

Solvency II

**Insurance and Pensions Unit,
European Commission**

These slides accompany the explanation of the acquis to Albania and North Macedonia and can only be used for that purpose. Their content is subject to further development of the acquis and interpretation by the Court of Justice of the European Union

Regulation of insurance

Legislation developed in the EU since 1970's

In 1990's the "third generation" was completed, known as Solvency I – single license in the EU

Why was Solvency II needed?

- Solvency I was composed of 13 Directives on insurance and reinsurance supervision, insurance groups and winding up
- Was a minimum harmonisation regime

Aims of Solvency II

- ❖ Deepened integration of the EU insurance market
- ❖ Protection of policyholders and beneficiaries by introducing risk-sensitive economic capital requirements
- ❖ Improved supervisory convergence

Scope of Solvency II

- ❖ Covers EU insurers and reinsurers
- ❖ Small undertakings excluded from scope (exception: cross-border business and certain lines of business)
- ❖ Does not apply to pension funds covered by occupational pension funds directive
- ❖ Does not apply to credit institution and investment firms
- ❖ There is supplementary supervision for financial conglomerates (FICOD applies)

Overview

Group supervision

Pillar 1

**quantitative
requirements**

Pillar 2

**qualitative
requirements**

Pillar 3

**reporting &
disclosure**

Agenda

Group supervision

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Valuation of Assets and Liabilities

Market consistent valuation

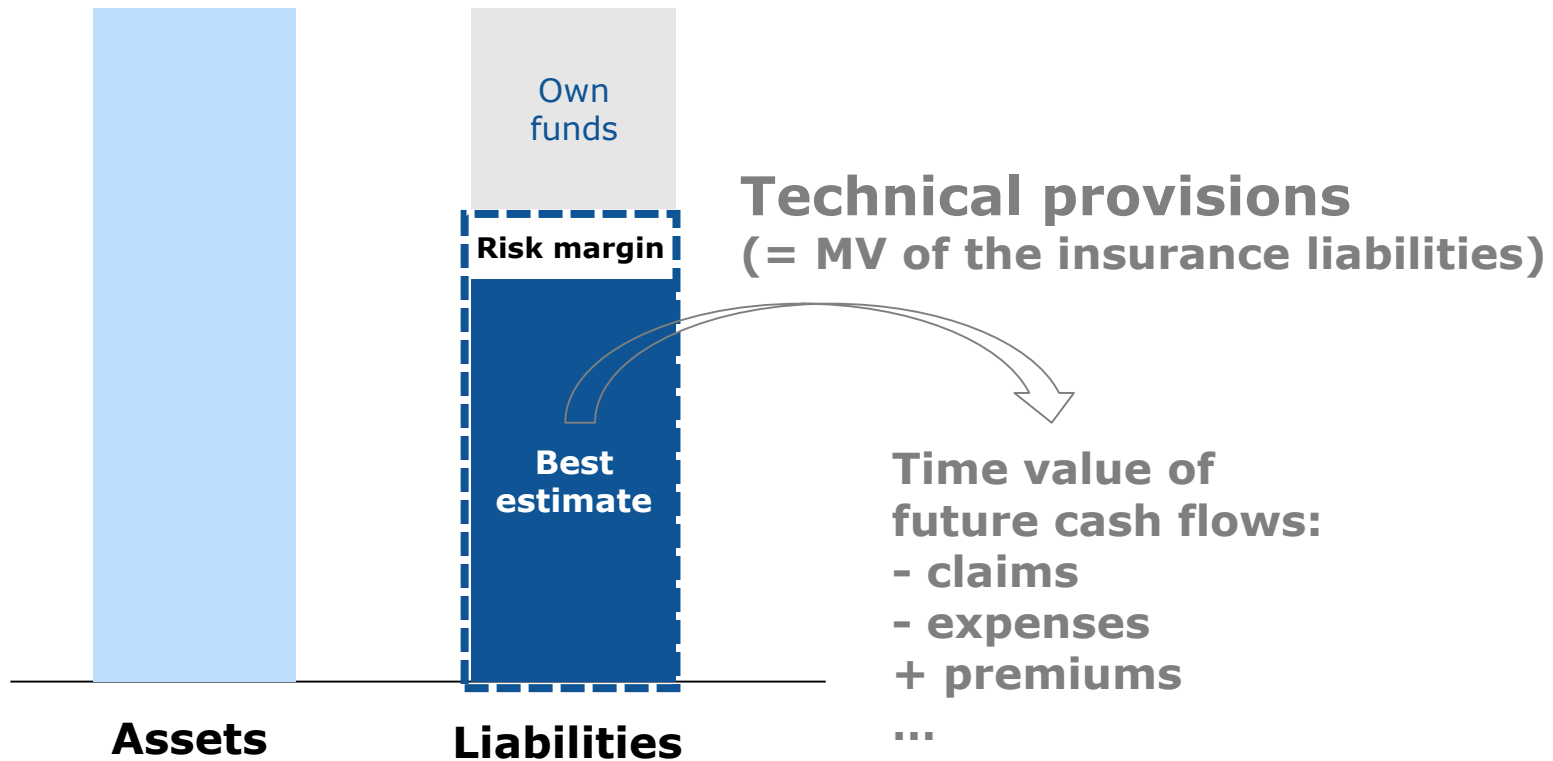
- ❖ **assets** shall be valued at the amount for which they could be **exchanged** ...
- ❖ **liabilities** shall be valued at the amount for which they could be **transferred, or settled** ...
- ❖ ...between knowledgeable willing parties in an arm's length transaction

Valuation of Assets and Liabilities

But there is usually no active market for insurance contracts...

- ❖ 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**.
- ❖ The **risk margin** ensures 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. It is **based on the cost of holding the regulatory capital required** to support the best estimate liability.

