

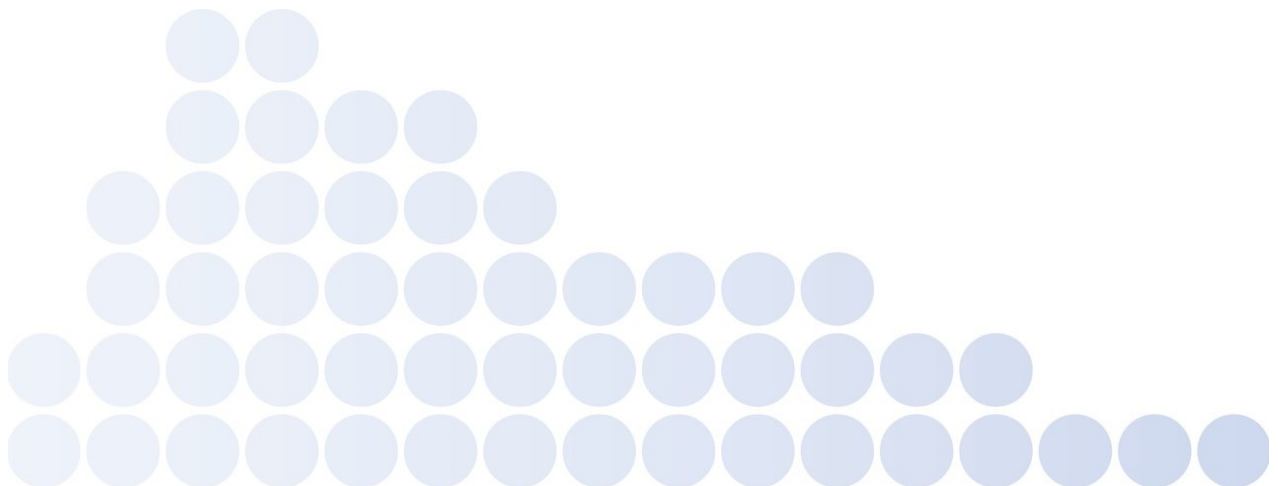


# Financial Services Commission

Solvency 2

Self Assessment Feedback Paper

Published: 06th May 2015



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## Introduction

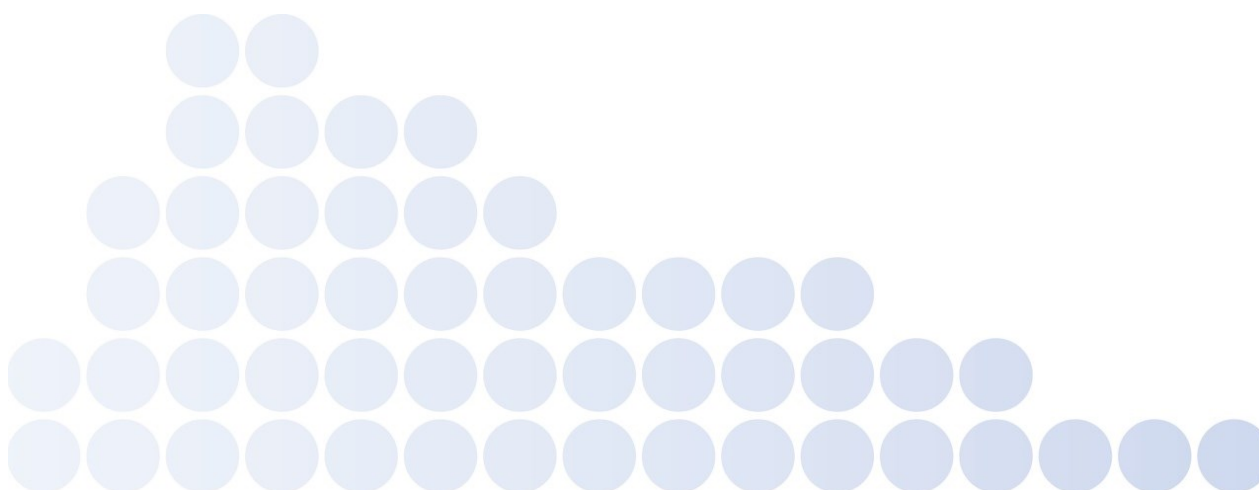
As part of the FSC's ongoing assessment of insurers' preparations for Solvency 2 a number of self-assessments were requested in quarter 3 of 2014. Details of these can be found in the appendix.

