„Solvency II“ –

New Rules in Europe for the Insurance Industry

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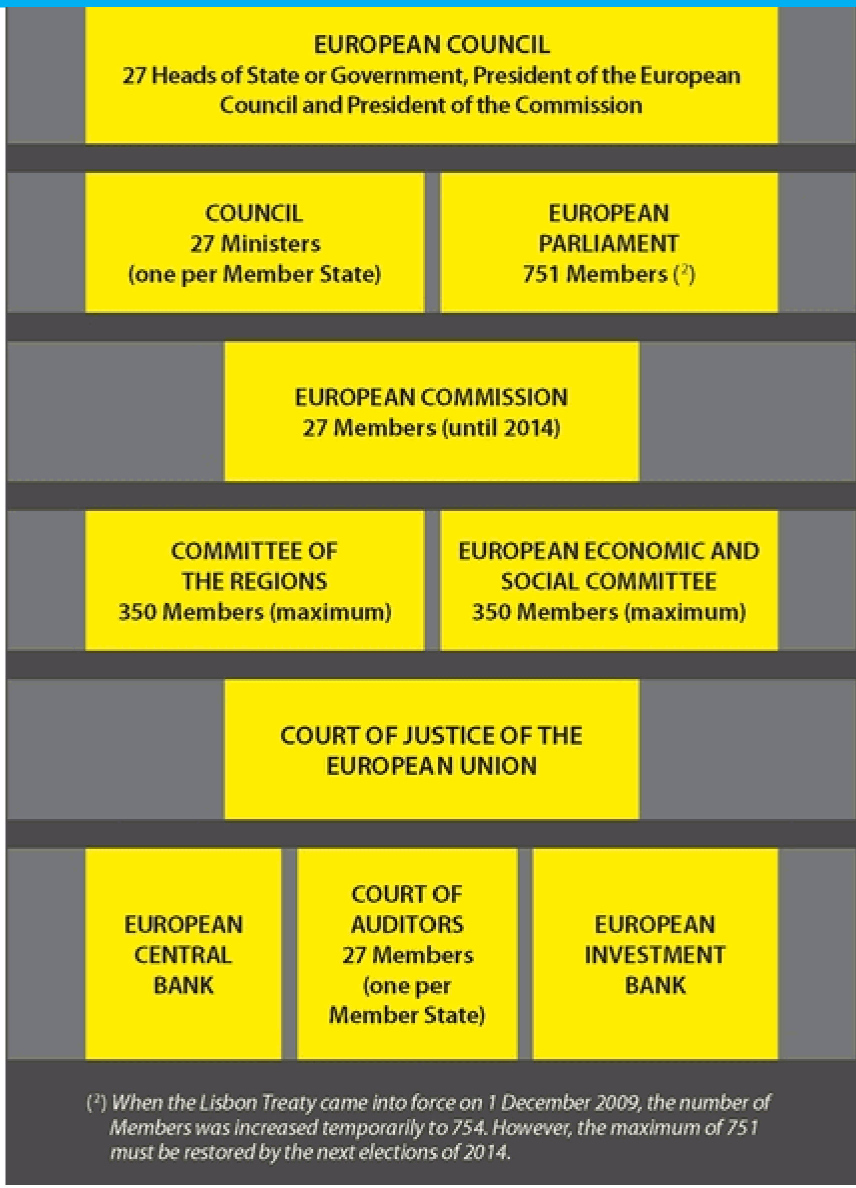
Main institutions of the European Union



- Basic directions
- Legislative
- Executive
- Council
- Judiciary
- Banking

Source: http://eur-lex.europa.eu/en/editorial/abc_c03_r1.htm#h4

There are three main legal acts:

(1) **Regulations**

- by entering into force they become law in all member states (no implementation needed)
- they override conflicting national law

(2) **Directives**

- they oblige member states to achieve certain results
- implementation needed in order to become national law

(3) **Court Decisions**

- legal acts with direct effect
- direct effect limited to the parties of the lawsuit

Lawmaking process for Solvency II

In 2007 proposal from the European Commission for a new Directive ruling the solvency of insurers;
Financial crisis has worked as a catalyst

In 2009 the European Parliament and the Council adopted Directive 2009/138/EC – „**Solvency II“ (S-II)**

Negotiation for amendments and transitional measures of S-II in another Directive – **Omnibus II** – not yet finalized

In 2012 „Quick Fix“ Directive which delayed the transposition date of S-II to 30 June 2013 and application to 2014

However: open-end timeframe cause of ongoing negotiations for Omnibus II with possible interim measures regarding S-II proposed by EIOPA

Content of S-II: Regulation of the Insurance Industry

Aim: Creating “better law” by bundling existing directives for the insurance sector and creating new and stricter rules

Steps towards <u>fully harmonized regulatory law</u> for the insurance industry on the EU level

Steps of Lawmaking („Lamfalussy process“)

Level 1 Solvency II Directive

- Overall framework principles – legally binding
- Developed by European Commission, European Parliament and European Council

Level 2 Implementing measures

- Detailed implementation measures – legally binding
- Developed by the European Commission and the European Insurance and Occupational Pensions Committee (EIOPC) and other Commissions

Level 3 Supervisory Standards

- Guidelines to enhance supervisory convergence – not binding
- Developed by European Insurance and Occupational Pensions Authority (EIOPA) [former Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)]

Level 4 Evaluation

- Monitoring compliance and enforcement
- Developed by the European Commission and EIOPA

Supervision structure

Directive S-II will have to be implemented by each Member State of the EU into national law

Supervisory authority of each Member State keeps in charge of supervision as the home regulator

EIOPA as a European organization aims at ensuring convergence of supervisory standards in Member States.