Market consistent valuation of liabilities (Art. 75)



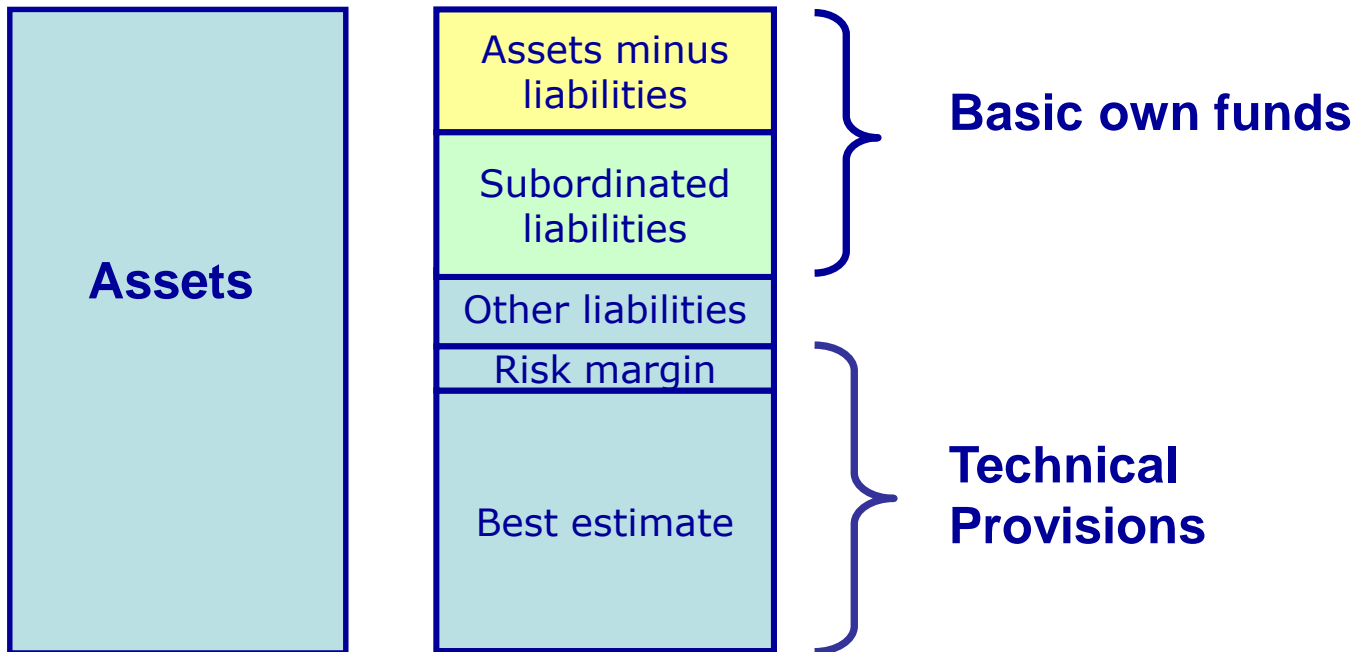
Own funds

- ❖ Available own funds is the sum of
 - ❖ *On balance sheet items: "excess of assets over liabilities" plus subordinated debt (**basic own funds**)*
 - ❖ *Off-balance sheet items: commitments which you have received from a third party and can call upon (**ancillary own funds**)*
- ❖ Own Fund items are classified into three tiers

Quality \ Nature	Basic own funds	Ancillary own funds
High	Tier 1	Tier 2
Medium	Tier 2	Tier 3
Low	Tier 3	—

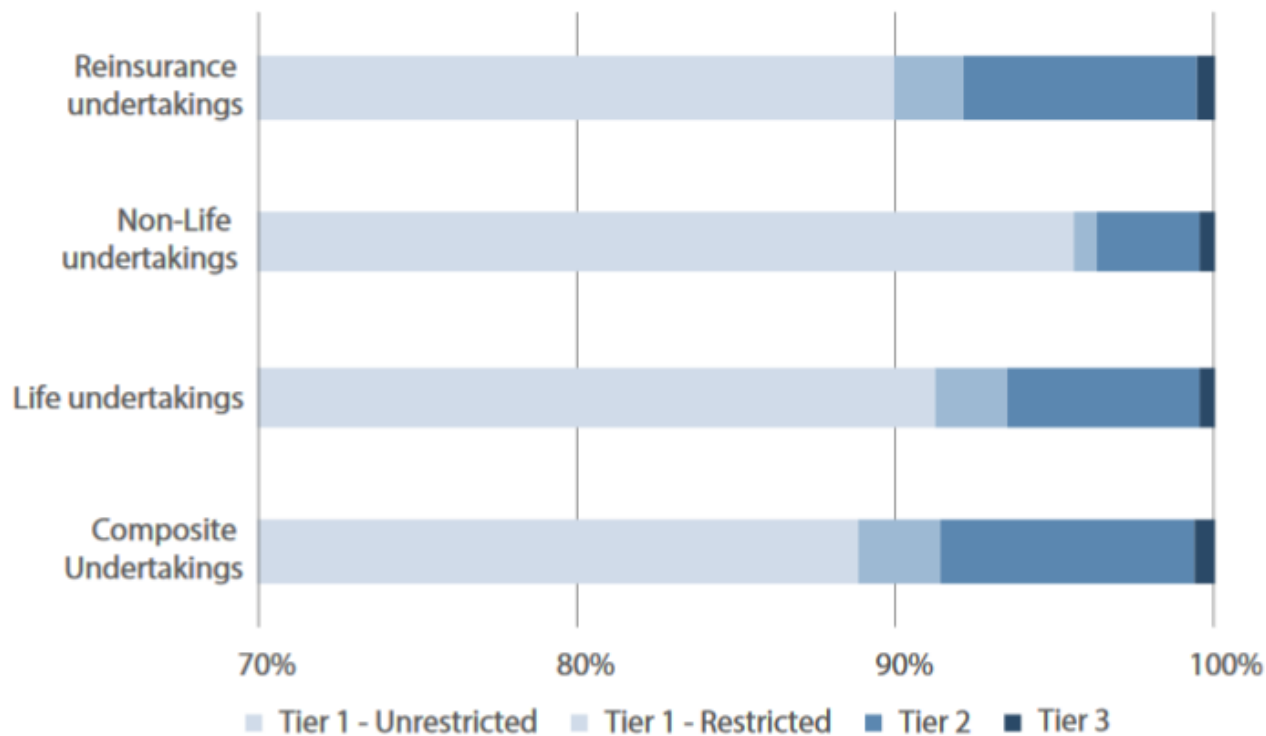
- ❖ The amount of **eligible** own funds is limited

