bipar ACADEMY

THE SOLVENCY AND FINANCIAL CONDITION REPORT

Article written for BIPAR Academy by ***Prof. Karel Van Hulle***, Associate Professor KU Leuven, Honorary Professor Goethe University Frankfurt, Member of the Insurance and Reinsurance Stakeholder Group of EIOPA.

The views and opinions expressed in this article are those of the author and do not necessarily reflect the position of BIPAR.

1. INTRODUCTORY REMARKS

One of the key objectives of the new solvency framework for insurance undertakings[1] is transparency. Compared with the banking sector, the insurance sector in the EU was not known for its transparency both towards supervisory authorities and towards stakeholders. Solvency II[2] completely changed this. The disclosure requirements introduced under Pillar 3 of the Solvency II framework are very extensive. This is certainly the case for the information to be provided on a regular basis to supervisory authorities (supervisory reporting). It is also true for the information to be provided to stakeholders (public disclosure).

The tool selected by the co-legislators under Solvency II for communicating with stakeholders is the Solvency and Financial Condition Report (SFCR)[3]. The SFCR aims at establishing market discipline, i.e. making it possible for all stakeholders to see how insurance undertakings subject to Solvency II are applying the new solvency rules. The requirement to publish that information should stimulate undertakings to do it right and should allow all interested parties to compare how insurance undertakings are carrying out their legal obligations (market discipline).

The SFCR must be published on an annual basis by all insurance undertakings and insurance groups subject to Solvency II. There is no exception for small and medium-sized undertakings. Subject to supervisory approval, insurance groups may publish a single SFCR, covering the information at the level of the group with that relating to their subsidiaries.

As there are about 3000 insurance undertakings applying Solvency II, more than 3000 SFCRs were published last year as many insurance groups published a separate group SFCR in addition to the SFCRs relating to their subsidiaries. EIOPA has analysed a sample of SFCRs and issued some recommendations on how to improve the quality of the reports[4]. Some private firms have also carried out an analysis of published SFCRs, sometimes with recommendations for improvement[5].

In addition to the legal requirements, this article takes into account the observations made by EIOPA in its supervisory statement. This article also includes a number of examples taken from specific SFCRs which have been selected on a random basis.

Overall, it can be said that this first-time publication of the SFCR was a success. Many SFCRs are really interesting to read. They provide an insight into the business strategy of insurance undertakings, into the

[1] For the sake of simplicity, the term "insurance undertakings" also includes "reinsurance undertakings"

[2] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II), OJ, L 335, 17.12.2009, p. 1

[3] The relevant legal requirements can be found in Articles 51, 53-56 and 308b (6) of the Solvency II Framework Directive, Articles 290-303, 359-371 and Annex XX of the Delegated Act and EIOPA Guidelines on reporting and public disclosure (EIOPA BoS-15/109, 14 September 2015)

[4] EIOPA's Supervisory Statement. Solvency II: Solvency and Financial Condition Report, EIOPA-BoS/17-310, 18 December 2017, 11 p.

[5] See, for instance, Deloitte (study of 61 SFCRs in Ireland), KPMG (study of the top ten health, life and non-life insurers in the Netherlands), LCP (study of SFCR reporting in UK and Ireland), ZEB ((study of the SFCRs published by the 25 largest German life insurers). See also, How do you SFCR?, solvencyiiwire.com.

way they are organized and how they manage their capital under a risk-based solvency capital regime. It was not easy for insurance undertakings to produce their first SFCR although a standardised presentation is provided for in Annex XX to the Delegated Regulation[6]. Undertakings are required to follow this structure. They must provide in the SFCR narrative information in quantitative and qualitative form supplemented, where appropriate, with quantitative templates. Most undertakings provide Quantitative Reporting Templates (QRTs) at the end of the report, sometimes in an Annex to the SFCR. EIOPA recommends that the addition of QRTs by itself should not prevent undertakings or groups from providing quantitative and qualitative information into the body of the SFCR. For the reader, it is important to provide background information so that the quantitative information in the QRTs can be more easily understood.

An advantage of having a standardised presentation is comparability. The disadvantage is a lack of creativity in presenting the undertaking or the group. An example of a group that tried to present itself in a readable fashion to its stakeholders in a document that precedes the official SFCR is UNIQA. The single SFCR of UNIQA is preceded by a document of 7 pages which sets out the general strategy of the group as well as its risk strategy in pictures and graphs. Some insurance undertakings do not follow the structure required by the Delegated Regulation. For instance, BNP Paribas Cardif, which includes in its SFCR the sections required by the Delegated Regulation but subdivides those in a different manner. This makes comparability with other SFCRs more difficult.

The length of the SFCR varies between 20 pages (for instance, the Belgian cooperative insurance group P&V) and 90 pages (for instance, Allianz AG). The group SFCR will obviously be more voluminous and may be as extensive as 217 pages as in the case of Allianz Group, i.e. 123 pages in the report and an appendix of 94 pages. This is even more so for the single SFCR covering both group and solo information. See, for instance, the single SFCR published by UNIQA (296 pages), which comprises the SFCR of the UNIQA group, as well as the solo SFCR of UNIQA Insurance Group AG and UNIQA Österreich Versicherungen AG.

The average length of the solo SFCR is between 40 and 70 pages.

[6] Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

2. WHEN IS THE SFCR PUBLISHED?

The first SFCRs were published in 2017 relating to information concerning the financial year 2016.

The solo SFCR concerning the financial year 2016 had to be published by 20 May 2017 (20 weeks after the financial year end date[7]). 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 was 1 July 2017 concerning the financial year 2016 (26 weeks after the financial year end date). That deadline will move after a transitional period of 4 years in 2020 to 20 weeks after the financial year end date.

For the SFCRs relating to the financial year 2017, the same dates apply, i.e. 20 May 2018 for the solo SFCR and 1 July 2018 for the group or single SFCR.