It was requested that the information to be provided be reviewed and approved by firms' Boards. The information supplied has now been reviewed and forms the basis of this feedback paper.

The paper looks at each pillar of Solvency 2 in turn, as well as a section on firms' implementation plans. At the outset of each section we provide a reminder of the FSC's expectations of firms.

Overall, good progress continues to be made, and the effort needs to be maintained as we enter the final straight. However, for some firms an increase in effort is required.

The FSC is engaged with those individual firms which we believe pose higher risk, and we will act where we judge firms are not making sufficient effort. The FSC is keen to maintain a two-way dialogue.



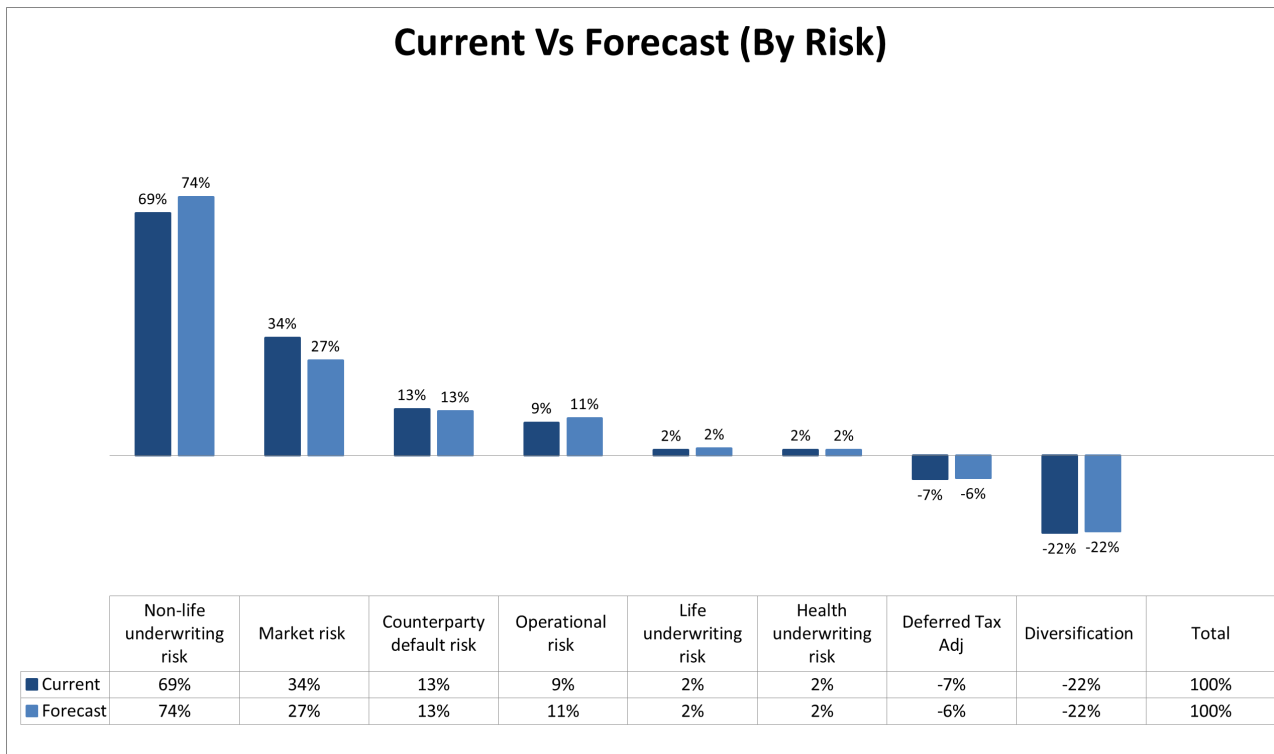
# 1. Pillar 1

## 1.1 FSC's Expectations of Firms

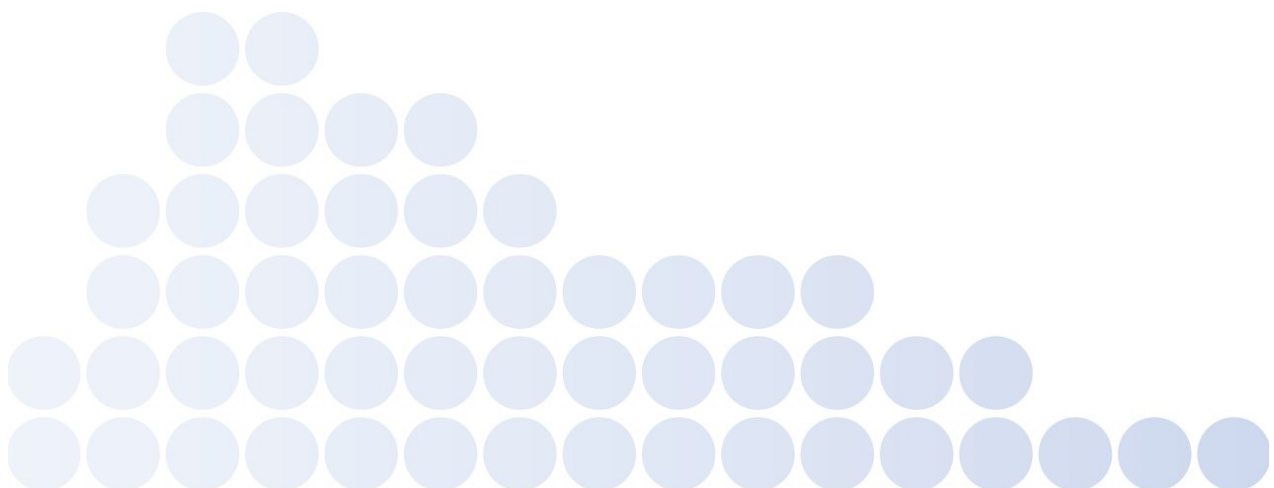
*"Firms should be actively managing and pursuing Solvency II capital plans".*

All firms demonstrated that they understood the likely capital position under S2 and are engaged in ensuring they will be compliant by 2016.

