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ADJUSTMENT OF THE SOLVENCY II REGULATORY FRAMEWORK TO NEW RISKS AND CHALLENGES OF MODERN CORPORATE GOVERNANCE

REVIEW ARTICLE

Abstract

Solvency II, as a regulatory framework that systematically governs the operations of (re)insurance companies in the European Union, has been in force since 2016. Since then, the Directive has significantly contributed to the stabilization of the insurance market and better protection for policyholders, thanks to the implemented system of effective risk assessment and capital adequacy of companies. However, the application of the Directive to date has highlighted the potentially excessive capitalization of the EU insurance market and the need for investments in certain business segments. Among these, sustainable business practices with a focus on climate and environmental risks stand out. A particularly important innovation introduced by the amendments to the Directive is the additional introduction of proportionality criteria for small and non-complex companies, which, by applying this principle, should benefit in terms of reporting, disclosure, governance, technical provision calculations, and their own risk and solvency assessments. The proposed amendments offer several advantages, but they may be criticized for adding reporting obligations and the potential overregulation that may arise during their implementation.

***Keywords**:* Solvency II amendments, sustainability, climate and environmental risks, risk management, proportionality, small and non-complex companies

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I Introduction

The Solvency II Directive[2], as the regulatory framework for insurance and reinsurance activities on the European Union market, has been in effect since 2016. From the moment the Directive's text was adopted in 2009, and through the justifications for the multiple delays in its implementation, its excessive demands in certain segments of its regulation were emphasized. The Directive was adopted primarily to improve the financial stability and reliability of the European insurance market. Its intended purpose and goal are to achieve greater competitiveness across the entire insurance industry, as well as the competitiveness of individual insurers and reinsurers, and to better protect the users of insurance services. The main goal of the Solvency II Directive was to establish a systematic legal framework for conducting the activities of (re)insurance companies across the entire internal market of the European Union and to facilitate the coverage of risks and liabilities for insurance and reinsurance companies headquartered in the EU. The Directive has largely achieved, and continues to achieve, its intended goals and purpose. However, after five years of its application, it became reasonable to question whether its quantitative regulatory content is aligned with these objectives. The general impression is that the period of the Directive's application has shown that the EU insurance market is overly capitalized, and despite the need for further improvement in capital allocation among market participants, there is enough room to release part of this capital and invest it in more necessary business segments.[3] In line with the announcements made at the beginning of the Directive's aplication, preparations for the necessary amendments and adjustments began in 2020, and in 2021, the European Commission prepared a proposal for a revised Directive that would significantly alter Solvency II. The proposed amendments focus on three main areas of regulation: reducing regulatory obligations for small and so-called non-complex insurance companies, or those with low-risk profiles (*small and non-complex companies*[4]), considering long-term risks and climate change risks, and strengthening group and cross-border supervision. These areas were identified as those in which certain deficiencies of Solvency II or its overregulation became apparent, with regulatory requirements failing to achieve the intended purpose of the Directive. After the Council and the Commission

[2] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance), OJ L 335, 17.12.2009, p. 1–155.

[3] Milo M. Marković, "Challenge for Serbia's Insurance Market on the Path to Solvency II," *Insurance Trends*, Journal of Insurance Theory and Practice, Association of Insurers of Serbia, 2/2024, pp. 333–361, p. 347.

[4] Solvency II is supplemented by a new Article 29a, which establishes criteria for specifying small and non-complex insurance companies. These criteria include tresholds for technical provisions and annual gross premium income, which are defined differently for undertakings engaged in life insurance and those involved in non-life insurance.

reached an agreement on the proposal for the Solvency II amendment text at the end of 2023, the Economic and Monetary Affairs Council of the European Parliament approved the proposal on January 29, 2024. The proposal was then discussed in the European Parliament during the session in April 2024, and finally, on April 23, 2024, the Legislative Resolution of the European Parliament and the Council on the amendment of Directive 2009/138/EC regarding proportionality, supervision quality, reporting, long-term guarantee measures, macroprudential tools, sustainability risks, group supervision, and cross-border supervision (COM(2021)0581 – C9-0367/2021 – 2021/0295(COD)) was adopted.[5]