As observed by EIOPA, the majority of insurance undertakings and groups published their SFCR on a timely basis and generally complied with the relevant Solvency II requirements. In some cases, groups went the extra mile to produce a separate group SFCR.

Sometimes, undertakings or groups will make the SFCR available in English, in addition to the local language. This is for instance the case with the Belgian insurance company AG Insurance, which indicates that the original version of the SFCR is the English version (and has therefore precedence over the Dutch and French versions). Other examples are Ageas, Allianz, PZU, Nordea, VIG and UNIQA. Munich Re indicates in its Group SFCR that the English version is a translation of the original German version and that only the German version is binding. When groups produce a separate group SFCR or a single SFCR, the report must be disclosed in the language or the languages determined by the group supervisor. This may, for instance, have been the case for the French insurance group, AXA, which publishes its Group SFCR in English and in French and for the Italian insurance group, Generali, which publishes its Group SFCR in English and in Italian. Aegon publishes its Group SFCR exclusively in English but offers a translation into Dutch of the Summary section.

[7] It is presumed here that the financial year end date is 31 December. In some cases, the financial year end date is different which means that the SFCR will then be published on a different date always 20 weeks after the financial year end date.

3. HOW TO OBTAIN THE SFCR?

For many undertakings, the SFCR can easily be found on the internet. Sometimes, one is referred on the internet to the website of the undertaking. For instance, in the case of the AXA Group SFCR, the report can be found under the section "investors/earnings presentations" on the AXA website. The Delegated Regulation prescribes the following means of disclosure:

- Disclosure on the 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);
- Provision of an electronic copy (if the report is not published on a website) which must take place within 10 working days to any person who requests the report within 5 years of the disclosure date;
- Provision of a printed copy (irrespective of publication on a website) which must take place within 20 working days to any person who requests the report within 2 years of the disclosure date.

In practice, it is easy to obtain the SFCR. That is fully in line with the intention of the co-legislators. EIOPA reports that some undertakings still do not own a website and that the broad access may in this case be compromised despite the possibility to request the document in a physical format. Some websites of insurance groups give direct access to all the SFCR Reports published by the group and by major entities of the group. See for instance, the websites of Achmea (all reports in English), Aegon (all reports in English), Nordea (reports available in the languages of the subsidiaries) and Mapfre (all reports only in Spanish).

There are also websites where one can find solo and group SFCRs of insurance undertakings and groups. See, for instance, www.solvencydata.com, a website where one can obtain the solo and group SFCRs of German and Austrian insurance undertakings and groups and www.solvencyiiwiredata.com, which provides a database of Solvency II public disclosures.

4. WHO ARE THE ADRESSEES OF THE SFCR?

The SFCR is addressed to all relevant stakeholders, including policyholders, beneficiaries, intermediaries, investors, analysts, supervisors, insurance undertakings, etc.

From this first exercise, it is clear that undertakings are somewhat confused as to who are the real addressees of their SFCR. Generali SA (Belgium) and the Generali Group make it clear in the introduction to their SFCR that the report is addressed to policyholders and beneficiaries. They also include an extensive glossary of terms[8] in their report which makes it easier for non-experts to understand the information and shows that they care about the readers of their SFCR. The Generali Group SFCR is long (126 pages) but it is at the same time written in a very accessible manner with pictures and graphs which makes it easy to read. It is a good example of what the SFCR should be, i.e. a document that all stakeholders should be able to understand. Aegon states in the introduction to its group SFCR that the report is addressed to all stakeholders. The report is written in a very readable manner and includes a glossary of technical terms in the back of the SFCR.

Some SFCRs are extremely lengthy and almost look like an annual report. For instance, the group SFCR (110 pages) of the Dutch financial group a.s.r., which even includes pictures and curriculum vitae of members of the supervisory and executive boards. Interesting is the "Cautionary statement" which is included in the Group SFCR of Aviva plc under "Other information" and which adds caution to any statement in the report which is forward-looking: "*By their nature, all forward-looking statements involve risk and uncertainty. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in these statements*". This is followed by a lengthy list of factors, such as the impact of ongoing difficult conditions in the global financial markets and government actions such as those arising from the referendum on UK membership of the EU. Is this not confusing the SFCR which should be a document addressed to all stakeholders with the annual report which serves a different purpose?

Some SFCRs include a report of the statutory auditors[9]. This is, for instance, the case for the SFCR of AIG Europe Ltd, which refers to the auditor's report in the table of contents as "the auditor's report **to the members** of AIG Europe Ltd" and in the

[8] Many insurance undertakings or groups include a glossary in the SFCR, which is very useful.

[9] This may be a requirement imposed by the supervisory authority as is the case in Italy and in the UK.

body of the SFCR as "the report of the external independent auditors **to the directors** of AIG Europe Ltd". It is unclear from this to whom assurance is being given. Other examples are the Group SFCR of Aviva plc, where the audit report is included at the end of the document under "Other information" and the AXA Group SFCR and the Generali Group SFCR which include a report of the statutory auditors in an annex to the report.

EIOPA in its comments makes a distinction between the Summary of the SFCR and the other parts of the SFCR. In their view, the Summary is primarily addressed to policyholders and beneficiaries. This is in line with Article 292 of the Delegated Act which states that the SFCR should include a clear and concise summary which should be understandable to policyholders and beneficiaries.

As insurance intermediaries are the natural advisers to policyholders and beneficiaries, they should be particularly interested in the Summary of the SFCR which contains valuable information and should be written in an understandable manner. Are insurance intermediaries required to read the SFCR of an insurance undertaking before they advise their clients to buy a product of that undertaking? There clearly is no legal requirement to do so. One would however expect an insurance intermediary who wants to offer a good service, to consult all useful information before advising the client, particularly when that information is readily available in the Summary section of the SFCR.