## 1.2 Solvency Capital Requirement (SCR) Analysis

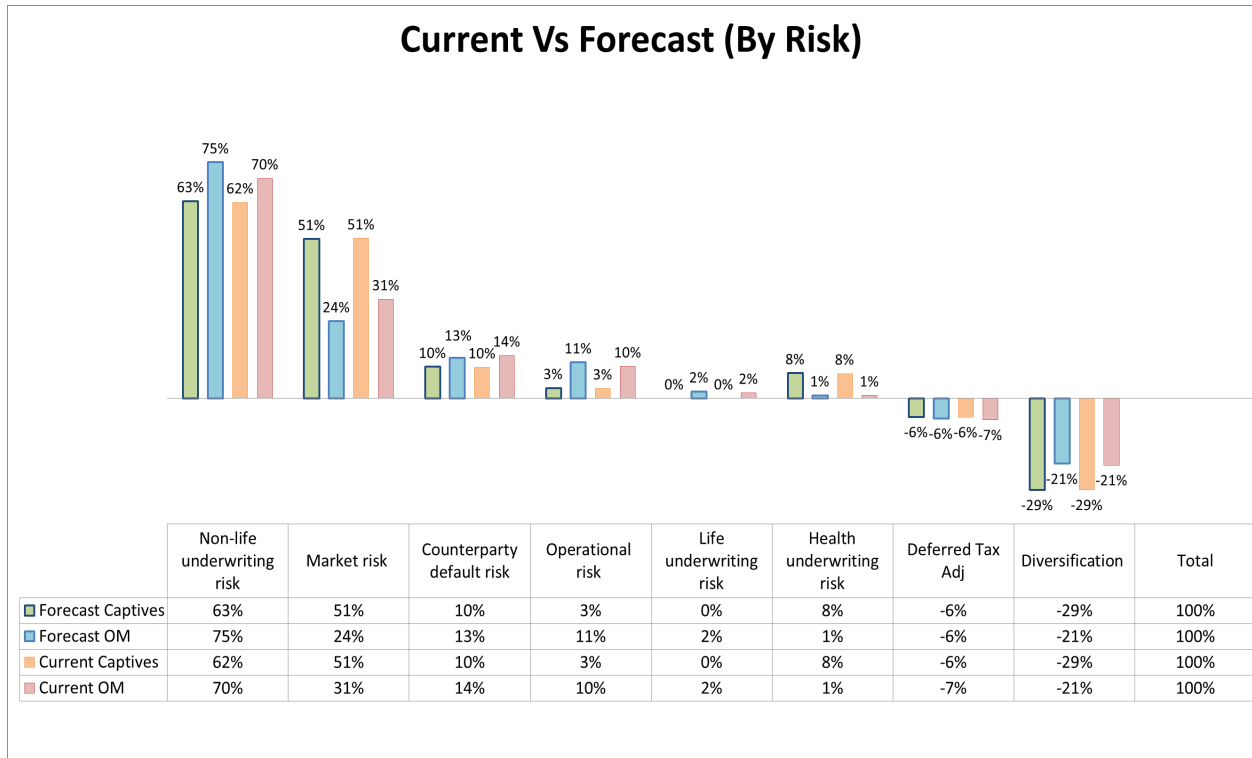


Unsurprisingly non-life underwriting risk is the largest component of the overall SCR for most insurers. It was evident from submissions that a number of companies plan to de-risk their investment portfolio in order to reduce their SCR, with the market risk as a percentage of the total predicted SCR greatly reduced for a number of companies relative to the current position. For the market as a whole this resulted in the market risk reducing from 34% of overall SCR to 27% (see charts above).



### 1.3 Captives Vs Open Market

The chart below confirms the FSC’s expectation that market risk was of greater significance for captives than for open market (OM) insurers. Interestingly captives are in most cases not intending to de-risk their investment portfolios.



### 1.4 Equity stress

The FSC notes that a number of approaches were adopted when carrying out the equity stress. All of the following relate to the base scenario only. Some firms did not make any allowance for the transitional provisions, and for example for Tier 1 applied an equity stress of 46.5% which was the 39% stress plus the 7.5% symmetric adjustment from the EIOPA preparatory stage technical specifications. Other firms applied a stress of 53.5% (100% less 46.5%) which points to either the stress being incorrectly applied or the template being incorrectly completed. Others applied a stress of 22%, which was the transitional stress for Tier 1, whereas others applied 29.5%, presumably 22% plus the 7.5% symmetric adjustment. A small number of firms applied a different parameter and it is not clear how these were derived.

The FSC expects that all insurers that meet the criteria for using the lower transitional equity risk stress parameters will choose to do so. The FSC will provide further commentary in the [Frequently Asked Question \(FAQ\)](#) section of its website in due course.

### 1.5 Own funds

All firms treated their ordinary share capital as Tier 1. While this may have been appropriate for the preparatory phase and a best endeavours exercise, the FSC now expects all firms to ensure that own funds meet all the criteria to be classified in Tiers 1 and 2. These criteria are set out in the Delegated Acts, and firms should be mindful of the EIOPA Guidelines on Classification of Own Funds.

[https://eiopa.europa.eu/Publications/Guidelines/COF\\_GLs\\_EN.pdf](https://eiopa.europa.eu/Publications/Guidelines/COF_GLs_EN.pdf)

Possible examples where share capital would not qualify as Tier 1 include:

- There are various classes of shares and some rank ahead of others – only the most deeply subordinated will be Tier 1;
- There is no restriction in the share instrument on issuing dividends or subsequently cancelling them in the event the SCR is breached