Ancillary own funds



Available funds – Own funds quality

Figure 29: Tiering of own funds EEA by business type



Shows the breakdown of eligible own funds to meet the SCR into the tiers of own funds which it consists of.

Capital requirements

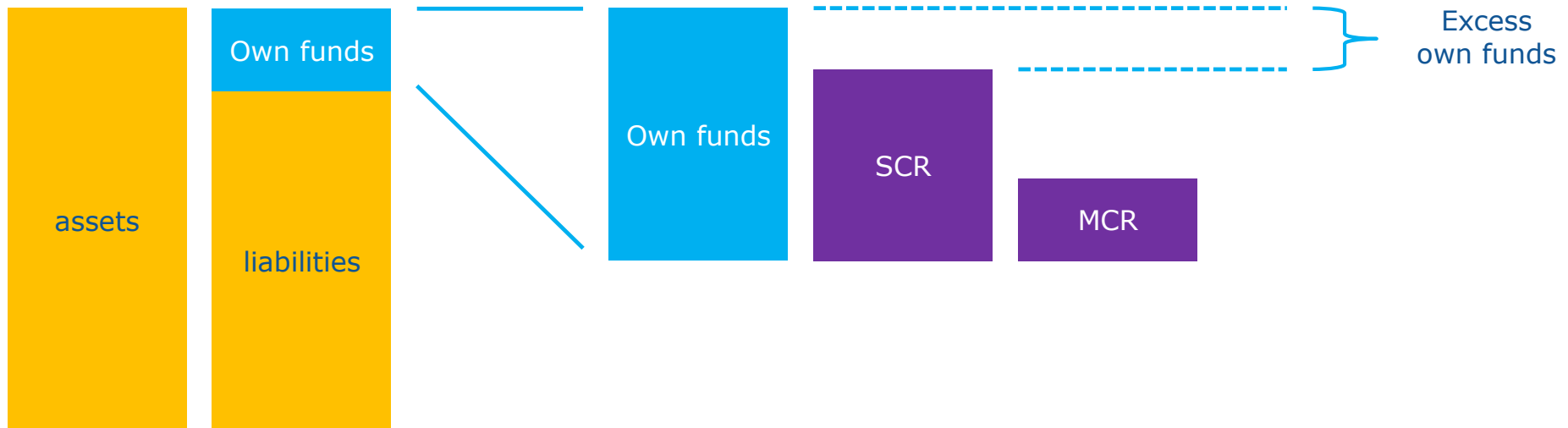
Two levels of supervisory intervention:

(1) Risk-based Solvency Capital Requirement (SCR)

- 'shall correspond to the Value at Risk of basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 99.5% over a one-year period.'*

(2) Factor-based Minimum Capital Requirement (MCR)

*'....subject to a confidence level of **85%** over a one-year period.'*



Ladder of supervisory intervention

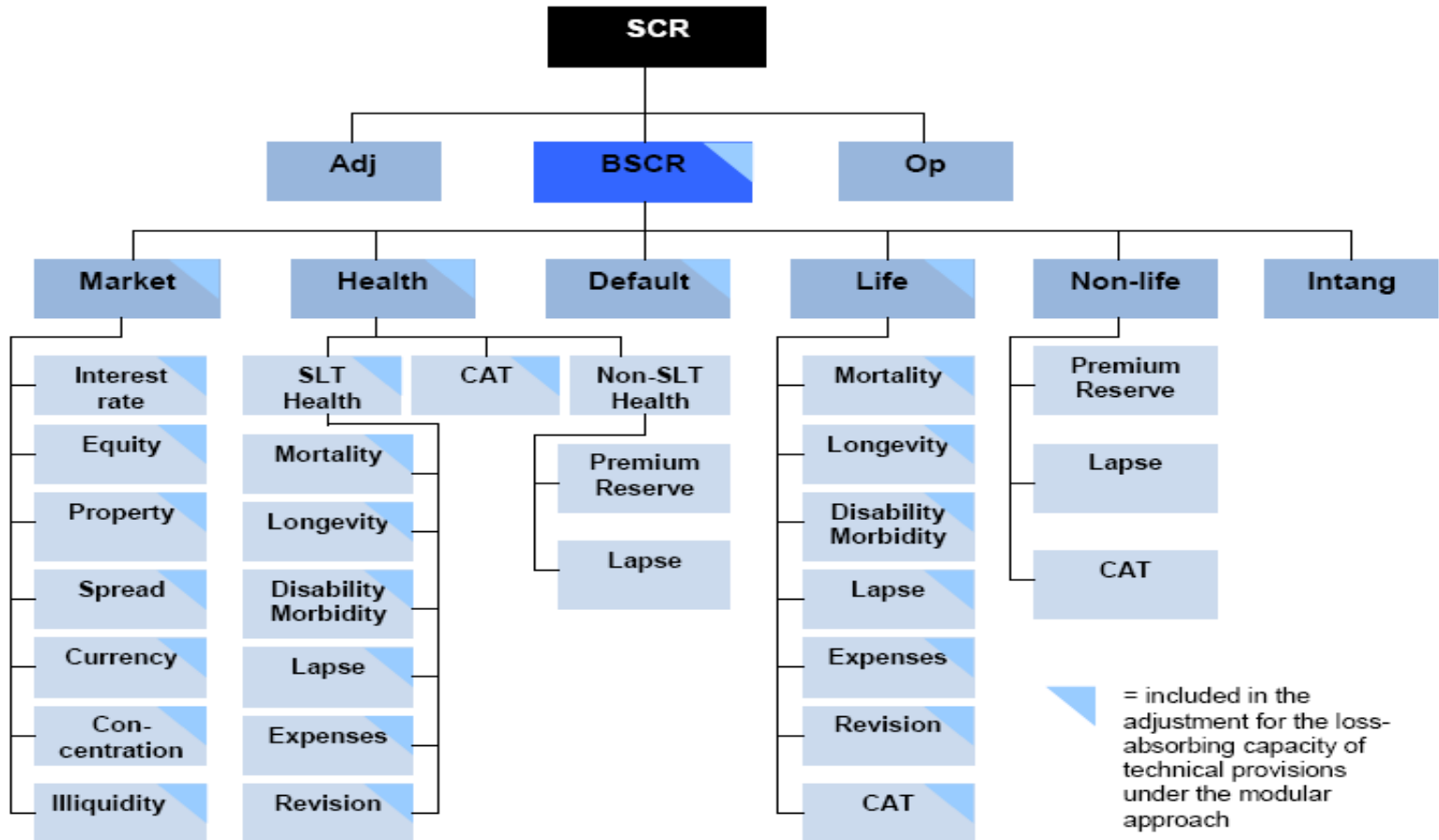
❖ Breach of Solvency Capital Requirement:

- ❖ *recovery plan*
- ❖ *Re-establish compliance within 6 + 3 months*
- ❖ *extension in exceptional market situation possible*

❖ Breach of Minimum Capital Requirement:

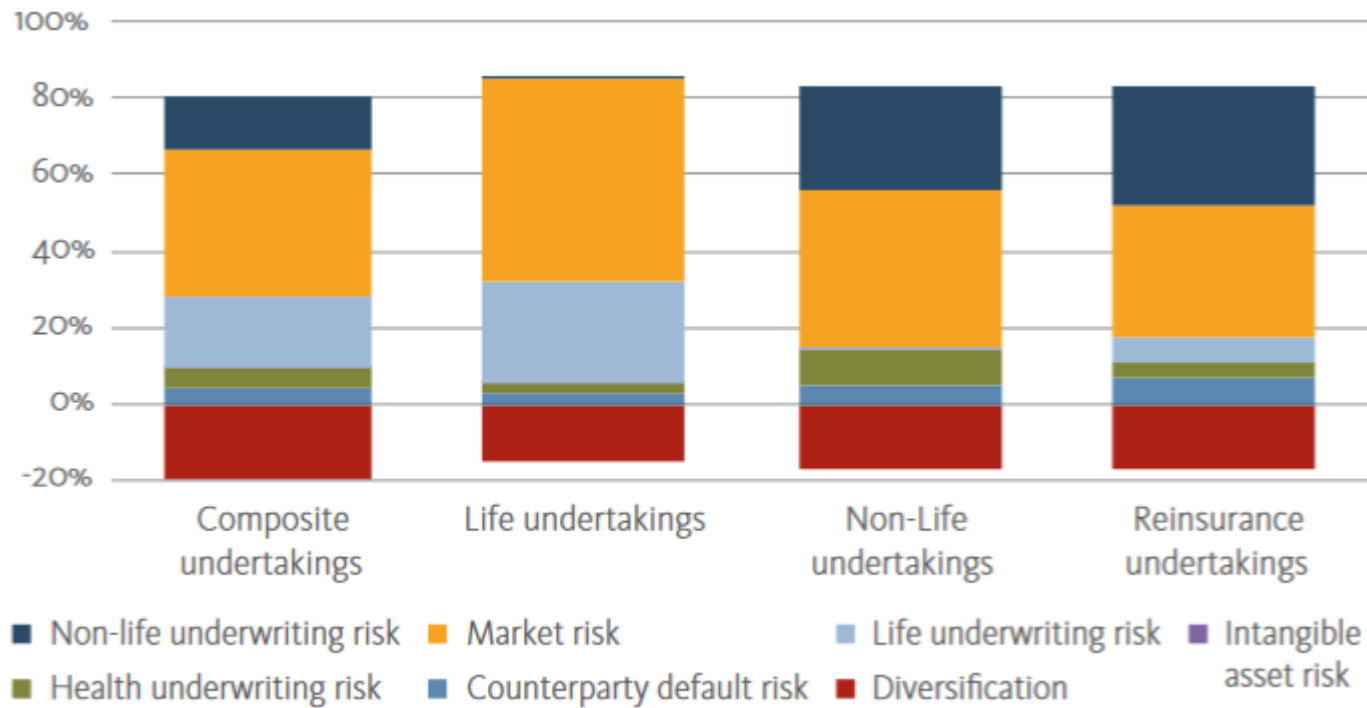
- ❖ *short-term finance scheme*
- ❖ *ultimate supervisory action (1 + 2 months)*

