

Gearing up for Solvency II

Directive 2009/138/EC – more commonly known as the Solvency II framework – was passed by the European Parliament in November 2009. The legislation, which covers insurance companies, is now in the Level 2 stage, whereby European authorities and the pan-European regulator, EIOPA, are scrutinising prospective implementation procedures across the 30 European nations involved. The framework is due to come into national and European law by November 2012, although many aspects are yet to be finalised. Nonetheless, the general direction of travel is clear; this note takes stock of the current state of play.

Background

Solvency II is the follow-up to reforms in the insurance market that were introduced in the 1970s, known as Solvency I. The old framework was more decentralised, allowing individual countries to set their own prudential standards and regulation on how much minimum capital insurance firms were to hold against unforeseen events. But in 2001 European policymakers started to look at establishing a new, more holistic risk-based framework. This would be built around the ‘total balance sheet’ concept, with individual risks and their interactions being considered when valuing insurers’ assets and liabilities. Alongside wanting to increase policyholder protection, the main aims of the reforms were to create a harmonised and consistent regulatory framework across Europe that better allocated capital to risk and limited the systemic risk from any individual insurer.

The three pillars

The new regime will apply to insurance and reinsurance firms that operate in Europe and have either gross premium incomes exceeding €5 million, or gross technical provisions above €25 million. Lloyd’s of London syndicate firms will also be expected to conform to the framework. The Solvency II framework has three pillars:

Pillar 1 - Quantitative requirements

The adoption of a ‘total balance sheet’ approach will mean that insurers’ assets and liabilities are valued in accordance with market-consistent principles. Asset values will easily be derived from the prices at which they are exchanged on the global financial market on a mark-to-market/fair value basis, but liabilities will be valued using a different approach.

At the foundation, liabilities will be valued on a best-estimate basis, and boosted upwards by an appropriate risk margin that reflects the inherent uncertainty of future cashflows. This margin will be determined by a ‘cost-of-capital’ approach. These two items will form what is known as the Technical Provisions.

Above the Technical Provisions are the Minimum (MCR) and Solvency (SCR) Capital Requirements. The MCR will act as an initial safety buffer and be calculated on a quarterly basis. Any fall below this level would trigger instant intervention from the regulatory authorities and, ultimately, business closure. The SCR, meanwhile, will be more sensitive towards risk and, is expected to be continuously reviewed and recalculated when its underlying assumptions materially change. It is anticipated that the SCR will include all measurable risk that a firm is likely to face and any risk mitigation techniques applied by the insurer. The SCR will correspond to the Value-at-Risk of the

firms' net assets based on 99.5% confidence of remaining solvent within the next 12 months. Any fall below the SCR would result in companies having to reduce their risk profile and/or restore their own funds in order to meet the SCR within six months. The aim here is to ensure that individual institutions remain well capitalised.

One key feature of the SCR is that insurance firms will have some flexibility in how they calculate it. Firms may adopt a 'standardised' model created by the regulator, which is likely to result in large SCRs as it may overestimate the risk associated with individual investments. However, firms may instead use their own internally-developed risk models to calculate their SCR, provided that the models pass certain robustness checks. This approach is likely to result in lower SCRs, as it would enable firms to closely match their risks and capital requirements.

Pillar 2 - Qualitative requirements and supervision

The second pillar of Solvency II will strengthen the corporate governance systems that are already in place within insurance firms. Risk management protocols will be reinforced, with the aim of increasing accountability among staff. Policies will be defined more generally in terms of assessing current and future expected risk exposures.

As part of this, the onus will now fall on the insurer to conduct an ORSA (Own Risk and Solvency Assessment) and report to the regulator how its findings fit into the business strategy. This will examine the firm's overall solvency requirements, taking into account their specific risk model and approved risk tolerance limits, ongoing compliance with the capital requirements of Pillar 1 and, the extent to which their risk profile deviates from the assumptions that underlie their SCR.

Pillar 3 - Disclosure

The third pillar seeks to promote greater transparency and has consequently, caused a great deal of debate. Firms will be required to publish a Solvency and Financial Condition Report (SFCR) and a Regular Supervisory Report (RSR). The SFCR is expected to be published on an annual basis to the public at large, while the RSR will only be published to regulators, and released on a basis that suits both parties.

The SFCR will outline the firm's principal business activity and forward-looking strategy, alongside their governance mechanisms. Risk profiles and management will be clearly laid out, with explanations of how and why they differ from their published financial statements. This is likely to be welcomed by stakeholders, given the write-downs and solvency concerns that the industry has recently faced.

The RSR will be between the regulator and regulatee on a strictly private and confidential basis. It will qualify the financial statements within the SFCR, detail and explain any changes from the previous report, and will be compiled at least once a year. Tighter reporting will be enforced through quarterly and annual Quantitative Reporting Templates and these will provide more clarification on various items including the Technical Provisions, capital requirements and, analysis of their valuation methodology. Regulators will regard the RSR as 'core' information because it is hoped it will be of a better quality and so be an important supervision tool.

Solvency II is a sea change from the patchwork of legislations that existed in yesteryear's European insurance market. The approach taken by the European Commission will be more 'principles-based', with firms being examined on the extent to which they meet a set of regulatory principles rather than detailed rules. Additional capital on top of the minimum requirements will reflect the economic risks underwritten by the company, while greater standardisation of controls and reporting should level the European playing field. The complexity of the legislation means that implementation could be delayed – there is talk of an extension from 2012 to January 2013 – but insurers are already planning changes to their business. Private equity firms would be well advised to supply them with the risk and governance data that they need.

If you have any questions or comments, please contact Devash Tailor: dtailor@bvca.co.uk