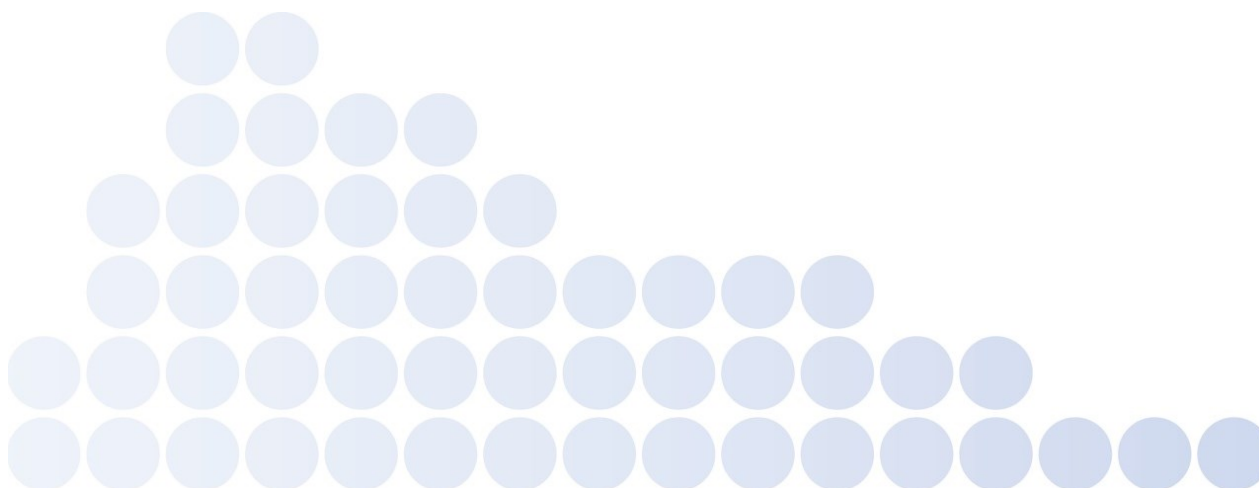
## 1.6 Technical Provisions

The FSC's SCR and balance sheet template did not include a detailed split of technical provisions and, for example, premium provisions were combined with the claims outstanding. This limited the scope for analysis but nonetheless it was possible to glean a number of observations (this will be less of an issue once Solvency 2 goes live given the granularity of the Quantitative Reporting Templates (QRTs)).

Firstly it was apparent from conversations with firms that the treatment of run-off costs differed. Some firms overlooked it entirely; others made a modest allowance whereas others made an appropriately cautious allowance. This appeared to be among the most contentious of assumptions when setting the provisions. The FSC will provide further commentary in the [FAQ](#) section of its website in due course.

Secondly the Solvency 2 balance sheet is expected to be carried out on a cashflow basis and most firms correctly restated the intermediary balances (debtors and creditors) with a movement into the technical provision. Some firms however appeared to overlook this.

The FSC intends to carry out a thematic review on the setting and validation of technical provisions this quarter and will aim to provide more substantial feedback ahead of Solvency 2.



## 2 Pillar 2

### 2.1 FSC's Expectations of Firms

*"Firms should be actively progressing plans to meet governance requirements, including providing a credible Forward Looking Assessment of Own Risks (FLAOR) report in line with required timescales. Related to this, firms should be embedding these requirements and be able to demonstrate this to the FSC"*

The FSC issued a [Guidance Note 14 \(GN14\)](#) in December 2013, on the Systems of Governance (SoG). This sets out the expectations of firms in respect of the criteria of sound and prudent management within the existing regulations, and also the corporate governance requirements of the Solvency 2 directive. These guidelines were divided into those which should already be in place, so-called "current guidelines", and the balance which need to be met before 1st January 2016 to ensure compliance with the Solvency 2 directive, so-called "Solvency 2 guidelines".

