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The Recalibration of the European System of Financial Supervision in Regard of the Insurance Sector: From Dreary to Dreamy or *Vice Versa*?^{*1}

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Coming (great) events cast their (long) shadow before. As the financial crisis gave birth to the creation of the European System of Financial Supervision (ESFS), the imminent *Brexit* now serves as an impulse to rather extensively reorganize it. Pursuant to the preferences of the Commission—as revealed in its draft for a regulation amending the regulations founding the European Supervisory Authorities (ESA)—the supervision (and regulation) of the financial sectors should be further centralized and integrated and additional powers should be given to the ESAs. To a large degree these alterations are intended to adjust the competences of the European Securities and Markets Authority (ESMA) to better meet its new objectives under the Capital Markets Union (“CMU”). In view that an equivalent to the CMU or the Banking Union—in the sense of a European Insurance Union—is not yet on the horizon for the insurance sector (or the occupational pensions sector), one could *prima vista* take the view that insurance supervision and regulation is once again taken captive by the necessity of regulatory reforms stemming from other financial sectors. However, even if that is partially the case, the outcome of the intended reforms might still be advantageous for the insurance sector and an important step in the right direction. Therefore, it needs to be intensively discussed.

At this stage, some of the most prominent envisioned changes to the structure, tasks and powers of the European Insurance and Occupational Pensions Authority (EIOPA) and their necessity, usefulness or counter-productivity still have to be examined.

* SAFE policy papers represent the authors’ personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

¹ Some Comments on the EU Commission’s Proposal for a Regulation of 20 September 2017 in: COM(2017) 536 final, and the Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Brussels, of 20 September 2017 in: COM(2017) 542 final.

Centralization of Supervision

When the ESAs were created—with the exception of ESMA *vis-à-vis* rating agencies—they were primarily assigned to promote convergence of supervisory practices of the national supervisory authorities, i.e. the European Banking Authority (EBA) in the banking sector, EIOPA in the insurance sector, and ESMA in securities markets. The creation of the Banking Union and the resulting centralization of supervision of many financial institutions under the auspices of a European authority—albeit not under that of the EBA or another ESA but the Single Supervisory Mechanism (SSM) at the ECB—has brought a very significant change. We are currently witnessing a similar development with regard to capital markets. The CMU is intended to unify capital markets in Europe supported by a more integrated European financial supervision. The Commission's proposals can thus be seen as a stepping stone to by and by abolish national supervision of financial markets and creating a fully centralized supervisory system (at least in relation to some financial institutions). Whilst such a centralization appears to be called for in regard of large banking undertakings and groups, financial conglomerates and capital markets, which are defined by a substantive amount of cross-border business, one might question its appropriateness in the insurance sector where business (i.e. the tendering of insurance cover) remains to be local for the most part. On the contrary, one cannot ignore that to a large extent insurance cover is no longer provided by stand-alone insurance undertakings but rather by companies belonging to insurance groups or financial conglomerates which may as such not be efficiently supervised on a purely national level. The current group supervisory system still ails from a certain lack of centralization and thus lends itself to a significant degree to supervisory arbitrage. In view, for example, of pending reform of the regulation of Global Systemically Important Insurers (G-SIIs), e.g. the creating by IAIS of the Insurance Capital Standard (ICS) or the requirements to provide for Higher Loss Absorbency (HLA), one could argue that at least those insurers (and insurance groups) that are of particular importance to the European Union as a whole would be more efficiently supervised by EIOPA directly. Such discussion about the creation of an Insurance Union remains, however, for a later day. For the moment, EIOPA, other than ESMA in respect of certain sectors of capital markets, is pursuant to the Commission's concept not to be granted full and unabated supervision over any European insurance undertakings. Furthered centralization of supervision in the insurance sector is rather limited to certain aspects. For example, EIOPA will be more involved in the authorization and supervision process pertaining to non-EU insurers and, as will be discussed later, in the authorization for the application of internal models. Whilst such tasks will diminish the powers of the national supervisors (and the group supervisor) they will also help to create a more level playing field.