II The Sustainability Factor as Part of the Solvency II Reform

The significance and necessity of sustainability in economic operations came into focus among the broader public, especially in the business sector, during and immediately after the Covid-19 pandemic. Sustainability is becoming an indispensable factor of all modern corporate governance systems. When assessing sustainability in business, *environmental, social, and governance (ESG)* factors are taken into consideration. Generally speaking, the drive for companies to become sustainable is not a new idea. However, 2015 marked a significant turning point, as the Paris Climate Agreement[6] was adopted as a "global response to the threats posed by climate change, taking into account sustainable development," and the United Nations introduced the Sustainable Development Goals within the 2030 Agenda.[7] [8]

In the insurance industry, as regulated by the Solvency II Directive and its anticipated amendments, special emphasis is placed on environmental factors, particularly risks caused by climate change. The insurance industry, based on effective

[5] European Parliament legislative resolution of 23 April 2024 on the 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 (COM(2021)0581 – C9-0367/2021 – 2021/0295(COD)). Available at: *https://www.europarl.europa.eu/RegData/seance_pleniere/textes_adoptes/definitif/2024/04-23/0295/P9_TA(2024)0295_HR.pdf* (accessed on 3 July 2024.) (hereinafter referred to as: Legislative Resolution on the Amendment of Solvency II).

[6] The Paris Agreement is a legally binding international treaty that outlines a plan of action to limit global warming. It was adopted by 196 parties at the UN Climate Change Conference held in Paris at the end of 2015. All EU Member States have signed and ratified it, and it entered into force at the end of 2016. The EU's objective under this Agreement is to become the first climate-neutral society and economy by 2050.

[7] *Transforming our World: The 2030 Agenda for Sustainable Development," United Nations General Assembly, October 21, 2015*. The 2030 Agenda was adopted at the United Nations Conference on Sustainable Development held in New York, where 150 world leaders endorsed a new global development program through 2030. This program established 17 *Sustainable Development Goals (SDGs)*.

[8] Nataša Petrović Tomić, "Sustainable Business – Are ESG Standards the Pillars of Resilience in a New Business Model?", *Bankarstvo 2023*, p. 204.

risk assessment and capital adequacy for the assumed risks, is the foundation of the Solvency II system. To achieve the environmental and climate goals outlined in the European Green Deal[9], large amounts of investment from the private sector need to be directed toward sustainable investments, including investments from insurance and reinsurance companies[10]. According to the European Parliament, the insurance and reinsurance sector can provide European economic entities with private sources of financing and make the economy more resilient by offering protection against a wide range of risks.[11]

Sustainable financing should imply financing directed toward investments that reduce exposure to climate and environmental risks.[12] To implement the plans outlined by the European Commission in the Green Deal, it is therefore essential to direct private sector investments into sustainable investments. A large proportion of these investments come from insurance and reinsurance companies. Accordingly, it was concluded that the capital requirements defined in the original text of Solvency II should not obstruct sustainable investments by insurance and reinsurance companies, but they should certainly reflect the full risk of investments in environmentally harmful activities. Therefore, an adjustment of capital requirements to align with the needs of sustainable operations in the insurance sector and all related activities is necessary.[13] In analyzing these needs, the European Insurance and Occupational Pensions Authority (EIOPA) plays a crucial role. EIOPA will, in its reports and the creation of regulatory technical standards, take into account sustainability risks, particularly in terms of the justification for investments associated with environmental and social goals (Article 304a, which proposes an addition to Solvency II). After consulting with the European Systemic Risk Board (ESRB), EIOPA will assess the justification for special prudential treatment of exposures related to assets or activities significantly aligned with environmental or social objectives.

[9] The European Green Deal, launched by the European Commission in 2019, is a set of initiatives aimed at achieving a green transition in the EU, complementing the efforts of the 2015 Paris Agreement. It commits to integrating climate and environmental risk management more effectively into the EU's prudential framework, with the ultimate goal of achieving climate neutrality by 2050. This transition is expected to foster economic growth, new business models and markets, job creation, and technological development. The Green Deal also seeks to ensure a fair and prosperous society with a modern and competitive economy. More information: *https://www.consilium.europa.eu/hr/policies/green-deal/* (accessed on 30 June 2024).

[10] Point (95) of the Legislative Resolution on the Amendment of Solvency II.

[11] Point (2) of the Legislative Resolution on the Amendment of Solvency II.

[12] In its Strategy for Financing the Transition to a Sustainable Economy (from 6 July 2021),*(Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions — Strategy for Financing the Transition to a Sustainable Economy' (COM(2021) 390 final)*, the European Commission is committed to proposing amendments to Solvency II to integrate sustainability risks into insurers' risk management systems, requiring insurers to conduct analyses of climate change.