### 2.2 Systems of Governance

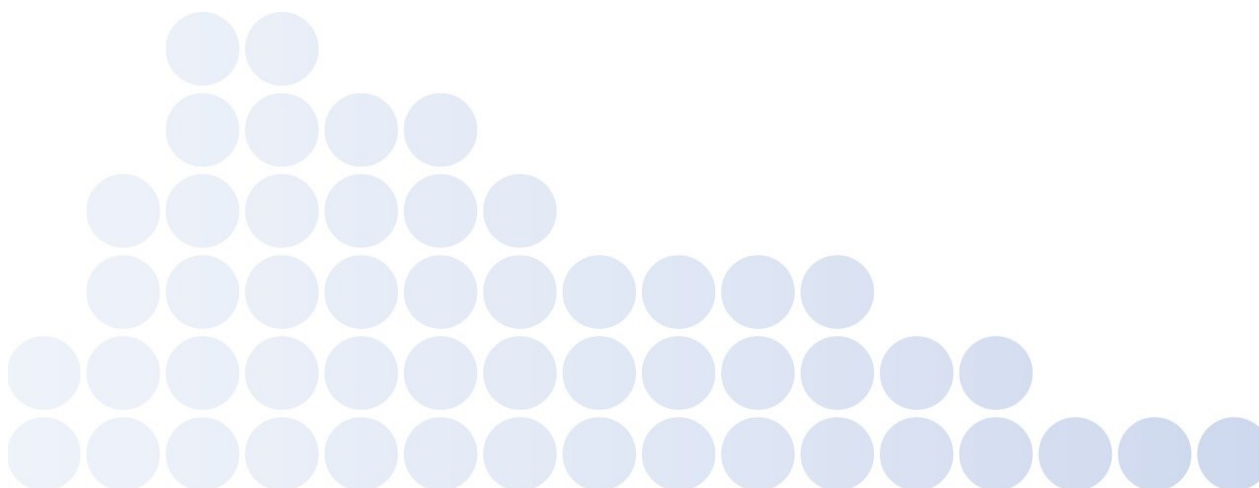
"Current Guidelines"

Adherence to [GN14](#) was seen as evidence that the firm was being run in a sound and prudent manner. It was anticipated in the June review that the majority of respondents would be indicating full, or substantial, compliance against these guidelines.

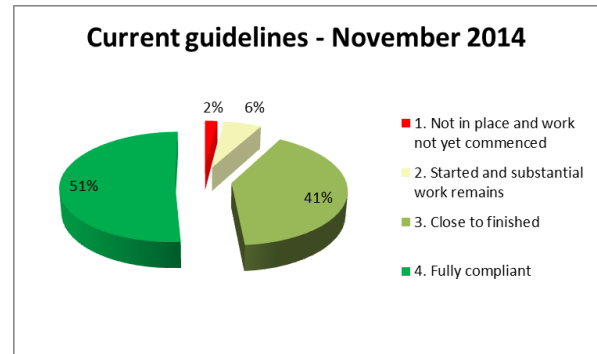
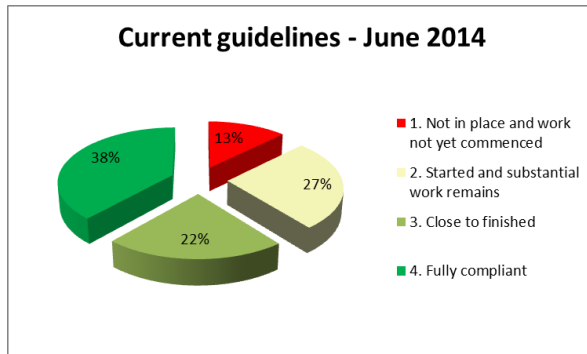
However the results showed that the market had not paid sufficient attention to meeting "current" [GN14](#) guidelines. In the [feedback paper](#) issued in October 2014, the FSC stressed the importance of adhering to these guidelines and confirmed that it would be looking for their full adoption when the results of the second self-assessment were reviewed. Unfortunately, this does not appear to be the case in all firms.

In overall terms, progress has been observed since the previous data submissions, both in the level of detail provided in the accompanying text and in the state of readiness reported.

In some cases, following a review of their initial self-assessment, firms have reduced their scores where further work was identified as being necessary to become compliant with several key guidelines. These changes were explained in the text and increased the credibility of their overall self-assessment.



## 2.3 Current guidelines – June and November 2014



The FSC had expected firms to be fully compliant with [GN14](#) requirements by 28<sup>th</sup> November 2014. As can be seen above, the overall score was only 51%, which was disappointing. The FSC will be following-up with firms who do not appear to have credible plans to achieve full compliance in the immediate future. Several firms reported that a number of [GN14](#) guidelines would be completed after review by their Boards at meetings planned in the weeks immediately after the deadline. If these items were subsequently approved by their Boards, then the current aggregate position will improve significantly.

