Solvency II Primer
Regulatory Update
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axxsys

Periodically we publish an update on regulatory developments we feel are of interest to our clients. The purpose is partly to keep people up to date and to help them adjust their regulatory efforts according to current events.

Background

Solvency II is a European Union (EU) directive that aims to harmonise regulation of insurance and reinsurance companies inside the 28 Member States and 3 European Economic Area (EEA) countries (Iceland, Liechtenstein and Norway). Given that Switzerland is the home of several major insurers operating within the EU it is interesting that they have not been directly involved in the Solvency II project. The European Commission has, however, published third-country equivalence decisions and Switzerland has been found to have an equivalent system, see [CD]. Bermuda has also passed the equivalence test for group capital purposes which is convenient as one would speculate that many of the major insurers has company structures with significant capital related business domiciled in Bermuda (or similar tax havens).

Most importantly Solvency II aims to improve consumer protection by specifying how much capital EU insurers must hold in reserve in order to reduce the risk of insolvency. It does, however, also introduce other regulatory requirements such as authorisation, corporate governance, supervisory reporting, public disclosure and risk assessment and management, beyond the solvency and reserving aspects.

Discussions about systemic risk in the financial system often tend to focus on the banking sector but the insurance sector in general and AIG in particular played a very central role in the financial crash in 2008 highlighting the need for better supervision of the sector, see [AIG] for a good discussion. Time will tell how effective Solvency II will be in enforcing stability.

Solvency I was first introduced in 1973 but significant developments in risk management practices to control investment risk and calculate required capital since then has been the main driver for the development of Solvency II. The framework Directive was adopted on April 22nd 2009 and a recast was published in the Official Journal on December 17th 2009, see [SOL_II]. Certain aspects, such as the time schedule for the implementation (which has slipped several times), were subsequently amended by the so called Omnibus II Directive which was adopted on April 16th 2014 and published in the Official Journal on May 22nd 2014, see [OMDII].

The deadline for transposition of Solvency II into national law was March 31st 2015 and it is scheduled to come into effect on January 1st 2016. See Figure 1, below, for a graphical representation of Solvency II key dates.

The regulation will apply to all insurance firms operating within the relevant countries with gross premium income exceeding €5 million or gross technical provisions in excess of €25 million. Firms with a business below these limits are addressed to as 'Non-Directive' firms and are excluded from the regulation.

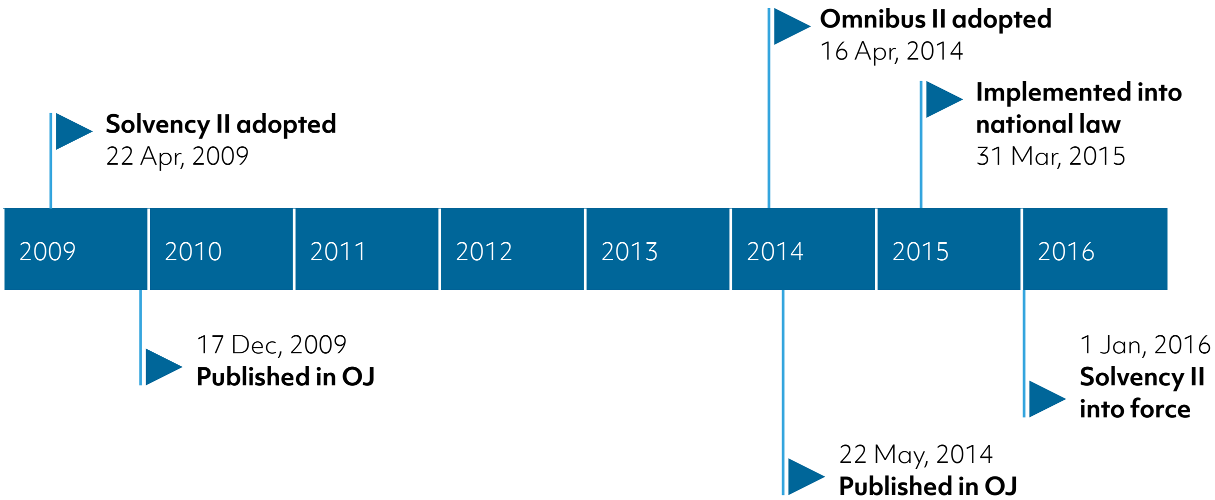

Figure 1.
After several delays it now seems fairly certain that Solvency II will come into force on January 1st 2016. This timeline contains key dates in the development of the regulation.