Risk modules of the Standard Formula

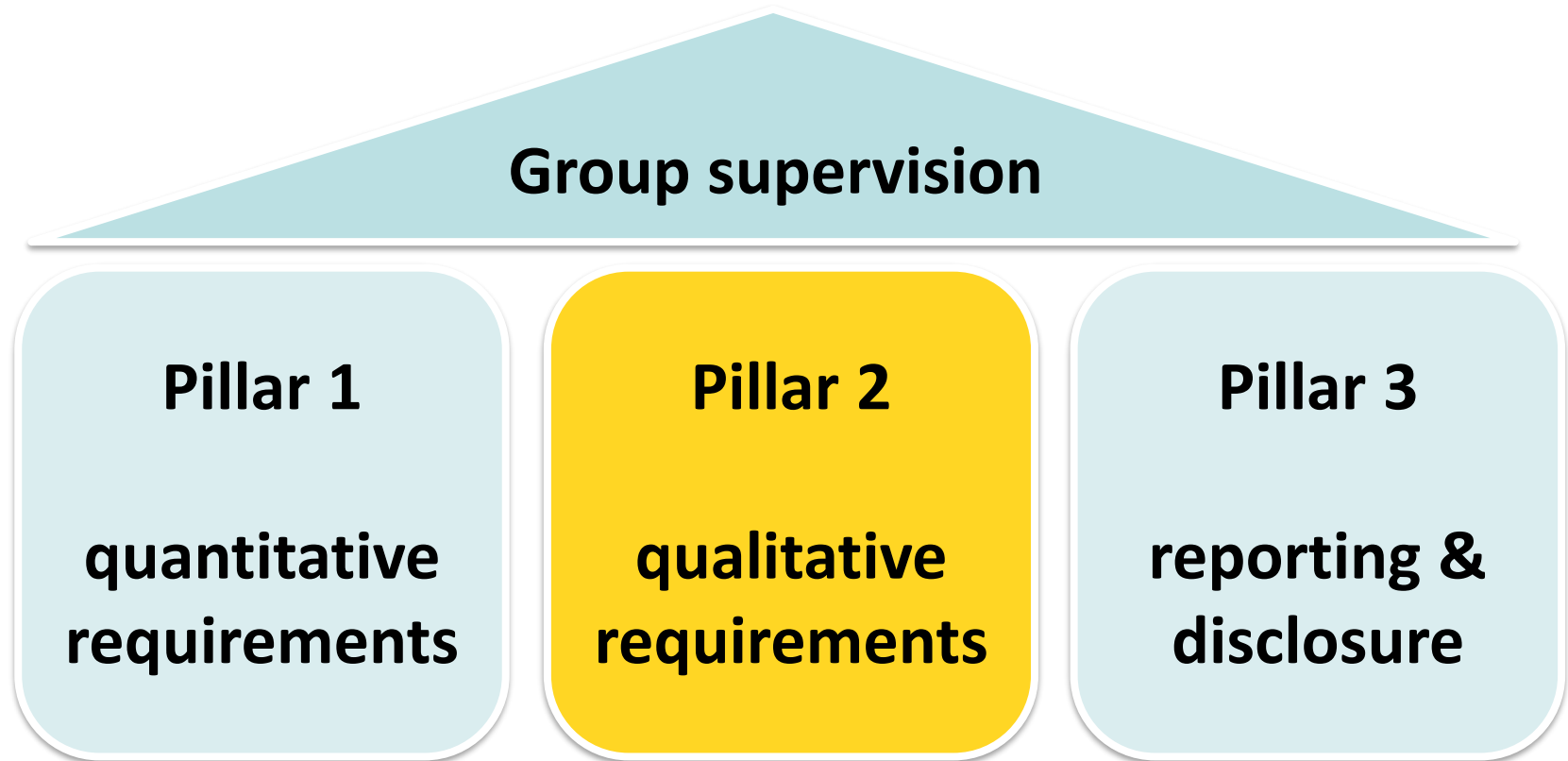


Capital requirements

Composition



Overview



Overview

- ❖ 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
- ❖ Strengthened supervisory review, harmonised supervisory standards and practices
- ❖ Principle of proportionality:
 - ❖ *No one-size fits all approach, reflects the nature, scale and complexity of the business*
 - ❖ *Applies both, to the implementation of the Directive by Member States as well as to the exercise of supervisory powers*
 - ❖ *Applies to all three pillars and groups*

Risk management system

- ❖ Integration into the organisational structure and decision-making processes
- ❖ Covers risks included in the SCR and those not covered
- ❖ Own Risk and Solvency Assessment (ORSA)
 - ❖ *Regular assessments of overall solvency needs*
 - ❖ *compliance with SCR, MCR and technical provisions*
 - ❖ *deviations of the risk-profile of the undertaking from the SCR*

Other key functions

❖ Internal audit function

- ❖ *Evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance*
- ❖ *Findings and recommendations are reported to the administrative or management board*

