Solvency II:
State of Play

Guernsey, 18th December 2009

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Internal Market & Services DG

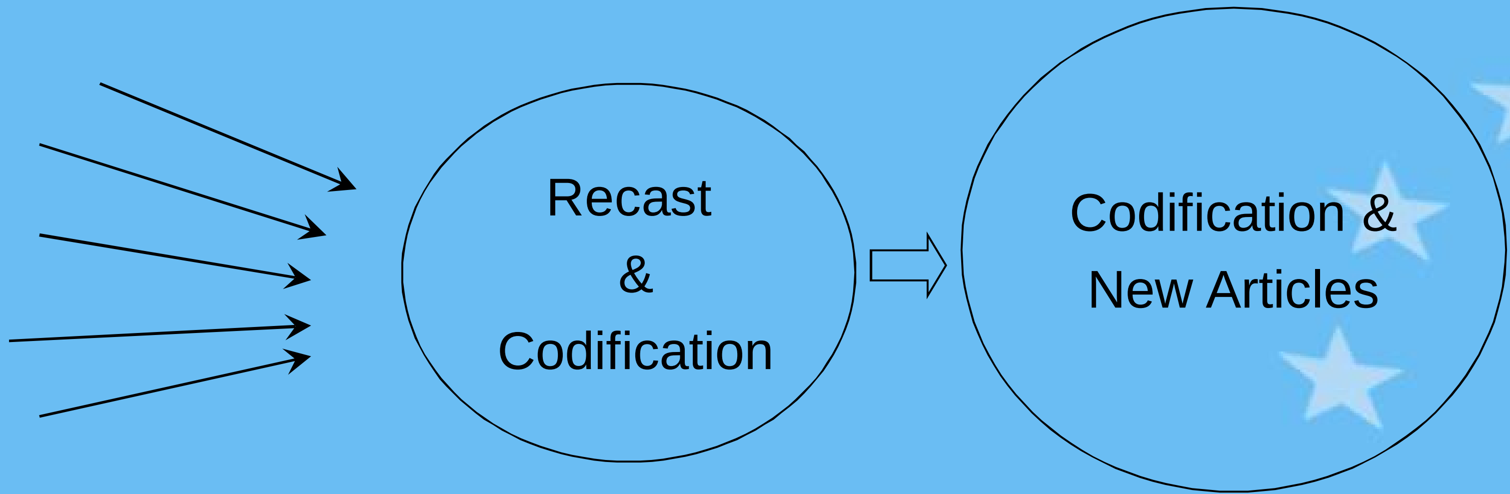
Why do we need Solvency II?

- Lack of risk sensitivity in existing rules
- Lack of an early warning mechanism
- Minimum harmonisation in Solvency I impedes proper functioning of internal market
- Suboptimal supervision of groups
- International accounting and supervisory developments

Framework Directive

14 existing Insurance Directives (direct insurance, reinsurance, groups etc.)

+ Solvency II



= 1 Directive ‘EU Insurance sourcebook’

Solvency II – 4 Principal Objectives

- Deepen the Single Market
- Enhance policyholder protection
- Improve (international) competitiveness of EU insurers
- Further Better Regulation

The new regime…

- Establishes risk-sensitive capital requirements to encourage and reward good risk management
- Places emphasis on the responsibility of the senior management to manage their business responsibly
- Fosters and demands greater supervisory convergence → Single Market

Intensive consultation process

- Framework for Consultation developed with MS and with CEIOPS
- Three waves of cfa to CEIOPS
- Interviews with selected number of companies including SMEs
- QIS 1 and QIS 2
- Impact Assessment with 45 options

Consultation continued

- Commission proposal prepared following consultation and dialogue with CEA, AMICE, CRO Forum, CFO Forum, Groupe Consultatif, CEIOPS, EIOPC
- Close contact with ECON members in EP
- QIS 3 and QIS 4
- Several public hearings and public meetings with stakeholders

