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Solvency II

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Summary

Sometimes referred to as Basel for insurers, the Solvency II directive imposes capital reserve requirements on insurance companies.

The directive is a consolidation of 13 separate directives affecting the insurance industry, updated in the light of the financial crisis. Significant parts of it are uncontroversial. Other parts, however, have been fiercely resisted and argued against by the industry.

Much of the directive's content is highly technical and it covers a wide range of topics and activity.

The start date for the directive was delayed on multiple occasions to make time for the political and technical arguments to be agreed and for an agreed text to be produced.

It came into force on 1 January 2016 in the UK.

1. Introduction

Solvency II is difficult.

- The directive is a consolidation of 13 separate directives affecting the insurance industry, updated in the light of the financial crisis. Significant parts of it are uncontroversial. Other parts, however, have been fiercely resisted and argued against by the industry. The insurers believed that new rules introduced after the financial crisis will punish them, even though they were neither the cause of the crash, nor significant contributors to it. The only insurer that was rescued was AIG and this was due to its investment trading activities not its mainstream insurance business. The industry believes that the directive over values the liabilities of the companies and as a consequence is asking the industry to provide more capital cover than it needs. The consequence, it says, is that the industry will be less profitable and the returns it can earn on its investments, which lead directly to the value of the pensions it pays out, will be unnecessarily reduced.
- Much of the directive's content is highly technical and it covers a wide range of topics and activity.
- The start date for the directive was delayed on multiple occasions to make time for the political and technical arguments to be agreed and for an agreed text to be produced. This has meant that there are multiple versions and iterations of the directive.
- If one can grasp just one issue then it might be this: "Often called "Basel for insurers", Solvency II is somewhat similar to the banking regulations of Basel II".[1]

1.1 Resources

There are several website resources which together contain a comprehensive amount of material:

- European Union Europa - Solvency II
- European Commission – Solvency II: FAQs
- Financial Services Authority-International and EU – Solvency II
- The directive (directive 2009/138/EC) can be found here.

[1] Treasury Peer: *Solvency II for Dummies*

2. Summary and Implementation

2.1 Summary

Because the directive covers such a broad area of insurance regulation, it is a very long and technical document which is often difficult for a non-industry specialist to grasp in its entirety.

The directive incorporates no less than 13 existing directives, so much of it is simply a restatement of existing provisions.[2] It is the solvency capital and the valuation of illiquid assets that have provoked nearly all of the comment and criticism at industry level. The remaining 'pillars' concern, supervision, supervisory reporting and public disclosure have been largely uncontentious.

Shown below are extracts from several guides to the completed directive drawn from the European Commission and professional or trade bodies.

European Commission

> **Aim of Solvency II**
>
> The aim of a solvency regime is to ensure the financial soundness of insurance undertakings, and in particular to ensure that they can survive difficult periods. This is to protect policyholders (consumers, businesses) and the stability of the financial system as a whole.
>
> Solvency rules stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed. Equally importantly, the rules also lay down the principles that should guide insurers' overall risk management so that they can better anticipate any adverse events and better handle such situations.
>
> **What is new about Solvency II (as compared with existing legislation)?**
>
> 'Solvency II' will introduce economic risk-based solvency requirements across all EU Member States for the first time. These new solvency requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better coverage of the real risks run by any particular insurer. The new requirements move away from a crude "one-model-fits-all" way of estimating capital requirements to more entity-specific requirements.
>
> Solvency requirements will also be more comprehensive than in the past. Whereas at the moment the EU solvency requirements concentrate mainly on the liabilities side (i.e. insurance risks), Solvency II takes account of the asset-side risks. The new regime will be a 'total balance sheet' type regime where all the risks and their interactions are considered.
>
> In particular, insurers will now be required to hold capital against market risk (i.e. fall in the value of insurers' investments), credit risk (e.g. when third parties cannot repay their debts) and operational risk (e.g. risk of systems breaking down or malpractice). These are all risks which are currently not covered by the EU regime. However, experience has shown that all these risk types can pose a material threat to insurers' solvency.[3]

Professional industry commentators

> **Structure of the Directive**

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[2] Europa Euro Lex web site at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008PC0119R(01):EN:HTML

[3] EU Commission: Solvency II FAQs

The three pillars of Solvency II The proposed Solvency II framework has three main areas:

- Pillar 1 covers the capability of an insurer to demonstrate it has adequate financial resources in place to meet all its liabilities and consists of the quantitative requirements like the amount of capital an insurer should hold.
- Pillar 2 sets out requirements for the governance and risk management framework that identify and measure the risk against which capital must be held as well as for the effective supervision of insurers.
- Pillar 3 focuses on disclosure, reporting and transparency requirements around these risks and capital requirements.

