SOLVENCY REQUIREMENTS FOR EU INSURERS

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Solvency II is Good for You

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*"Not everything that can be counted,
counts, and not everything that
counts can be counted"*

Albert Einstein

FOREWORD

On 1 December 2004, I met Karel Van Hulle for the very first time at a meeting of the so-called Insurance Committee in Brussels. Shortly before – in November 2004 – Karel became the Head of the Insurance and Pensions Unit of the European Commission's Directorate General for Internal Market and Services.

It was also the penultimate meeting of the Insurance Committee before the European Insurance and Occupational Pensions Committee (EIOPC) – the Level 2 committee of the Lamfalussy process – replaced it on 13 April 2005. I was representing Portugal.

The meeting agenda was rich and full: introducing the draft Work Program for 2005, Karel (the Chairman of the Committee) stressed that Solvency II would be the Committee's main work focus in 2005. The need for an impact assessment meant that formally, it would not be possible to table a proposal of Solvency II in 2005, but a draft proposal would be prepared by the end of the year.

Furthermore, Karel announced that 2006 was the target date for any proposal on insurance guarantee schemes. All delegations who took to the floor stressed the importance, scale and ambition of the Solvency II project, the complexity even exceeding that of Basel II, the project of the banking sector.

In fact, what I remember most of Karel from that meeting was the impression he made on the insurance experts from the very first day, by mentioning that in his first contact with insurance, one thing is taken for granted: insurance is by far more complex than banking.

From that day in December 2004, until February 2013 when Karel left the European Commission, I had the privilege of working very closely with him in various capacities.

On 10 July 2007, the European Commission presented its proposal for the Solvency II Directive. At that time, Portugal held the European Union Presidency and the Portuguese government asked me to chair the Council working group in charge of the Member State negotiations.

The headline of the European Commission's press release read: "Solvency II: European Union to take global lead in insurance regulation". The European Commission proposed a ground-breaking revision of European Union insurance law to improve consumer protection, modernise supervision, deepen market integration and increase the international competitiveness of European insurers. Under the new system, insurers would be required to take account of all types of risk to which they are exposed and to manage those risks more effectively. In addition, insurance groups would have a dedicated "group supervisor" that would enable better monitoring of the group as a whole. The European Commission aimed to have the new system in operation by 2012, which was good news for consumers, for the insurance industry and for the economy of the European Union as a whole.

During the second half of 2007, Karel and I worked very closely to ensure that good progress was made during the Solvency II discussions. After intensive negotiations between the European Commission, the European Parliament and the European Council, the three European legislative institutions agreed on a compromise text for the Solvency II Framework Directive. On 22 April 2009, the European Parliament's plenary session adopted the Directive, which finally became Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

Over the years, I learned to trust and respect Karel. Karel represented the European Commission in the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and in the International Association of Insurance Supervisors (IAIS). Most of the time, we agreed and were of the same opinion. And, when we disagreed, I always appreciated Karel's pragmatic way of finding a good compromise and moving forward.

This book tells the story of Solvency II through the lens of one of its major architects. Karel always understood that a major reform like Solvency II had to be built on extensive consultation and debate, and ultimately benefits from the contributions of many dedicated people from both the public and the private sectors. This is what makes Solvency II a unique piece of legislation in the financial sector.

History will look positively on Karel's commitment and passionate work in the area of insurance regulation. He was instrumental in driving Solvency II through difficult waters in times of crisis. He did so because he essentially believed in sound principle- and risk-based regulation. I am sure that at the end of the book, which makes for pleasant reading, the reader will agree: "Solvency II is good for you!"

Gabriel Bernardino
Chairman, European Insurance and
Occupational Pensions Authority (EIOPA)

PREFACE

One might be alarmed, looking at the length of this book: so many pages to convey the message that "Solvency II is good for you". Can this be right? I think it is. It is precisely because I believe that "Solvency II is good for you" that I decided to write this book. I had not expected it to be so long, but the length of the book is the result of complexity added to the initial principles-based text, because of both the financial crisis and the reluctance in the insurance world and in the supervisory community to leave too many questions unanswered.