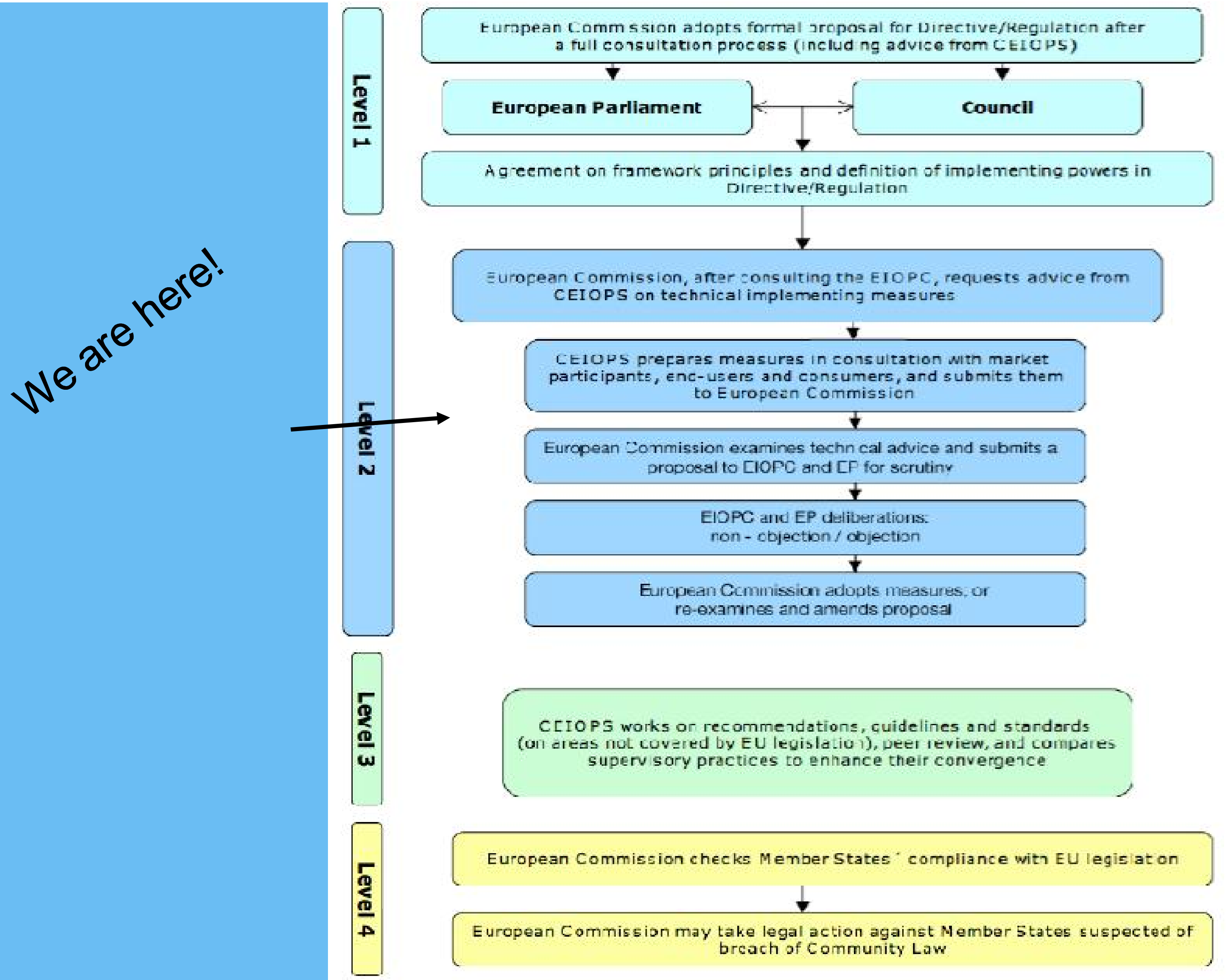
Legislative Process - **Lamfalussy**

Level 1: Framework Directive

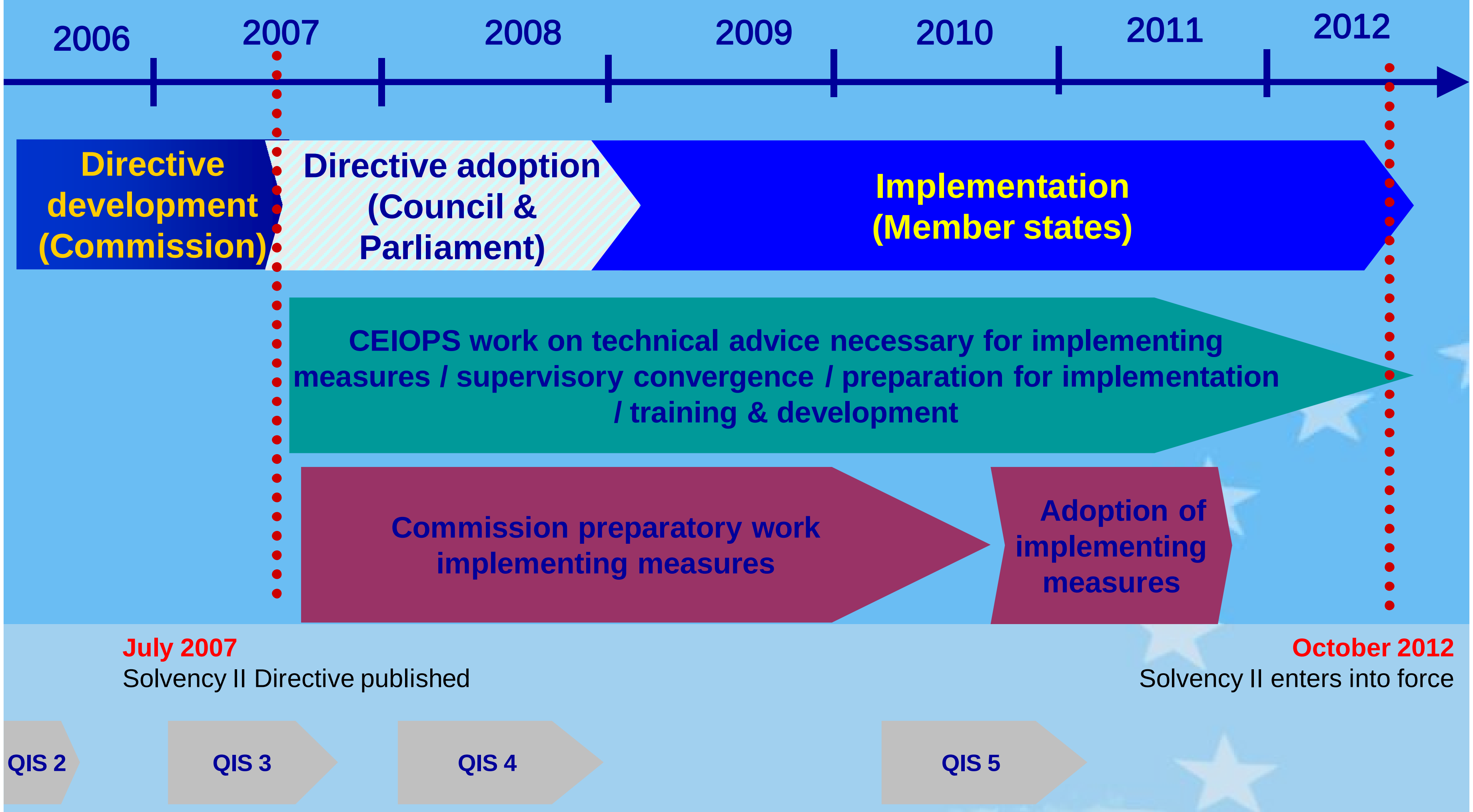
Level 2: Implementing Measures (Commission)

Level 3: Convergent implementation assisted by close co-operation between national authorities

Level 4: Rigorous enforcement of Community legislation by the Commission


We are here!
Level 1
European Commission adopts formal proposal for Directive/Regulation after a full consultation process (including advice from CEIOPS)
European Parliament
Council
Agreement on framework principles and definition of implementing powers in Directive/Regulation
Level 2
European Commission, after consulting the EIOPC, requests advice from CEIOPS on technical implementing measures
CEIOPS prepares measures in consultation with market participants, end-users and consumers, and submits them to European Commission
European Commission examines technical advice and submits a proposal to EIOPC and EP for scrutiny
EIOPC and EP deliberations: non - objection / objection
European Commission adopts measures; or re-examines and amends proposal
Level 3
CEIOPS works on recommendations, guidelines and standards (on areas not covered by EU legislation), peer review, and compares supervisory practices to enhance their convergence
Level 4
European Commission checks Member States´ compliance with EU legislation
European Commission may take legal action against Member States suspected of breach of Community Law

