The Solvency II project and the work of CEIOPS

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Outline

• Reasons for a change in the insurance EU regulatory framework

• The Solvency II project
  – Drivers
  – Process
  – Main aspects of CEIOPS advice (including QIS3)
  – Pending Key issues

• Supervisory challenges and role of CEIOPS
The Solvency II project
Reasons for a change
Characteristics of the current regime

- **Prudential tools based on technical provisions, investment rules and, as an addition, capital requirements: limited risk sensitiveness and implicit limits**
- **Only general reference to sound internal control: focus on financial aspects rather than governance**
- **Three directives, but minimum harmonization: room for national discretion**
- **National GAAPs often a support to prudential supervision: inconsistency with IFRS**
- **Group supervision based on “solo plus” approach**
The Solvency II Project: Drivers

Balancing objectives

- Enhancing consumer protection / supporting fair competition
- Building the internal market for insurance products
- Principle based / level playing field in practice
- Harmonization / recognition of diversities
- Risk sensitiveness / practical applicability
- Reliance on internal management / legal enforceability
The Solvency II Project: Drivers

Consistency with economic reality and risk sensitiveness

Incentive for internal risk management

Comparability with banking rules

Streamlined group supervision

Worldwide consistency (IAIS)

Compatibility with IASB
The Solvency II Project Process
Current and future CEI OPS contribution

01/07 03/07 04/07 06/07

QIS3

Amended Framework for Consultation

Further advice

Directive negotiation and preparation of Level 2 measures

Further QIS 4, QIS 5, (QIS 6?)

Further Advice depending on the outcome of the QIS3 results and on Implementing Measures
The Solvency II project
Process: QIS3

• Aims of this exercise:
  – High participation rate by the industry
  – Practicability and suitability of calculation
  – Impact on balance sheets
  – Suitability of the tentative calibrations
  – Impact at group level

• General approach
  – Minimum of options and double calculations
  – Reduced complexity (simplifications) and better explanation of underlying rationale
  – Focus on materiality
  – “Best efforts basis”
The Solvency II project
Process: QIS3

• Timeframe of QIS and further Pillar I advice:

  - 1 April – 30 June QIS executed
  - July – Sept CEI OPS processes answers
  - end October CEI OPS approves report and takes steps for providing further advice
The Solvency II project
The three pillars

Pillar I
Financial requirements
- Valuation of assets and liabilities
- Solvency Capital requirements
- Internal model
- Capital

Pillar II
Qualitative requirements and review
- Supervisory review process
- Internal governance and other qualitative requirements

Pillar III
Market discipline and transparency
- Public disclosure
- Supervisory reporting

Protection of policyholder
Competitive EU market
The Solvency II Project: Main aspects of CEIOPS advice

PI LLAR I

Technical provisions:

- Optimal use of market information
- Market valuation for headgeable risk components
- Calculation of best estimate (critical component) plus risk margin (CoC approach) for non-hedgeable risks
- Use of realistic assumptions for best estimate (e.g. no surrender value; inclusion of all future expenses and costs, including inflation)
The Solvency II Project: Main aspects of CEI OPS advice

PILLAR I

Capital requirement (SCR):

The “non-zero failure” assumption

“The SCR should deliver a level of capital that enables an insurance undertaking to absorb significant unforeseen losses over a specified time horizon and gives reasonable assurance to policyholders that payments will be made as they fall due”

99.5% confidence level over 1 year
The Solvency II Project: Main aspects of CEIOPS advice

PILLAR I

*Capital requirement (SCR):*
- Standard formula in a modular approach
- A scenario or factor based calculation is prescribed for each risk module
- Capital charges for each module are added taking into account correlation
- Recognition of risk mitigating effects of profit-sharing business
- Accession to the use of internal model (after validation)
- Possible use of partial model under certain conditions
- Recognition of diversification effects
The SCR Standard formula
The modular approach

SCR

Basic SCR
Operational risk

Non-Life
Market
Health
Default
Life

Premium reserve
Catastrophe

Currency
Property
Interest rate
Equity
Spread

Expense
Claims
Epidemic

Mortality
Lapse
Expenses
Disability
Revision

Correlation
Factor based
Scenario based
Adjustment for Risk-mitigating effect of future profit-sharing

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PI LLAR I

Minimum capital requirement (MCR):