Given its role as the European regulator of the insurance sector the European Insurance and Occupational Pensions Authority (EIOPA) has been driving the Solvency II initiative in a manner similar to how ESMA has driven EMIR and MiFID II. A lot of Solvency II information can be found on its website, see [EIOPA].

In the UK, the Solvency II Directive has been transposed by the Financial Conduct Authorities (FCA) and the Prudential Regulation Authority (PRA), and in this paper we will focus on this implementation. The PRA is naturally responsible for regulation of risk capital given its mandate to secure the stability of the financial system, so the larger part of the Solvency II transposition in the UK has fallen on the PRA, see [BPS] for the final rules published on the March 20th 2015. FCA also had to make changes to its conduct rules to align with the directive, primarily regarding information to consumers, and the final rules were published on March 27th 2015 in a Policy Statements publication, see [PS]. It should be expect that there will be minor differences between the national implementation of the Directive across the different national regulators but those details are beyond this paper.

After the deadline for implementation, the European Commission is responsible for ensuring that member states are complying with the legislation. If they are not doing so, the Commission will take enforcement action.

The Solvency II framework has 3 main areas, commonly referred to as pillars:

Solvency II Framework Directive		
Pillar I Qualitative Requirements	**Pillar II Supervisory Review**	**Pillar III Reporting**
– Assets and Liabilities – market consistent valuation – Investments – Solvency capital requirements (SCR) – European Standard Formula, or Internal Model – Minimum capital requirement (MCR)	– System of governance – Own risk and solvency assessment (ORSA) – Supervisory review process – Supervisory Intervention including capital add-ons	– Public Disclosure annual solvency & financial condition report (SFCR) – Information to be provided for supervisory purposes (RTS)

Pillar 1: Valuation and Capital Requirements

The first pillar introduces harmonised standards for all quantitative aspects such as how to calculate the amount of capital an insurer should hold. In the calculation of capital requirements all quantifiable risks for both assets and liabilities are taken into account, including insurance risks (non-life underwriting, life underwriting, health underwriting), market, credit, operational and counterparty risks. Needless to say, it is a fairly complex quantitative exercise to address all these risks.

The key concept in Solvency II is Solvency Capital Requirement (SCR) which is the capital required to ensure that insurers can meet their obligations to policy holders and beneficiaries over the following 12 months with a 99.5% probability. SCR is calculated using either the standard formula, see [SF] for details, or with proper regulatory approval an internal model. The details for how to submit an application for approval of an internal model can be found on [IM]. The SCR calculation must include existing business as well as new business expected over the course of 12 months, and is required to be recalculated at least once per year. If the SCR level is breached coupon and dividend payments to investors will be suspended to shore up capital.

External investment mandates present an infrastructure challenge as the lowest capital requirements are obtained if a "look-through" approach is used to properly account for the risks associated with all assets. Historically many investment managers have only provided limited information about the positions held by a fund to clients and often with a time lag. Investment in reporting systems might now be necessary if an investment manager wants to bid for the lucrative business from insurance clients – it certainly can be become an important competition parameter.

Another central concept in Solvency II is Minimum Capital Requirement (MCR) which represents the threshold capital level below which the national supervisor will intervene with the risk that the authorisation to sell new insurance and reinsurance business could be withdrawn and in severe cases the company could be forced into wind up. The MCR level is intended to correspond to an 85% probability of adequacy over a one year period and is bounded between 25% and 45% of the SCR.

Pillar 2: Risk, Governance and Supervision Requirements

As Solvency II is risk based there is particular emphasis on having an effective risk management system in place which:

– clearly defines the risk profile and how it is measured, monitored and controlled,

– has a strategy for risk management covering appetite and tolerances,

– includes strategic processes to adjust the risk profile according to the declared risk appetite,

– outlines reporting procedures

It is a requirement that an Own Risk and Solvency Assessment (ORSA) report is being produced which is a self-assessment of the solvency situation with a detailed explanation of the company's view on all relevant risks (including how the risk management system has been setup and why it is considered appropriate). There is no framework or guideline for the ORSA report because the regulators want the board of the company to own the ORSA process.

