

# On the Proposal to Improve the Application of the Principle of Proportionality in Insurance Regulation and Its Impact on the Principle – Theoretical Analysis

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*“We have to abandon the arrogant belief that the world is merely a puzzle to be solved, a machine with instructions for use waiting to be discovered, a body of information to be fed into a computer in the hope that, sooner or later, it will spit out a universal solution.”<sup>2</sup>*

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## Abstract

The principle of proportionality is well-known as a general legal principle of EU law. It also plays a key role in EU insurance regulation – application of proportionality is indispensable to allow small and medium-sized undertakings to comply with the complex and often excessively burdensome “Solvency II” regulation. However, the ongoing Solvency II review reveals that the principle is not applied in practice, mostly because of its wide and highly judgmental meaning. As a result, European Insurance and Occupational Pensions Authority (EIOPA) suggested amendments to the current application of the principle that are believed to make proportionality work as intended. The amendments have been adopted by the European Commission in the proposal for a Directive amending Solvency II. The article analyses the proposal and discusses its potential influence on proportionality as a principle and the overall application of Solvency II.

**Keywords:** principle of proportionality, Solvency II review, principles, rules, low-risk profile undertaking

## 1. Introduction

On 22 September 2021, after almost two years of an intensive process of revision of the Solvency II Directive (“Solvency II”), the European Commission (“the Commission”) adopted a comprehensive “review package” of Solvency II, including a proposal for a Directive amending Solvency II (“the Proposal”).<sup>3</sup> One of the focal points of the revision was the application of the principle of proportionality (further referred to also as

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<sup>2</sup> V Havel, *The End of Modern Era*, The New York Times, March 1, 1992.

<sup>3</sup> Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision, Brussels, 22.09.2021, COM (2021) 581 final.

“proportionality” or “principle”, as relevant) – a fundamental element of the principle-based Solvency II framework. Following the request from the Commission, the European Insurance and Occupational Pensions Authority (EIOPA)<sup>4</sup> issued technical advice on how to improve the application of the principle of proportionality. EIOPA’s improvements were further adopted by the Commission in the Proposal. Both the Commission and EIOPA maintain that proportionality continues to exist and function as a principle regardless of the amendments suggested by the Proposal. Nevertheless, the amendments do raise questions about whether the principle of proportionality is still a principle or whether it has been transformed into a rule and what the consequences are of such a change for the overall application of the Solvency II framework. The paper attempts to address these questions by analysing the Proposal, in particular whether it has the potential to cure the problems that currently inhibit the application of the principle. The analysis shows that where the new mechanism of the application of proportionality becomes automatic, the principle of proportionality works like a rule. Therefore, the author dissents from the Proposal and the view of the Commission on two points. First, although the amendments suggested by the Proposal do facilitate the application of proportionality, they do not solve the problem altogether. Second, the new mechanism of application of the principle creates the risk that proportionality would be applied more as a rule and less as a principle. Consequently, the original function of proportionality will fade away.

The paper is organised as follows. Section two discusses the meaning of the principle of proportionality specifically in insurance regulation and explains the reasons why proportionality does not work as it should. Section three of the paper provides a summary of the Proposal, particularly where it refers to the new process of the application of proportionality. Section four assesses the impact of the Proposal on proportionality as a principle and its practical application. Section five concludes.

## **2. Present – The Principle of Proportionality**

### ***2.1. Background***

Solvency II is a Directive of European Union law providing a comprehensive framework for a solvency and supervisory regime for (re-)insurers in the European Union (EU). The key objectives of Solvency II are improving customer protection, ensuring financial stability, deepening EU market integration and increasing international competitiveness of EU insurers. The framework revolves around three areas, commonly known as Pillars. Pillar I sets out the financial requirements, such as the capital requirements and harmonised

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<sup>4</sup> EIOPA is an independent advisory body to the European Commission, the European Parliament and the Council of the European Union. It is also one of three European Supervisory Authorities (along with the European Banking Authority and the European Securities and Markets Authority). EIOPA’s main objective is to protect the public interest by promoting a sound regulatory framework for and consistent supervision of insurance and occupational pensions sectors in Europe. As European Supervisory Authority, EIOPA has a limited quasi-rule making authority and takes active part in legislative procedure concerning matters on the European financial market, including insurance.

standards for the valuation of assets and liabilities (technical provisions). Pillar II provides provisions on the (re-)insurers' system of governance and supervisory review process. Pillar III introduces supervisory reporting and public disclosures. Solvency II entered into force in 2016 with the aim to “modernise” the previous prudential framework of Solvency I by making it more risk sensitive and transparent. In other words, the new solvency regime requires (re-)insurers to manage their business accordingly to their true risk profile. For instance, the capital must be calculated considering all the risks borne by the insurer (so-called “risk-based capital requirements”) and the system of governance should mirror the sophistication of the insurer’s risk profile.

Since the European insurance industry is considerably heterogenic, it was important to ensure that the solvency regime was flexible enough to fit all the different types of (re-)insurers. To this end, two techniques were employed. Firstly, Solvency II was constructed using a principle-based approach. It means that Solvency II seeks to set principles that specify the intention of regulation and supervisory objectives, rather than set rules and detailed requirements. On the one hand, it gives Member States a discretion in how they implement a Directive into their national legal systems; on the other hand, it leaves much scope for interpretation and thereby leads to uncertainties about how to apply principles in practice. Secondly, to ensure that Solvency II was not unnecessarily burdensome for small and medium-sized insurers and non-traditional insurers, such as mutuals and (re-)insurance captives, Solvency II introduced the principle of proportionality. The function of proportionality is to adjust the intensity of the regulatory burden of Solvency II to the risk profile of an individual (re-)insurer and thus to reduce that burden where the risk profile is low.

## **2.2. The Meaning of Proportionality**

As a preliminary remark, it is necessary to underline that the principle of proportionality embedded in Solvency II should not be confused with the general legal principle of proportionality in EU law,<sup>5</sup> known as the known Article 5(4) of the Treaty on the EU.<sup>6</sup> These are two different principles which, although relatable, are not the same. Given the objectives and the limited breadth of this paper, it will not consider the differences between these two concepts;<sup>7</sup> rather, it will focus on the principle of proportionality referred to in Solvency II.