Europeanization by Structural Reform of EIOPA

Whereas EIOPA has been a European agency since its creation, with all organs, members of its organs and employees only acting in the interest of the European Union as a whole, reality proved it—and the other ESAs—to be a horse of a different colour. All significant decisions of EIOPA are taken either by the Board of Supervisors or the Management Board with voting rights only granted to the representatives of the national supervisory authorities (NSAs). Even though the directors of the NSAs or their replacements are in the discharge of their duties within EIOPA subject to a duty (and a right) of independence, thus are barred from accepting instructions from their governments and from acting in the national interest, it may be feared that any decision (at least in face of a crisis) could be overly oriented towards the safeguarding of national interests. The Commission aspires to further Europeanize the regulation and supervision of the insurance sector by altering the organizational structure of EIOPA. The Commission aims to retain the Board of Supervisors as the main organ of EIOPA, which respectively means that the majority of decisions is still under the purview of the national supervisors. Yet, it plans to rechristen the Management Board and to shift several powers from the Board of Supervisors to the thence-called Executive Board. Under the current structure of EIOPA such would not result in a significant loss of importance of the national supervisors since the Management Board comprises the Chairperson, several members elected by and from within the members of the Board of Supervisors, the Executive Director and a Representative of the Commission, with only the two former categories of members having a voting right (except concerning budget questions where the representative of the Commission has a voting right). Under the provisioned amendments of the EIOPA Regulation, the Executive Board would, however, consist of the Chairperson and a number of full-time members, i.e. employees of EIOPA. The task of this Executive Board would for the most part, as is the case today for the Management Board, remain the preparation of decisions of the Board of Supervisors. Under the current regime the Management Board displayed, however and although a distinct organ on paper, some traits more similar to a preparatory sub-committee, especially in view that voting members were, except for the Chairman, exclusively elected by and from within the voting members of the Board of Supervisors. Under the proposed regime it would rather be a genuinely distinct organ exclusively composed of European staff *katexochen*. This would dramatically alter the equilibrium between EIOPA and the NSAs, since projects will often be predefined by the preparatory work done by EIOPA *sensu stricto*. Further, the Executive Board would take over several tasks and powers from the Board of Supervisors. For instance, the Executive Board is intended to take the final decision on the settlement of disputes between NSAs, on the breach of Union law and on the execution of stress tests. These structural changes will *in toto* result in a significant disempowerment of the NSAs and result in a massive Europeanization of insurance supervision. This means that EIOPA would be granted several areas within which it could take insurance supervisory decisions unchecked by the

NSAs but with immediate effect for them. Whether these are happy news, is a question of perspective. One can, however, expect that the NSAs will not greet this proposal with open arms, but rather with teeth and claws.

New Tasks and Powers (Especially Pertaining to Internal Models)

EIOPA would also be assigned several new tasks and powers. It will e.g. be entrusted with monitoring and addressing issues pertaining to technological innovations and environmental, social and governance factors. One could question if these tasks and powers are truly new or were already entrusted to EIOPA under some of the catch-all competences. However, in view of the upcoming challenges in these fields it is certainly useful that the EIOPA Regulation would explicitly state that these factors should also be taken under consideration by EIOPA. An important clarification is provided by the draft in obligating EIOPA to not only help the European Commission to prepare equivalence decisions on the insurance supervisory systems of third countries, as has already been the case. EIOPA should also continuously monitor the regulatory and supervisory developments in those countries which have been afforded equivalence status in order to re-evaluate the decision in the event of any changes. EIOPA would also be explicitly tasked with developing and maintaining an up-to-date supervisory handbook; an obligation hitherto only assumed to exist implicitly.