❖ Compliance function

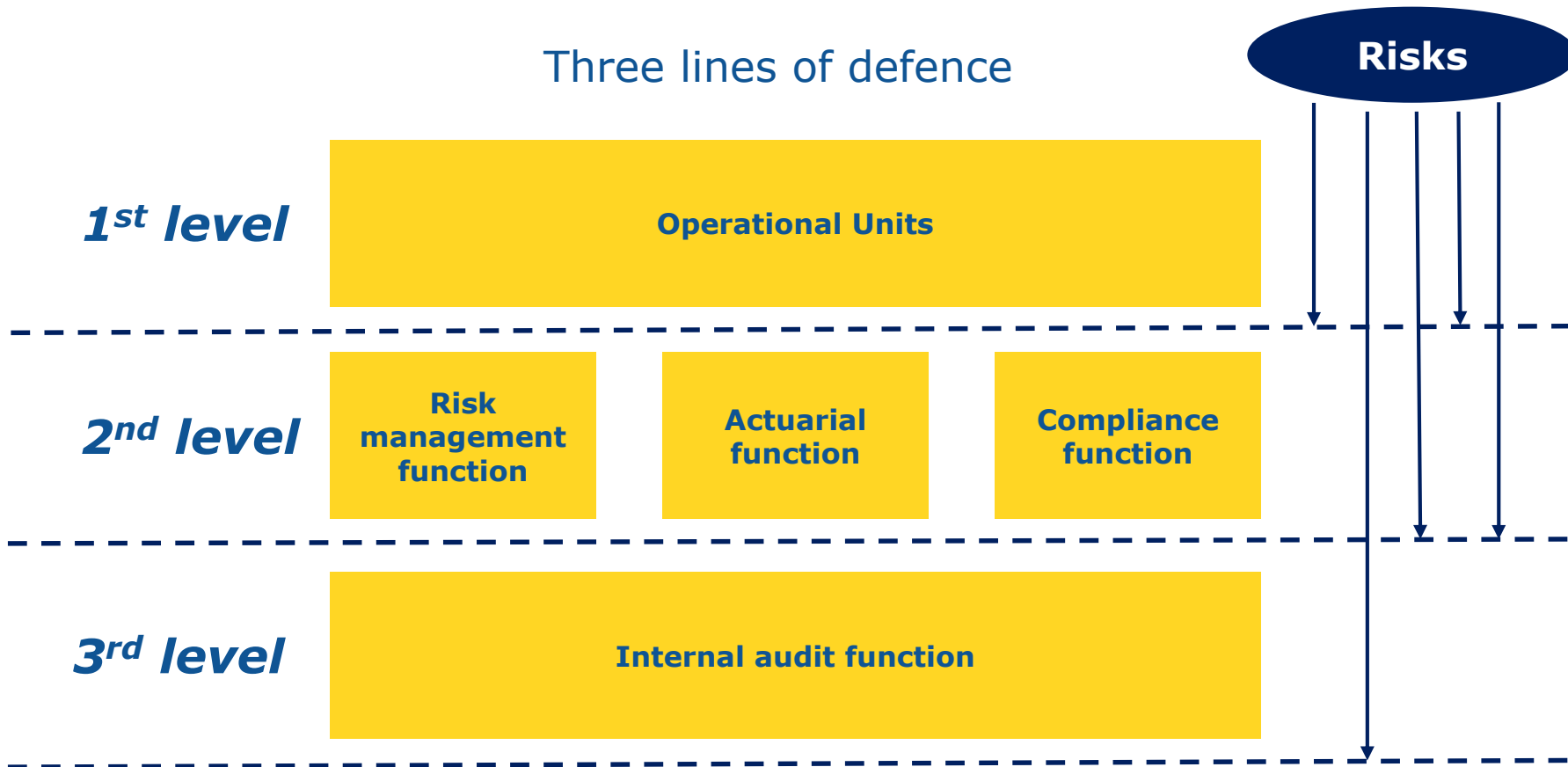
- ❖ *advises the compliance with the laws, regulations and administrative provisions*
- ❖ *assessment of the possible impact of changes in the legal environment*

❖ Actuarial function

- ❖ *Coordinates the calculation of technical provisions*
- ❖ *Ensures appropriateness of methods and assumptions*
- ❖ *Assesses data quality*

Key Functions: implementation

Three lines of defence



Capital add-ons (Art. 37)

- ❖ Exceptional circumstances following Supervisory Review Process
- ❖ Used where:
 - ❖ Risk profile of the insurer **deviates significantly** from the **assumptions underlying the SCR** (calculated using either the standard formula or an internal model)
 - ❖ Deficiencies in the undertaking's **system of governance**
- ❖ Annual review

Investments(Art. 132-135)

❖ "Prudent person" principle:

- ❖ *Freedom to invest: no investment limits, no prior supervisory approval*
- ❖ *Use of derivatives for risk reduction or efficient portfolio management only*
- ❖ *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*

Agenda

Group supervision

Pillar 1

**quantitative
requirements**

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Pillar III – reporting and disclosure

- ❖ Supervisory reporting – regular submission of information to supervision
- ❖ Public disclosure – annual report on the Solvency and Financial Condition of the insurer (SFCR)
- ❖ Supervisory authorities to conduct their tasks in a transparent and accountable manner

