Early lessons from Solvency II: are we on the right track?

Prof. Karel Van Hulle

KU Leuven and Goethe University Frankfurt

Member of the EIOPA Insurance and Reinsurance Stakeholder Group (IRSG)

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Agenda

1. The past
2. The present
3. Experience with Solvency II
4. Changes in the air
5. Are we on the right track?
6. The truth about Solvency II

1. The past

Insurance regulation under Solvency I

- Was boring: very difficult to explain to an outsider how to calculate the solvency margin under Solvency I
- Insurance regulation was highly prescriptive and paternalistic
- Insurance regulation was very legalistic and did not reflect the economics of the insurance business model
- Insurance regulation was more concerned with policyholder protection than with insurance
- Insurance supervisors were considered less important or qualified than their banking colleagues

Insurance supervision under Solvency I

- Insurance supervision was often limited to a detailed scrutiny of a number of forms
- Form over substance – tick the box exercise
- Insurance supervisors rarely engaged directly with supervised entities
- Insurance supervisors rarely had direct market experience: employment moves between supervision and industry or vice versa were often seen as suspect
- Insurance supervisors preferred detailed rules rather than a principles based approach, requiring judgment

2. The present

The birth of Solvency II

- For the EU, Solvency II is the most important change in insurance regulation since the last 30 years
- The birth of Solvency II was very much helped by the capital market crisis at the beginning of this century
- Crucial elements of Solvency II are:
  - The introduction of an economic risk based approach
  - The linkage between risk and capital
  - The crucial role to be played by risk management
- The need to move in the direction of a risk based solvency capital regime is now recognised throughout the world

Principle objectives of Solvency II

- Deepen the Single Market
- Enhance policyholder protection and financial stability
- Improve (international) competitiveness of EU insurers
- Further better regulation

Ways and means to achieve this

- Establishment of risk sensitive capital requirements to encourage and reward good risk management

- Emphasis on the responsibility of senior management to manage their business responsibly

- Fostering of greater supervisory convergence

- Institution of a regular dialogue between supervisor and supervised entities

Solvency II: 3 pillars and a roof

Group supervision
& cross-sectoral convergence

Groups are recognised as an economic entity
=> supervision on a consolidated basis
(diversification benefits, group risks)

Pillar 1: quantitative requirements

1. Harmonised calculation of technical provisions
2. "Prudent person" approach to investments instead of current quantitative restrictions
3. Two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR)

Pillar 2: qualitative requirements and supervision

1. Enhanced governance, internal control, risk management and own risk and solvency assessment (ORSA)
2. Strengthened supervisory review, harmonised supervisory standards and practices

Pillar 3: prudential reporting and public disclosure

1. Common supervisory reporting
2. Public disclosure of the financial condition and solvency report

(market discipline through transparency)

Solvency II Framework Directive

- Adopted on 25 November 2009
- Applicable from 1 January 2016 after amendment through Omnibus II (Directive of 16 April 2014)
- Omnibus II
  - New powers for EIOPA (successor of CEIOPS)
  - Introduction of transitional measures into Solvency II
  - Introduction of new regime for treatment of long term guarantee contracts
  - Makes Framework Directive more complicated

Omnibus II turns SII into a project in 4 stages

- Framework Directive containing the principles of the new solvency regime adopted by Council and EP (level 1)
- Implementation of the Framework Directive by the EC through a Delegated Act (Regulation): scrutiny of Council and EP (from 3 to 6 months) (level 2)
- Regulatory and Implementing Technical Standards developed by EIOPA which become legally binding after endorsement by the EC (level 3)
- Guidelines / Recommendations developed by EIOPA addressed to supervisors and/or insurers and which are applicable on a “comply or explain” basis (level 4)

Long term guarantee package

- Matching adjustment (cannot be combined with volatility adjustment or interest rate transitional)
- Extrapolation
- Volatility adjustment (MS may require prior approval)
- Extension of recovery period (7 years)
- Transitional measure on risk free interest rates (16 years)
- Transitional measure on technical provisions (16 years)
- Allowance for DA, RTS, ITS, annual reporting by EIOPA and reporting by EC after 5 years with possible review

Commission Delegated Regulation

- Adopted on 10 October 2014 (381 articles + annexes)
- Based upon 76 empowerments in the Solvency II Framework Directive as amended by Omnibus II
- Prepared on the basis of a formal Call for Advice sent to EIOPA in March 2009
- Advice provided to the EC (Nov. 2009 - Jan. 2010)
- Draft prepared by EC and consulted upon in the course of 2010-2011 and amended after adoption of Omnibus II
- Much attention paid to securitisation (new revival)
- Legal form of Commission Regulation (single rulebook)