A true innovation, or in some respects rather reinforcement of existing tasks and powers, is planned with regard to the approval process for internal models. The Commission's draft makes it incumbent on supervisory authorities including group supervisors to inform EIOPA about completed applications for the usage of internal models or internal group models and to provide the underlying documentation where requested before deciding on the application. For internal group models this appears to only be a clarification since EIOPA is already a member of the supervisory colleges and thus takes part in the joint decision on relevant applications. For decisions on single entity basis this, however, is a true innovation which enables EIOPA to efficiently supervise the national practices of authorizing the implementation of internal models. This empowerment seems very appropriate since a divergence in supervisory practices concerning the allowance of internal models, especially within a principle based system, increases the risk of supervisory arbitrage. By putting EIOPA in a position of being an information juncture it is not only able to better assess deficiencies and best practices. It should also be explicitly assigned to use such information, though this power already existed implicitly in the past, to issue guidelines on the assessment of internal models.

Altered Review over Guidelines and Recommendations

Following the issuance of the Solvency II Preparatory Guidelines², the legal instruments of guidelines and recommendations and the imperfect judicial protection against this rather hard category of *soft law* has received much attention. The Commission is to be lauded in trying to close the protective gap by providing for a new appeal mechanism. The draft allows the EIOPA Stakeholder Group (in the case of EIOPA this can only be the particular Stakeholder Group whose sector is addressed by the guidelines) to submit a petition to the Commission, if it believes that EIOPA has exceeded its competences. The Commission would be entitled to order EIOPA to alter or withdraw the relevant guidelines. The advantage of only granting petition rights to (the majority of the members of) the Stakeholder Group would be that guidelines became appealable whilst avoiding the creation of a burdensome *actio popularis*. In view of its continuous tendency to usurp additional powers also by excessive use of soft law instruments, one could, however, question if the Commission is really the best forum to decide such questions. To many, such a mechanism might seem like allowing the hens to appeal to the wolf for protection against the fox.

Reformed Funding System

The amendment which is most likely to spark an extreme amount of controversy relates to an envisioned change to the funding of EIOPA. Currently EIOPA is funded by a proportional contribution of the NSAs (amounting to 60% of the total budget) and a balancing contribution out of the EU-budget (of 40%). In addition, the EIOPA Regulation allows that fees can be collected from insurance undertakings. However, this only applies to undertakings directly supervised by EIOPA, which currently do not exist. The Commission's draft is intent on creating a *tabula rasa* and making all European insurers directly liable for funding EIOPA. Pursuant to the proposed concept, all entities supervised indirectly by EIOPA, that is all entities supervised by the NSAs belonging to the insurance and occupational pensions sector of the ESFS, would be obligated to contribute in a proportional manner to the annual budget of EIOPA. The remainder of the budget would be paid through a balancing contribution by the EU (with direct fees by directly supervised entities remaining possible, but for the time being irrelevant). This proposition apparently stems from the fact that in the past some NSAs were reluctant or even unable to forward their contributions to the ESAs, because they were themselves underfunded. The reason for this is most likely that some European NSAs are still exclusively funded from the general state budget (maybe with additional fees for supervisory actions), without an annual contribution of the supervised entities.

² See for the Solvency II Preparatory Guidelines and further guidelines: <https://eiopa.europa.eu/regulation-supervision/guidelines>.