Solvency II Timetable for 2007-2012



Solvency II
Key aspects

Solvency II: 3 pillars and a roof

Group supervision
& cross-sectoral convergence

Groups are recognised as an economic entity
=> supervision on a consolidated basis
(diversification benefits, group risks)

Pillar 1: quantitative requirements

1. Harmonised calculation of technical provisions
2. "Prudent person" approach to investments instead of current quantitative restrictions
3. Two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR)

Pillar 2: qualitative requirements and supervision

1. Enhanced governance, internal control, risk management and own risk and solvency assessment (ORSA)
2. Strengthened supervisory review, harmonised supervisory standards and practices

Pillar 3: prudential reporting and public disclosure

1. Common supervisory reporting
2. Public disclosure of the financial condition and solvency report

(market discipline through transparency)

Pillar 1

Quantitative requirements

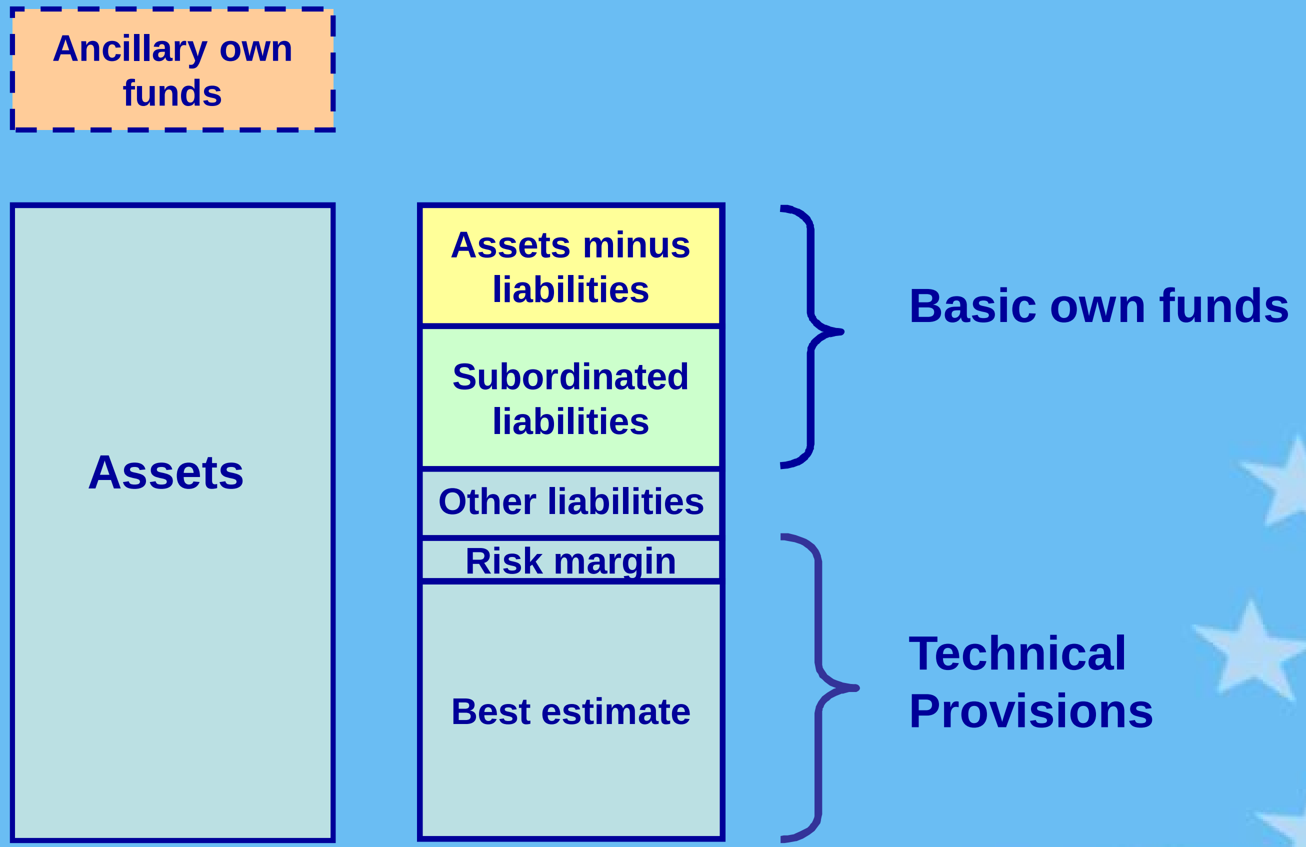
Valuation of Assets and Liabilities

- Assets shall be valued at the amount for which they could be exchanged, and liabilities at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction
- When valuing liabilities, no adjustment to take account of own credit standing shall be made
- The Commission shall adopt implementing measures to set out the methods, assumptions to be used

Valuation of Technical Provisions

- The value of technical provisions shall be set equal to the sum of a **best estimate** and a **risk margin**
- The **best estimate** is the expected present value of future cash flows, using the relevant risk-free interest rate term structure based upon up-to-date and credible information and applicable and relevant methods