The report is supposed to incorporate forward-looking consideration of various macroeconomic and market-stress scenarios. An effective ORSA can be a vital tool helping an insurer's understanding of its overall solvency requirements and focus its strategic decision making to optimise asset allocations.

The Solvency II Directive also states that all insurers should have an effective System of Governance (SOG) in place which is proportionate to the nature, scale and complexity of the business and provides sound and prudent management. The system of governance requirements covers: risk management, internal controls, internal audit, the actuarial function, and, if applicable, outsourcing.

It is further a requirement that the supervisor (regulator) conducts reviews of strategies, processes and reporting procedures and assess if the company is in compliance with requirements. If necessary the regulator can intervene if breaches are found.

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Pillar 3: Reporting and Disclosure Requirements

Parts must be made public and parts should be submitted to regulators only. The aim of this area of the regulation is to harmonise reporting between undertakings and territories. It is a requirement that firms must produce two key reports:

- **The Solvency and Financial Condition Report** (SFCR). Firms are required to disclose this report publicly and to the local National Competent Authority (NCA) on an annual basis. The wording should account for the fact that the audience might not have the technical back ground to understand technical details. It must include descriptions of:
  - The business and the performance of the company
  - The system of governance and an assessment of its adequacy for the risk profile
  - Exposure, concentration, mitigation and sensitivity for each risk category
  - The basis for valuation methodologies used
- **The Regulatory Supervisory Report** (RSR) – This is a private report to the supervisor and is not disclosed publicly. As this report is for a technical audience only the contents and details can be more elaborate than the SFCR report. It must, however, include all aspects of the SFCR report and further:
  - The structure of own funds and their place in the capital structure of the company
  - The SCR and MCR amounts
  - How SCR has been calculated
  - If applicable, the difference between the underlying assumptions of any internal models use compared to those of the standard formula
  - The amount of any non-compliance with MCR or SCR including explanations of its origin, co sequence, and remedial measures taken.
  - Any other relevant disclosures

To support the structure of the two reports several Quantitative Reporting Templates have been developed by EIOPA, see [QRT] for details. Each template has a reporting frequency associated to it and instructions if it should be included in the SFCR and the RSR report.

'These templates are common across territories but the local NCA has the discretion to require additional structured information via National Specific Templates (NST).'

In the UK the final NST's were published by the PRA alongside the final rules, see [NST] for details. Information must be submitted using the Bank of England Electronic Data Submission (BEEDS) portal, see [BEEDS] for details, which enables firms to complete and submit all Solvency II regulatory data online. Only files in the XBRL format will be accepted.

Final Thoughts

Solvency II will have a significant impact on the business model of insurance companies and you can argue that they now are allowed to pursue a more modern risk based approach to investment. You can also argue that they currently lack experience in this type of investment and that it is far from trivial to progress from buy and hold strategies to more dynamic strategies. It is obviously up to the individual insurer to what extend they wish to utilise the new opportunities but the more adventurous firms could potentially face some tricky situations where severe adverse market shocks suddenly lead to breaches of capital requirement levels.

Insurers will also have to get used to a higher degree of scrutiny following all the new requirements to publish information. It takes a significant higher discipline and quality of internal business processes when information has to be made public at specific times, as opposed to just being made available internally - nobody wants his dirty laundry displayed before the world!

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We help investment management businesses understand and meet the regulatory challenges they face. Axxsys' operational expertise and long track record of working with the buy-side community are supported by our strong regulatory network and long-standing relationships with trade repositories, system vendors, clearing houses and ARMs. As a result, our technical specialists are uniquely placed to see regulation from the point of view of the client business, providing tailor-made solutions that manage regulatory risk and create value within the operating model.

For more information about Solvency II and the strategic and operational impact it may have on your investment management business, please contact info@axxsysconsulting.com or +44 (0)20 7526 4900.

References

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