Agenda

Group supervision

Pillar 1

**quantitative
requirements**

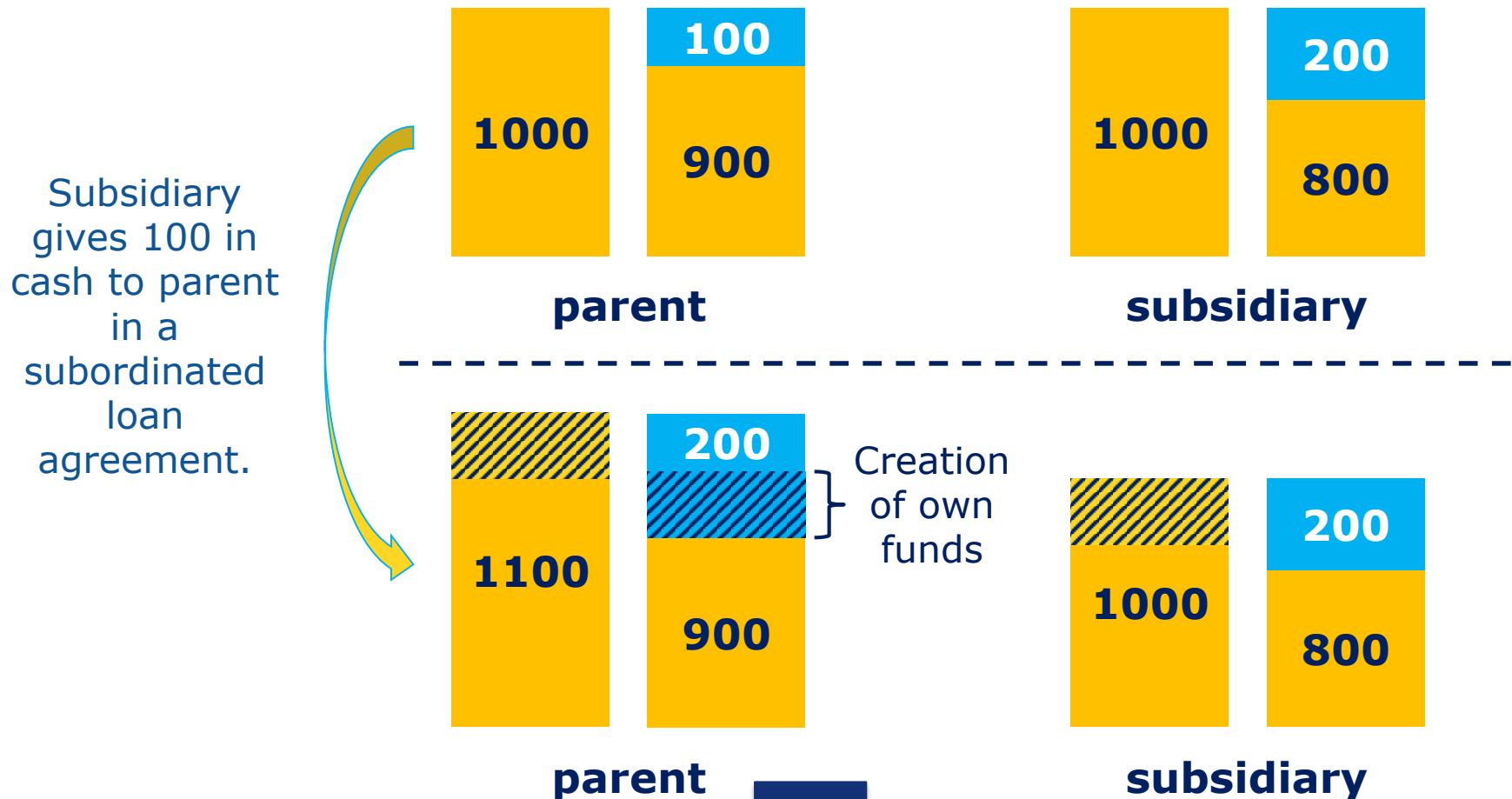
Pillar 2

**qualitative
requirements**

Pillar 3

**reporting &
disclosure**

Why do we need group supervision?



Group supervision

- ❖ Enough eligible own funds to cover the **group SCR** at the level of the group is requested
- ❖ One responsible **group supervisor** (home supervisor)
- ❖ A **college of supervisors** have to be organised including the home supervisor (Member State of the parent undertaking), the host supervisors (Member States with related undertakings in their territories) and EIOPA
- ❖ Supervision on risk concentration, intragroup transactions and system of governance at the level of the group

Developments

Recent issues

Long-term investments

- ❖ *Infrastructure*
- ❖ *Securitisation*
- ❖ *Private equity and long-term equity*
- ❖ *Unrated debt*

Sustainability

- ❖ *Take sustainability into account in decision-making*
- ❖ *Sustainability-related disclosure requirements*

Outlook: Review in 2020

- ❖ Long-term guarantee measures
 - ❖ *Volatility adjustment*
 - ❖ *Matching adjustment*
 - ❖ *Transitional measures*
- ❖ Further work on long-term investments
- ❖ Reporting requirements
- ❖ Group supervision