- The **risk margin** shall ensure that the value of the technical provisions is equivalent to the amount insurance and reinsurance undertakings would be expected to require in order to take over and meet the obligations

Visualising Own funds



Capital Requirements

- Two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR)
- Provides for a ladder of intervention
- Breach of MCR triggers ultimate supervisory action

SCR General principles

- Designed to ensure all quantifiable risks are taken into account
- SCR can be calculated using either a standard formula or an internal model
- SCR calibrated to the Value-at-Risk of basic own funds subject to a confidence level of 99.5% over a 1 year time horizon
- Covers at least underwriting risk, market risk, credit risk and operational risk
- SCR shall take account of the effect of the use of risk mitigation techniques

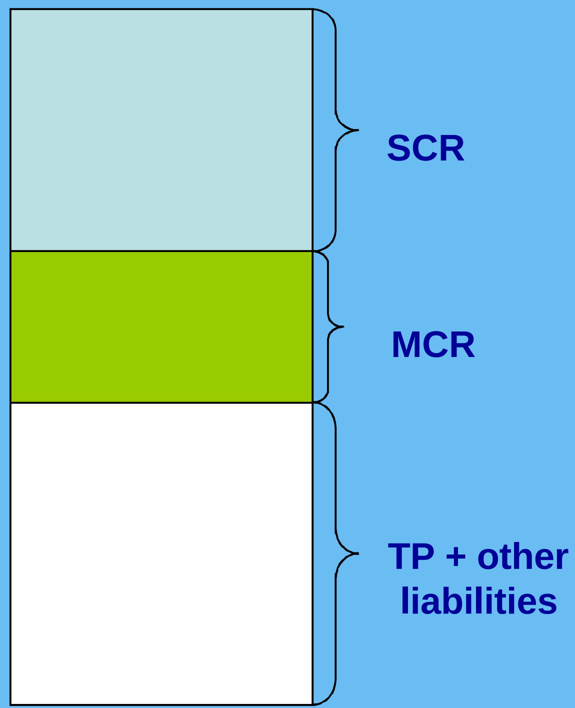
MCR

- MCR shall satisfy the following principles
  - MCR shall be calculated in an auditable, robust and simple manner
  - MCR shall be calibrated to a Value-at-Risk (VaR) subject to a confidence level of 85% over a one-year time horizon
- MCR shall be subject to an absolute floor
- MCR shall not fall below 25% nor exceed 45% of the undertaking's SCR
- MCR shall be calculated quarterly
- Breach of MCR triggers ultimate supervisory action

Investments

- “Prudent person” approach:
  - Insurer is able to invest in assets whose risks it can identify, measure, monitor, manage, control and report
  - Insurer invests in the best interest of policyholders
  - Insurer pays due attention to ALM
  - Insurer pays due attention to concentration and liquidity issues
- Freedom to invest: no asset categories prescribed, no prior supervisory approval