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<sup>5</sup> Article 5(4) of the Treaty on the EU states that ‘the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties’. In this context, the principle of proportionality regulates how the EU exercises its powers. Namely, it requires that, to achieve its aims, the EU will only take the action it needs to and no more. R Geiger, *Commentary to Article 5 TEU* in Geiger, R, Khan, D-E, Kotzur, M, *European Union Treaties. A Commentary. Treaty on European Union, Treaty on the Functioning of the European Union*, C.H.Beck, Hart Publishing, Munich, 2015, 35. The principle in this context is applied as part of cohesion policy and within the EU legislative procedure.

<sup>6</sup> Consolidated Version of the Treaty on European Union, OJ C 326, 26.10.2012, 13–390.

<sup>7</sup> On the relation of the principle of proportionality set out in Article 5(4) of the TEU to the proportionality in Solvency II framework *see* M Ostrowska, ‘The principle of proportionality in the EU Insurance

There is no legal definition of proportionality. However, based on the interpretation of Solvency II<sup>8</sup> and the legislative process,<sup>9</sup> proportionality appears to require that the Solvency II framework is applied in a manner proportionate to the risk profile of a (re-)insurance undertaking, where the risk profile is defined as the result of the combination of nature, scale and complexity of the risks inherent in the (re-)insurance undertaking's business. Proportionality does not need to be mentioned explicitly in a provision to be applied and, in fact, it is not. Solvency II mentions proportionality directly only a few times.<sup>10</sup>

As already mentioned, the idea behind the introduction of proportionality was to reduce the regulatory burden of the framework (see also recital 19 of Solvency II). Indeed, Solvency II has been, and still is, considered complex, especially for medium and small-sized local undertakings and non-traditional undertakings<sup>11</sup> such as the (re-)insurance captives.<sup>12</sup> This is because Solvency II introduces a sophisticated risk-based solvency regime and does not create a separate regime for small and medium-sized insurers – in principle, the same regulation applies to all (re-)insurance undertakings operating in the EU insurance market. The policymakers were aware that Solvency II should not produce a “one-size-fits-all” effect and that the regulation must be applied differently depending on the individual risk profiles (risk profile differentiation) and size of the undertakings (size differentiation).<sup>13</sup> Otherwise, the burden of the regulation for small and medium-sized insurers and insurers with a simple or specific risk profile would be unbearable and could lead to competition issues.<sup>14</sup> Proportionality allows for reducing that burden by enabling the undertaking to apply the requirements with different intensities, where the intensity is adjusted to the risk profile and size of the undertaking.

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regulation, Modern Aspects of the Legal and Regulatory Insurance Concept – Proceedings' (Post Conference Publication), September 2020, AIDA, 24-41.

<sup>8</sup> See eg recital 18, 21 of Solvency II, Article 29(3), Article 41(2), Article 45(2) of Solvency II.

<sup>9</sup> Commission staff working document - Accompanying document to the Proposal for a Directive of the European Parliament and of the Council concerning life assurance on the taking-up and pursuit of the business of Insurance and Reinsurance - Solvency II - Impact assessment report, Brussels, 10.07.2007 {COM(2007) 361 final} {SEC(2007) 870} (SEC/2007/0871), points 3.3.4, 4.5.

<sup>10</sup> See for example Article 29(3), Article 34(6), Article 41(2) of Solvency II.

<sup>11</sup> There is no legal definition of a non-traditional undertaking, however, mutuals, (re-)insurance captives and other forms of self-insurance are commonly considered as such.

<sup>12</sup> See eg ECIROA, *Position Paper on Solvency II – the Principle of Proportionality and its application*, 2010, p. 16; EIOPA, *Consultation Paper on proposals for Solvency II 2020 Review. Cover Note – Package on Supervisory Reporting and Public Disclosure*, EIOPA-BoS-19-304, 25 June 2019, 9.

<sup>13</sup> K Van Hulle, *Solvency Requirements for EU Insurers. Solvency II is good for you*. Intersentia Ltd., Cambridge, 2019, 171.

<sup>14</sup> Commission Staff Working Document Impact Assessment Report Accompanying the documents Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of insurance and reinsurance undertakings and amending Directives 2002/47/EC, 2004/25/EC, 2009/138/EC, (EU) 2017/1132 and Regulations (EU) No 1094/2010 and (EU) No 648/2012, point 2.6.1.

The importance of the role of proportionality explains why the correct application of the principle is a prerequisite for the proper application of the framework; in other words, to apply the framework as was originally intended. What this means is that proportionality should be considered almost every time (re)insurers and national supervisory authorities (“supervisors”)<sup>15</sup> apply the Solvency II framework, including soft law regulation.<sup>16</sup>

### **2.3. Problems of the Present – Why Does Proportionality Not Work**

If Solvency II had been applied as intended, insurers and supervisors would have followed a principle-based approach and looked at *the substance rather than at the letter of the regulation*.<sup>17</sup> Only this way, proportionality would have provided its intended function (reduction of the unnecessary regulatory burden). Unfortunately, the years of application of Solvency II have proven that intentions do not always translate into practice. Input received from the industry from the “EU Commission Public Consultation on the Fitness Check on Supervisory Reporting” shows that the majority of (re-)insurance undertakings are currently dissatisfied with how proportionality is applied and see a need for improvement.<sup>18</sup> Specific problems voiced by representatives of the industry have one common driver – the lack of clear instructions on how to apply proportionality in practice.

Indeed, little attention is paid in Solvency II to the principle. As mentioned earlier, there is no definition of proportionality that would explain *when* exactly it should be applied and, most importantly, *how* it should be applied. Moreover, where the principle is referred to directly, it makes the provision ambiguous and broadens its scope of interpretation. Article 41(2) of Solvency II is a prime example:

“The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.”

The (re-)insurance undertaking willing to comply with this provision faces two fundamental questions. First, what “the nature, scale and complexity of the operations” means. Second, when the operations are considered such that application of a lighter regime is justified.

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<sup>15</sup> “National supervisory authority” or “supervisor” should be understood as a public authority of a Member State charged with the supervision of (re-)insurance undertakings and (re-)insurance intermediaries operating therein.

