capital requirements they will need to issue equity (or equity like securities) or retain earnings. The cost (or opportunity cost) of doing this is the cost of equity, which is equal to the risk free rate plus the equity risk premium minus the interest that can be earned from investing the regulatory capital in low risk securities. We assume that low interest securities pay the risk-free rate; the net cost of capital will therefore be the equity market premium, for which a figure of 3.5% is appropriate.

35. However, firms are likely to restructure their organization to minimise the additional cost imposed on them. This figure is therefore likely to be an upper estimate of the additional burden, even before the impact on economic, as opposed to regulatory, capital is considered (see below).

#### **Regulatory versus economic capital**

36. The amount of capital that a firm assesses is prudent to hold, to meet regulatory and other business needs, is referred to as economic capital. In terms of impact on reinsurance premia and price what matters is the change in economic rather than regulatory capital. Regulators typically expect reinsurance companies to hold a level of additional capital in excess of the total required solvency margin. In the UK this is broadly of the order 150%+ of the required solvency margin. If life reinsurers did have to hold an additional £700 million capital, as suggested, then it would reduce this margin to around 4% unless they raised their total (economic) capital to compensate<sup>11</sup>. However for reasons explained below we would expect economic capital to rise but perhaps not enough to maintain the 150%+ margin.

37. Reinsurers may hold significant amounts of economic capital to avoid costs related to market discipline and supervisory intervention. In addition, they can hold economic capital to: avoid the risk of losing market confidence; as insurance against difficulties in raising new capital; for strategic and reputational reasons, such as to finance mergers and acquisitions, or to satisfy rating agencies prior to expansion into other markets; and to allow flexibility in decision making. Institutions will typically also hold economic capital to accommodate fluctuations in market risk requirements, which may be volatile.

38. Some studies have shown that there is a positive but non-linear relationship between economic and regulatory capital<sup>12</sup> in the banking sector. We believe this is also likely to be the case for reinsurers. Thus, some of any increase in regulatory capital is likely to be absorbed. But there would still nevertheless be an increase in economic capital, creating, as already illustrated, pressure for a rise in premiums and prices. To some extent, this can be mitigated by the gains made from removing collateralised systems in other Member States. However this depends on how the firm will decide to spread the gains to different business lines and the impact of any pressure to restructure due to higher solvency margins.

39. The changes that we are seeking to make to the Commission's proposals will bring the Directive in line with current UK requirements therefore minimizing the impact on economic capital.

#### **Collateralisation**

40. The proposals would remove all collateral requirements within the EU. This will benefit UK reinsurers by reducing barriers to trade and therefore provide greater access to some markets for reinsurance. Currently UK-based reinsurers

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<sup>11</sup> ABI's May 2004 publication shows that the largest 8 UK based life reinsurers would have held £508 million required capital under the 1 per mille requirement, as at 31 December 2003. Assuming the 150%+ relationship, total capital held is therefore £1,270 million. Using 3 per mille the regulatory minimum capital increases to £1,220 million.

<sup>12</sup> See FSA Occasional Paper Series 22, "What determines how much capital is held by UK banks and building societies?".

generally do not do business in collateralised markets. This is because they will be subject to both UK solvency margins as well as foreign collateral requirements.

41. The removal of collateral could lead to more efficient risk sharing, thus improving profitability and supporting greater financial stability. However, a reinsurer's decision to provide insurance cover is not solely based on collateralisation issues but will also depend on other factors (competition, market size, etc). This, along with current UK-based reinsurers practice of not doing business in markets requiring collateral, makes it difficult to estimate the likely benefits from the removal of collateral. But there could potentially be considerable benefits from increased access.

#### **Impact on quantities of insurance services**

42. This will be affected for two reasons. First, insurance premium are likely to increase as a result of the Commission's proposal. Making simple assumptions (gross return on capital of 15%, interest earned on capital of 4% and that UK reinsurers typically hold 150%+ of the required solvency margin) industry estimates suggest, as a result of the proposals, consumer premiums for mortality business could also increase, on average by between 10% and 15%, depending on the profile of the insured population (see annex 3).
43. Second, UK life insurers rely materially on re-insurance to share risks. So we understand that it is not unusual for life offices to shift through reinsurance about 50% of risks<sup>13</sup>. The extent to which life insurers find reinsurers willing to take these risks will diminish if solvency margins for reinsurers increase to 3 per cent mille. This would also affect product innovation as reinsurance is also used in respect of new products.