Supervisory ladder of intervention



supervisory action is proportionate to level and length of non-compliance

principles-based	Breach of SCR ⇒ recovery plan 6 + 3 months
rules-based	Breach of MCR ⇒ short-term finance scheme + ultimate supervisory action 1 + 2 months

Pillar 2

Governance and Supervisory Review

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Pillar 2

- Qualitative requirements to cover risks which are not captured in the SCR
- Enhanced internal control, governance, and risk management, as well as self-assessment of capital needs (ORSA)
- Strengthened supervisory review, harmonised supervisory standards and practices

Pillar 2: Supervisory Activities

Supervisory activities

- general rules on supervision
- supervisory powers
- supervisory review process
- principle of proportionality

Qualitative requirements on undertakings

- system of governance
- principle of proportionality

System of governance

- An effective system of governance which provides for sound and prudent mgt
- System must be proportionate to the nature, scale, complexity of operations
- A number of functions must be set up:
  - Risk management
  - Internal control
  - Internal audit
  - Actuarial

Risk Management Function

- Part of the risk management system
- Must cover at least: underwriting and reserving, A-L mgt, investment, liquidity and concentration risk, operational risk, reinsurance and other risk mitigating techniques
- Specific tasks in relation with use of partial or full internal model

Actuarial Function

- **Technical provisions:**
  - Coordinates the calculation of technical provisions
  - Ensures appropriateness of methodologies and underlying models used as well as the assumptions made in the calculation
- To be carried out by persons who have knowledge of actuarial and financial mathematics, i.e. no actuarial qualification as such required

Own risk and solvency assessment

- Not a capital requirement
- Results need to be reported to supervisor
- Regular assessment of:
  - overall solvency needs;
  - compliance with SCR, MCR and technical provisions;
  - significance with which the risk profile of the undertaking deviates from the SCR

Supervisory Review Process

- Covers qualitative and quantitative requirements
- Evaluation of an undertaking’s ability to comply with Solvency II and to assess the risks it faces
- Supervisory authorities empowered to follow up on findings
- Requires appropriate monitoring tools

Capital Add-ons

- Possible under exceptional circumstances following the SRP
- Used where the standardised approach does not reflect the undertaking's risk profile
- Undertaking must make all efforts to remedy deficiencies that led to add-on
- Annual follow-up by supervisor

Pillar 3

Supervisory reporting and public disclosure

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Pillar 3

Supervisory Reporting

- General principles for the submission of information to supervisors
- Implementing measures

Public Disclosure

- Disciplinary effects
- Solvency and financial condition report
- Implementing measures

Supervisory reporting

- Will be streamlined throughout EU (templates)
- Should allow the supervisor
  - To assess the system of governance applied by the undertaking, the business it is pursuing, the valuation principles applied for solvency purposes, the risks faced and the risk management system, the capital structure, needs and management
  - To make any appropriate decisions resulting from the exercise of supervisory rights and duties

Report on solvency and financial condition

- Annual report on solvency and financial condition
- Must be kept up-to-date
- Undertakings can disclose additional information on voluntary basis
- Includes capital add-ons and non-compliance with MCR and SCR
- Report must be approved by undertaking's management before publication

Group Supervision

A new approach

Reinforcement of group supervision

- Identification and nomination of a group supervisor
- Rights and duties of the group supervisor for all key elements of group supervision
- Enhancement of the duty to exchange information
- Full recognition of diversification effects
- Internal model to calculate the group SCR
- Group ORSA and Group Solvency and Financial Condition Report
- Subgroups: max. three levels of supervision
- Implementing measures to further specify principles at level 2

Group supervision to be further developed in the future

- Group support deleted in final text
- Problem of separation of power and responsibility
- Who pays in the end?
- Review clause on supervisory cooperation (2014) and group supervision (2015)

State of play

- EP adopted agreed text on 22 April 2009 (593 votes in favour against 80 opposed)
- Council adopted agreed text on 5 May 2009
- Final text adopted by Council on 10 November 2009
- Final text signed by the Presidents of Council and European Parliament (end November 2009)
- Publication of final text in Official Journal before end 2009