<sup>16</sup> K Van Hulle, *Solvency Requirements for EU Insurers. Solvency II is good for you*. (Cambridge 2019) 172.

<sup>17</sup> K Van Hulle, *Solvency II: Reasonable Expectations* in P Marano, M Siri (eds) *Insurance Regulation in the European Union. Solvency II and beyond* (Palgrave Macmillan 2017) 321.

<sup>18</sup> EIOPA, *Consultation Paper on proposals for Solvency II 2020 Review. Cover Note – Package on Supervisory Reporting and Public Disclosure*, EIOPA-BoS-19-304, 25 June 2019, 9.

Therefore, the problem starts with defining *the exact meaning of the three proportionality criteria “nature, scale and complexity”*. Next, *when to apply proportionality*. To address these issues, the industry calls to find a way to measure “the nature, scale and complexity” and to introduce a mechanism by which small undertakings would immediately know whether or not the proportional regime (ie lighter regime) applies to them.<sup>19</sup> The lack of a common understanding in this area creates undesirable variability in judgements as to what is proportional and what is not. This, in turn, translates into the increased costs and risk of incompliance for the (re-)insurance undertakings. It is well illustrated by the following example. To use the simplified formula to calculate the solvency capital, an insurer must prove that it meets certain requirements. To this end, the insurer needs to first invest in verifying whether or not the requirements are met and subsequently apply for the supervisory authority’s approval. Since the process is claimed to be timely, costly, and, most importantly, obtaining a supervisor’s approval is uncertain, many small undertakings do not take the risk and thus do not benefit from proportionality.

This example reveals another problem - *no convergence in how supervisors apply proportionality*. What may be accepted as proportional in one jurisdiction, may not be so in another. Besides, it is also a complaint that some supervisors appear to focus on whether an undertaking can afford the costs of complying with a requirement, instead of focusing on whether the nature, scale and complexity of the undertaking justify a simplified application of the requirement.<sup>20</sup> To address the problem, the “Committee of European Insurance and Occupational Pensions Supervisors” (CEIOPS), and later EIOPA, issued several guidelines on how to apply proportionality in specific cases.<sup>21</sup> This method, however, did not prove to be effective enough because guidelines are non-binding and usually limited in scope. As such, they do not enhance the overall application of proportionality.<sup>22</sup>

Finally, the above leads to *the problem of legal uncertainty*. Under the current framework, if the undertaking wishes to apply a lighter regime, it must first invest in judging if the lighter regime is justified. The judgement consists of a self-assessment of the undertaking’s risk profile considering the three criteria mentioned earlier (nature, scale and complexity). The ultimate decision on the application of the lighter regime is taken by the undertaking based on that self-assessment. Supervisors not agreeing with the undertaking’s decision react

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<sup>19</sup> Speech by R Batten, Senior Policy Adviser, Dutch Association of Insurers (VVD) at the Conference on Review of the Solvency II organized by the European Commission on 29.01.2020, video of the conference available at <[webcast.ec.europa.eu/conference-on-review-of-the-solvency-ii](http://webcast.ec.europa.eu/conference-on-review-of-the-solvency-ii)> last accessed 16 January 2022].

<sup>20</sup> INSURANCE EUROPE, AMICE, *Proposal for making proportionality work in Solvency II*, 30.09.2019, 1.

<sup>21</sup> For example, see CEIOPS, *Advice to the European Commission on the Principle of Proportionality in the Solvency II Framework Directive Proposal*, CEIOPS-DOC-24/08, May 2008; EIOPA, *EIOPA’s Supervisory Statement Solvency II: Application of the proportionality principle in the supervision of the Solvency Capital Requirement*, EIOPA-BoS-19-033, 11 March 2019.

<sup>22</sup> INSURANCE EUROPE, AMICE, *Proposal for making proportionality work in Solvency II*, 30.09.2019, 1.

ex-post. Given the above, both the assessment and the decision may result in being quite subjective and therefore uncertain as to whether it is fair enough to receive the supervisor's approval. Because the lack of predictability of supervisors' decisions increases the costs of compliance, the undertakings often refuse to take the risk.<sup>23</sup> Consequently, proportionality is not followed to the fullest extent possible and the Solvency II framework remains burdensome for many undertakings.

Against this background, Grima suggested two possible ways of applying proportionality. The first one requires determining mathematically the initial benchmark for calibration of the regime used. This would depend, however, on the assumptions made for the benchmark or the average (re-)insurance undertaking and might result in an unfavourable "one size fits all" effect. The alternative way is to apply "the rule of common sense", wherein the policymaker or the supervisor would have to use their experience and expertise to determine what needs to be done to measure the undertakings' risk.<sup>24</sup> In the same vein, the ideas of how to improve the application of proportionality came from the industry.<sup>25</sup>

### 3. The Proposal – Improving Proportionality

Due to the difficulties with the application of proportionality, it has been put at the heart of Solvency II review.<sup>26</sup> Within the review process, EIOPA was asked by the Commission for technical advice on the review of Solvency II, including the application of proportionality. In response, EIOPA offered an extensive plan for the improvement of the application of proportionality which was further adopted with no substantial changes in the Proposal.<sup>27</sup> The changes address all the above-mentioned problems. The following paragraphs will briefly describe the proposed improvements.

Since it turned out to be too challenging for the undertakings to identify their risk profile using the criteria of nature, scale and complexity, the undertakings are not sure if they are entitled to benefit from the regulatory relief provided by proportionality. To tackle this problem, EIOPA suggests introducing *a definition of "low-*

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<sup>23</sup> (n 19).

<sup>24</sup> S Gima, 'Proportionality in the application of insurance solvency requirements: the case of small EU jurisdictions' in AUTHOR, *XXI Conference Modern Aspects of the Legal and Regulatory Insurance Concept. Proceedings* (PUBLISHER September 2020) 224.