What with the other parts of the SFCR? EIOPA indicates that the remaining sections should be mainly addressed to analysts and investors. This may be too blunt as there are other stakeholders that might also be interested in this more technical information, but it rightly puts the finger at one of the problems of the SFCR which will have to be addressed when the Solvency II Framework Directive will be reviewed in 2021. The present structure of the SFCR is so detailed that it partly overlaps with the annual report. In fact, it is possible to refer in the SFCR to information already included in the annual report, without repeating that information in the SFCR. This is, for instance, done in the Group SFCR of AXA and makes reading that report difficult and frustrating because it cannot be readily understood without having at the same time the annual report at hand.

Because the SFCR serves a range of stakeholders with different levels of expertise, expectations and objectives, the challenge is to strike the right balance between the needs and capabilities of the different types of stakeholders.

5. CONTENTS OF THE SFCR

5.1. SUMMARY

Because the SFCR is lengthy and because some of the information is technical, it is important to present the relevant quantitative and qualitative information contained in the various sections in a concise and comprehensible manner in the first section of the SFCR which is called "Summary". The Summary section must be easy to understand for stakeholders in general and for policyholders and beneficiaries, including insurance intermediaries, in particular. Insurance is complex but it should be possible to explain in simple terms the main elements of the

business, the main risks to which the undertaking or the group is exposed to, the way the company or the group is organised and its capital and solvency position.

EIOPA expects the SFCR Summary to at least include:

- the key elements and drivers of the undertaking's business model and business strategy;
- main indicators for the undertaking's underwriting performance and investment performance including material lines of business and material geographical areas where the business is carried out;
- any significant business or other events with material impact on the solvency and financial condition that have occurred over the reporting period;
- the key elements of the system of governance;
- information about the undertaking/group key risks;
- solvency ratio with and without volatility or matching adjustment;
- the approach towards the use of transitional arrangements, including the solvency ratio without the transitional adjustment to the relevant risk-free interest rate term structure or without transitional measure on technical provisions;
- the amount of the Solvency Capital Requirement (SCR) and the eligible amount of own funds to cover the SCR, classified by tiers;
- the amount of the Minimum Capital Requirement (MCR) and the eligible amount of basic own funds to cover the MCR, classified by tiers;
- information about any non-compliance with the MCR or significant non-compliance with the SCR over the last reporting period

The list provided by EIOPA excludes some of the more technical information which can be found in the section "Valuation for solvency purposes" and in the QRTs and which is more directly addressed to experts.

For insurance intermediaries, the information contained under each of the bullet points listed by EIOPA is relevant, as it provides an answer to the following questions (only listed as examples):

- What is the main business of the insurance undertaking or group (life, non-life, health, reinsurance…)? What products and services are being offered? How are these products offered to the public (agents, brokers, banks)? What is the strategy going forward? Has the undertaking or group a specific policy to ensure that policyholders are treated fairly?
- What are the earnings of the undertaking or group? From what business line? What is the combined ratio (incurred losses + expenses divided by total earned premiums)? What assets are invested in and what is the return on these investments?
- Have there been acquisitions, sales of parts of the undertaking or group, important losses, unexpected events?
- How is the undertaking or group organized? Who is reporting to whom? Have there been any changes in the organization of the undertaking or group? How is risk management organized? What committees are established within the Board? Is there a risk committee? Is the undertaking or group using a partial or full internal

model? How is the governance of the model organized in practice?

- What are the specific risks the undertaking or group is exposed to? Who is in charge of identifying those risks? How are they being monitored? What is the targeted risk profile? Who is in charge of the risk management function? Is there a CRO? To whom is the CRO reporting?
- What is the solvency ratio, i.e. the percentage of eligible own funds compared with the level of the SCR (solvency capital requirement)? Did it change from the previous year? How was it influenced by the use of the volatility adjustment or the matching adjustment (measures which influence the amount of technical provisions and thus the solvency ratio)?
- Has the undertaking or group used any of the transitional measures which influence the level of technical provisions and thus the solvency ratio? What is the impact of these measures on the solvency ratio?
- What is the amount of the SCR? Is there a target level and how does the amount of the SCR relate to this target level? What is the eligible amount of own funds to cover the SCR divided by tiers? What is the level of Tier 1 capital (strongest form of capital)? Are there any changes compared with the previous period and how are they explained?
- What is the amount of the MCR (minimum capital requirement)? What is the eligible amount of basic own funds to cover the MCR, classified by tiers? Are there any changes compared with the previous period and how are they explained?
- Has there been any non-compliance with the MCR during the reporting period? Has there been any significant non-compliance with the SCR over the reporting period? Has a recovery plan been put in place and how is it being implemented? This information is particularly important because it shows possible weaknesses in the solvency position of the undertaking or group.

An answer to these questions gives an insight in where the undertaking or group stands in terms of its business strategy, its relation with policyholders, its capital position, its solvency and its risk management.

In general, few undertakings or groups publish a good Summary. It is non-existent (for instance, BNP Paribas Cardif), too short (for instance, Nordea Life Holding AB (half a page) and P&V Group (1 page)) or too unfocused, i.e. not a real summary of the report (for instance, AIG Europe Ltd (2 pages)). The Summary section does not have to be long. Good examples are AG Insurance, Ageas, Aviva plc, AXA Group, Generali Group and Aegon Group where the Summary section is not long (from 2 pages to 4 pages) but where the reader receives the main points of the various sections of the SFCR in a readable manner. An interesting Summary section is that provided in the Group SFCR of Achmea. It is 31 pages and includes a detailed analysis of the various risks captured in the standard formula for the SCR.

For policyholders and beneficiaries as well as for insurance intermediaries, the Summary should be the place to look at. If the Summary is well prepared, the undertaking or group is likely to have a consumer focus.