Backup

Hierarchy of Rules

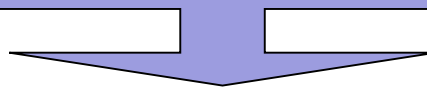
Directive



Implementing / Delegated Acts



Guidelines to ensure convergent implementation

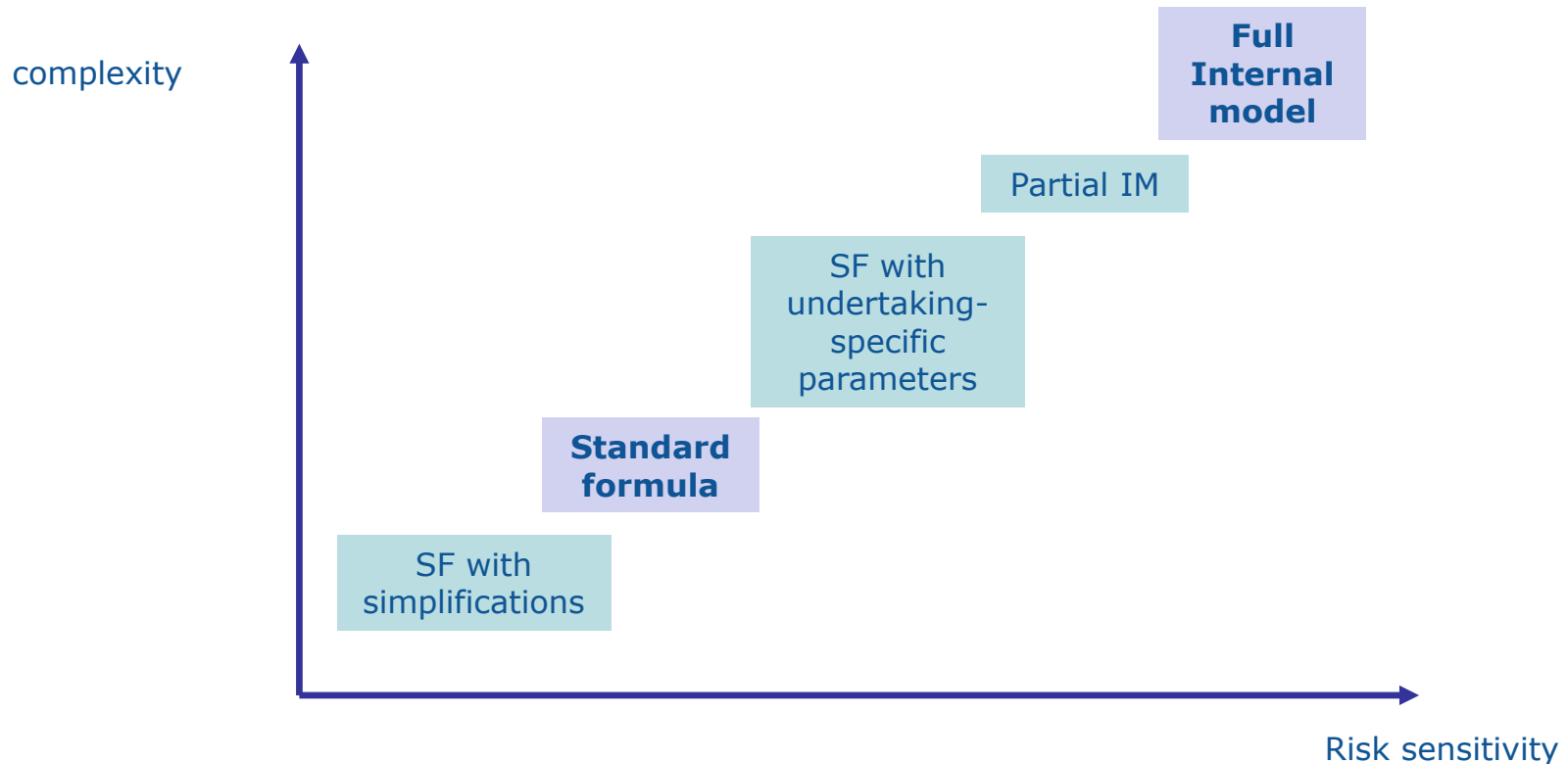


Monitoring of implementation

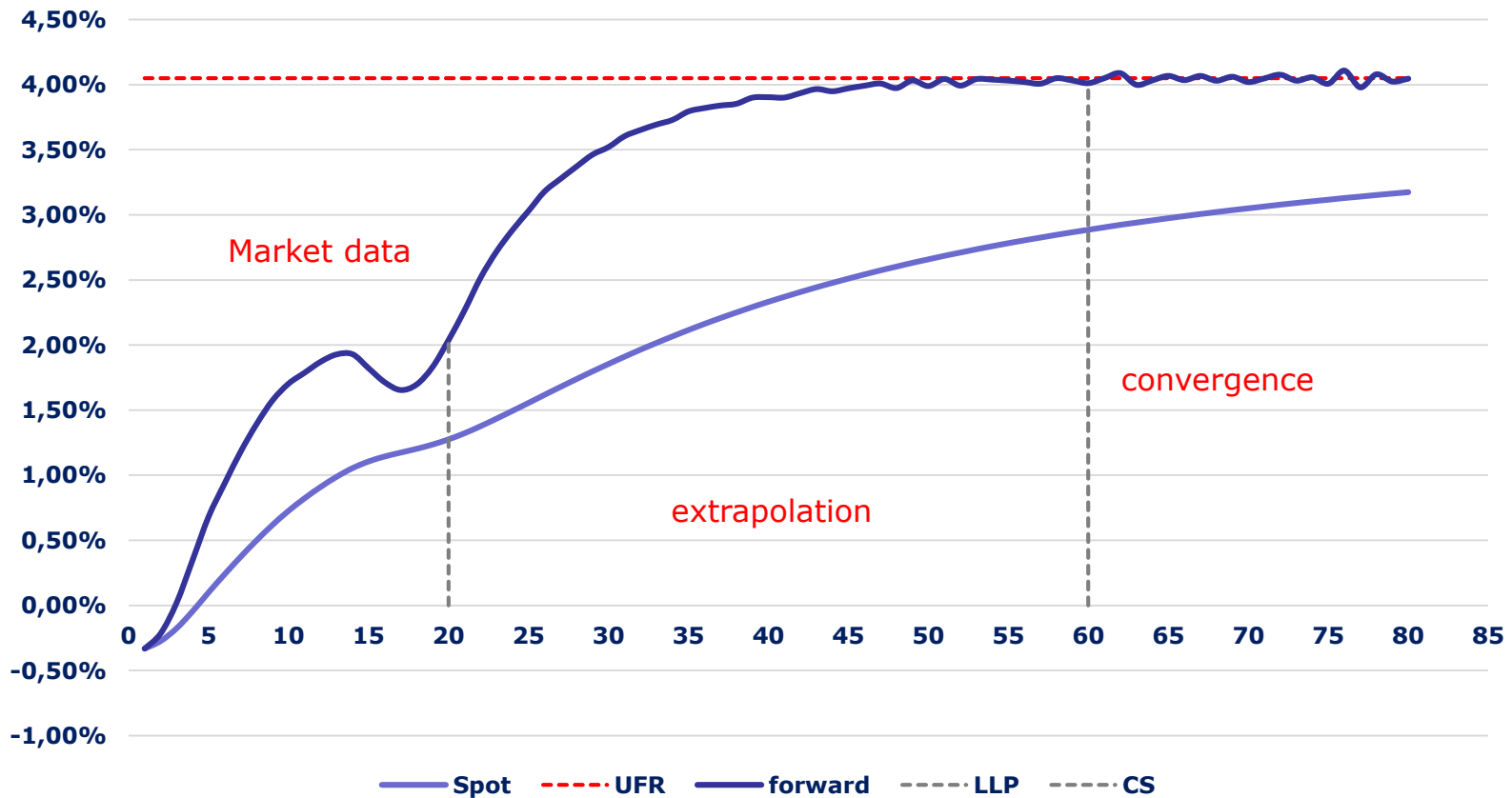


Capital requirements

Approaches for calculation



Extrapolation



Volatility and matching adjustment

Market values
driven by
interest rates
and credit
spreads

assets

Liabi-
lities

Discounting
with risk-
free rates

*Is it reasonable to allow insurers to use part of the
credit spread for the discounting of liabilities?*

Volatility adjustment and matching adjustment

	Volatility adjustment	Matching adjustment
scope	All liabilities	Only certain business (e.g. bulk annuities)
calculation	Centrally by EIOPA	Undertaking-specific
ALM requirements	Liquidity planning	Matching of asset and liability cash flows
Prior approval	MS option	Always required

Volatility adjustment and matching adjustment

