bipar ACADEMY

SOLVENCY II: WHAT IS GOOD FOR THE GOOSE IS GOOD FOR THE GANDER

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INTRODUCTORY COMMENTS

Solvency II constitutes the biggest change in insurance regulation since the last 30 years.
It took about fifteen years to develop the new solvency regime, which applies from 1 January 2016 to about 5000 (re) insurance undertakings in the European Economic Areas (EAA).

The new regime is obviously also relevant for insurance intermediaries. Indeed, one of the objectives of Solvency II is the establishment of a more mature relationship between insurers and the insurance market. Insurance intermediaries play a key role in that market. Although that role may be changing as a result of increased market conduct regulation, there can be no question that the role of insurance intermediaries as providers of advice in an area that is complex for most buyers of insurance will remain very important.

As a result of Solvency II, the insurance market will become more transparent. Although the public disclosure requirements will only start to apply from 2017 onwards, market pressure will lead (re) insurers to already release important information during the course of 2016. As the information is new and readers of the information are not familiar with the new concepts, the market might overreact and clients might become nervous.
It is important that insurance intermediaries have some knowledge about these new concepts. They cannot be expected to play the role of an auditor or of a financial analyst. However, if they want to continue providing high quality professional advice in the future, they need to know to what extent the information released by insurers is relevant for their clients and what that information means.
In this contribution, we will look more specifically at the public disclosure requirements under Solvency II and how these disclosures should be understood.

Under the past Solvency I regime, it was perfectly possible for insurers to publish a very comfortable solvency margin because the solvency margin did not reflect the true risk position of the undertaking. Under Solvency II, the basic message is that an insurer should not engage in activities for which he does not have the necessary amount of capital. A direct linkage is established between risk and capital. An insurer that does not have the right amount of capital will either have to look for more capital or to de-risk his balance sheet.

> "The new regime is obviously also relevant for insurance intermediaries.[...] Insurance intermediaries play a key role in that market."

RISK BASED SOLVENCY CAPITAL

Following the example from banking regulation, Solvency II introduces a three pillar approach, whereby pillar 1 contains the quantitative requirements (capital, valuation in the solvency balance sheet, own funds), pillar 2 deals with the qualitative requirements (governance, including risk management, and the supervisory review process) and pillar 3 introduces the transparency requirements (supervisory reporting and public disclosure). As a result, it is no longer sufficient to just look at the capital position of an insurer: it is equally important to look at governance and risk management. Information about governance and risk management as well as about the capital position is included in the information package which insurers will have to disclose to the public.

Capital requirements and own funds

Solvency II establishes two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR).

The SCR is risk-based and prospective and includes all important risks that can be quantified (underwriting risk, market risk, credit risk, operational risk).

The SCR serves to calculate the solvency ratio (Own funds/SCR%). The solvency ratio must be at least 100%. A solvency ratio of 100% does not mean that an insurer cannot fail. Solvency II is not a zero-failure regime. It ensures that an insurer with a solvency ratio of 100% can withstand the worst annual loss over the next 200 years.

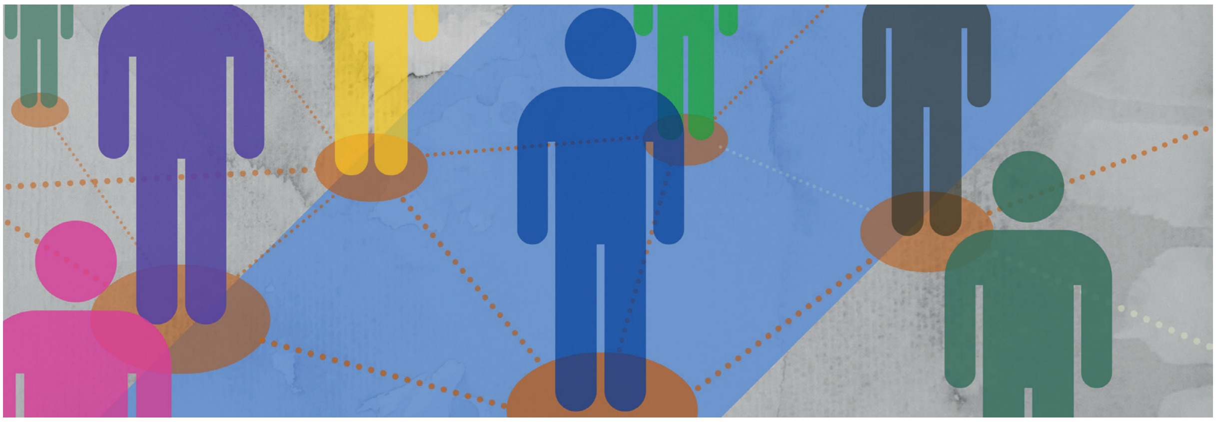
Some comments:

- The SCR and thus the solvency ratio will be volatile as they are based upon a calculation of assets and liabilities in the balance sheet at market value and markets are more volatile today than ever before;
- In practice, insurers will aim at a solvency ratio that is higher than 100%, for instance, because they want to have more capital (free funds) so as to obtain a higher rating in the market, to protect themselves against the volatility of the SCR and a possible breach of the SCR as a result of this volatility, to make new acquisitions or to protect themselves against a hostile bid;
- In most cases, the SCR will be calculated on the basis of the standard formula introduced by Solvency II. In some cases, the SCR will be calculated on the basis of an internal model developed by the insurer and approved by the supervisor;
- The solvency ratio under Solvency II is not comparable with the solvency margin under Solvency I as the solvency margin under Solvency I is only partially risk based. It will therefore not be uncommon that the solvency ratio under Solvency II will be lower than the solvency margin under Solvency I.

The MCR represents the minimum level of security. It is calculated in a simpler manner and will usually be situated between 25% and 45% of the SCR.

Insurers need to hold own funds to cover the SCR and the MCR. The own funds represent the excess of assets over liabilities and include subordinated liabilities. They are classified into three tiers whereby Tier 1 represents the highest quality of capital. Own funds should absorb losses and be of sufficient quality.
Although supervisors will monitor already in 2016 the respect of the MCR and the SCR, for the public at large, these amounts will only become (generally) publicly available during the course of 2017 as part of the Solvency and Financial Condition Report (SFCR), which each insurer will have to make public. However, particularly large insurance undertakings will report about their SCR already in 2016, mainly because of market or peer pressure.

Insurance groups are also required to calculate a group SCR and a group MCR because insurance groups may have risks that are different from the risks to which individual group members are exposed. This means that for an insurance group, a group SCR and a group MCR will be



available in addition to SCR and MCR amounts for each member of the group (parent and subsidiaries).

Breach of the SCR or the MCR

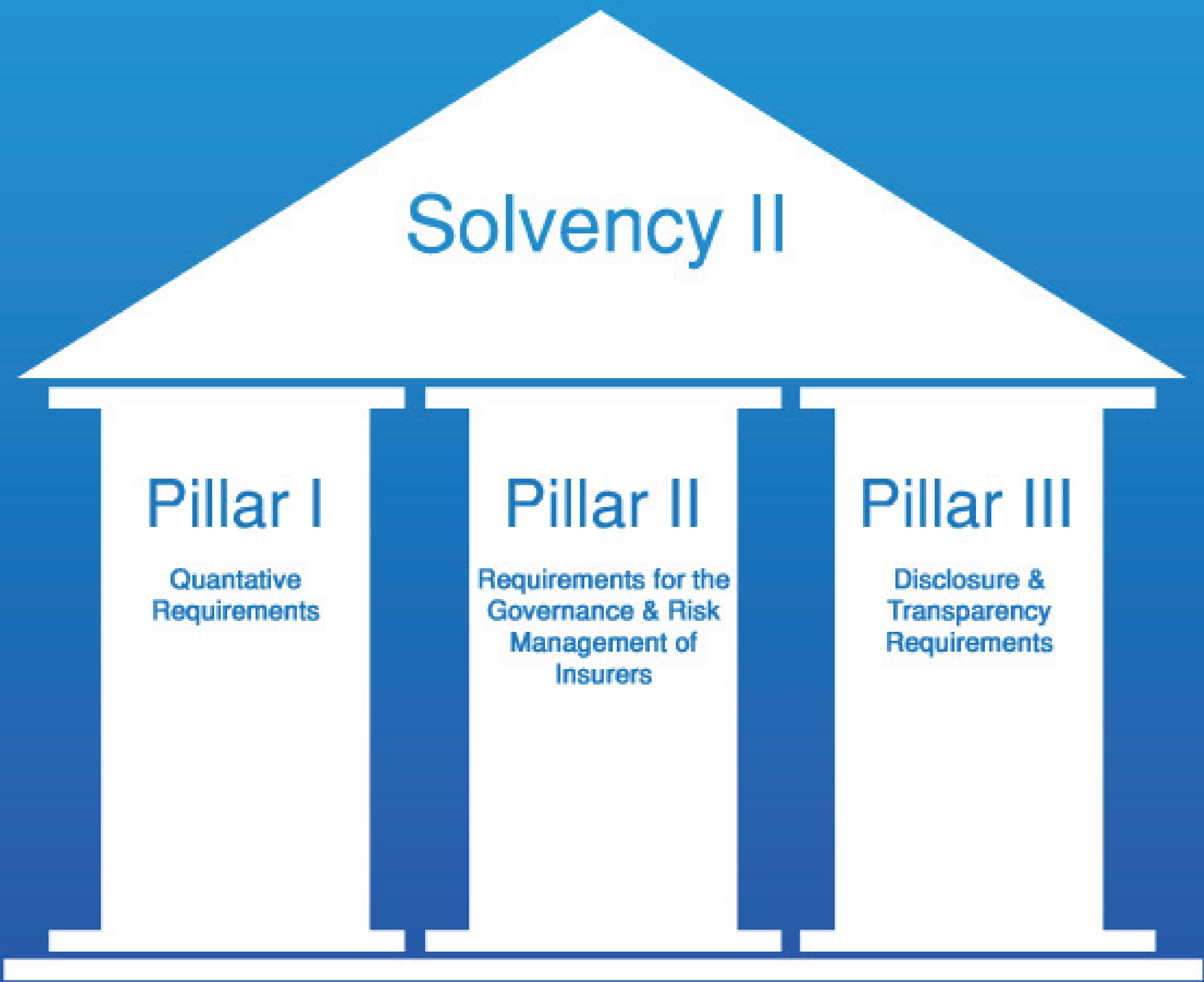
If an insurer has a solvency ratio that is lower than 100% and thus breaches the SCR, it does not mean that the insurer is insolvent. As the SCR is volatile, a breach of the SCR is not dramatic. It means that the insurer will be called in by the supervisor "for a cup of coffee" and that he will be subject to intensified supervision. The insurer will have to take the necessary measures to meet the SCR again within 6 months. In (very) exceptional circumstances, the recovery period for the SCR can be prolonged up to 7 years. In that case, more than one insurer will most likely benefit from this measure as it would be the result of serious problems in the market.