Update of Delegated Regulation

- Paint was still fresh and we have the first changes:
  - Commission Delegated Regulation (EU) 2016/467 of 30 September 2015 concerning the calculation of regulatory capital requirements for several categories of assets by insurance and reinsurance undertakings
  - Commission Delegated Regulation (EU) 2017/1542 of 8 June 2017 concerning the calculation of regulatory capital requirements for certain categories of assets held by insurance and reinsurance undertakings (infrastructure corporates)
  - Draft Commission Delegated Regulation of 17 April 2018 concerning the calculation of regulatory capital requirements for securitisations and simple, transparant and standardised securitisations held by insurance and reinsurance undertakings

3. Experience with Solvency II

3.1. Capital requirements

Pillar I

- Most people are satisfied with the standard formula but nobody is really excited
- Market consistent valuation of insurance liabilities remains a challenge: there is no satisfactory theoretical solution yet for measuring long term liabilities
- Capital charges for equity investment remain controversial
- Too much actuarial involvement in the development of the standard formula? Limits to quantification?
- Supervisors look at the SCR as the MCR!
- Too many changes in the calibration

Use of LTG measures 2016

Type	Total	VA	TTP	MA	TRFR	DBER	None
Life	601	276	109	22	2	1	288
Non-life	1614	236	13	0	0	0	1368
Life & non-life	399	192	41	16	3	0	194
Reinsurance	331	26	0	0	1	0	312
Total	**2945**	730	163	38	6	1	**2162**

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Breach of SCR on 31 December 2016

Country	Undertakings	Country	Undertakings
Bulgaria	3	Malta	2
Cyprus	1	Netherlands	3
Czech Republic	1	Norway	1
France	4	Poland	1
Greece	1	Romania	1
Ireland	3	Spain	2
Italy	4	UK	12
Luxembourg	6	**EEA Total**	**44**

Weighted average SCR Ratio (Q3 2017)

- Total EEA: 239%
- Lowest: Latvia: 132%
- Highest: Germany: 338%
- Poland: 278%

Weighted average MCR Ratio (Q3 2017)

- Total EEA: 644%
- Lowest: Belgium: 421%
- Highest: Sweden: 927%
- Poland: 803%

Use standard and internal model 2017

	Standard	Partial	Full	Total
Life	550	29	22	601
Non-life	1540	38	36	1614
Life and non-life	367	24	8	399
Reinsurance	312	7	12	331
Total	**2769**	**98**	**78**	**2945**

3.2. Governance and supervisory review

Pillar II: Governance

- Regulators and supervisors rightly attach a great deal of importance to this area
  - Risk management (linkage between risk and capital)
  - Risk culture with tone from the top
  - Proportionality
  - ORSA
- Risk of regulatory overshooting : too many requirements and too little proportionality
- Difficult combination of three lines of defence governance model with the 4 key governance functions

Capital add-ons solo undertakings 2017

Country	Number	Life	Non-life	Reinsurance	Life and non-life
EU total	**20**	**7**	**10**	**3**	**0**
France	2	1	1	0	0
Ireland	1	1	0	0	0
Norway	2	0	2	0	0
UK	15	5	7	3	0

Capital add-ons on groups - 2017

Country	Number	Life	Non-life	Reinsura nce
EU total	**4**	**0**	**4**	**0**
UK	4	0	4	0

Own Risk and Solvency Assessment

- Analysis and recommendations by EIOPA (19 June 2017):
  - Majority of undertakings have made good progress in implementing the ORSA process
  - Need for greater involvement of the administrative, management or supervisory bodies
  - Scope of risk assessment must be further expanded
  - Overreliance by undertakings on the standard formula
  - Quality of stress testing including reverse stress tests and scenarios used in the ORSA can be further improved

Supervisory convergence

- Goldplating by MS and national competent authorities
- Risk of goldplating by EIOPA if supervisory convergence is convergence to the highest level of regulation/supervision
- New supervisory culture
  - Risk based
  - Proportionate
  - Forward looking, preventive and proactive
  - Challenging, sceptical and engaged
  - Comprehensive
  - Conclusive

EIOPA tools for supervisory convergence

- Guidelines and recommendations
- Monitoring of implementation in practice
- Supervisory colleges
- Supervisory handbook
- Peer reviews
- Bilateral engagements with national competent authorities
- Balance sheet reviews
- Country reviews
- Technical assistance
- Mediation

3.3. Public disclosure and supervisory reporting

Pillar III

- Change in culture: insurance sector has no transparency tradition. Is it too much, at once?
- Problem of data quality: comparability not evident. Can all insurers and supervisors deliver the same quality?
- Extensive supervisory reporting is needed because SII is principles based
- Supervisory reporting should help bring about a real dialogue between supervisor and supervised entities
- Public disclosure (SFCR) should help all stakeholders to better understand the complexity of the insurance business model