### **Environmental and Social**

44. There are no significant environmental and social benefits or costs
45. In conclusion the cost/benefits analysis (including analysis in annex 1) suggests that the Commission's proposal to set life reinsurance solvency margins at 3 per mille will not provide a net gain to the UK. The Directive does offer a potential net benefit if the solvency margins are set at levels similar to those currently used in the UK as in the third option.

## **6. EQUITY AND FAIRNESS**

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46. The proposals will not have significant direct or indirect impacts on equity and fairness.

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<sup>13</sup> ABI figures show that in 2002, reinsurance bought as a proportion of sums assured of new life business was almost 80% and that reinsurance was slightly less than 40% of premium of in-force life business.

## 7. CONSULTATION WITH SMALL BUSINESS

47. Having consulted small firm associations and groups, it is unclear how small firms will be impacted. The reinsurance industry in the UK is composed of large organisations, and because they base prices on economic capital it is difficult to assess the impact a change in regulatory capital will have on premiums and prices.
48. The Commission's proposal is expected to have only a small impact on non-life reinsurers and, on insurers and their customers. This is because the new European regime is little different to the regime currently in operation in the UK.
49. However, the proposals for life reinsurers will have a significant impact not only on life reinsurers themselves, but possibly also on direct life insurers and their customers. Life reinsurers will need to carry more capital than they currently do and it could lead to increased prices charged to direct insurers which could be passed on to retail customers. With smaller insurance firms tending to purchase more reinsurance cover, because they have lower amounts of capital and seek to protect it, this may mean they are relatively more vulnerable. However as explained these effects are hard to quantify.

## 8. COMPETITION ASSESSMENT

50. The following table highlights the competitive changes that are likely to occur due to the Commission's proposal. The first column highlights key areas that are likely to reduce competitive pressures within the UK reinsurance market, the second column covers areas that are likely to lead to no change, and the last column covers areas that are likely to improve competition.

<p><b>Damaging competition</b></p>	<p>The minimum guarantee fund (the minimum capital required to do business) will be set at €3 million. This may act as a burden on smaller firms who have relatively less resources than their larger competitors.</p> <p>Higher solvency margins for life reinsurance will potentially lead to lower volumes of life business.</p> <p>Some firms could potentially decide to relocate to jurisdictions outside the scope of the Directive to avoid complying with higher solvency requirements.</p>
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<b>No change to competition</b>	<p>A few firms dominate the Reinsurance market. However, no one firm has more than 20 percent of the market share, with the three largest firms accounting for 44 per cent of the total. The proposal is unlikely to change this structure.</p> <p>With the UK currently applying a similar regime to the proposal there is unlikely to be significant changes to the market structure, higher ongoing or set up costs for new or potential firms. Furthermore the change in the burden of implementation should be small for all firms.</p> <p>With new developments in products (such as securitisation) and advancement in risk management techniques, the reinsurance market is characterised by fairly rapid technological change.</p> <p>The proposals should not have an impact on a firm's ability to choose the price, quality, range or location of its products. It sets the adequate level of capital a firm would be required to hold for doing reinsurance business (with requirements changing according to product – life or non life) and lets the market determine price.</p>
<b>Improve competition</b>	<p>The proposals set solvency requirements proportional to the size of the business underwritten according to risk. This should prevent a disproportionate impact on smaller firms.</p> <p>The proposals may also lead to a competitive advantage for Europe over other regions. For instance, the US also has collateral requirements and firms are supervised by each state leading to inconsistencies in the application of rules and regulations.</p>

51. Two of the three damaging effects on competition mentioned in the Table will not materialise under the third option that we are seeking to negotiate.

## 9. ENFORCEMENT AND SANCTIONS

52. The FSA will be responsible for implementing the reinsurance Directive through the prudential sourcebook. The impact on public finances will be negligible. The FSA already applies a similar standard of regulation to non-life reinsurers. However, the solvency requirements currently applied in the UK to pure life reinsurers are lower than for the life insurers, and lower than the Commission's proposal.
53. If reinsurers fail to comply with the Directive then the FSA will have the authority to remove the authorisation to do business from them or impose fines.
54. If the Directive is implemented but not adopted by some Member States, they will face infraction proceedings. However it is hard to quantify what the judgement of a court might be and therefore the infractions fine that may be imposed.