[13] Jelena Kočović, Tatjana Rakonjac Antić, Marija Koprivica, Kristina Bradić, „Pravci razvoja tržišta osiguranja", *Tokovi osiguranja*, br. 3/2024, str. 536-548.

In addition to Solvency II and the proposed amendments, other documents, primarily regulations and directives adopted at the EU level, also impact the insurance and reinsurance sector by regulating the increase in resilience and contributing to sustainability.[14] In defining sustainability factors, the Legislative Resolution on the amendment of Solvency II refers to the definitiont in Article 2, point 24 of Regulation (EU) 2019/2088 of the European Parliament and Council on disclosures related to sustainability in the financial services sector.[15] According to this, sustainability factors include environmental and social issues, as well as matters related to employees, respect for human rights, and the fight against corruption and bribery. Sustainability risk refers to an environmental, social, or governance (*ESG*) event or condition that, if it occurs, could cause a real or potentially negative impact on the value of an investment or on the value of a liability (proposed addition to Article 13 of Solvency II).

Under the proposed changes to Solvency II, insurance and reinsurance companies will be required to explicitly consider short-term, medium-term, and long-term periods when assessing sustainability risks (proposed addition to paragraph 2 of Article 44 of Solvency II). The supervision of the existence of appropriate policies and strategies for implementing this assessment will fall to supervisory bodies. The Legislative Resolution on the amendment of Solvency II also includes provisions for including information related to sustainability risks in the solvency and financial condition report of an insurance company (amendments to paragraph 1a of Article 51 of Solvency II).

Sustainability risk is also becoming increasingly significant in terms of insurers' investment activities. Insurance and reinsurance companies will also have to take sustainability risk into account when deciding on their investment strategies and the potential long-term effects of investment decisions on sustainability factors (proposed addition to Article 132 of Solvency II).

1. Climate and Environmental Risks

Sustainable financing involves focusing on investments that reduce exposure to climate and environmental risks. The European Climate Law[16] emphasizes

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[14] Among these documents, the most significant are Regulations (EU) No. 537/2014 and (EU) 2019/2088 on sustainability-related disclosures in the financial services sector; Directives 2004/109/EC and 2006/43/EC of the European Parliament and the Council; Directive (EU) 2022/2464, which supplements the previously mentioned directives regarding corporate sustainability reporting; and the latest Directive (EU) 2024/1760 on due diligence for sustainable business and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859.

[15] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance), OJ L 317, 9.12.2019, pp. 1–16.

[16] *Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law'), PE/27/2021/REV/1, OJ L 243, 9.7.2021, p. 1–17.*

that the existential threat posed by climate change requires greater ambition and stronger action from both the Union and its member states in the field of climate policy. Risks such as those associated with climate change are difficult to quantify, or they may materialize over a period longer than the one typically used for calibrating the required solvency capital. These risks can be better accounted for in the company's own risk and solvency assessment (*ORSA*). Solvency II requires that insurance and reinsurance companies, as integral part of their business strategy, carry out a periodic *own risk and solvency assessment* (ORSA), which includes assessing risks and solvency (Article 45, paragraph 4 of Solvency II). The ORSA is an integral part of the business strategy and is continuously considered in making strategic decisions. If insurance and reinsurance companies are significantly exposed to climate change risks, they should be required to conduct analyses of the impact of long-term climate change scenarios on their operations at appropriate intervals within their ORSA. Such analyses should be proportionate to the nature, scale, and complexity of the company's business risks. Therefore, long-term climate risk assessments should not be mandatory for small companies or those with low-risk profiles.[17]

In recent years, climate change has posed serious risks, resulting in more frequent, unpredictable, territorially unusual, and often catastrophic weather events. All of this causes significant damage and enormous material losses. Damages associated with climate change risks could account for a significant percentage of the total claims portfolio in insurance. This data indicates the need for the insurance sector to adapt to new risks and innovate its products and services in proportion to the representation of climate and environmental risks. According to the EIOPA risk matrices, ESG risks saw a significant increase in 2023, while in 2024 they maintain a stable medium level.[18] The EIOPA risk matrices point out that the EU insurance industry has seriously recognized the impact of sustainability risks on its business and has already significantly adapted its assessments of environmental and climate risks to meet new ESG requirements. However, EIOPA in its opinion on sustainability under Solvency II in 2019, warned about an inapprorpiate understandingand interpretation of the term "climate risk." Climate risks should not be understood solely as risks related to weather events; it is more accurate to term these risks as "climate change-related risks." These risks, in a broader sense, include changes such as global warming, sea level rise, migration caused by climate chang, and more.[19]

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[17] Point (31) of the Legislative Resolution on amending Solvency II.