<sup>25</sup> See eg Association of Mutual Insurers and Insurance Cooperatives in Europe (AMICE) INSURANCE EUROPE, *Proposal for making proportionality work in Solvency II*, 30.09.2019 and DUTCH ASSOCIATIONS OF INSURERS, INSURERS IRELAND, *Discussion Paper. A Proportionality Toolbox for Solvency II*. July 2019, available at: [www.insuranceireland.eu/news-and-publications/news-press-release/dutch-and-irish-insurance-associations-call-for-a-proportionality-toolbox-for-solvency-ii](http://www.insuranceireland.eu/news-and-publications/news-press-release/dutch-and-irish-insurance-associations-call-for-a-proportionality-toolbox-for-solvency-ii), last accessed 16 January 2022.

<sup>26</sup> Because Solvency II is in force since 2016, gradual reviews have been undertaken since then to ensure that the regime remains fit for purpose. Unlike the previous review, the ongoing review is comprehensive and focuses on all three Pillars of Solvency II. For details see European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, *Formal request to EIOPA for technical advice on the review of the Solvency II Directive*, FISMA/D4/SR/et/ARES(2019)865485, Brussels, 11.02.2019.

<sup>27</sup> EIOPA, *Opinion on the 2020 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020.

**risk profile undertaking**” (LRU) where the LRU is identified based on clear pre-defined quantitative criteria.<sup>28</sup> This way, once the undertaking is qualified as the LRU, it does not have to self-assess its risk profile each time before applying a provision because it is entitled by default to apply a lighter version of the requirements.<sup>29</sup>

The undertakings which believe that they comply with the criteria for LRU would be granted the benefit of **automatic application of proportionality**. The automatic application represents **a new two-step approach**. In the first step, the undertaking (i) informs the supervisor that it falls within the scope of the LRU definition, (ii) indicates what proportionality measures it intends to use and (iii) declares that no strategic change that would lead to non-compliance with the LRU criteria is planned within the next three years (ex-ante notification). Upon the receipt of the notification a one-month opposition period starts. Within this period, the supervisor may either question the undertaking’s compliance with the LRU criteria or not react to the notification. In the former, the supervisor is obliged to provide reasons and evidence supporting the objection. In turn, where the supervisor does not react to the notification, this is considered “silent consent” to the LRU classification. This way, the ex-ante notification reverses the burden of proof.<sup>30</sup> The undertaking whose notification was not challenged within the opposition period is officially recognised as the LRU and thereby entitled to apply the proportionality measures. In the second step, all undertakings, including the LRUs, report the proportionality measures used (ex-post reporting).<sup>31</sup>

A different process would apply to **the undertakings which do not comply with the LRU criteria**. They will not be excluded from the possibility to apply the proportionality measures specified in the Proposal. However, contrary to the LRUs, they will not benefit from the new two-step approach. Instead, to apply the measures, they will have to submit a request for approval to their supervisor and convince the supervisor as to why they should be able to apply the lighter regime even though they do not comply with the LRU criteria. The burden of proof remains, therefore, with the undertakings. Additionally, they will have to declare that no strategic change that would have an impact on the risk profile of the undertaking is planned within the next three years.<sup>32</sup> The idea behind this mechanism is to allow those undertakings which are close to fulfilling the LRU criteria to use the lighter regime. EIOPA mentions two cases for which the mechanism is dedicated: (i) undertakings with a very specific risk profile, not captured by the criteria identifying low-risk profile

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<sup>28</sup> Article 1(5)(b) and 1(13) of the Proposal (proposed Article 29a) and EIOPA, *Opinion on the 20202 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 48, 49.

<sup>29</sup> Article 1(13) of the Proposal (proposed Article 29c(1)).

<sup>30</sup> EIOPA, *Background Document on the Opinion on the 20202 Review of Solvency II. Analysis*, EIOPA-BoS-20/750, 17.12.2020, 374.

<sup>31</sup> Article 1(13) of the Proposal (proposed Article 29e(1)) and EIOPA, *Opinion on the 20202 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 49.

<sup>32</sup> Article 1(13) of the Proposal (proposed Article 29d(1)).



undertakings and (ii) medium-high risk profile undertakings which intend to apply proportionality with regard to immaterial risks<sup>33,34</sup>

Analysis of the new two-step approach and the approval mechanism leads to the conclusion that undertakings which are not qualified as LRU or whose request for approval was rejected will not be able to apply the proportionality measures indicated in the proposed Article 29c(1). However, following EIOPA's proposal, it seems that they will be able to apply proportionality elsewhere.<sup>35</sup> In this case, the application of proportionality remains unchanged.

Importantly, the benefit of the automatic application of proportional measures (ie lighter version of a provision) by LRUs is limited to the specific proportional measures indicated in the proposed Article 29c(1). These are mostly the requirements on disclosure and reporting duties and the system of governance which, contrary to other Pillars, are of qualitative nature and are, therefore, the most troublesome ~~in applying proportionality~~.<sup>36</sup> Thus, again, the application of proportionality for the requirements not mentioned in Article 29c(1) remains unchanged.

Finally, to address the lack of convergence in how supervisors apply proportionality, EIOPA suggests ***“extending the scope of the current report on exemptions and limitations”*** of reporting by considering the use of proportionality for all the three Pillars of Solvency II.<sup>37</sup>

The simplified comparison of the current application of proportionality and the Proposal is illustrated in Figure 1 in the Appendix.

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<sup>33</sup> The Solvency II framework does not define an immaterial risk. Instead, it explains that ‘a risk shall be considered material where its impact on the calculation of the risk margin could influence the decision-making or the judgment of the users of that information, including supervisory authorities’ (Article 38(3) of Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). Therefore, a risk should be considered immaterial where it does not fall within the above definition.

<sup>34</sup> EIOPA, *Opinion on the 20202 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 50.

<sup>35</sup> EIOPA, *Opinion on the 20202 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 50.

<sup>36</sup> EIOPA, *Opinion on the 20202 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 48.

<sup>37</sup> Article 1(12) point b of the Proposal and EIOPA, *Opinion on the 20202 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 51.

#### **4. The Critique: Will the Proposal Remedy the Present?**

At the time of writing, the Proposal is being discussed by the European Parliament and the Council and it is still unknown whether it will be officially adopted and if so, to what extent. Thus, it is impossible to give a confident opinion on the repercussions of the Proposal. Yet, seeing in which direction application of the principle and its meaning potentially might develop, it is possible to discuss the possible consequences. This section will first analyse the discussed Proposal in terms of its potential to resolve the identified problems. Subsequently, it will consider the Proposal from a broader perspective. More specifically, the meaning of the potential change for the long-run application of proportionality and Solvency II will be discussed.