I was privileged to have been made responsible for the development of a new, risk-based solvency capital regime for (re)insurance undertakings in the EU. However, at the start, it seemed an almost impossible task. Carrying out such a profound change in a naturally conservative sector sounded like a daring proposition. However, I was wrong. The enthusiasm with which the insurance industry, the supervisory community, finance ministries and stakeholders in general approached this project was impressive. The support for this project was such that it led me to conclude my presentation on the objectives of Solvency II at a conference organised by Confrontations Europe in the European Economic and Social Committee in Brussels on 8 March 2007 with the words: "Solvency II is good for you".

Solvency II is good because it moves risk management to the forefront. It fosters a holistic and forward-looking appreciation of risk and enhances market forces by increasing transparency and disclosure. Solvency II has created a more transparent, more professional and thus more secure insurance market. That became clear when the financial crisis also hit the insurance industry. The importance attached to risk management and the careful preparation of the project, with consultations, quantitative impact studies, workshops and seminars, created an environment that helped the insurance industry to survive one of the worst possible scenarios that could have been imagined: a prolonged low interest rate environment, which hits both sides of the balance sheet and makes it difficult to continue to offer long-term guarantees. As can be seen from the last stress test carried out by EIOPA, the insurance industry is not only well capitalised, but it is also capable of withstanding very severe natural catastrophe scenarios.

Solvency II is not only good, it is also good *for you*: as a *policyholder or beneficiary*, because it increases the level of security, making it less likely that an insurer will fail; as a *(re)insurer*, because it rewards professionalism, making the industry more attractive to young professionals; as a *supervisor*, because it delivers the right supervisory tools, making it easier to carry out forward-looking supervision; as an *actuary*, because it puts the actuarial function on the map, making full use of the actuarial profession's expertise; as a *risk manager*, because it adopts the newest techniques in risk management, giving proper recognition to the importance of risk management; as an *insurance intermediary*, because it brings transparency and a customer focus, making it easier to advise clients on the best insurance solution; as an *academic*, because it provides detailed data on the insurance industry, allowing for evidence-based research; and as a *consumer*, because it delivers better-designed products, making life easier by better responding to customer demands.

Solvency II is good for society as a whole because it strengthens an industry the importance of which is probably the best-kept secret in the world. However, without an insurance industry that is strong and well managed, our society will not be able to meet the challenges that face us, such as climate change, increased longevity, health care, pension financing, and so on.

Of course, Solvency II is not perfect. It was never meant to be. And Rome was not built in a day. A review is planned for 2020/2021. This review should be carried out very carefully. It should provide better treatment for long-term business, with appropriate recognition of the insurance business model. Learning from our experience and from that in other parts of the world, we should improve the system where we can, but do so with full respect for the principles of a risk-based solvency regime, which creates a link between risk and capital and which aims at protecting policyholders and beneficiaries.

In the first part of this book, I explain the origins of Solvency II. The project was inspired by developments both within Europe, particularly in Germany, the Netherlands, Switzerland and the UK, but also outside Europe, in countries such as Australia, Canada and the USA, and in international bodies, such as the Basel Committee, the IASB and the IAIS. Valuable input was obtained from the actuarial profession and from the risk management community.

Like all EU legislation, Solvency II is not the work of anonymous "Brussels". The Solvency II framework was extensively consulted on and debated. It took more time than expected, in part because of the financial crisis. Many people contributed to the project: a small team of civil servants and national experts at the EC, in close cooperation with supervisors organised within CEIOPS/EIOPA and with experts from the (re)insurance industry. They were helped by actuaries, chief risk officers, policy advisers, experts in finance ministries, consumers and civil society in general. The ultimate decisions were taken by the EC and by the co-legislators: the EP and the Council. Although the negotiations were sometimes difficult and challenging, one should not forget that Solvency II is a European project and that – by producing Solvency II – we Europeans showed that we are capable of carrying out a major reform that is in the interest of the EU, its undertakings and its citizens, and that has, right from its inception, influenced similar reforms in many other parts of the world, as well as within the IAIS.