[18] For more details, see: *EIOPA Insurance Risk Dashboards* available at: *https://www.eiopa.europa.eu/tools-and-data/insurance-risk-dashboard/insurance-risk-dashboards-previous-publications_en#insurance-risk-dashboard-february-2024-q3-2023-solvency-ii-data* (accessed on June 28, 2024).

[19] For more details, see: *EIOPA Opinion on Sustainability within Solvency II* available at: *https://www.eiopa.europa.eu/document/download/d5ae4db7-cc30-40db-ad5e-045876e3c7b3_en?filename=Opinion%20on%20Sustainability%20within%20Solvency%20II%20%28EIOPA-BoS-19/241%29%E2%80%8B* (accessed on June 28, 2024).

In EIOPA's Opinion on Supervising the Application of Climate Change Risk Scenarios in the ORSA[20], climate change-related risks are categorized into two main categories: transition risks and physical risks. Transition risks are those that arise from the shift to a low-carbon economy and one that is resilient to climate change. These include risks directly related to business operations, such as reputational damage, legal risks, market sensitivity, technological risks, and others, often linked to insufficiently developed climate change protection systems. Physical risks are those arising from the physical effects of climate change, such as risks from specific events, especially weather disasters like storms, floods, wildfires, etc., as well as risks arising from longer-term climate changes such as global warming, sea level rise, decreased availability of drinking water, changes in biodiversity, and more.

According to Solvency II, risks are considered material when ignoring them can affect decision-making or judgment by the management or supervisory bodies of insurance companies and their relevant staff in the ORSA process. Insurance companies should assess the material nature of their exposure to climate change risks through a combination of qualitative and quantitative analyses. Climate change affects the frequency and severity of natural disasters, which are likely to increase further due to environmental degradation and pollution. This could change the exposure of insurance and reinsurance companies to natural catastrophe risks and invalidate the standard parameters for natural catastrophe risks under Solvency II.[21] Therefore, the European Parliament's Legislative Resolution on Solvency II amendments outlines that EIOPA should regularly review the scope of the natural catastrophe risk module and the calibration of its standard parameters to avoid a permanent misalignment between these parameters and the actual exposure of insurance and reinsurance companies to such risks.[22]

III Modern Corporate Governance System for Insurance and Reinsurance Companies

Corporate governance in (re)insurance companies is one of the most important aspects of business within the (re)insurance sector. Well-organized corporate governance leads to successful company performance, a stable insurance market,

[20] *EIOPA Opinion on the supervision of the use of climate change risk scenarios in ORSA, 2021.*, available at: *https://www.eiopa.europa.eu/document/download/f984b53b-3549-49a4-9beb-7fe5057ecd94_en?filename=Opinion%20on%20climate%20change%20risk%20scenarios%20in%20ORSA.pdf* (accessed on June 29, 2024).

[21] The risk parameters, including the risk of natural disasters, are established by the Delegated Regulation (EU) 2015/35 accompanying Solvency II; (*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) Text with EEA relevance, OJ L 12, 17.1.2015, p. 1–797*).

[22] Point (96) of the Legislative Resolution on the Amendment of Solvency II.

and secure, satisfied insurance servic customers.[23] Corporate governance implies a defined organizational structure of the company's governing bodies, but Solvency II does not regulate traditional corporate governance with a focus on these bodies. Instead, it focuses on managerial functions, such as the internal control and compliance system, risk management, actuarial function, internal audit, and others.[24] Solvency II specifically highlights the importance of risk management as the foundation for the successful business of (re)insurance companies. Effective management implies establishing a balance between business management and business oversight[25]. Therefore, according to Solvency II, in addition to the successful business management, it is important for the proper governance of (re)insurance companies to establish a stable system of control and business oversight.[26]

1. Risk Management

In the corporate governance segment of insurance companies, the most significant changes introduced by Solvency II pertain to alterations of the risk management structure. Solvency II establishes a *risk based regulatory framework* for risk management and capital requirements in (re)insurance companies, based on the risk exposure of each individual company over a one-year period.[27] Risk management, within this established corporate governance structure, can be defined as the first line of defense against the instability of the economic entity.[28]

The risk management system in insurance companies encompasses the strategies, processes, and reporting procedures required to identify, measure, and monitor risks, manage those risks, and provide continuous reporting, on both individual and group level, on the risks to which the company is exposed or could be exposed, and the interdependence of those risks (Article 44, Paragraph 1, Solvency II).[29] *The risk report* should contain key information about the risk management system and its practical application, serving as an effective mechanism for identifying

[23] Nikolina Maleta, *Statusno pravo osiguranja Europske unije i Bosne i Hercegovine*, PRESSUM, Mostar 2023, p. 108.