- Requirement based on simple and robust calculation of loadings on market risk, life/non life/health underwriting risk
- Reflection in a simple and robust manner of risk mitigation effects of profit-sharing business
- Inclusion of an absolute minimum floor
- Immediate application of the new calculation, but transitional flexibility in MCR coverage
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PILLAR I

*Safety measures:*

- Set of principles for eligibility of assets and list of eligible assets
- Aim to address risks not covered by the SCR standard formula (consideration of possible future enhancement of the formula and, on a case by case bases, of the application of internal model)
- Quantitative limits to address specific risks in a broader context of overall prudence (to be set by implementing measures)
The Solvency II Project: Main aspects of CEIOPS advice

PI LLAR I

Eligible element of capital:

- Classification of capital elements under three tiers according to the extent they comply with set criteria (subordination, loss absorbency, permanence, perpetuality and absence of mandatory service costs)
- Basic Own funds (excess of assets over liabilities and subordinated debts) can comprise tiers 1, 2 and 3
- Ancillary own funds (subject to supervisory approval) can comprise tiers 2 and 3.
- In CEIOPS’ view, further work is needed in relation to, for example, the composition of the tiers and the system of limits to be applied; considering also the cross-sector dimension with banking supervision to achieve an appropriate harmonised framework.
The Solvency II Project: Main aspects of CEIOPS advice

PILLAR II
Supervisory review process: “dialogue” with the management (ORSA)

The review may highlight that there are:

1. Risks not captured by the standard f. (or not captured enough)
   - Partial or full internal model
   - Capital add-on

2. Deficiencies in governance, risk management or internal control
   - Restoring measures
   - Capital add on
The Solvency II Project: Main aspects of CEIOPS advice

PILLAR III

Disclosure of capital requirements

- Overall capital requirement, without specification of any capital add-on
- Public disclosure of any breach to MCR or SCR, if necessary, before the year end (a transitional period may be needed)
- Adequate consumer information
The Solvency II project
Dynamics of capital requirements and interaction between pillars

- **Pillar I**
  - Insurance, market, credit and operational risk

- **Pillar II**
  - Additional risks or deficiencies

- **Pillar III**
  - Disclosure of Solvency requirements and breaches

Diagram:
- **MCR**
- **SCR**
- **Adjusted SCR**
- **Available Capital**

- **Safety net**
- **Standard model**
- **Internal Model**
- **Supervisory intervention**

- Decrease / [increase] if internal model reflects risks more appropriately
- Increase if risks not appropriately reflected or governance deficient
- Including capital add-on following SRP

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Pending issues in QIS3

- Calculation of equity and property risk charge
- Treatment of free assets
- Reflection of loss absorption components
- Operational risk for unit-linked business
- Relation between SCR and MCR
- Treatment of composite insurers
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Pending political issues

• Group supervision
  - Advice of CEIOPS, based on the current framework for consultation. In this context, CEIOPS advised to limit sub-group supervision and to recognize diversification effects.
  - “Innovative” proposal presented at Level 2
  - EU Commission is striving to reconcile MS positions

• Small companies
  - Exemptions under certain thresholds
  - Uniform applicability of standard rules, combined with principle of proportionality
  - Simplification of SCR calculation
  - Abandon “size factor” in QIS3

• Occupational Pensions
Potential hurdles to the success of SII

- Complexity of the new supervisory framework
- Supervisory discretion inherent to a principle based approach
- Inconsistent national implementations
- Divergent approach and tools in national supervision
- Lack of expertise at national level
- Fragmented supervisory process
- High cost for compliance

The legislative framework should set the basis for avoiding or limiting these issues.
But this needs to be complemented by appropriate actions at level 3.

These issues will be covered by CEIOPS’ role as a Level 3 Committee.
The way forward

- Solvency II is not only a set of rules addressed to firms, but a comprehensive system for carrying out day to day supervision.
- Its success will also depend on how CEIOPS will cover its role as a Level 3 Committee, supporting national supervisors.
- At the moment CEIOPS is contributing to creation of the regulatory framework (level 1 and, soon, level 2).
- But actual implementation of Solvency II should rely on advanced and convergent supervisory arrangements and tools at EU level (level 3).
- CEIOPS intends to develop its activity accordingly, in cooperation with all stakeholders.