Solvency and Financial Condition Report

- Analysis and recommendations from EIOPA (18/12/2017):
  - Timely and compliant
  - Different language styles and formats: comparability
  - Need for better “summary”
  - QRT’s alone do not convey the message
  - ORSA information needs to be more specific
  - Information on risk sensitivity can be improved
  - Information on valuation not sufficiently clear
  - Information on eligible own funds must be more detailed
  - Comparative information needed

Exemptions item-by item reporting 2016

Country	Number of exemptions	Number of undertakings
EU Total	**134**	**3047**
Germany	74	339
Norway	45	71
Liechtenstein	13	38
Denmark	2	86

Exemption quarterly reporting (2017)

Country	Number of exemptions	Number of undertakings
EU total	**703**	**3047**
France	215	507
Luxembourg	182	272
UK	114	334
Germany	74	339
Norway	45	71
Malta	28	60
Sweden	22	140
Liechtenstein	13	38
Denmark	8	86
Portugal	2	43

3.4. Group supervision

Group supervision

- Difficult to implement because of legal, cultural, psychological, language, etc. reasons
- Group supervision was one of the most difficult issues in the development of Solvency II
  - The texts are unreadable: what is a group?
  - Group support was deleted
  - All supervisors are equal, but some are….
  - Some supervisors still fail to see the relevance of group supervision
  - Need for common supervision of large insurance groups

First assessment of group supervision

- EIOPA assessment (22 December 2017)
  - Group definition
  - Removal of sub-group supervision
  - Cooperation within colleges of supervisors
  - Need for greater consistency for approval of group internal models

- EC assessment (5 April 2018)
  - Reforms will be dealt with as part of the 2020 review
  - Greater role for EIOPA in ensuring supervisory convergence in the area of internal model applications as part of the ESA review

4. Changes in the air

Review of the Delegated Regulation

- Specific review clause in recital 150 to the DA
- Review to take place before December 2018
- Call for advice from EC to EIOPA
  - Proportionality
  - Simplification
  - Calibration changes and technical improvements
  - Undue restrictions to corporate finance
- EIOPA first set of advice (137 p.): 30 October 2017
- EIOPA's second set of advice (610 p.): 28 February 2018

Review of the Framework Directive

- Review clause foreseen in Article 77f for LTG package
- Review to take place before 1 January 2021
- Likely topics on the agenda:
  - Sustainable finance
  - Long-term insurance
  - Proportionality
  - Changes to the standard formula
  - Changes to the calibration (Brexit)
  - Group supervision

5. Are we on the right track?

Solvency II: a dynamic process

- Solvency II is not perfect and was never meant to be
- Solvency II has been designed as a flexible regime that can and should be regularly amended in order to take account of practical experience
- Many reviews are specifically foreseen in the Framework Directive and the Delegated Regulation (for instance, enhancement of group supervision: 31 December 2018)
- Conflicting objectives interfere in the process: level playing field with banking, capital markets union, long term investments, sustainable finance

Early lessons from Solvency II

- Insurers and insurance supervisors have difficulties to work with a principle based approach
- Insurers are developing strategies to optimize capital
- EIOPA stress tests show that most insurers are well capitalised
- Risk management of most insurers has improved
- Insurance and insurance regulation/supervision is taken more seriously (also by banking supervisors)
- Supervisory colleges are playing an important role in furthering a single European rulebook

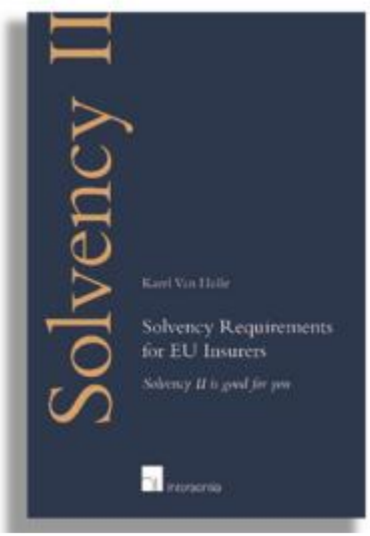
Important aspects of Solvency II

- Solvency II puts more emphasis on the responsibility of each individual undertaking
- Internal models are an inherent part of Solvency II
- Solvency II recognises the strength and the weakness of human nature: more focus on risk management and governance
- Solvency II cannot work without a change in management culture and supervisory culture
- Insurers and reinsurers should use the SFCR to demistify their activities to external stakeholders

5. The truth about Solvency II

Where do I learn the truth about SII?

- **“Solvency Requirements for EU Insurers: Solvency II is good for you”**
- Author: Karel Van Hulle
- Foreword: Gabriel Bernardino (Chairman of EIOPA)
- Publisher: Intersentia (Mortsel - Cambridge)
- ISBN 978-1-78068-177-1
- Number of pages: 350 pp.
- Price: 125 EUR
- When? October 2018
- Is it worth it? YES



ICIR International Center for Insurance Regulation

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