[24] See: Maria Grazia Starita, Irma Malafronte, *Capital Requirements, Disclosure, and Supervision in the European Insurance Industry; New Challenges towards Solvency II*, Palgrave Macmillan, *2014*, p. 158. Also: FMA – Österreichische Finanzmarktaufsicht (Ed.): *Handbook Solvency II, An Introduction to the New European Insurance Supervision Law, FMA*, LexisNexis ARD ORAC, 2016, p. 58.

[25] M. Grazia Starita, I. Malafronte, p. 158.

[26] See more: N. Maleta, pp. 108–137.

[27] See: Korneel van den Broek, "Long-term insurance products and volatility under the Solvency II Framework," *European Actuarial Journal*, Vol. 4, Iss. 2, 2014, (pp. 315–334), p. 316.

[28] Also see: Andrew Crockett, "Objectives and Developments in International Supervision of Financial Institutions," The Geneva Papers on Risk and Insurance, Vol. 26 No. 1, 2001, (pp. 31–36), p. 33.

[29] Also see: Marion Rittmann, *Neuausrichtung der Versicherungsaufsicht im Rahmen von Solvency II*, Gabler Research, 1 Auflage, 2009, pp. 42–43.

potential risks and taking preventive actions.[30] According to Solvency II, the risk management system should be organized in a way that ensures effectiveness and good integration into the organizational structure and decision-making processes of the (re)insurance companies.[31] Risk management contributes to meeting the capital requirements set out in the first pillar of Solvency II, fulfilling supervisory requirements under the second pillar, and ensuring solvency that is appropriate for market needs under the third pillar.[32]

The risk management function includes the identification of risks, risk analysis, and the measurement of their intensity and frequency, followed by evaluating their significance for the specific company and, ultimately, choosing a risk management strategy[33]. According to the new Directive on Corporate Sustainability Due Diligence[34], which applies to (re)insurance companies, due diligence regarding human rights and the environment must also be risk-based. Companies are required to integrate the due diligence standards for human rights and environmental concerns into their relevant policies and risk management systems (Article 7).

The risk management system, regulated by the internal rules of each (re) insurance company, should, according to the proposed changes to Article 44 of Solvency II, also include sustainability risk assessment, including the analysis of climate change. In their own risk and solvency assessment (ORSA), insurance companies should analyze climate change scenarios and their exposure to climate-related risks. Small and so-called non-complex insurance companies are exempt from this obligation (Article 5 of the proposed Article 45a, Solvency II). Companies that are required to analyze climate change risks, if significantly exposed, must consider at least two long-term climate change scenarios, which differ depending on whether the expected global temperature increase is less than or substantially exceeds two degrees Celsius.

According to Solvency II, the own risk and solvency assessment (ORSA) should be performed regularly and immediately whenever there is a significant change in the risk profile of a specific (re)insurance company.[35] Therefore, when making the

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[30] Also see: M. Grazia Starita, I. Malafronte, p. 167.

[31] N. Maleta, p. 112.

[32] M. Grazia Starita, I. Malafronte, p. 38.

[33] See: Andreas Klein (Ed.), *Risikomanagement und Risiko-Controlling*, Haufe Gruppe, Freiburg-Berlin-Munich, 2011, p. 28; also see: Christian Weißensteiner, *Reputation als Risikofaktor in technologieorientierten Unternehmen: Status Quo – Reputationstreiber – Bewertungsmodell*, Springer Gabler, 2013, p. 18; also see: Marijana Ćurak, Drago Jakovčević, *Osiguranje i rizici*, PRIF, Zagreb, 2007, p. 69; see also: Safet Kozarević, *Rizik menadžment i osiguranje*, Ekonomski fakultet Univerziteta u Tuzli, 2010, pp. 2.7–2.8; Ratko Vujović, *Upravljanje rizicima i osiguranje*, Univerzitet Singidunum, Belgrade, 2009, pp. 80., 97–98.