### Most Prepared - June 2014

- 2.4 Decision-making
- 2.1 The Board
- 2.9 Fit requirements
- 2.10 Proper requirements
- 2.2 Organisational and operational structure

### Least Prepared – June 2014

- 2.20 Asset-liability management policy
- 2.42 Critical or important operational functions and activities
- 2.19 Reinsurance and other risk-mitigation techniques – risk management policy
- 2.11 Fit and proper policies and procedures
- 2.48 System of Governance at group level

### Most Prepared – November 2014

- 2.4 Decision-making
- 2.1 The Board
- 2.9 Fit requirements
- 2.10 Proper requirements
- 2.46 Entity responsible for the fulfilment of the group governance requirements

### Least Prepared – November 2014

- 2.24 Assessment of non-routine investment activities
- 2.42 Critical or important operational functions and activities
- 2.12 Outsourcing of key functions
- 2.44 Intra-group outsourcing
- 2.45 Outsourcing written policy

The areas most commonly reported as requiring further work were:

- Actuarial;
- Audit; and
- Investment policies.

Actuarial policy is the area where a disappointing number of firms had made little or no progress since the last self-assessment. Priority should be given to moving this forward given the importance of this function under Solvency 2.

Examples were seen where firms have decided to carry out an external validation of their new procedures and policies, as well as the results of their FLAOR. The results of these reviews were then to be discussed at the following Board meeting, before they approve their roll-out across the company.

Whilst this is not a requirement under Solvency 2, it appears to be a prudent approach to follow. As the FSC will be focussing on how firms are embedding these processes into “business as usual”, there are many firms who

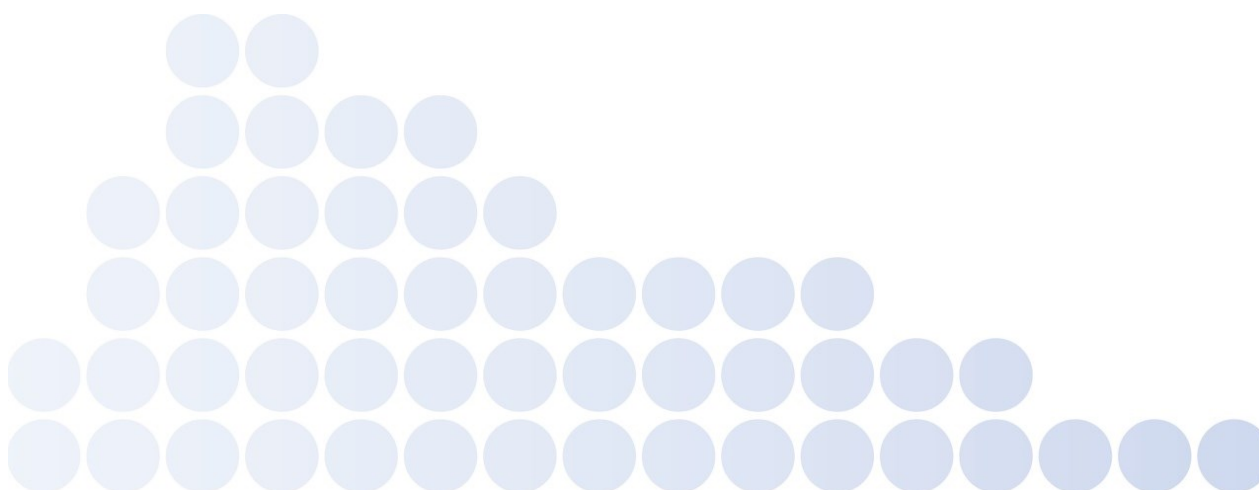


would benefit from further validation and testing of their procedures. Independent evaluation would also provide the FSC with a degree of comfort regarding a possible focus on a tick-box approach taken by some Boards in the approval of policies and procedures. Examples were found where plans and self-assessments showed firms presenting a large number of documents for approval at a single Board meeting. In such circumstances, there is a significant risk that insufficient rigour was exercised. Further validation will be sought when the FSC meets with these firms.