Instruments:

(1) quantitative impact studies (QIS)

(2) guidelines and standards for implementation

Objectives of S-II

Main objective: **Improved protection of policy holders and beneficiaries**

Unification of the insurance market

Ensure **risk-appropriate own funds** for insurance undertakings

Modernization of the regulatory frame

Supervisory convergence in tools and practice in the EU

Financial stability and **fair stable markets** as <u>secondary objectives</u>

Scope of S-II

Scope: Direct **life and non-life insurance** undertakings and **reinsurance** undertakings headquartered inside the EU

Exceptions:

(1) insurance forming part of a statutory system (control by other governmental bodies)

(2) very small insurance undertakings with gross premium income not exceeding 0.5 million EUR or gross technical provisions under 2.5 million EUR

(3) pension funds (separate Directive)

Main principles of S-II

Principle-based supervision

<u>Aim</u>: more individual responsibility of insurance companies

<u>Advantages</u>: flexibility; discretion for companies about how to meet obligations

Principle of Proportionality

<u>Aim</u>: no overburdening of small and mid-size companies

Risk-sensitivity

<u>Aim:</u> all risks shall be taken into account

Tree Pillar System

Roof: group supervision

Pillar 1: quantitative requirements

- measurement of assets, liabilities and capital

Pillar 2: qualitative requirements

- effective risk management system

Pillar 3: transparency requirements

- Reporting and disclosure requirements

Pillar 1: Quantitative requirements

Financial requirements which a company has to meet in order to be considered solvent (**solvency requirements**)

<u>Main contents</u>:

(1) Measuring solvency based on the **total balance sheet approach**

(2) Calculation of a **Minimum Capital Requirement (MCR)** and a **Solvency Capital Requirement (SCR)** based on a complete risk profile, which has to be covered with own funds

(3) **Investment** management

Total balance sheet approach

Economic valuation of the **entire balance sheet**

Liabilities and assets to be valued on a **market basis**:

Assets and liabilities shall be valued at the amount for which they could be exchanged or transferred between knowledgeable willing parties in an arm's length transaction

Liabilities comprise technical provisions, basic own funds and other liabilities

Technical provisions

Technical provisions shall correspond to the amount the companies would have to pay if they were to transfer their obligations immediately to another company

Calculation:

(1) market consistency and

(2) risk sensitivity

(a) **hedgeable risks:** valued at market valuation

(b) **non-hedgeable risks:** best estimate plus risk margin

Own funds

Own funds consist of **basic own funds** and **ancillary own funds**

Basic own funds (i.e. capital) consist of the excess of assets over liabilities and subordinated liabilities

Ancillary own funds consist of other items which can be called upon to absorb losses, approved by the supervisory authorities

Both categorized into **three tiers** along <u>availability</u> and <u>subordination</u>

Minimum Capital Requirement (MCR)

MCR = Level of own funds below which policy holders and beneficiaries are exposed to an unacceptable level of risk

Covered by basic own funds

Frequency of calculation: every 3 months. Report to the supervisory authorities required.

Method of calculation: **linear function** laid down in S-II

Function: **absolute minimum** for company capital

Linear function calculation

Linear function:

Factor-based combination of basic volume measures (technical provisions, written premiums, capital-at-risk, deferred tax, administrative expenses)

Corridor between cap of 45% and floor of 25% of the SCR

certain amount of money as absolute floor depending on the kind of insurer

Solvency Capital Requirement (SCR)

SCR = level of capital required to give 99,5% confidence that the existing assets will cover the liabilities for one year

Covered by own funds

Frequency of calculation: once a year. Report to the supervisory authorities required.

Method of calculation: **standard formula** as stated in S-II or an internal model validated by the supervisory authorities

Function: **early warning system**

Standard formula calculation

Standard formula:

Sum of Basic Solvency Capital Requirement (BSCR), capital requirement for operational risk and adjustment for the loss-absorbing capacity of technical provisions and deferred tax

BSCR encompasses, as sub-sections, life and non-life underwriting risk, health underwriting risk, market risk, counterparty default risk and intangible risk

Calculation of the SCR for each module and sub-module and then aggregation

Main criticism of the SCR

Main criticism concerns the capital charges for the SCR on different assets – **asset-liability mismatch**

- European government bonds have a capital charge of zero, despite recent sovereign debt crisis
- short-dated favored over longer-dated credit
- asset-backed securities and direct equity holdings with very high capital charge
- high-yield bonds more attractive than shares