##### ***4.1. Meaning of Proportionality Criteria and the Right to Apply Proportionality***

Turning first to the meaning of the three proportionality criteria, the Proposal does not clarify what “nature, scale and complexity of the risks” mean, nor does it offer a way to measure them. Instead, following EIOPA’s proposal, it has been decided to skip identifying the risk profile of the individual undertaking and address the problem that follows – identification of *the right* to apply the lighter regime. Since proportionality allows the application of a lighter version of a provision to those undertakings with relatively simple and low-risk profiles, a definition of an “average low-risk profile undertaking” was suggested. The definition is based on hard quantitative thresholds and does not contain any open or judgmental criteria. Hence, it is fair to say that the definition of the LRU represents a “checkbox exercise” for the undertakings and eliminates the problem of judgement and uncertainty resulting therefrom.

It is with no doubt that the solution satisfies the industry’s main demand, ie automatism of the proportionality application. The undertakings will immediately know whether or not they qualify as the LRU and therefore if they are entitled to apply the proportional measures. Neither the LRU nor the supervisor will have to decipher the meaning of the nature, scale and complexity of their risks or perform a judgement on the risk profile.

However, there are three, perhaps four, possible concerns about the Proposal. The first one pertains to the ex-ante notification and, more specifically, the nature of the declaration the undertaking makes within the notification. One of the three elements included in the notification is the undertaking’s declaration that no strategic change that would lead to non-compliance with the LRU criteria is planned within the next three years. Since no further reference is made to the declaration, it is not entirely clear what the function and potential consequences of acting against the declaration are.

The second concern regards the LRU definition. As already mentioned, the nature of the LRU criteria leaves no room for judgement. Either the undertaking fulfils the criteria or does not. Therefore, it seems that if compliance with the criteria is well demonstrated, the undertaking should be confident enough about the

success of its ex-ante notification and thereby of obtaining the LRU status. There is, however, one point of the Proposal that questions this assumption. Namely, all undertakings which are expected to exceed the thresholds indicated for the criteria for the LRU within three years should, in principle, not be considered the LRU.<sup>38</sup> Neither EIOPA nor the Proposal explains this restriction in detail. One may assume that the restriction will be an argument for the supervisor to challenge the ex-ante notification within the one-month period. Yet, it is unknown how the supervisors will assess the expectation of exceeding the thresholds. This, in turn, may undermine the function of a seemingly easy “checkbox exercise”.

The third concern is the benefit of the automatised application of the proportionality measures is restricted to the LRUs only. According to EIOPA’s estimates, 16% of the total number of undertakings will potentially fall within the scope of the definition.<sup>39</sup> Technically, the rest of the undertakings will also be able to apply the proportionality measures, but the application process will remain unchanged, ie as today or it will be preceded by the approval process. This leads to the fourth concern regarding the three proportionality criteria. Although their meaning will no longer be relevant for the LRU, most of the undertakings will still have to face the challenge of their interpretation and judgement. The problem will then persist. Finally, it is worth noting that the LRU concept aligns with one of the methods of application suggested by Grima. As he notes, this method risks resulting in the “one-size-fits-all” effect. The risk seems to be mitigated in the case of the Proposal. Namely, the use of the proportionality measures dedicated to the LRUs (and identified in the proposed Article 29c(1)) is not restricted to the LRUs only. It is possible that the measures are also applied by undertakings which do not comply with the LRU criteria (see the approval process) whereas those undertakings that stopped complying with some of the LRU criteria can maintain their status. Nevertheless, the LRU concept may result in different and potentially negative consequences related to the use of rules which is further discussed in paragraph 4.4. below.

#### ***4.2. Legal Certainty and the Burden of Proof***

According to the Proposal, legal certainty will be regained by establishing a one-month opposition period for the supervisors to challenge the undertaking’s eligibility to hold the LRU status (ex-ante notification). If the supervisor does not react to the notification within the prescribed period (“silent consent”), it will not be able to question the LRU status of the undertaking afterwards, in principle. If, however, the notification is challenged, it is the supervisor’s responsibility to provide the relevant justification and evidence to prove the undertaking is not eligible. Thus, the burden of the proof is reversed to the supervisors. The undertakings will only need to demonstrate compliance with the LRU criteria and, since the criteria are quantitative, it should be relatively easy for them to provide clear evidence.

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<sup>38</sup> EIOPA, *Background Document on the Opinion on the 20202 Review of Solvency II. Analysis*, EIOPA-BoS-20/750, 17.12.2020, 373.

<sup>39</sup> EIOPA, *Background Document on the Opinion on the 20202 Review of Solvency II. Impact Assessment*, EIOPA-BoS-20/751-REV-10, June 2021, 288.

Legal certainty will be regained for *the right to apply proportionality* only. Although the right will be guaranteed, the supervisors will still have the possibility to challenge *the use of any proportionality measures* even if the classification of low-risk profile undertakings has not been challenged after the prior notification.<sup>40</sup> What this means is that the undertaking would remain sure as to its qualification as the LRU, but the way it applies the lighter regime may be challenged at any time. It is hard to object to this solution. Even though the application of proportionality is indispensable to the correct application of Solvency II and should be implemented whenever application of a requirement without relief is unnecessarily burdensome, proportionality must be applied carefully. Namely, the application of a proportional measure cannot compromise the regulatory objectives (ie policyholders' protection, financial stability) and, most importantly, it cannot lead to a non-application of a requirement.<sup>41</sup> The oversight of the use of proportional measures is. Therefore, in the interest of the Solvency II objectives (policyholders' protection and financial stability).

