Solvency II: State of Play

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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

Recast & Codification

Codification & New Articles

= 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
Solvency II Timetable for 2007-2012

- 2006: Directive development (Commission)
- 2008: CEIOPS work on technical advice necessary for implementing measures / supervisory convergence / preparation for implementation / training & development
- 2009: Commission preparatory work implementing measures
- 2010: Adoption of implementing measures
- 2011: Implementation (Member states)
- 2012: Directive adoption (Council & Parliament)

October 2012: Solvency II enters into force
Solvency II
Key aspects
Solvency II: 3 pillars and a roof

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)

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
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

Assets

- Ancillary own funds
- Assets minus liabilities
  - Subordinated liabilities
  - Other liabilities
  - Risk margin
  - Best estimate

Basic own funds

Technical Provisions
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

- **SCR**
- **MCR**
- **TP + other liabilities**

**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
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
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
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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