Pillar 1 is all about the calculations, models and capital requirements. The Solvency Capital Requirement (SCR) is a risk responsive capital measure calibrated to ensure each insurer will be able to meet its obligations over the next 12 months with a probability of 99.5%. If this level of capital is not reached it will likely result in regulatory intervention and require remedial action. The Minimum Capital Requirement (MCR) is the minimum amount of capital the insurer needs to cover its risks. If an insurer´s risk capital falls below the MCR they will be prohibited from writing any further business. The SCR can be calculated by using a Standard model or an Internal. An Internal model can be implemented fully or partially if it satisfies the tests and requirements of the supervisors, which is only recommended for the largest firms.

Pillar 2 is maybe the most comprehensive of all three pillars taking the Own Risk & Solvency Assessment (ORSA) in consideration. The ORSA can be defined as "the entirety of the processes and procedures employed to identify, assess, monitor, manage, and report the short and long term risks a reinsurance undertaking faces or may face and to determine the own funds necessary to ensure that overall solvency needs are met at all times". It is thus the process by which the company demonstrates how the SCR will continue to be met whilst executing its business plan. It is the key linkage between the company´s risk capital modeling capability and the way the business operates and should be an integral part of the business strategy, taken into account strategic decisions and should be used to help identify and manage risk. Another key aim of the ORSA is to promote a forward looking perspective, typically 3-5 years. The ORSA should not be too burdensome and therefore not overly complex, and be proportionate to the nature. The ORSA shall also scale and the complexity of the risks inherent in the business should take into account risks that may appear in the future with a reasonable degree of probability. Methods can range from simple stress tests to more or less sophisticated economic capital models. A small insurer might produce a report of a couple of pages whilst it may be several hundred pages for an international group supported by appendices. There is no framework or guideline for the output because the regulators want the board of the company to own the ORSA process. The ORSA is important because within the Supervisory Review Process the ORSA contributes to a qualitative view of the management's ability to assess, measure and manage its own business and the inherent risks within the organisation. This assessment requires insurance undertakings to properly determine their overall solvency needs for short and long term risk and shall be part of the risk management system. A statement shall explain how the undertaking was determined in relation to its solvency requirements needs and risk profile. It requires a description of how the ORSA process and outcome is appropriately evidenced and internally documented as well as independently reviewed.

Pillar 3 is about supervisory purposes, disclosure and transparency requirements like Solvency & Financial Condition Report (SFCR) and Quantitative Report Template (QRT) – the output area.[4]

4 Treasury Peer: *Solvency II for Dummies*

A detailed description of some of the technicalities of applying the 'Pillars' can be found in a speech by the then Financial Services Authority Chief, John Tiner, in April 2006.[5]

Industry trade organisation: Association of British Insurers.

> Solvency II is intended as a single rule-book that creates a level playing field for insurers operating across the European single market. For this to be realised, national supervisors need to interpret and apply the rules consistently. EIOPA, the pan-European supervisory authority, has a critical role to play in ensuring this.
>
> The UK industry will also be a part of this conversation. Many UK firms operate across multiple European jurisdictions and therefore interact with different European regulators, so consistency in approach and interpretation would enhance efficiency. More importantly, convergence and consistency are essential to fully realise the intention of a level playing field, to ensure the competitiveness of the insurance industry in the UK as well as across Europe. In a range of areas, including the calibration of shocks for a variety of risk types, the treatment of sovereign exposure and the application of key concepts such as the volatility adjustment, it is clear there will not be a level playing field from day one. But, the New Year will provide an opportunity to review and address this.
>
> The successful implementation of Solvency II has been a top priority this year for many ABI members and, with more UK firms having received internal model approval than in any other EU Member State, it is an achievement to reflect on as we near the end point – even if this milestone is unlikely to feature prominently in many New Year's celebrations. When we wake up on January 1, 2016, it will be the start point of another journey for the industry. Firstly, embedding and adapting to Solvency II. Secondly, engaging with regulators and governments to ensure a convergent and consistent approach, which provides a high level of policyholder protection without impacting on the competitiveness of the UK industry.[6]

2.2 Implementation

The directive was formally adopted by the Council of Ministers in November 2009 but its implementation was pushed back on a number of occasions, most recently because of the failure of the Council, Commission and Parliament to agree key parts of the proposal.

There are two guides to the implementation of the directive. How the FCA will implement its supervisory and regulatory duties under the directive can be found in a policy statement PS15/8 Solvency II published in March 2015 which is on the FCA website, together with links to other Papers and resources here.

With respect to the capital requirements and the calculation of 'solvency', the relevant pages of the Prudential Regulatory Authority on the Bank of England website are the most relevant.

Throughout 2016 a large number of notices and papers were issued by the PRA concerning the practical reporting and other administration of the regime.

In February 2017 the Director of Insurance Supervision at the PRA gave a speech about the implementation of Solvency II one year on. The speech can be found on the Bank of England Website here.

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5 FSA website 6 April 2006
6 ABI blog piece 18 December 2015

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