Next steps

- EC has asked CEIOPS to develop advice for implementing measures
- CEIOPS has published three sets of draft advice in March, July and October 2009
- CEIOPS delivers final advice on first two sets on 10 November 2009
- Final advice on outstanding issues to be delivered by CEIOPS by end January 2010

Development of implementing measures

- EC drafts legal texts in co-operation with experts of MS
- CEIOPS delivers draft specifications for QIS 5 (standard formula) in March 2010
- QIS 5 is launched in August 2010
- Final results of QIS 5: March/April 2011
- Adoption of implementing measures: October 2011

Solvency II and financial crisis

- Introduction of a dampener mechanism under pillars 1 (symmetrical adjustment mechanism for measuring equity risk) and 2 (extension of period for recovery of SCR)
- Specific reference to financial stability in mandate of supervisors
- CEIOPS' paper: lessons to be learned from the financial crisis (February 2009)

Third Country Equivalence under Solvency II

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Relevant Articles in Directive

- Group Solvency calculation (Article 225)
- EU parent with subsidiary in the US: Is the solo solvency regime in US equivalent to that under Solvency II?
- Group supervision (Art. 263 and 263a)
- US parent with subsidiary in the EU: Is the prudential regime for group supervision in US equivalent to that under Solvency II?

Procedure for equivalence assessment

- Either Commission decision or determination by group supervisor
- If determination by group supervisor: mandatory consultation of other supervisors in college and of CEIOPS (need for a consistent approach). Determination by group supervisor not mandatory for other groups.

Commission Decision

- EC will first adopt implementing measure specifying the assessment criteria
- Measure will undergo scrutiny of European Parliament
- Commission may adopt decision based upon agreed assessment criteria after consultation of CEIOPS
- Commission decision is determinative

Planning of equivalence assessment

- Commission has asked CEIOPS to start work on assessment criteria
- Draft advice from CEIOPS: December 2009
- Final advice from CEIOPS: March 2010
- Commission will determine third countries after consultation with stakeholders
- Final advice from CEIOPS: July 2011
- Informal discussions with third country supervisors and industry
- Commission decisions to be adopted in June 2012

Consequences of positive equivalence determination

- The calculation of the group solvency as regards the specific undertaking can be based upon the solvency requirements laid down in the third country concerned
- Member states will rely on the equivalent group supervision exercised by the third-country supervisory authority

Consequences of absence of equivalence determination

- The third country insurance undertaking will be treated as a related insurance undertaking
- Application of group supervision provisions by analogy or of other methods ensuring appropriate supervision or requirement to establish a holding company with head office in the EU

How will this work in practice?

- First step is agreement on assessment criteria: reference has to be Solvency II but equivalence does not mean uniformity
- Second step will be identification of third countries concerned: most relevant countries from an EU point of view
- Stakeholders and relevant supervisory authorities will be closely associated with the process
- Decisions will be regularly reviewed in the light of developments in the EU and in third country concerned

Some clarifications

- Equivalence recognition has nothing to do with market access
- The work carried out within the IAIS on solvency can be helpful towards the process of equivalence recognition
- Equivalence recognition not only looks at the regulation as such but also at the way the regulation is applied in practice

How can the process be facilitated?

- EC entertains regulatory dialogues with a number of countries
- Any third country interested in a discussion about equivalence can do so either with the EC or with CEIOPS
- Any interested party will be able to respond to the draft advice that CEIOPS will publish

Captives

- Are covered by Solvency II unless scoped out
- Definition now included in Insurance Directives
- Need to take account of specificities of captives recognised in Solvency II Framework Directive

Captives/CEIOPS

- National guidance on QIS 4 technical specifications by Malta, Ireland, Lux.
- CP 71 on Non Life Underwriting Risk
- CP 79 on Simplifications and Specifications for captives
- QIS 5 the ultimate test

Concluding remarks

- Solvency II is a complex project
- Important technical issues still need to be resolved
- EC takes final decision on measures for implementation
- Need for pragmatic approach which does not aim at perfectionism

Questions?

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