5.2. BUSINESS AND PERFORMANCE

Article 293 of the Delegated Regulation indicates the elements which this section of the SFCR should include:

- general information about the undertaking or group and its business including any significant business or other events that have occurred over the reporting period that have had a material impact on the undertaking;
- qualitative and quantitative information about the underwriting performance;
- qualitative and quantitative information about the investment performance;
- description of other material income and expenses of the undertaking;
- any other material information regarding the business and performance of the undertaking or group.

Article 359 of the Delegated Regulation further requires the group SFCR to include a description of the legal structure and governance and organisational structure of the group with a description of all subsidiaries, material related undertakings and significant branches as well as qualitative and quantitative information on relevant operations and transactions within the group.

Annex XX of the Delegated Regulation prescribes the following structure:

A. Business and Performance

- A.1 Business
- A.2 Underwriting Performance
- A.3 Investment Performance
- A.4 Performance of other activities
- A.5 Any other information

The EIOPA Guidelines indicate that section "A.1 Business" should include

- the name and location of the legal or the natural persons that are direct and indirect holders of qualifying holdings in the undertaking, the proportion of ownership interest held and, if different, the proportion of voting rights held;
- a list of material related undertakings including the name, legal form, country, proportion of ownership interest held and, if different, proportion of voting rights held;
- a simplified group structure.

For the Group SFCR, section "A.1 Business" should also include an explanation of the material differences between the scope of the group used for the consolidated financial statements and the scope for the consolidated data for the group solvency.

This section of the SFCR can be defined as the passport of the undertaking or group. It also shows the strengths and weaknesses of the business and provides an insight in the business strategy.

Usually, this section covers between 10 and 15 pages. It describes the business, sets out the organizational structure of the undertaking or group, explains significant events during the reporting period, indicates who the supervisory authority is and the external auditor and gives an insight in the underwriting performance with the operating profit per geographical area and per line of business, the investment performance by asset class and the performance of other activities (for instance, asset management or fund management).

Sometimes, insurance undertakings or groups describe themselves in a short paragraph.

See, for instance:

- the Single SFCR of UNIQA (p. 22): *"The insurance companies in the UNIQA Group provide comprehensive products in property and casualty insurance, life insurance as well as health insurance to their customers. The listed holding company UNIQA Insurance Group AG manages the Group and also operates indirect insurance business (i.e. inward reinsurance). In addition, it carries out numerous service functions for UNIQA Österreich Versicherungen AG and the international insurance companies in order to take best advantage of synergy effects and to consistently implement the Group's long-term corporate strategy."*

- the Group SFCR of Munich Re (p.7):*"Munich Re combines primary insurance and reinsurance under one roof. This enables the Group to cover large parts of the value chain in the risk market. At the same time, it leverages synergies in revenue and costs, whilst reducing the risk-based capital required through broad diversification."*

- the Group SFCR of Ageas (p. 10): *"Wherever Ageas operates around the world it does so with one focus: the customer. And with one goal in mind: to provide its customers with peace of mind when they need it most. By offering a range of Life and Non-life products accessible through a broad range of channels Ageas helps customers plan for the long term while protecting them against unforeseen risks to their welfare."*

5.3. SYSTEM OF GOVERNANCE

Article 294 of the Delegated Regulation indicates the elements which this section of the SFCR should include:

- governance structure, description of the risk management system and of the implementation of the key governance functions (risk management, internal control, internal audit, actuarial);
- information on the remuneration policy and practices;
- fit and proper policies;
- description of the Own Risk and Solvency Assessment (ORSA) 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;
- a description of the outsourcing policy as well as a description of the undertaking or group's outsourcing of any critical or important operational functions or activities and the jurisdiction in which the service providers of such functions or activities are located;
- an assessment of the adequacy of the system of governance to the nature, scale and complexity of the risk inherent in the business;
- any other material information regarding the system of governance of the undertaking or group.

Article 359 of the Delegated Regulation further requires the group SFCR to include: a description of how the risk management and internal control systems and reporting procedures are implemented consistently in all the undertakings within the scope of group supervision; a statement, where applicable, that the group has chosen the option to prepare a single ORSA report for the group; information on any material intra-group outsourcing arrangements.

Annex XX of the Delegated Regulation prescribes the following structure for this section of the SFCR:

B. System of Governance

- B.1 General information on the system of governance
- B.2 Fit and proper requirements
- B.3 Risk management system including the own risk and solvency assessment
- B.4 Internal control system
- B.5 Internal audit function
- B.6 Actuarial function
- B.7 Outsourcing
- B.8 Any other information

The EIOPA Guidelines indicate that section "B.1 General information on the system of governance" should include an explanation how the key functions have the necessary authority, resources and operational independence to carry out their tasks and how they report to and advise the administrative, management or supervisory body (AMSB) of the insurance undertaking.

Where the undertaking is using a partial or full internal model to calculate the SCR, section "B.3 Risk management system including the own risk and solvency assessment" should describe the following information concerning the governance of the internal model:

- the responsible roles and specific committees if any, their main tasks, position and scope of responsibilities;

- how existing committees interact with the AMSB in order to ensure a proper functioning of the internal model;
- any material changes to the internal model governance during the reporting period;
- a description of the validation process used to monitor the performance and on-going appropriateness of the internal model.

The governance section of the SFCR is usually very extensive. For instance, the Group SFCR of Aegon (20 pages), the Group SFCR of Allianz SE (32 pages), the Single SFCR of UNIQA (34 pages), the SFCR of Generali Belgium(40 pages), the Group SCR of a.s.r; (35 pages), the Group SFCR of Vienna Insurance Group AG (30 pages). The AXA Group SFCR devotes 3 pages to the System of Governance mainly containing references to the annual report, which is not particularly reader friendly.