The second part of this book contains a detailed description of the Solvency II regulatory framework. It shows that solvency is not just about capital. It is about people, about risk management and about a dialogue between supervisors and supervised entities in an atmosphere of trust. This second part has been written without too much technical detail. I have tried to give a holistic picture of Solvency II, how it fits into the European single market, what its main characteristics are and how it relates to other parts of EU legislation that are relevant for the (re)insurance industry. I have also provided some examples and identified good practices. As insurance is technically complex, solvency regulation is not easy to understand. Nevertheless, I have written this book so that non-experts can also understand what this is all about. That may be a disappointment for experts, who might have wanted more technical detail. I have however learned from experience that even experts sometimes lose their way. This book might help them to get back on the right track.

I have not covered a number of topics that certainly merit more attention, such as a comparison between the US Risk-Based Capital model and Solvency II, and between Solvency II and the International Capital Standard that is being developed by the IAIS and that will hopefully see the light of day as planned by the end of 2019. A discussion of these topics would have made the book even longer.

I could not have written this book without the help of many people. As a non-expert in insurance, most of what I know I have learned from others: my colleagues at the EC, especially the national experts seconded to the EC, my colleagues at KU Leuven and at Goethe University in Frankfurt, and my many friends in the supervisory community, in EIOPA, in the actuarial profession, in the communities of risk managers and insurance intermediaries, and in the (re)insurance industry. I would like to thank so many people by name, but I am afraid that if I do so, I might miss out people who deserve to be mentioned.

However, I would like to make a few exceptions. I want to thank in particular Lieve Lowet (Schuman European Affairs), who has not only been a source of inspiration but also agreed to read and reread many of my drafts and whose comments have been very valuable. I would also like to thank Ben Carr (Aviva), former national expert in my Solvency Technical Team at the EC, who reviewed the Pillar 1 chapter of this book, and Ivo van Es (member of the ECON Secretariat), former member of the Solvency Technical Team at the EC, who provided insights from a EP perspective.

Finally, I want to thank my wife, Greta, for her patience and understanding. It has at times been difficult, but she knew that this book was important to me and she gave me the time and the support to finish it.

Karel Van Hulle
30 April 2019

CONTENTS

LIST OF ABBREVIATIONS

AAE	Actuarial Association of Europe
AD	Accounting Directive
AIFM	alternative investment fund managers
ALDE	Alliance of Liberals and Democrats for Europe (EP)
AMSB	administrative, management or supervisory body
AR	Audit Regulation
BCBS	Basel Committee of Banking Supervisors
BIS	Bank for International Settlements
BMA	Bermuda Monetary Authority
BoS	Board of Supervisors (EIOPA)
BSCR	basic solvency capital requirement (basic SCR)
CEA	Comité Européen des Assurances (now Insurance Europe)
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Pensions Supervisors
CEO	Chief Executive Officer
CESR	Committee of European Securities Regulators
CFO	Chief Financial Officer
Co-Co	Coordinating Committee
COM	(European) Commission (Services)
ComFrame	Common Framework for the Supervision of IAIG
COMP	Directorate-General for Competition (EC)
CoR	European Committee of the Regions
COSO	Commission of Sponsoring Organizations (Treadway Commission)
Council	Council of Ministers of the EU
CQS	credit quality step
CRA	Credit Rating Agency
CRD	Capital Requirements Directive
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
DA	Delegated Act