## 10. MONITORING AND REVIEW

55. The Reinsurance Directive will be succeeded by Solvency II, which will update the whole system of solvency requirements for the insurance industry, including reinsurance, taking account of changes in the financial market, such as the use of derivatives, new insurance products and risk management

techniques. We expect Solvency II to be implemented by 2008 at the very earliest.

## 11. CONSULTATION

56. The Treasury has worked closely with the FSA and has consulted on the proposed Directive with representatives of the financial services industry, in particular through a series of roundtable meetings. The following table provides a list of organisations the Treasury has been in contact with.

<b>Companies</b>	Swiss Re, General Re, Munich Re, Revios Reinsurance, Lloyds of London, Pool Re, Wellington Re, Equitas, Groupama, Fortis, Royal & SunAlliance, Royal London, Cornhill, Aegon, BUPA, Sabre Insurance
<b>Trade Associations</b>	Association of British Insurers, London Market Insurance Brokers' Committee, International Underwriting Association, Federation of Small Businesses
<b>Government</b>	Financial Services Authority, Small Business Services, Small Business Practitioners Panel (FSA), Trade Partners UK, Office of Fair Trading

57. The Government will continue to consult interested parties on the proposed Directive and has set up a series of drafting groups to advise on detailed issues. These groups draw extensively on the expertise of experienced City practitioners.

58. UK industry supports our third option, i.e. the introduction of a Reinsurance Directive that will bring other Member States reinsurance supervision more in line with the UK and also remove collateral requirements, which currently exist in some EU Member States. There are two key concerns for industry over the Commission's proposal. Firstly, solvency margins for life reinsurance will be raised.

59. The second related concern is the reduced incentive for life insurers' risk diversification by transferring some the risks that they take (retrocession). At the moment, these risk transfers are compensated with a reduction in solvency requirements of up to 50%. Under the Commission's proposals this reduction will be limited to up to 15% of the solvency margin. This may limit the availability of capacity for life re-insurance and in turn affect direct insurers that are increasingly relying on re-insurance.

60. Industry estimates suggest that solvency margins under the Directive would be 140% higher than the current UK solvency margin for life reinsurance, as a result of both the above concerns, and would require industry to hold an additional £700 million of capital (although, as noted above, this figure is likely to be an upper estimate).

## 12. SUMMARY AND RECOMMENDATION

61. The purpose of the proposed Reinsurance Directive is to harmonize the level of supervision of reinsurance business in the EU. It introduces a mandatory licensing system which will allow firms a “passport” to do business cross border, and removes the collateral requirements for doing reinsurance business in some Member States.
62. The main concern with the Commission’s proposal is that the solvency requirements for life reinsurance will have a significant impact on industry. However this is hard to quantify. The industry estimate of additional capital of £700 million required if the proposed solvency requirements for life reinsurance were adopted is likely to be an upper estimate. A somewhat lower figure is likely when company restructuring, and the feed through to economic capital are taken into consideration. However, there is no evidence to suggest that life reinsurance is more risky than it is currently treated in the UK and thus to support proposals that life solvency requirements should be relatively higher than they currently are.
63. Taking into consideration the cost/benefit analysis, views of industry and other Member States we conclude that:
- ⚡ A EU-wide supervisory regime for reinsurers should bring benefits, and is supported by most Member States and UK industry.
  - ⚡ The proposals will provide a net benefit only if the detailed parameters are set at the right levels. Although UK-based reinsurers will benefit from the removal of collateral, the higher solvency margins for life reinsurance under the Commission’s proposal will be very damaging.
64. We therefore recommend the UK should adopt the third option, i.e. support the Directive as it currently stands but only if minimum solvency margin for life reinsurance is reduced from the proposed 3 per mille to a level more consistent with the current UK requirement, which better reflects the underlying risk of this type of business.