There is a tendency to repeat the laws, regulations and administrative provisions (see, for instance the Group SFCR of a.s.r. which makes references to the Corporate Governance Code and the Banking Code in the Netherlands). This cannot be the objective of the SFCR. The information should relate to the specific situation of the undertaking or the group.

In terms of the Own Risk and Solvency Assessment (ORSA), EIOPA expects the SFCR to include information:

- on the process for performing and on-going monitoring of the ORSA, including the involvement of the Board;
- on the link to the business strategy and how the main areas/risks of the business strategy are considered in the ORSA, namely in the overall solvency needs;
- on the timing and frequency of the ORSA and the triggers for performing additional assessments.

The objective of the ORSA is to ensure that an insurance undertaking or group does not engage in business for which it does not have the right amount of capital. It is therefore useful to see how undertakings or groups carry out this legal requirement in practice. A good example of the ORSA process can be found in the SFCRs of Generali Belgium (p. 46-47), AG Insurance (p. 18-20), AachenMünchener Lebensversicherung AG (p. 31-34) and in the Group SFCR of Allianz SE (p. 38-44).

Particularly important is the way the undertaking or group organizes its risk management. Insurance is about managing risks. Many insurance undertakings or groups report extensively in their SFCR about the way in which they organize the so-called three lines of defence, i.e. how they deal with risks at the operational level (first line of defence), at the independent oversight (risk management) level (second line of defence) and at the assurance (internal audit) level (third line of defence). In its Group SFCR, Allianz SE (p. 28-30) describes how this three lines of defence model, which is not specifically recognised under Solvency II, is integrated in the governance model of Solvency II with its 4 key governance functions (risk management, internal control, internal audit and actuarial).

Information on the remuneration policy and practice is important for a good assessment of the way the undertaking or group is managing risk. An extensive

example can be found in the Group SFCR of a.s.r. (p. 37-44) which includes the amounts of remuneration paid to individual members of the Supervisory and Executive Boards. Aviva refers in its Group SFCR for further details in respect of the remuneration policy to its annual report.

If the undertaking or group uses a partial or full internal model, it is important to know how the governance of the model is organized. See, for instance, the Group SFCR of Allianz SE (p. 41-42), the Group SFCR of Arag SE (p.32) and the Group SFCR of Aviva plc (p. 22).

Interesting is the following statement of principles reflecting Canada Life Assurance Europe plc's philosophy of doing business and disclosed in the SFCR under the Compliance Function:

The following principles reflect the Company's philosophy of doing business, and sets out the compliance and ethical standards to be observed by staff across the Company in relation to legal, regulatory and market conduct responsibilities. The emphasis is on conducting business following the best practice approach with strong customer focus. The principles which reflect the Policy and which underpin the development and implementation of compliance arrangements across the Company have been adopted:

Principle 1: Customer Focus

We will have due regard to the interests of our customers and will treat them fairly. We will provide information to our customers in a way that is fair, timely and not misleading. We will make every effort to ensure the suitability of information provided, with a particular focus on the outcome for our customers.

Principle 2: Integrity

We will be honest and straightforward in all our business dealings.

Principle 3: Skill, Care and Diligence

We will conduct and manage our business with due skill, care and diligence.

Principle 4: Business Imperative

We will view compliance as an imperative for the business and central to the decision-making process.

Principle 5: Best Practice

We will observe high standards of compliance practice and will operate to the spirit of the requirements, and not just to meet minimum legal and regulatory requirements.

Principle 6: Market Conduct

We will ensure that our business dealings, particularly relating to sales, marketing and promotions or our products, are conducted in accordance with best practice in market conduct and in full compliance with all relevant legal and regulatory requirements.

Principle 7: Management and Control

We will ensure that appropriate procedures are in place to manage and control the business effectively and to meet regulatory requirements.

Principle 8: Relations with Regulatory Authorities

We will deal with regulatory authorities in an open and co-operative way.

Principle 9: Compliance Awareness, Training and Visibility

We will maintain a high profile, strong awareness, and visibility for our compliance principles and will ensure that staff are kept up to date on new regulatory developments and familiarise themselves with particular requirements specific to their business."

5.4. RISK PROFILE

In accordance with Article 295 of the Delegated Regulation, this section of the SFCR includes information on the risk profile of the undertaking or group including the exposure from off-balance sheet positions and the transfer of risk to special purpose vehicles; risk concentrations; risk mitigation techniques and processes for monitoring the continued effectiveness of these risk mitigation techniques; risk sensitivities with a description of the methods used, the assumptions made and the outcome of stress testing and sensitivity analysis for material risks and events; any other material information regarding the risk profile of the insurance undertaking or group.

Article 359 of the Delegated Regulation requires further qualitative and quantitative information in the group SFCR on significant risk concentrations.

Annex XX of the Delegated Regulation prescribes the following structure for this section of the SFCR:

C. Risk Profile

- C.1 Underwriting risk
- C.2 Market risk
- C.3 Credit risk
- C.4 Liquidity risk
- C.5 Operational risk
- C.6 Other material risks
- C.7 Any other information

The EIOPA Guidelines indicate that special attention needs to be paid to information concerning transfer of risk from the undertaking to special purpose vehicles. The undertaking needs to describe whether the special purpose vehicle has been authorised. It must identify the risks that are transferred to it and explain how the fully funded principle is assessed on an ongoing basis.

EIOPA believes that the information on the risk sensitivity to different scenarios or stresses, including the sensitivity of the SCR of the undertaking or group should be better structured and be more comprehensive. It expects the reporting of sensitivities to include at least the following:

- description of the methods used, i.e. scenario, stress-tests, sensitivity analysis for the different risks;
- adequate information on the underlying assumptions of the methods used, including how the future management actions are taken into consideration;
- the impact of the sensitivity measured as an amount of the SCR for that specific risk and as a percentage point of the overall SCR ratio;
- an interpretation of the results considering the strategy and business model of the undertaking or group and any impact on the management of the most material sensitivities.