The main objection that may be voiced here regards legal certainty and may question the function of the LRU concept. As already clarified, the concept of the LRU, together with the ex-ante notification and the opposition period, is supposed to give undertakings certainty about their right to apply proportional measures. In principle, once the opposition period ends and the supervisor does not oppose to the notification, the supervisor cannot question the right to apply the lighter version of a provision unless the undertaking stops complying with the LRU criteria. However, the Proposal introduces the following leeway: where the supervisor has serious concerns in relation to the risk profile of a LRU, the supervisor may, in exceptional circumstances, request that LRU refrains from using one or several proportionality measures, provided this is justified on consideration of the impact on the organisation of the undertaking and the specificities or change of its risk profile.<sup>42</sup> The provision grants supervisors the power to question the right to apply proportional measures at any time and despite the compliance with the LRU criteria. This, in turn, reduces the certainty of the legal status of the LRU, which is contrary to the function and the rationale of the LRU concept. Although one may claim that phrases like “serious concerns” or “exceptional circumstances” indicate that the supervisory power is limited to a very narrow scope of cases, neither the Proposal nor EIOPA explain how “serious concerns” or “exceptional circumstances” should be understood. Hence, it leaves room for judgement and supervisory discretion that the industry sees as uncertainty.

In addition to the above, we must be mindful that legal certainty is only “guaranteed” with respect to the LRUs. The same is true for the benefits resulting from the change in the burden of the proof. The burden is only reversed for those undertakings whose compliance with the LRU criteria is clear and unquestionable. The situation is different in the case of the undertakings which have a specific or medium-high risk profile

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<sup>40</sup> EIOPA, *Opinion on the 2020 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 50.

<sup>41</sup> K Van Hulle, *Solvency Requirements for EU Insurers. Solvency II is good for you*. Intersentia Ltd, Cambridge, 2019, 172.

<sup>42</sup> Article 1(13) of the Proposal (proposed Article 29c(2)).

and do not comply with all the LRU criteria, but there are reasons for them to be granted the LRU status regardless. These undertakings are required to describe their risk profile and provide adequate justifications as to why they believe the LRU status should also apply to them, or why they should be entitled to use proportionality despite their medium-high risk profile.<sup>43</sup> Thus, not only must they provide evidence to convince the supervisors, but they will also face the burden of the interpretation of “the nature, scale and complexity” of their risks.

#### ***4.3. Supervisory Convergence in Applying Proportionality***

The lack of supervisor convergence in applying proportionality was addressed in two ways. Firstly, the LRU concept introduces the benchmark that is supposed to work as a point of reference for the supervisors in the way they apply proportionality or control the use of proportional measures.<sup>44</sup> Secondly, EIOPA proposes to extend the scope of the current public EIOPA report on exemptions and limitations of reporting by considering the use of proportionality for all three Pillars of Solvency II.<sup>45</sup>

Undoubtedly, it is difficult to judge or predict the effectiveness of this remedy. On the one hand, it is sensible to believe that the public report showing a complete picture of the use of proportionality measures will contribute to the harmonisation of the application of proportionality among all national supervisors. On the other hand, the report will not constitute binding law and nor will it impose an obligation on supervisors to follow the results of the report. Hence, the fear is that the report will share the fate of EIOPA’s guidelines on the application of proportionality (see paragraph 2.2. above). Furthermore, because proportionality is a principle, it should be realised that perfect harmonisation of the application of proportionality is impossible. The variability of application among the supervisors does not stem only from the form of recognition accorded to the principle, but also from the diverse socio-political and cultural understandings as to what should be considered proportionate or disproportionate, and why, in a given factual situation.<sup>46</sup> Thus, as long as the application of proportionality allows supervisory discretion and judgement, the outcome will vary.

#### ***4.4. Principle or Rule***

The industry’s complaints about the current application of proportionality should be no surprise. ***Proportionality is a principle*** and was designed to be one. The lack of precision in meaning and the necessity to perform a judgement are natural qualities of all principles. Clearly, depending on the point of view and

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<sup>43</sup> EIOPA, *Opinion on the 2020 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, 50.

<sup>44</sup> EIOPA, *Background Document on the Opinion on the 2020 Review of Solvency II. Analysis*, EIOPA-BoS-20/750, 17.12.2020, 370.

<sup>45</sup> EIOPA, *Opinion on the 2020 Review of Solvency II*, EIOPA-BoS-20/749, 17.12.2020, p. 51.

<sup>46</sup> I Rodopoulos, *The dialectical function of the principle of proportionality: a European perspective*, KritV, CritQ, RCrit. Kritische Vierteljahresschrift für Gesetzgebung und Rechtswissenschaft / Critical Quarterly for Legislation and Law / Revue critique trimestrielle de jurisprudence et de législation, Vol. 100, No. 3 (2017), 206.

interests, these qualities can be considered negative or positive. Therefore, the policymakers' decision on whether or not to use principles should depend on the objectives of the regulation and the ways to achieve them. For this reason, the author strongly believes that the discussion on the improvement of the application of proportionality should take into account the results of the broad literature on the costs and benefits of the use of principles and rules in regulations. To this end, this paragraph will present the overview of key findings relevant to the discussion that will help to look at the Proposal from the broader perspective and give an idea of what might be the long-term consequences of transforming the principle of proportionality into a rule.

To start with, it should be uncontroversial to say that principles, owing to their structure, are fundamentally distinct from rules. The difference between them has been studied by many scholars and there is an extensive body of academic literature that focuses on the pros and cons of the use of principles and rule-based regulation.<sup>47</sup> Alexy, for example, describes the key difference in the following way. The principles express the idea of optimisation (the principles are “optimisation commands”) and, therefore, they can be fulfilled to different degrees, where the degree of fulfilment depends on the facts of the case at hand. On the contrary, rules can be only either complied with or not. They are, therefore “definitive commands”.<sup>48</sup>

The difference in structure results in different functions of principles and rules. Namely, *principles grant discretion* to those who apply them, thereby increasing the role of judgement. Unfortunately, discretion comes with unwanted costs. First, as much as it gives the desired freedom in decision-making, it also *requires effort*. In practice, judges (i.e. those who apply principles) should first specify the meaning of open-ended terms such as “reasonable”, “appropriate” or “nature, scale and complexity of the risk”. Subsequently, they must determine the facts of the case at hand to give content to those vague phrases. Second, discretion is known for producing *variability in interpretation and enforcement of the principle*. Those who are subject to regulation may see it as the unpredictability of the outcomes on the concrete application of the principle and therefore a burden. The rules are altogether different. They serve to eliminate discretion and to reduce the role of judgement. In consequence, the cost of the application of rules is much lower.<sup>49</sup>

If the cost of the application of the principle is so high, why are the principles often chosen over the rules? Scholars in behavioural economics and decision-making explain that people tend to resort to principles instead of rules because the principles allow them to reach a compromise in a very diversified environment.<sup>50</sup>

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<sup>47</sup> See eg R Alexy, *On the Structure of Legal Principles*, Ratio Juris Vol. 13 No. 3 September 2000, 295; F De Vries, *How Can Principles-Based Regulation Contribute to Good Supervision?* in Kellermann, AJ, de Haan, J, de Vries, F (eds.), *Financial Supervision in the 21st Century*, Springer, Heidelberg, 2013, 169; R M Dworkin, *The Model of Rules*, University of Chicago Law Review, Vol. 35, Iss. 1, 1967, 14-46; J Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, Australian Journal of Legal Philosophy, vol. 27, 2002, 47-82.