# A

## ANNEX 1 - REINSURANCE SUPERVISION COMPARED

Supervision	Germany	France	UK	Netherlands	Italy	Denmark	Sweden	Spain	Luxembourg
License required in order to practice reinsurance									
€# Domestic reinsurers	X	X	.	X	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	.	X	X	X
Reinsurers are subject to supervision	.	.	.	.	.	.	.	.	.
Reinsurers are supervised directly	.	X	.	X	.	.	.	.	.
Reinsurers are supervised indirectly	.	.	.	.	X	.	X	.	.
Reinsurers are subject to on-site inspections									
€# Domestic reinsurers	.	.	.	.	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X
Management must be "fit and proper"									
€# Domestic reinsurers	X	.	.	X	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X
Changes in management must be reported									
€# Domestic reinsurers	X	X	.	X	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X
Sufficiency of technical provisions examined									
€# Domestic reinsurers	.	.	.	X	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X
Solvency requirements exist	X	X	.	X	X	.	.	.	.
Financial statements must be submitted									
€# Domestic reinsurers	.	.	.	.	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X
Annual submission									
€# Domestic reinsurers	.	.	.	.	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X
Quarterly submission									
€# Domestic reinsurers	.	.	.	.	.	.	.	.	.
€# Non-domestic reinsurers	X	X	.	X	.	X	X	X	X

## A ANNEX 1 - REINSURANCE SUPERVISION COMPARED

Assets examined											
€#	Domestic reinsurers	X	X	X	.	.	X	X	.	.	.
€#	Non-domestic reinsurers	X	X	X	.	.	X	X	.	.	X
Sanctions: license can be withdrawn											
€#	Domestic reinsurers	X	X	X	.	.	X	X	.	.	X
€#	Non-domestic reinsurers	X	X	X	.	.	X	X	.	.	X
Sanctions: fines may be imposed											
€#	Domestic reinsurers	.	X	X	.	.	X	X	.	.	X
€#	Non-domestic reinsurers	.	X	X	.	.	X	X	.	.	X

Source: European Commission, "Study into the methodologies for prudential supervision of reinsurance with a view to the possible establishment of the EU framework", 31 January 2002, KPMG.

# ANNEX 2 - ECONOMIC COSTS AND BENEFITS

Option	Do nothing	Apply the proposal as currently drafted
Costs	<p>The directive is not implemented in the EU. Therefore there are no implementation costs.</p>	<p>Will result in additional costs in setting up the new regime for domestic implementation. However since the current UK regime is similar to the proposals this additional cost will be marginal.</p>
Regulatory Capital	<p>Collateralisation systems in other Member States will continue to restrict reinsurers' choice of investments leading to an inefficient allocation of capital, which could be making reinsurance cover more expensive than it should be.</p>	<p>Would lead to increased capital requirements for life reinsurance business and reduced reduction factor for retrocession, requiring firms to hold additional capital. Industry has calculated that they would be required to hold an additional ongoing <b>£700<sup>14</sup>million</b> capital if proposed solvency requirements on life were adopted. Although this figure is likely to be a worst case scenario The opportunity costs of this extra capital adds a further ongoing <b>£24.5<sup>15</sup>million</b> to total costs.</p>
Economic Capital	<p>No significant impact</p>	<p>The proposal to set the minimum guarantee fund at €3 million should not impact on UK based reinsurers most of whom under current UK rules already have to apply this minimum.</p> <p>May lead to firms relocating to areas, which are not under the scope of the Directive. However given the market structure (dominated by about 8 large firms) and the fact that firms hold a buffer to regulatory capital, the firms are likely to absorb some of this additional burden.</p> <p>It is not clear how economic capital will change. Firms normally hold capital higher than required by regulation. Therefore they may decide to absorb some of the additional capital requirements. The Association of British Insurers (ABI) estimate that on average reinsurers hold 150%+ of the current required solvency margin.</p>

<sup>14</sup> See the Association of British Insurers May 2004 publication, "Reinsurance Directive Commentary on Proposal Life Reinsurance Solvency Capital Requirements". The estimate is based on the difference between solvency requirements for life reinsurers under the current UK regime and the proposal by the Commission, for the 8 largest UK based reinsurers, as at 31 December 2003

<sup>15</sup> If firms face increased capital requirements they will need to issue equity (or equity like securities) or retain earnings. The cost (or opportunity cost) of doing this is the cost of equity, which is equal to the risk free rate plus the equity risk premium minus the interest that can be earned from investing in low risk securities. We assume that low interest securities pay the risk-free rate; the net cost of capital will therefore be the equity market premium, for which a figure of 3.5% is appropriate.