A good example of sensitivity analyses can be found in the Group SFCR of Aviva plc (p.31-32), which includes the economic and non-economic assumptions, the impact on capital coverage as well as the limitations of the sensitivity analyses undertaken.

For examples of other material risks that might affect the undertaking or group, see:

- the Group SFCR of Ageas SA/NV (p. 38-49). In terms of other material risks, Ageas identifies the following risks to which Ageas can be exposed: regulatory change risk, competitor risk, distribution risk, reputation risk, country risk, economic environment risk, other environmental risks, concentration risk, intangible risk and strategic risk.
- the Group SFCR of Achmea (p. 61-78). As other material risks, Achmea identifies: strategic risks, risk of regulatory changes, risk relating to digitisation/ICT change programmes, risk relating to compliance with operational risk and with laws and regulations;
- the Group SFCR of Allianz SE (p. 52-68). As other material risks, Allianz refers to strategic risk and reputational risk;
- the Group SFCR of Aegon (p. 62-63) mentions as other material risks: the possible changes in the Ultimate Forward Rate (UFR) which are discussed between EIOPA and the EC and the treatment of the loss-absorbing capacity of deferred taxes which is discussed in the Netherlands with the supervisor (Nederlandse Bank). The sensitivity and possible impact on the capital position of Aegon is also quantified.

5.5 VALUATION FOR SOLVENCY PURPOSES

In accordance with Article 296 of the Delegated Regulation, this section of the SFCR includes information on:

- the value of each material class of assets, as well as a description of the bases, methods and assumptions used for their valuation for solvency purposes and a quantitative and qualitative explanation of any material differences between the bases, methods and main assumptions used by the undertaking or group for the valuation for solvency purposes and those used for their valuation in the financial statements;
- the value for each material line of business of technical provisions, as well as a description of the bases, methods and main assumptions used for their valuation for solvency purposes;
- the level of uncertainty associated with the value of technical provisions;
- the impact on the technical provisions, the SCR, the MCR, the basic own funds and the eligible own funds of using the matching adjustment or the volatility adjustment or the transitional measures relating to the interest rate or technical provisions;
- recoverables from reinsurance contracts and special purpose vehicles and any material changes in the relevant assumptions made in the calculation of technical provisions compared to the previous reporting period;
- the value of each material class of other liabilities, as well as a description of the bases, methods and assumptions used for their valuation for solvency purposes and a quantitative and qualitative explanation of any material differences between the bases, methods and main assumptions used by the undertaking or group for the valuation for solvency purposes and those used for their valuation in the financial statements;
- similar information as above in the case of the use of alternative valuation methods;
- any other material information regarding the valuation of assets and liabilities for solvency purposes.

Article 359 of the Delegated Regulation further requires the group SFCR to provide a quantitative and qualitative explanation of any material differences between the bases, methods and main assumptions used at group level for the valuation for solvency purposes of the group's assets, technical provisions and other liabilities, where those differ materially from those used by any of its subsidiaries for the valuation for solvency purposes of its assets, technical provisions and other liabilities.

Annex XX of the Delegated Regulation prescribes the following structure for this section of the SFCR:

D. Valuation for Solvency Purposes

- D.1 Assets
- D.2 Technical provisions
- D.3 Other liabilities
- D.4 Alternative methods for valuation
- D.5 Any other information

The EIOPA Guidelines contain further clarifications concerning the information to be provided in the case of aggregation of assets by class, the content by material classes of assets (intangible assets, financial assets, financial and operating leases, deferred tax assets, related undertakings), the use of significant simplified methods for the calculation of technical provisions, the information to be provided in the case of aggregation of liabilities other than technical provisions by class and the content by material classes of liabilities other than technical provisions.

Regarding the description of the bases, methods and main assumptions used for the valuation of assets, liabilities and technical provisions, EIOPA believes that the SFCR should include more relevant, undertaking or group specific information. The following recommendations are given:

- For the valuation of investments: the focus should be on the entity's specific approaches to investments, the conditions under which each valuation method is applied, the type of investments to which the method is applied and the relative weight of investments valued by each method;
- For the valuation of deferred tax assets and deferred tax liabilities: the information should include the identified relevant differences between accounting standards and Solvency II and the reason or sources for such differences, any unused tax losses and the maturity date of any losses;
- For the valuation of technical provisions: a description should be provided of the level of uncertainty, by linking it at least to the assumptions underlying the calculation, such as economic and non-economic assumptions, expected profits in future premiums, future management actions and future policyholder behaviour.

This section is no doubt the most technical section of the SFCR. It contains important information concerning the valuation of assets and liabilities in the solvency balance sheet and a comparison with the valuation of the same assets and liabilities for financial reporting purposes. The differences can be very important.

For instance, the Group SFCR of Aviva plc indicates that the excess of assets over liabilities was £25.2 billion on a Solvency II basis which is £5.6 billion higher than the value under the International Financial Reporting Standards (IFRS), primarily driven by the difference in valuation of technical provisions.

This section also shows the impact on the solvency ratio of using the matching adjustment and the volatility adjustment. In its Group SFCR, Aegon indicates that the combined impact of the matching adjustment and volatility adjustment on the group solvency ratio is 26%.

A study by ZEB of the SFCRs published by the 25 largest German life insurance undertakings shows the importance of applying the volatility adjustment and the interest rate transitional on technical provisions for the solvency ratio: for insurance undertakings that only use the volatility adjustment, the difference in the solvency ratio with and without volatility adjustment is 101% and for insurance undertakings that use both the volatility adjustment and the interest rate transitional, the difference is 283%.