[34] *Directive (EU) 2024/1760 of the European Parliament and of the Council of 13 June 2024 on corporate sustainability due diligence and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859, Text with EEA relevance. PE/9/2024/REV/1, OJ L, 2024/1760, 5.7.2024.*

[35] See also: Alessandro Ferriero, "Solvency capital estimation, reserving cycle and ultimate risk," *Insurance: Mathematics and Economics 68*, Elsevier, 2016, (pp. 162–168), p. 162.

assessment, the company's exposure to various types of risk is considered over a one-year period, and based on that, *risk management* creates a risk portfolio for the (re)insurance company. In line with the amendments to Solvency II outlined in Article 45a by the Legislative Resolution, the time intervals for risk assessments must be proportionate to the nature, scope, and complexity of the climate-related risks present in the company's operations, but should not exceed three years. Long-term climate change scenarios must be reviewed at least every three years and updated as necessary.

2. Proportionality

A particularly significant innovation anticipated in the amendments to Solvency II is the further implementation of proportionality criteria with regard to specific elements of corporate governance, such as risk management, reporting obligations, supervision, etc. According to this criterion, small companies and those with a low-risk profile (non-complex companies) should be exempt from some of these obligations. The proper implementation of the principle of proportionality is key to avoiding excessive burdens on insurance and reinsurance companies. The Legislative Resolution on the amendment of Solvency II specifically emphasizes that this Directive should be applied in accordance with the principle of proportionality. To facilitate the proportional application of Solvency II to companies that are smaller and non-complex than the average insurance company, and to ensure that they are not subject to disproportionately burdensome requirements, it is necessary to provide risk-based criteria that enable their identification.[36]

Companies that meet the criteria for classification as small and non-complex insurance companies, based on a *risk-based* criterion, are categorized through a simple notification process to the supervisory body. If, within a maximum of two months from such a notification, the supervisory body does not oppose the classification on legitimate grounds related to the assessment of relevant criteria, the company should be considered small and non-complex. Once classified in this way, the company should, in principle, automatically benefit from proportionality measures regarding reporting, disclosure, governance, audit of written policies, calculation of technical provisions, own risk and solvency assessment (ORSA), and liquidity risk management plans.[37] If the supervisory body determines that the company is no longer in compliance, or there is a risk of non-compliance with the required solvency capital, or if the company's risk profile changes significantly, or if its management system becomes ineffective, the application of the proportionality

[36] Point (14) of the Legislative Resolution on the amendment of Solvency II.

[37] Point (15) of the Legislative Resolution on the amendment of Solvency II.

criteria may be suspended. The Legislative Resolution on the amendments to Solvency II also anticipates that proportionality measures will be available to companies that are not classified as small and non-complex, but for which some of the Directive's requirements are considered too expensive or complex, given the risks associated with their operations.[38] These companies should be allowed to apply proportionality measures based on the analysis of each specific case, and with prior approval by their supervisory authorities.

Proportionality is applied to small and non-complex insurance companies to ease their obligations regarding information disclosure, reporting, including simplified sustainability reporting, the calculation of technical provisions, and other aspects of corporate governance. To improve proportionality within quantitative requirements, insurance and reinsurance companies should be allowed to calculate the required capital for minor risks using a simplified approach within the standard formula, for a period of up to three years.[39]

3. Reporting

One of the mechanisms that ensures a good governance system in (re) insurance companies is the obligation to publicly disclose solvency and financial condition reports.[40] The success of the insurance market is largely conditioned by the information that insurers provide regarding the risks they cover.[41] Insurance and reinsurance companies are required to publicly disclose these reports annually under Solvency II. The report must include prescribed information either in full or by referencing information that is of the same nature and scope and has been publicly disclosed in accordance with other legal or regulatory requirements.[42] The most significant changes brought by the Legislative Resolution on the amendments to Solvency II in the reporting segment concern the application of the principle of proportionality in the context of reporting obligations, particularly easing the regulatory obligations for small and non-complex insurance companies. Simplifications are also anticipated for group-level reporting. To simplify the reporting requirement for insurance and reinsurance groups, it should be possible, under certain conditions, to provide information from the regular supervisory report relating to the group and its subsidiaries in an aggregated manner for the entire group.[43]

[38] Point (17) of the Legislative Resolution on the amendment of Solvency II.
[39] Point (52) of the Legislative Resolution on the amendment of Solvency II.
[40] Also: Karel van Hulle, "Solvency II could become a global model," *Revija za pravo osiguranja* No. 2/2011, (pp. 67-71), p. 68.
[41] See: Donatella Porrini, "Risk Classification Efficiency and the Insurance Market Regulation," *Risks 2015*, 3, (pp. 445-454), p. 452. Also: M. Rittmann, p. 45. Also: A. Klein, p. 46.
[42] N. Maleta, p. 34.
[43] Point (21) of the Legislative Resolution on the amendment of Solvency II.