A breach of the MCR is more serious as the MCR reflects the minimum level of protection of policyholders and beneficiaries. Breaching the MCR would amount to an unacceptable level of risk. An insurer who breaches the MCR will be put into run-off by the supervisor unless the MCR is met again within a short period of time.

Transitional measures

One of the important innovations of Solvency II is the required valuation of all assets and liabilities in the balance sheet at market value. This requirement also applies to insurance liabilities (technical provisions), which must therefore be discounted (i.e. calculated at their present value on the balance sheet date). In order to smooth the transition from Solvency I to Solvency II, insurers may continue to apply the Solvency I valuation approach to discount rates (which were usually higher under Solvency I) or to technical provisions (which were not always calculated as prudently as required under Solvency II), subject to a phasing-in of the Solvency II valuation over a period of 16 years, i.e. until 2032.$

These transitional measures only apply to contracts concluded before 2016 and insurers must disclose their financial position (in the SFCR) also without the application of the transitional measure.



source: solvencyiinews.com

Long term guarantees measures

In times of low interest rates and the resulting market volatility, the calculation of technical provisions at market value becomes a real challenge. In order to limit the impact of market volatility on the amount of technical provisions and thus allow insurers to continue offering long term guarantees, Solvency II now includes three measures which make sure that the short term market volatility is only reflected in the balance sheet to a limited extent:

- extrapolation: stable extrapolation of the risk free interest rate term structure (for very long term liabilities);
- volatility adjustment: adaptation of the risk free interest rate term structure based upon the risk-corrected spread of a representative portfolio of assets;
- matching adjustment: risk-corrected spread of the insurer's assets in the case of a close matching of assets and liabilities with predictable cash-flows.

The application of the volatility or the matching adjustment is (in principle) subject to supervisory approval. Insurers must disclose their financial position (in the SFCR) also without the application of the volatility adjustment or the matching adjustment.

Comparability of the numbers

Because of the transitional measures and the long term guarantees measures, it is not possible to immediately compare the amounts of the SCR disclosed by insurers. It will be necessary to check (in the SFCR) whether any of the transitional measures or the long term guarantees measures have been applied and what impact these measures have on the financial position of the insurer.

> "All insurance undertakings and insurance groups must disclose on an annual basis a report on their solvency and financial condition."

DISCLOSURE REQUIREMENTS

New under Solvency II is that all insurance undertakings and insurance groups must disclose on an annual basis a report on their solvency and financial condition: the Solvency and Financial Condition Report (SFCR). Subject to supervisory approval, insurance groups may publish a single SFCR, covering the information at the level of the group as well as the information for any of the subsidiaries within the group.

> "Insurance undertakings must disclose their solo SFCR concerning the financial year 2016 for the first time by 20 May 2017."

For market parties it may, for instance, be important to know:

- whether an insurance undertaking is well capitalised and whether the capital is high quality capital;
- to what extent an insurance undertaking has made use of the transitional and/or long term guarantees measures;
- how the risk management of the insurance undertaking is organised;
- to what extent the insurance undertaking is heavily dependent on traditional business;
- the level of diversification by country, line of business and risk type.