<sup>48</sup> R Alexy, *On the Structure of Legal Principles*, Ratio Juris Vol. 13 No. 3 September 2000, 295.

<sup>49</sup> D Kahneman, O Sibony, C R Sunstein, *Noise. A Flaw in Human Judgement*, William Collins 2021, 357.

<sup>50</sup> D Kahneman, O Sibony, C R Sunstein, *Noise. A Flaw in Human Judgement*, William Collins 2021, 352.

A prime example of is proportionality. Because the insurance market is highly diversified and Solvency II represents a risk-based approach, it was impossible to create a legal framework that would address each type of undertaking individually. It is also noted that producing a sensible rule can be hard without relevant and precise information.<sup>51</sup> Indeed, there is perhaps no definition of a simple and low-risk profile undertaking that would fit all low-risk profile undertakings. The LRU definition represents an “average” low-risk profile undertaking. Currently, Solvency II, as a principle-based framework, sets standards and relies on trusted experts (insurers and supervisors) to specify their meaning and calibrate them to the situation at hand. Besides, various arguments on the prevalence of the principles in the regulatory environment are presented by legal scholars. For instance, De Vries notices that, contrary to precise rules, principles are durable.<sup>52</sup> This is valuable particularly in a rapidly changing financial sector. Principles make it possible to respond quickly to changes so that legislation needs to be changed less often. Moreover, Quintyn and Taylor highlight that although rules have the advantage of being more transparent and also of being more amenable to judicial review than the exercise of discretion, they reduce the scope for the decisions to be influenced by factors other than an objective assessment of the technical merits of the case,<sup>53</sup> which might not always be desirable for supervised entities in individual cases.

The above supports the original choice of introducing proportionality in the form of a principle. The idea of flexible regulation not only fits the diversified insurance market but also satisfies the requirements of high-quality legislation. Clearly, the opinion on the importance of the principle, as well as its effectiveness, may vary depending on the perspective. The undertakings focused on costs and their individual interests will surely find the application of the principle costly and, therefore, will favour rules. In turn, policymakers will better appreciate the principle as their focus is on accommodating different interests and, on top of that, producing an optimal regulation. In the author’s view, the issue of proportionality should be tackled with both perspectives in mind. More specifically, in deciding on how to improve the functioning of proportionality, the policymaker should address the industry’s concerns, but the original role of proportionality (making the regulation flexible for all the regulated entities) must remain the priority.

The Commission and EIOPA seem to have the same view and claim that proportionality continues to exist and function as a principle, regardless of the amendments suggested by the Proposal. However, a closer analysis of the Proposal may suggest the opposite. Namely, where the application of proportionality is automatic (with respect to the LRUs) and the judgement is eliminated, the proportionality no longer functions as an optimisation command, but rather as a definitive command and thus a rule. One could argue, however, that the automatic application is an exceptional case of the application of the principle because, with respect

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<sup>51</sup> (n 51).

<sup>52</sup> F De Vries, *How Can Principles-Based Regulation Contribute to Good Supervision?* in Kellermann, AJ, de Haan, J, de Vries, F (eds.), *Financial Supervision in the 21st Century*, Springer, Heidelberg, 2013, 169.

<sup>53</sup> M Quintyn, M Taylor, *Regulatory and Supervisory Independence and Financial Stability*, IMF Working Paper WP/02/46, 2002, 18.

to the undertakings that are not LRU, the principle is applied as before, ie based on the judgement of the risk profile. Furthermore, given that only around 16% of the total number of undertakings will be potentially qualified as LRU, the non-automatic application of proportionality will prevail. In principle, the argument is valid, yet it may be feared that the reality will be different. Namely, what is the reason to believe that the undertakings that are not LRUs will apply the principle of proportionality in a non-automatic manner if they have not been doing it so far? In the author's opinion, there is a risk that the distinction of the LRU status will create the impression that proportionality is reserved to the LRUs only. Since the performance of judgement was the main source of problem in the application of proportionality, it may be tempting for the authorities to focus on the easier solution (automatic application) only and they may become even more reluctant to consider cases of no LRUs. If this was the case, the practical application of proportionality would be limited to the LRUs and proportionality would work as a rule. Clearly, it would also go against the original idea behind the principle of proportionality according to which all the undertakings (not only the LRUs) should apply all the Solvency II framework (not only the enumerated proportional measures) in a proportional manner. It is hard to accept this scenario, particularly given the fact that the heterogeneity of the insurance market will keep increasing (due to new emerging models of business) and the flexibility of regulation will be required to ensure an insurance market that is safe for consumers and attractive to the regulated entities.

## 5. Conclusion

The modern regulations are rule-based, principle-based or a combination of the two. The establishment of the new Solvency II framework was founded on the idea of principle-based regulation. The remarks on principles and rules show that the principle that is tightened, so as to eliminate that discretion, turns into a rule.<sup>54</sup> The analysis above demonstrates that the Proposal does tighten proportionality in a way that eliminates discretion to a certain extent. Thus, it is plausible to claim that proportionality is being turned into a rule in the part where it is applied automatically. However, at the same time, it is also clear that EIOPA does not want to abandon the original idea behind the Solvency II framework (principle-based regime) and wants to keep proportionality as a principle. For this reason, the Proposal accentuates the supervisory discretion and introduces exemptions to the LRU rule to make it less strict (ie the approval process for specific and medium-high risk profile undertakings and the supervisory power to question the right to apply proportional measures in exceptional circumstances). Consequently, the improved proportionality seems to have a mix of qualities attributed to principles and rules. However, the author does not agree with the thesis that proportionality continues to function as a principle.