Given the experience during the COVID-19 pandemic and the challenges businesses faced during that period, the amendments also anticipate certain exceptions, including the possibility of extending reporting deadlines defined under Solvency II. The Commission, after consulting with EIOPA, should have the authority to extend reporting deadlines in exceptional circumstances such as health crises, natural disasters, and similar extreme events.[44] It is also proposed that deadlines for the preparation of audited reports could be extended.

Regarding quantitative regular reporting, certain limitations are introduced, particularly when the submission of some information would impose an excessive burden considering the nature, scope, and complexity of the risks present in a company's operations. These limitations apply if such reporting is not essential for effective supervision, does not jeopardize financial stability, and when the information can either be submitted annually or upon request (proposed Article 35a, Solvency II). This limitation on regular supervisory reporting applies only to companies that collectively represent no more than 20% of the life or non-life insurance or reinsurance market share in the member state. The life insurance market share is based on gross technical provisions, while the non-life insurance market share is based on written gross premiums. When determining eligibility for these reporting limitations, supervisory bodies will prioritize small and non-complex companies. Additional exceptions to regular supervisory reporting are anticipated for insurance companies themselves.

The amendments to Solvency II also introduce anticipate reporting requirements, particularly those related to business sustainability, and proportionality measures for small and non-complex companies. Furthermore, they complicate the solvency and financial condition report by splitting it into two distinct parts. The first part consists of information specifically aimed at policyholders and insurance customers, while the second part focuses on information intended for market experts (proposed amendments to Article 51, Solvency II). This is complemented by the requirements under the Corporate Sustainability Reporting Directive[45] which introduces additional requirements under which insurance companies, together with credit institutions, play a key role in the transition to a fully sustainable and inclusive economic and financial system, in accordance with the European Green Deal.

4. Supervision

Solvency II has introduced significant innovations in the supervision of the European Union insurance market. A higher level of control has been achieved,

[44] Point (23) of the Legislative Resolution on the amendment of Solvency II.

[45] *Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (Text with EEA relevance) PE/35/2022/REV/1 OJ L 322, 16.12.2022, p. 15–80)*

and broader powers have been granted to the supervisory authorities, particularly in the area of financial oversight. Compared to the previous system, Solvency II has reformed the foundations of the supervision of insurance and reinsurance activities within the European Union.[46] Supervision is now risk-based and includes continuous monitoring of the proper conduct of insurance and reinsurance operations, as well as compliance with supervisory regulations. The supervisory authorities have the task of identifying weaknesses in *risk management* within financial institutions and making critical decisions regarding actions to be taken in such situations.[47] The supervision of (re)insurance companies involves a balanced combination of indirect supervision and direct controsl (Article 29, paragraph 2 of Solvency II). Therefore, the supervisory measures are tailored to the nature, scope, and complexity of the risks associated with the activities of (re)insurance companies, and delegated acts, as well as regulatory and implementing technical standards, are adjusted according to the size and scope of the companies' operations. The principle of proportionality and the current supervision system especially protect small insurance companies.[48]

However, the continuous improvement of insurance and reinsurance companies supervision, whose operations are based on the freedom to provide services and the freedom of establishment, is an ongoing trend. This improvement in supervisory mechanisms should be carried out without undermining the goal of further integration of the single insurance market, in order to ensure consistent consumer protection and safeguard fair market competition across the entire single market. Due to recent market developments, it is necessary to implement additional mechanisms for controlling corporate governance in insurance companies and apply significant changes in the financial markets, such as inflation, low interest rates, and others, within insurance supervision. Given the nature, scope, and complexity of risks, supervisory bodies should be able to collect relevant macroprudential information about the investment strategies of insurance and reinsurance companies, analyze this information along with other relevant data available from other market sources, and integrate a macroprudential perspective into their supervision of insurance and reinsurance companies. This could include monitoring risks associated with specific credit cycles, economic downturns, and collective behavior or "herding behavior" in investments.[49]

Due to the importance of additional regulation exempting small and non-comlex companies based on the principle of proportionality, the amendments to Solvency II thoroughly regulate the process of qualifying insurance companies

[46] See also: Mirko Kraft, „Auswirkungen von Solvency II und der neuen EU-Finanzaufsichtsarchitektur auf die Kapitalallokationsstrukturen von Versicherungsgruppen", *Zeitschrift für die gesamte Versicherungswissenschaft,* December 2012., Volume 101, Issue 5, (pp. 657. – 674.), p. 659.