In a way, the Commission's proposition now circumvents national legislators' decisions of who has to pay for the soundness of the insurance sector (i.e. the tax payer or the insurance undertakings and, thus, indirectly the policyholders). This appears questionable in itself. Further, it remains unclear and needs to be substantiated in subsequent EU legislation, how the contributions should be levied. It can be expected that it will be the NSAs who collect the contributions for the account of EIOPA. Hence, it is difficult to see the true advantage of this procedure compared to the current system. Most likely the changes and making the insurers directly liable to EIOPA are intended to pave the way for future changes. Thusly understood, the Commission wants to create a system which can be switched at a moment's notice to make the ESAs, including but not limited to EIOPA, the direct supervisor of the supervised entities—with contribution channels already established—and to eradicate national supervision. Irrespective of one's thoughts about the prospect of a fully centralized supervision of the insurance sector, one cannot but fear that the proposed amendment will increase the contributory burden on the undertakings at least in those countries, such as Germany, that have in place a funding system that reliably provides for an annual contribution to the NSA. In conjunction with the establishment of EIOPA most of such NSAs increased the fee in order to allow for the payment of their obligatory contributions to EIOPA. Once a direct contribution to EIOPA is established, such system would be expected to again lower the national contributions in order to avoid a sort of "double-taxation". However, given past experience, it seems more likely for a camel to go through the eye of the needle than for the state to lower taxes or contributions once raised. In conjecture, it would be safe to assume that the proposed amendment would mean a cost increase for supervised entities. This is even more true in light of EIOPA being expected to increase its staff by one-third in reaction to the planned amendments.

Information Request with a Bite

EIOPA's power to request information from the NSAs, other national authorities and insurers is intended to put it into a position to discharge of its duties in an orderly fashion. Whilst the EIOPA Regulation already creates an obligation for NSAs, other national authorities and insurers to appropriately respond to an appropriate request of information, it does not provide for any legal consequences where such obligation is breached. Though this has not been a problem thus far, the Commission sees fit to provide legal consequences and hence provide EIOPA with a means to force parties to comply. EIOPA should be given the power to impose fines on insurers, *nota bene* not on NSAs, if they neglect their duty. Currently, EIOPA may only request the provision of information directly from insurers as an *ultima ratio*-measure, meaning when the necessary information cannot be provided by the NSA or other state authorities. Insofar the imposition of fines in the insurance sector—other than in the sectors supervised by ESMA—will remain, for the time being, hypothetical.

Power of Strategic Planning for NSAs

One of the planned amendments that appears rather benign at first sight but might have a very pronounced impact relates to the new power of EIOPA to address so-called strategic supervisory plans to NSAs. This instrument enables EIOPA to identify for the NSAs with a three-year-horizon (in conjunction with the work programmes of EIOPA) the specific priorities for supervisory activities. The NSAs are, furthermore, obligated to assess EIOPA's annual work programme and adopt their own work programme and report towards EIOPA. This ties the concrete supervisory practices of the NSAs much closer to the control and the steering of EIOPA. The Commission's propositions are quite vague as to the level of abstractness that the strategic supervisory plans are supposed to have. Hence, it is not inconceivable that EIOPA could use this power to directly supervise certain (big) insurance undertakings.

Résumé

Other than the changes to the governance structure, i.e. the creation of the Executive Board *in lieu* of the Management Board, and the funding scheme, the proposed amendments of the EIOPA Regulation seem *in praxi* rather minor and often only of declaratory nature. In many instances, however, the alterations seem to be intended to prepare for future recalibrations of the ESFS. One might understand the proposed amendments, thus, as an effort to softly steer the EIOPA Regulation towards a future implementation of an Insurance Union with a single supervisory authority, i.e. EIOPA. Viewing reactions from many stakeholders, on the one hand, it appears that such a fruit is not yet ripe for plucking. On the other hand, it seems contradictory that most Europeans regard the American system of state based supervision and regulation of the insurance sector as anachronistic, yet cling onto a system of national supervision. At least concerning large undertakings and pan-European insurance groups one should entertain the idea of a centralized supervision. This would support the creation of a truly Internal Market of insurance and, if only by reducing supervisory expenditures, further increase the competitiveness of European insurers on a global level. For those who for one reason or another are opposed to centralized supervision, the proposed amendments should come as a warning. The EU is out to centralize, it is out to integrate and it is not taking prisoners. With Great Britain, one of the biggest opponents to centralized financial supervision, out of the Union, the creation of a fully integrated financial market seems more feasible. Since the British financial market now enters into competition with the European Union market, centralized financial supervision and a resulting robust fully integrated market might be just what the doctor ordered.