Contents of the SFCR:

Description of the business and performance of the undertaking:

- Business in general;
- Underwriting performance;
- Performance of the investments;
- Other material income and expenses;

Description and assessment of the adequacy of the system of governance:

- Governance structure, description of the risk management system and of the implementation of the key governance functions (internal control, internal audit, actuarial);
- Information on the remuneration policy and practices;
- Fit and proper policies;
- Description of the ORSA (Own Risk and Solvency Assessment) process, including a statement explaining how the undertaking has determined its own solvency needs given its risk profile and how its capital management activities and its risk management system interact with each other;
- Outsourcing policies;

Risk profile:

- Risk exposure, including the exposure arising from off-balance sheet positions and the transfer of risk to special purpose vehicles;
- Risk mitigation and the processes for monitoring the continued effectiveness of these risk mitigation techniques;
- Description of the methods used, the assumptions made and the outcome of stress testing and sensitivity analysis for material risks and events;

Valuation for solvency purposes:

- Valuation of assets;
- Valuation of technical provisions;
- Valuation of other liabilities;

Capital management:

- Own funds, SCR and MCR;
- Specific information on the duration based equity risk sub-module;
- Specific information on the use of an internal model;
- Information regarding any non-compliance with the MCR or any significant non-compliance with the SCR;
- Impact of long term guarantees and transitional measures on the amount of own funds and liabilities;

Summary of the SFCR:

- Clear and concise;
- Understandable to policyholders and beneficiaries;
- Must highlight any material changes over the period.

The SFCR must follow a prescribed structure and include narrative information in quantitative and qualitative form, supplemented, where appropriate, with quantitative templates defined by implementing technical standards . In order to avoid duplication, reference can be made to public disclosures under other legal or regulatory requirements.

The information must be updated in the event of any major development affecting significantly the relevance of the information disclosed. Additional information may be added and in certain cases supervisory authorities may allow undertakings not to disclose certain information, for instance when competitors of the undertaking would gain significant undue advantage.
Insurance undertakings must disclose their solo SFCR concerning the financial year 2016 for the first time by 20 May 2017. This deadline will move after a transitional period of 4 years in 2020 to 14 weeks after the financial year end date. For the SFCR at group level or the single SFCR covering both group and solo information, the reporting deadline is 1 July 2017 concerning the financial year 2016. That deadline will move after a transitional period of 4 years in 2020 to 20 weeks after the financial year end date.

How to obtain the SFCR?

- Website of the undertaking or of the relevant trade association (the report must remain available on that website for at least 5 years after the disclosure date);

- Electronic copy (if the report is not published on a website): to any person who requests the report within 5 years of the disclosure date (10 working days for submission);

- Printed copy (irrespective of publication on website): to any person who requests the report within 2 years of the disclosure date (20 working days for submission).

> "The information published by insurance undertakings will allow intermediaries to provide a better service to their clients"

CONCLUDING OBSERVATIONS

From 2017 onwards, much more information will become available on the European insurance industry than ever before. It is still unclear how undertakings will apply the new disclosure requirements. It is however expected that the new requirements will lead to market discipline because of peer pressure.
It will not always be easy to interpret the information as the regime is new and some of the concepts are not yet familiar to a broader audience. In addition, there will be accounting data which may be different and which are not readily comparable as some will be based on local standards while others will follow IFRS (International Financial Reporting Standards). Rating agencies might also use different data although it might be expected that they will increasingly use the Solvency II data which are now more in line with the risks that insurers are exposed to.

It is also expected that the information disclosed by insurance undertakings will become more quickly available and that it will be subject to a great deal of scrutiny by investors, financial analysts, supervisory authorities and by the market as a whole.

Insurance intermediaries should also expect that the information disclosed by insurance undertakings will become more quickly available and that it will be subject to a great deal of scrutiny by investors, financial analysts, supervisory authorities and by the market as a whole.
Although Solvency II is complex, there can be no doubt that the introduction of a risk based solvency regime that links capital with the risks to which insurers are exposed, will allow the insurance market to operate more efficiently and more professionally: insurers are incentivised to better manage their risks and insurance supervisors have the means and the tools to better carry out their task. The availability – for the first time – of a great deal of relevant information about insurance undertakings and the insurance market will play an important role in helping the insurance industry to provide a better service to their clients.

This is also the case for insurance intermediaries. The information published by insurance undertakings will allow intermediaries to provide a better service to their clients because they will have a better insight in the way insurance undertakings are managed, which is highly relevant for their clients, who not only want to have a professional view on the products offered in the market but also on the providers of these products. Comparing these providers will become easier as a result of Solvency II. That is good for these providers themselves but also for the professionals that work with them: what is good for the goose, is good for gander!