[47] See: Julie Dickson, „Supervision: Looking Ahead to the Next Decade" in A. Joanne Kellermann, Jakob de Haan, Femke de Vries (edt.): *Financial Supervision in the 21st Century*, Springer, 2013., p. 222.

[48] N. Maleta, p. 140.

[49] Point (59) of the Legislative Resolution on the amendment of Solvency II.

as small and non-complex and define the powers of supervisory authorities in this process, as well as the monitoring of proportionality measures (proposed Articles 29b, 29c, 29d, and 29e of Solvency II). The Legislative Resolution on the amendments to Solvency II also includes provisions strengthening and detailing cross-border and group-level supervision, additional powers for supervisory authorities in cases of solvency and liquidity threats to insurance companies, supervisory measures to preserve the financial position of companies during exceptional sectoral shocks, non-compliance with required solvency capital, and improving other macroprudential supervisory measures. The aim is to raise the overall quality of supervision while simplifying the oversight and control of insurance activities.

IV Conclusion

The insurance industry at global, European, and national levels is extensively regulated and supervised, requiring multiple reporting obligations from insurers, including non-financial reports. Detailed legal regulation is essential for the comprehensive and systematic development of the industry, but at the same time, it can lead to an atmosphere of overregulation. Good legal regulation and normative governance should be based on qualitative, rather than predominantly quantitative, requirements to achieve an effective regulatory framework. The Solvency II Directive represents a systematic regulatory framework for the operation of (re)insurance companies within the European Union. This framework has been supplemented by several legislative and non-legislative acts, but the proposal for the first significant amendment to the Directive was adopted by the European Parliament in 2024, with these amendments expected to come into effect in 2026.

The insurance industry at the European level is one of the leading, if not the largest, institutional investment activities. Insurers, in their role as investors, must increasingly consider factors of sustainable business and investment when evaluating their investments. For the insurance sector in the context of ESG (Environmental, Social, and Governance) factors, environmental and climate risks are primary concerns. Therefore, it is understandable that the proposed amendments to Solvency II largely focus on integrating sustainability risks into the risk management systems of insurance companies, particularly those risks caused by climate change. However, it is the transition to a climate-neutral economy should not dominate the regulatory framework of Solvency II or serve as the primary normative tools for implementing a sustainable economy, at the expense of the risk-based prudential framework of this Directive. While the insurance industry supports and can make a significant contribution to the development of sustainable business practices and the green transition, additional caution is needed to avoid going to the other extreme and neglecting the fundamental purpose of the regulatory framework for the insurance

industry, which is to ensure a stable market based on capital adequacy in relation to the risks undertaken.

A better implementation of the principle of proportionality is also one of the key and significant changes anticipated in Solvency II. It will enable smaller insurers, defined as small and non-complex companies, to benefit from simplifications and proportionality measures, thus creating a more suitable and stable market for such qualified insurance companies. Applying the principle of proportionality in the area of mandatory risk-based reporting helps to avoid the regulatory burden that many insurers currently face. The disproportion between the scope of business and the risks undertaken on one hand, and capital requirements and other regulatory obligations on the other, does not contribute to the functionality and further development of the insurance market. Therefore, the application of the principle of proportionality with regard to technical provisions, gross written premiums, and some other solvency elements is eagerly awaited as an adjustment of the Solvency II framework to meet the needs of the insurance market.

If the proposed amendments to Solvency II are implemented as planned, they will contribute to better protection for insurance service users and free up significant funds for investments in the green and digital transitions. However, the proposed changes indicate an increase in reporting obligations, which, even under the current regulatory framework, are not insignificant. Additionally, the proposed delegated acts to further elaborate the changes to the Directive could contribute to the increasing complexity and overregulation of the insurance industry's regulatory framework. This burden will be particularly felt by by non-EU countries aspiring for membership, and thus need to align their legislation with the *acquis communautaire*.

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