It is, of course, impossible to judge whether or not the suggested solution will be successful. However, it is possible consider potential scenarios as to how the market may react to the Proposal. In the first scenario, the

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<sup>54</sup> D Kahneman, O Sibony, C R Sunstein, C. R, *Noise. A Flaw in Human Judgement*, William Collins 2021, 351.



Proposal is successful and proportionality is applied as intended by all undertakings (LRUs and no LRUs). In the second scenario, the LRU rule overpowers the idea of proportionality as a principle. More precisely, because rules are easier to follow than principles, the existence of the rule may create a wrongful belief that the use of proportional measures is reserved to the LRU only. For example, following De Vries,<sup>55</sup> if the undertaking will not be sure which level of compliance is required to fulfil a principle, but it is clear the undertaking does not qualify as the LRU, it may be inclined to err on the side of caution (over-compliance) rather than putting effort to self-assess its risk profile and initiate discussions with the supervisor to apply a proportional measure. The same could be true for the supervisors.

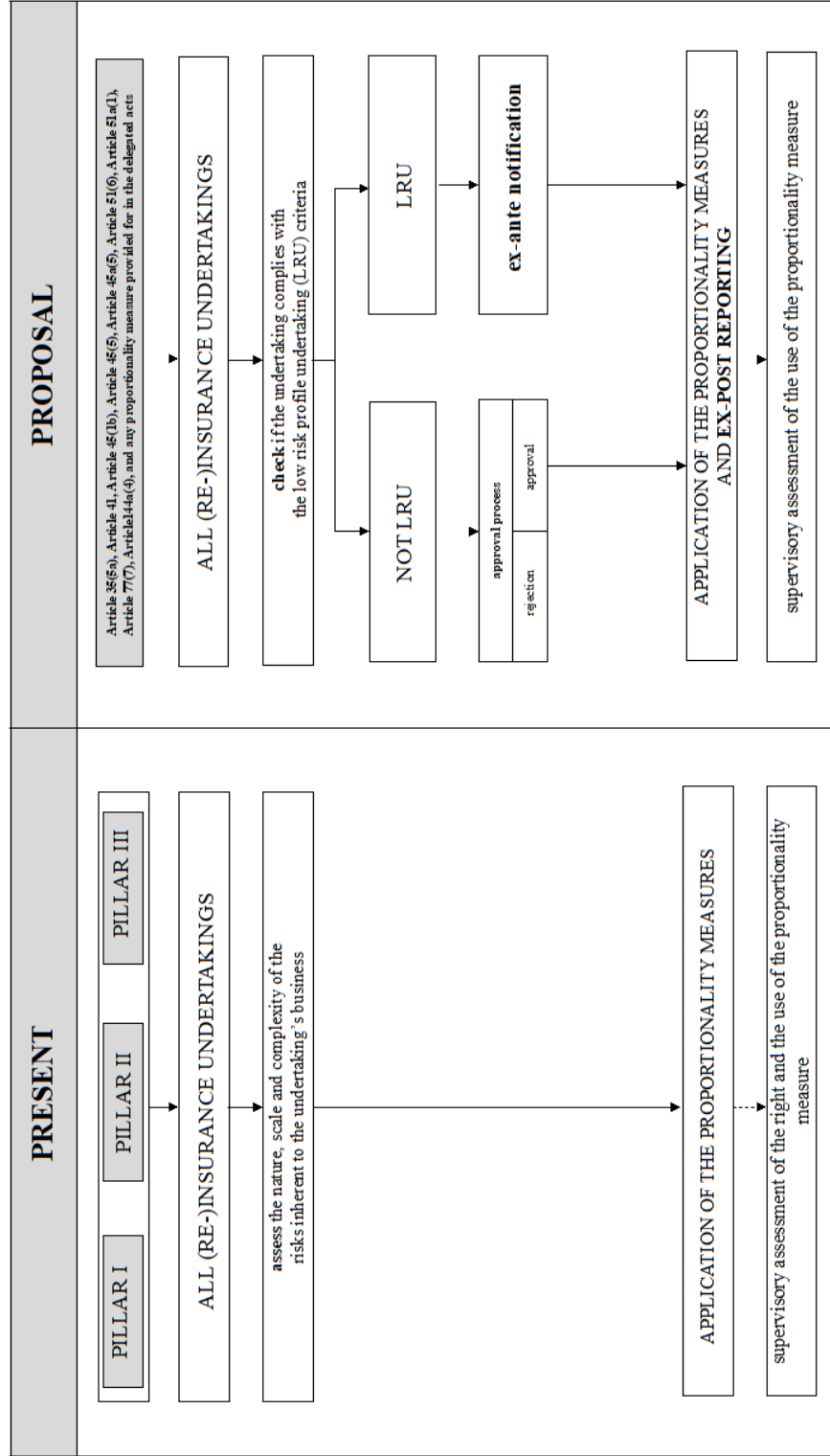
The task to improve the application of the principle is not an easy one. Clearly, the Proposal is an attempt to strike a fair balance between regulatory satisfaction and market satisfaction. The priority was to facilitate the application of proportionality in cases where the use of the lighter version of a provision is the most obviously justified, but the problems of legal uncertainty and ambiguity of the proportionality criteria prevent the undertakings from the actual application. Nevertheless, in the author's opinion, the discussed solutions risk being a halfway measure. More attention should be paid to the supervisors' awareness of proportionality, as such, and its application, so that the undertakings would not be reluctant to discuss the use of proportional measures with the supervisors and could see it as a natural element of the application of Solvency II rather than a burdensome process doomed to failure.

## APPENDIX

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<sup>55</sup> F De Vries, *How Can Principles-Based Regulation Contribute to Good Supervision?* in AJ Kellermann , de Haan, J, de Vries, F (eds.), *Financial Supervision in the 21st Century*, Springer, Heidelberg, 2013, 170.

Figure 1. The current application of proportionality vs. the improved application of proportionality



Source: Produced by the author.