In its SFCR, Alte Leipziger Lebensversicherung auf Gegenseitigkeit indicates that it is using neither the volatility adjustment nor the interest rate transitional. Its solvency ratio is 289%. If it were to use the volatility adjustment and the interest rate transitional, its solvency ratio would be 570%.

5.6. CAPITAL MANAGEMENT

In accordance with Article 297 of the Delegated Regulation, this section of the SFCR includes information on four areas which are important to understand the solvency position of the undertaking and the way the undertaking manages its capital:

Own funds

- objectives, policies and processes for managing the own funds;
- separately, for each tier, information on the structure, amount and quality of own funds at the end of the reporting period and at the end of the previous reporting period;
- the eligible amount of own funds to cover the SCR, classified by tiers;
- the eligible amount of basic own funds to cover the MCR, classified by tiers;
- a quantitative and qualitative explanation of any material differences between equity as shown in the financial statements and the excess of assets over liabilities as calculated for solvency purposes;
- for each basic own-fund item subject to transitional arrangements, a description of the nature of the item and its amount;
- for each material item of ancillary own funds, a description of the item and the amount of the ancillary own fund item;
- a description of any item deducted from own funds and a brief description of any significant restriction affecting the availability and transferability of own funds within the undertaking.

Article 359 of the Delegated Regulation requires further information concerning the method used for the calculation of the group solvency capital, on significant restrictions to the fungibility and transferability of own funds eligible for calculation the group SCR and on material sources of group diversification effects.

SCR and MCR

- the amount of the SCR and the MCR;
- the amount of the SCR split by risk modules or by risk categories;
- whether and for which risk modules and sub-modules of the standard formula the undertaking is using simplified calculations;
- whether and for which parameters the undertaking is using undertaking-specific parameters;
- impact of any undertaking-specific parameters that the undertaking is required to use and the amount of any capital add-on applied to the SCR, together with concise information on the justification by the supervisory authority concerned (unless the undertaking's Member State has used the option not to require this information until 31 December 2020);
- information on the inputs used by the undertaking to calculate the MCR;
- any material change to the SCR or the MCR over the reporting period and the reasons for any such change.

Use of the duration-based equity risk sub-module

- indication that the use of the duration-based equity risk sub-module has received the approval of the supervisory authority;
- the amount of the capital requirement for the duration-based equity risk sub-module resulting from such use.

Use of an internal model

- description of the various purposes for which the undertaking is using its internal model;
- description of the scope of the internal model in terms of business units and risk categories;
- where a partial internal model is used, a description of the technique which has been used to integrate any partial internal model into the standard formula including, where relevant, a description of alternative techniques used;
- description of the methods used in the internal model for the calculation of the probability distribution forecast and the SCR;
- explanation, by risk module, of the main differences in the methodologies and underlying assumptions used in the standard formula and in the internal model;
- the risk measure and time period used in the internal model;
- description of the nature and appropriateness of the data used in the internal model.

Article 359 of the Delegated Regulation further requires a description of the undertakings which are in the scope of any internal model used to calculate the group SCR as well as a description of the main differences, if any, between any internal model used at individual undertaking level and any internal model used to calculate the group SCR.

Non-compliance with the MCR or significant non-compliance with the SCR

- the period and maximum amount of each non-compliance with the MCR during the reporting period, an explanation of its origin and consequences, any remedial measures taken and an explanation of the effects of such remedial measures;
- the amount of the non-compliance with the MCR at the reporting date, where non-compliance has not been subsequently resolved;
- the period and maximum amount of each significant non-compliance with the SCR during the reporting period, an explanation of its origin and consequences as well as any remedial measures taken and an explanation of the effects of such remedial measures;
- the amount of the non-compliance at the reporting date, where a significant non-compliance has not been subsequently resolved.

Annex XX of the Delegated Regulation prescribes the following structure for this section of the SFCR:

E. Capital Management

- E.1 Own funds
- E.2 Solvency Capital Requirement and Minimum Capital Requirement
- E.3 Use of the duration-based equity risk sub-module in the calculation of the Solvency Capital Requirement
- E.4 Differences between the standard formula and any internal model used
- E.5 Non-compliance with the Minimum Capital Requirement and non-compliance with the Solvency Capital Requirement
- E.6 Any other information

The EIOPA Guidelines contain further clarifications on the information to be disclosed concerning additional solvency ratios, the structure, amount, quality and eligibility of own funds and the differences between the standard formula and internal models used.

EIOPA recommends the information on the management of own funds to be described in the context of the undertaking's/group's strategy and business model, with specific reference to the time horizon used for business planning and any material changes over the reporting period.

Particularly important under this section is the information concerning the amount of the SCR and the MCR and the structure, amount and quality of the own funds. The solvency ratio (Own funds/SCR%) has now become important information used to compare the strength of insurance undertakings. 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.

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, insurance undertakings 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. See, for instance, the SFCR of Ageas (UK) Ltd which describes that "*the overall capital requirements and structure are assessed taking account of the following: capital required to support the planned growth in new business and renewal of premiums and profit targets; the required rate of return on capital employed; the required dividend; the Solvency II capital requirement and capital required to support the desired credit rating*".

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 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. This will be clearly visible under this section of the SFCR.

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).

If an insurance undertaking has a solvency ratio that is lower than 100% and thus breaches the SCR, it does not mean that the undertaking is insolvent. As the SCR is volatile, a breach of the SCR is not dramatic. The insurance undertaking will have to take measures to restore the SCR within 6 months. For instance, Ageas (UK) Limited publishes in its SFCR a solvency ratio of 91%. It explains that the drop in its solvency ratio is the result of the Lord Chancellor's decision to change the personal injury discount rate (Ogden rate). The report describes that the Board approved immediate actions to improve the solvency ratio by 25% after discussions with the supervisor (PRA). The actions included the issuance of an additional £50 m of share capital and the purchase of a whole account stop loss treaty.

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.