Infringement of solvency requirements

In case capital falls below SCR: supervisory **“ladder of intervention“**

- corrective action aimed at restoring the insurer`s finances
- progressively intensified action in case of detoriation

Capital falls below the MCR: **“ultimate supervisory action“**

- insurer`s liabilities will be transferred to another insurer
- license to be withdrawn or new business will be forbidden and existing business will be liquidated

Freedom of investment

- no particular category of assets
- no particular localization of assets

Investment of assets in accordance with the **prudent person principle**

- undertaking must identify, measure, monitor, manage, control and report investment risks
- undertaking must ensure the security, quality, liquidity and profitability of portfolio as a whole
- assets must be appropriate to duration and nature of liabilities

Pillar 2: Qualitative requirements

Requirements of an adequate and transparent governance system with clear allocation of responsibilities and effective reporting lines (**governance requirements**)

Aim: sound and prudent management

Main contents:

(1) **Fit and proper requirements** for managers

(2) Requirements of functions **(system of governance)**

(3) Requirements for **outsourcing**

(4) **Remuneration policy**

Fit and proper requirements for individuals

Scope: Persons who effectively run the company or have key functions

Requirements:

fit: adequate professional qualifications, knowledge and experience

proper: sound reputation and integrity

Notification and information about managers to the supervisory authorities

System of governance

System of governance must be **proportionate** to the nature, scale and complexity of the insurer

Has to include key functions:

(1) **Risk-management** function

(2) **Internal control**

(3) **Internal audit** function

(4) **Actuarial function**

Written policies are required for the first three functions

Risk management function

Installation of an effective and well integrated risk-management system in order to identify, measure, monitor, manage and report risks

Fundamental: **own risk and solvency assessment (ORSA)**

ORSA has a twofold nature as <u>internal assessment process</u> and <u>supervisory tool</u>

ORSA

Frequency: regularly (at least once a year) plus ad hoc (after significant change in risk profile)

Includes: **quantitative and qualitative risks**

- overall solvency needs, risk tolerance limits, business strategy, compliance, deviation from SCR

Integral part of business strategy

Proportionate to the business practiced

Reporting of results to supervisory authorities

Remuneration policy

Remuneration is not expressly ruled in S-II, but as part of advice by EIOPA for Level 2 implementing measures

Aim: remuneration policy must not reward short-term profits

Policy principles:

- should support the long-term interest of the undertaking
- for entire organizational structure with focus on management and risk-takers
- clear and transparent with regular internal review
- variable components linked to the long-term interest of the company and to be retained in case of detoriation

Disclosure to the supervisory authority, which can require reassessment

Pillar 3: Transparency requirements

Transparency comprises public and private reporting

Aim: assuring market discipline through transparency

Main contents:

(1) Private Report to Supervisors („RTS“)

(2) Public disclosure in the Solvency and Financial Condition Report (SFCR)

RTS

RTS: Private information for supervisory purposes

Frequency: predefined periods – not set yet; upon occurrence of predefined events; during enquiries

Principles for information:

- - reflecting nature, scale and complexity of the business
- - accessible, complete, comparable and consistent
- - relevant, reliable and comprehensible

SCFR

SCFR: Public information on an annual basis

Scope:

- description of business
- system of governance and its adequacy
- risk exposure
- methods used for valuation of assets and liabilities
- capital management, including SCR and MCR

Possibility of non-disclosure of information in case of undue advantage for other competitors or binding obligations of secrecy or confidentiality

Supervisory powers

Supervisory powers in general: preventive and corrective measures administrative or financial nature; power to require all information

Specific rights and powers:

RTS

Supervisory review process

Capital add-on

Supervision of outsourced activities

Transfer of portfolio

On-site investigations

Capital add-on

Capital add-on leads to an **adjusted SCR**

Exceptional circumstances necessary (last resort).

Main cases:
(1) Risk profile deviates significantly from assumptions underlying SCR and internal model is inappropriate or ineffective or internal model is being developed

(2) Risk profile deviates significantly from assumptions underlying SCR because risks are captured insufficiently

(3) System of governance deviates from imposed standards

Group supervision

Group supervision aims at ensuring effective cooperation between involved supervisory authorities

Main contents:

Rules for **group solvency;**

interaction of group and solo supervision;

integration of **third state supervisors**

Third state supervisors

Third state supervision is relevant for groups which have a head office or subsidiaries and participations outside the EU

If third state supervisory regime is **equivalent** to S-II, the member state supervisors shall rely on the third state supervision

If there is **no equivalence**, calculation of SCR based on S-II

EU-U.S. Dialogue Project led by the Steering Committee

- dialogue between EIOPA and the US Federal Insurance Office
- to contribute and increase mutual understanding and cooperation

References

Full text document of S-II:

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

Further reference:

https://eiopa.europa.eu/home/index.html

Information about EU-U.S. Dialogue Project:

https://eiopa.europa.eu/fileadmin/tx_dam/files/pressreleases/2012-12-21_EU-US_Steering_Committee.pdf

https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EU_US_Dilaogue_Project_Factual_Report.pdf

Thanks for your attention!