DG	Directorate-General (European Commission)
EBA	European Banking Authority
EC	European Commission
ECAI	External Credit Assessment Institution
ECB	European Central Bank
ECFIN	Directorate-General for Economic and Financial Affairs (EC)
ECIROA	European Captive Insurance and Reinsurance Owners Association
ECON	Economic and Monetary Affairs Committee (EP)
ECR	European Conservatives and Reformists (EP)
EEA	European Economic Area
EEC	European Economic Community
EESC	European Economic and Social Committee
EFR	European Financial Services Roundtable
EIB	European Investment Bank
EIF	European Investment Fund
EIOPA	European Insurance and Occupational Pensions Authority
EIOPC	European Insurance and Occupational Pensions Committee (EC)
EMAC	Economic and Monetary Affairs Committee (EP)
EMIR	European Market Infrastructure Regulation
EMPL	Directorate-General for Employment, Social Affairs and Inclusion (EC)
ENTR	Directorate-General for Enterprise and Industry (EC)
EP	European Parliament
EPIFP	expected profits in future premiums
EPP	European People's Party (EP)
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FD	Solvency II Framework Directive
FICOD	Financial Conglomerates Directive
FINMA	Swiss Financial Market Supervisory Authority
FISMA	Directorate-General for Financial Stability, Financial Markets and Capital Markets Union (EC)

FIN-USE	Forum of User Experts in the Area of Financial Services
FIO	Federal Insurance Office (Treasury Department USA)
FoE	freedom of (cross-border) establishment
FoS	freedom to provide (cross-border) services
FSA	Financial Services Authority (UK)
FSAP	Financial Sector Assessment Program
GAAP	generally accepted accounting principles
GDV	German Insurance Association
GNAIE	Group of North American Insurance Enterprises
GREENS	The Greens/European Free Alliance (EP)
G-SII	global systemically important insurer
GSP	group-specific parameters
GUE/NGL	European United Left/Nordic Green Left (EP)
IAA	International Actuarial Association
IAASB	International Auditing and Assurance Standards Board
IAD	Insurance Accounts Directive
IAIG	internationally active insurance group
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAS	Individual Capital Adequacy Standards (UK)
ICP	Insurance Core Principle (IAIS)
ICS	International Capital Standard (IAIS)
IDD	Insurance Distribution Directive
IFRS	International Financial Reporting Standards
IGD	Insurance Groups Directive
ILS	insurance-linked securities
IMD	Insurance Mediation Directive
IORP	institutions for occupational retirement provision
IORP I	IORP Directive (2003)
IORP II	IORP Directive (recast) (2016)
IRSG	Insurance and Reinsurance Stakeholder Group (EIOPA)
ISA	international standards on auditing
ITS	implementing technical standards
JLS	Directorate-General for Justice, Freedom and Security, Private Law and Criminal Law (EC)
JURI	Legal Affairs Committee (EP)

LAC-DT	loss-absorbing capacity of technical provisions and deferred taxes
LGD	loss-given-default
LTG	long-term guarantees
MA	matching adjustment
MARKT	Directorate-General for Internal Market and Services (EC)
MCR	minimum capital requirement
MiFID	Market in Financial Instruments Directive
MS	Member State
NAIC	National Association of Insurance Commissioners (USA)
NCB	national central bank
NSA	national supervisory authority
NSLT	health not similar to life techniques
NTNI	non-traditional non-insurance
OECD	Organisation for Economic Cooperation and Development
OEEC	Organisation for European Economic Cooperation
OJ	Official Journal of the European Union
ORSA	own risk and solvency assessment
PD	probability of default
PEIF	Pan-European Insurance Forum
QIS	quantitative impact study
QRT	quantitative reporting template
RSR	regular supervisory report
RTS	regulatory technical standards
S&D	Progressive Alliance of Socialists and Democrats (EP)
SANCO	Directorate-General for Health and Consumers (EC)
SCE	European Cooperative Society
SCR	solvency capital requirement
Sec Gen	General Secretariat (EC)
SFCR	solvency and financial condition report
SII	systemically important insurer
SLT	health similar to life techniques
SME	small and medium-sized enterprise
SPE	special-purpose entity
SPV	special-purpose vehicle
SRP	supervisory review process
SST	Swiss Solvency Test

STS	simple standardised and transparent securitisations
TFEU	Treaty on the Functioning of the European Union
UCITS	undertakings for collective investment in transferable securities
UK	United Kingdom
USA	United States of America
USP	undertaking-specific parameter
VA	volatility adjustment
VaR	value-at-risk