One should keep in mind that each SFCR only describes the situation of the undertaking at a specific point in time. Comparative numbers will be available as from 2018, although several insurance undertakings have already provided comparative amounts for the SCR and the MCR for the period prior to 1 January 2016. Comparative numbers allow the reader to better assess the situation of the undertaking over a period of time. This is in particular relevant for the solvency ratio (Own funds/SCR%), which may be affected by a number of elements, such as the long-term guarantee measures (the volatility or matching adjustment) or transitional measures (the adjustment of the risk-free interest rate or the technical provisions). Solvency ratios are not yet readily comparable because of these measures but the evolution of the solvency ratio over time is an important piece of information.

In terms of the solvency ratio, the investment strategy of the undertaking is also relevant. Diversification of investments will influence the solvency ratio. Under Solvency II, an investment in sovereign bonds requires no capital charge (in the standard formula) because such an investment is considered without risk. This may however not always be true. On the other hand, if an insurance undertaking diversifies its investments, that may have an impact on its solvency ratio: an investment in equity or property requires a capital charge as opposed to an investment only in sovereign bonds. However, an investment in equity or property might deliver a higher return, which may be more advantageous for policyholders. Just reading the solvency ratio is therefore not enough.

Solvency ratios are sometimes very high. This may not always be in the interest of policyholders as it may reflect a lack of vision. Capital should be used for investment and not for creating an artificially high capital buffer. An efficient allocation of capital may result in lower premiums for policyholders. An interesting example is Gresham Insurance Company Ltd, member of the Aviva plc group, which publishes in its SFCR a solvency ratio of 1.175% (almost 12 times its regulatory capital) and an MCR of 2.390%. No indication is given in the SFCR why the solvency ratio is so high. A reason might be found in the Summary section of the SFCR which indicates that "*the majority of written premiums is ceded to the company's immediate parent Aviva Insurance Limited through a quota share reinsurance arrangement.*" This example shows how important it is to look at the business model and not merely at the solvency ratio.

Low solvency ratios do not mean that the undertaking is experiencing difficulties. Important is to see what the capital management strategy is. Undertakings will sometimes express their intention in terms of the solvency ratio they want to keep as a target. That is very useful and can be tested. See, for instance, the SFCR of the UK insurance undertaking ELICO (The Equine and Livestock Insurance Company Limited): "*It is ELICO's intention to maintain own funds of no less than the higher of 110 percent of ELICO's SCR. In assessing the own funds, the Board considers its capital forecasts over a five year business planning period.*" And the SFCR of AM Trust Insurance Luxembourg S.A.: "*AILSA strives to maintain a SCR above 110%. AILSA prepares solvency projections for the following three years as part of its business planning process, which form part of the ORSA*".

Another interesting example is PZU which states in its SFCR that it is the intention to maintain target solvency ratios at the level of 200%. The company has agreed an early warning system whereby management actions are dependent on the current and projected level of coverage ratio of the SCR: green zone (above 160%), yellow zone (from 120% to 160%), red zone (under 120%) and final limit (under 100%).

In its SFCR, Canada Life Assurance Europe plc points out that "*the Company seeks to manage its total aggregated capital to exceed 125% of the SCR at all times on a Solvency II basis to protect against adverse changes in its overall risk profile, having regard to the risk preferences for material risks in the Company's Risk Strategy. In setting the target range for the solvency ratio, the Board considers the results of capital projections and stress tests produced as part of the ORSA process, which uses a five-year projection period.*"

Prof. Karel Van Hulle at the BIPAR 2016 Annual General Meetings, Prague

A very good presentation can be found in the document that precedes the Single SFCR of UNIQA which presents the group's risk strategy in an easy to read picture indicating that the solvency ratio should lie between 155% and 190% with a target solvency ratio of 170%.

6. *CONCLUDING OBSERVATIONS*

Although published SFCRs are not always readily comparable and although they may be lengthy and technical, there can be no doubt that they contain a wealth of information that can no longer be ignored.

Insurance intermediaries are therefore well advised to consult the SFCRs of the insurance undertakings, whose products they advise to their clients. That should not be too difficult and does not require them to become experts in accounting or actuarial science.

Insurance intermediaries should start their consultation of the SFCR with a reading of the Summary section of the SFCR. That section, which will rarely be more than 10 pages, contains the key elements of the SFCR. Following EIOPA's recommendations, it is likely that supervisory authorities will want to make sure that insurance undertakings and groups increase their efforts to make that section of the SFCR easier to read and more informative so that even non-experts can consult this section without being overwhelmed with technical information.

Reading this section, an insurance intermediary will have a general idea about the business strategy of the undertaking, its performance, any important events that have occurred during the reporting period, the key elements of the governance system, the main risks to which the undertaking is exposed, whether the undertaking has used transitional arrangements and what the impact of these arrangements are on the solvency position.

That section will also contain the solvency ratio, a point of reference that will increasingly be used in the market. Although caution must be applied when consulting that ratio, there can be no doubt that it is an important point of reference also for intermediaries. If there is a sudden drop in the solvency ratio or if the solvency ratio is lower than 100%, it would be good for the insurance intermediary to enquire why this is the case. Information can either be found directly in SFCR (for instance under the section "Capital management") or can be obtained directly from the undertaking. The intermediary should also inform the client about this. It is in the end for the client to decide whether or not a contract will be signed. For the intermediary, proper information of the client is an essential feature of professional behaviour.

The SFCR is for insurance undertakings an important communication tool. If the undertaking uses boilerplate language or repeats legal requirements rather than providing insights, it is unlikely that the undertaking or group has a consumer focus. That in itself is also important information for intermediaries. Intermediaries have a right to be well informed by the insurance undertakings whose products they advise to their clients. If the information is delivered in a readable manner, insurance intermediaries can be expected to read it and to use that information in the best interest of their clients.