# B

## ANNEX 2 - ECONOMIC COSTS AND BENEFITS

	Competitive costs	No significant change.	<p>Will depend on whether firms absorb or pass on additional capital requirements. Smaller firms may find it more difficult to do this.</p> <p>Under the proposals the minimum guarantee fund is set as a flat charge for all firms and therefore could impact on smaller firms proportionally more than large ones.</p> <p>The proposed capital requirements in the EU are significantly higher than those outside the EU and could encourage relocation of some reinsurance business outside the EU. This is partially mitigated via the Directive proposing a 15 per cent reduction for those reinsurers who transfer part of their risks onto other reinsurers (retrocession).</p>
	Consumers/ other end users	No significant change.	<p>Will depend on whether reinsurers decide to pass on the cost of additional capital requirements to insurers and if insurers pass on to final users. Again both insurers and reinsurers may have the capacity to absorb additional requirements. ABI estimates suggest consumer premiums for mortality business could increase on average between 10% and 15%<sup>16</sup>.</p> <p>No significant change</p>
	Other indirect costs	The status quo would mean the current concerns over the reinsurance industry (uncertainty for direct insurance companies, barriers to trade, administrative burdens and weakening EU position in international trade negotiations) would continue to persist.	
<b>Benefits</b>	Implementation	No significant change	No significant change
	Regulatory Capital	Solvency requirements applied to pure life reinsurers in the UK are on average 30% lower than the Commission proposals (i.e. the Commissions proposal is about 140% of current UK solvency requirement for life reinsurers).	<p>Would lead to increased capital requirements for life reinsurance business. This could help reduce the risk to policyholders and reduced claims on the UK insurance guarantee fund. With funds being paid only when a company fails and to final policyholders only, the gains from reduced claims are likely to be marginal. Furthermore, based on experience of insolvencies of life reinsurers, there is no evidence to suggest that increased solvency margins are needed to reduce insolvencies.</p> <p>Will remove the collateral<sup>17</sup> requirements of some Member States (such as France). This will reduce barriers to trade and provide greater access to some markets. Generally UK-based reinsurers do not do business in collateralised markets. This is because they will be subject to both UK solvency margins as well as foreign collateral requirements.</p>

<sup>16</sup> These estimates vary depending on the assumption of the profile of the insured population, gross return on capital (assumed 15% here), interest earned on capital (assumed 4% here) and that UK reinsurers typically hold 150%+ of the required solvency margin.

<sup>17</sup> Reinsurers have to pledge assets to cover outstanding claims provisions.

**B**  
**ANNEX 2 - ECONOMIC COSTS AND BENEFITS**

		No significant change.	Potential efficiency gains from the removal of collateral may lead to pressure for economic capital to fall.
Economic Capital		No significant change.	May lead to greater comparative advantage for Europe over other regions such as the US, which has collateral requirements and fragmented domestic implementation of the rules and regulations (US supervision of reinsurers is left to state supervision)
Competitive benefits		No significant change.	Gains from collateral could be passed on to insurers who in turn pass it on to end users.
Consumer/other end users		Insurers will not face the uncertainty of a new regime and potential changes to the premiums and cover they currently face.	Help to complete a single market in financial services as set out in the Financial Services Action Plan (FSAP) <sup>18</sup> . A report commissioned by the European Commission suggests that EU GDP will increase by 1.1% over a decade or so after completion of the FSAP. Since reinsurance is a small part of the FSAP these gains are likely to be small. Furthermore, the gains for the UK are limited by the fact that the UK already has a similar regime to the proposals. However, this does mean that adjustment costs for the UK will be proportionately lower compared to other Member States.
Other indirect benefits			Will also help reduce some of the concerns the Commission has raised over the uncertainty for direct insurance companies, administrative burdens and weakened position of the EU in international negotiations.

<sup>18</sup> Although the reinsurance Directive was not initially intended to be part of the FSAP it was added later.



# C

## ANNEX 3 - IMPACT ON PREMIUMS

Age	Status (sex & smoker)	Term	Gross return on capital 10%			Gross return on capital 15%		
			5years	15years	25years	5years	15years	25years
30	Male, non smoker		13%	13%	12%	21%	21%	19%
	Female, non smoker		12%	12%	12%	20%	21%	20%
	Male, smoker		11%	9%	8%	18%	16%	14%
40	Male, non smoker		10%	8%	7%	17%	14%	12%
	Female, non smoker		11%	10%	8%	18%	16%	14%
	Male, smoker		8%	5%	4%	13%	9%	6%
50	Male, non smoker		7%	4%		12%	7%	
	Female, non smoker		7%	5%		13%	9%	
	Male, smoker		4%	2%		6%	3%	

Source: Reinsurance Directive Commentary on proposed Life Reinsurance Solvency Capital requirements, Association of British insurers, May 2004.