Inconsistencies highlighted in the previous feedback report were still evident this time around. Examples included text remaining unchanged throughout the questionnaire, irrespective of which guideline was under consideration, and scores of 4 reported where the underpinning action had not yet been completed e.g. Fit & Proper stated to be scored at 4, yet the company had not finalised its Fit & Proper policy. Another example was where companies had scored several key functions which had been outsourced as complete yet the company's Outsourcing Policy had not been completed.

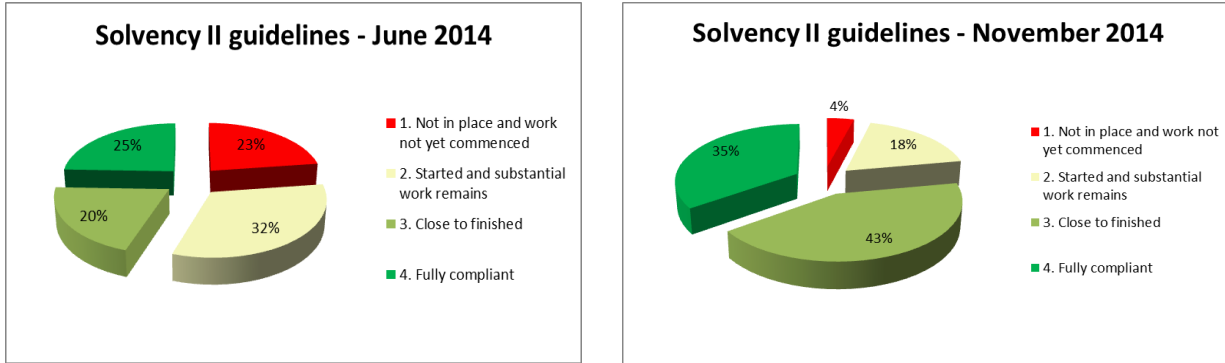
Also, a number of firms had reported scores of 3 in June 2014 with text suggesting that the outstanding work against that guideline would be completed before 28 November 2014. However, when their second self-assessment was reviewed, no progress had been made and the text provided does not explain the delay.

Another issue noted was that under 2.8 Contingency Plans, the majority of firms appear to have purely focussed on IT Disaster Recovery plans, rather than preparing contingency plans for any area where the firm considers themselves to be vulnerable. Firms should review their risk register to ensure that they have in fact prepared a full range of contingency plans.



## 2.4 Solvency 2 Requirements

The charts below compare the market state of preparedness in meeting the guidelines required to comply with the Solvency 2 directive, as at June 2014 and when the latest self-assessments were submitted in November.



In aggregate terms, the market has moved closer towards completion. However, as can be seen above, 23 per cent of scores remain at 1 or 2, showing that considerable work remains to be done. Whilst the majority of firms plan to complete all remaining Pillar 2 actions by mid-2015 to allow for slippage; testing and embedding, some firms' plans show later deadlines. They may now wish to move these dates forward to build in an appropriate buffer.

### Most Prepared – June 2014

- 2.5 Documentation of decisions taken at the level of the Board
- 2.27 Derivatives
- 2.50 Group risk management
- 2.15 Risk management function: general tasks
- 2.41 Actuarial reporting to the Board

### Least Prepared – June 2014

- 2.29 Capital Management Policy
- 2.30 Medium-term Capital Management Plan
- 2.34 Internal audit policy
- 2.35 Internal audit tasks
- 2.39 Underwriting policy and reinsurance arrangements

### Most Prepared – November 2014

- 2.5 Documentation of decisions taken at the level of the Board
- 2.49 Risks with significant impact at group level
- 2.50 Group risk management
- 2.15 Risk management function: general tasks
- 2.13 Role of the Board in the risk management system

### Least Prepared – November 2014

- 2.29 Capital Management Policy
- 2.30 Medium-term Capital Management Plan
- 2.38 Data quality
- 2.35 Internal audit tasks
- 2.39 Underwriting policy and reinsurance arrangements

The areas where most work remains are Capital Management, Internal Audit, and Underwriting and Reinsurance. As the majority of Gibraltar insurers are open-market insurers, it is of concern that Internal Audit and Underwriting, two core activities in a well-managed firm, are lagging behind.

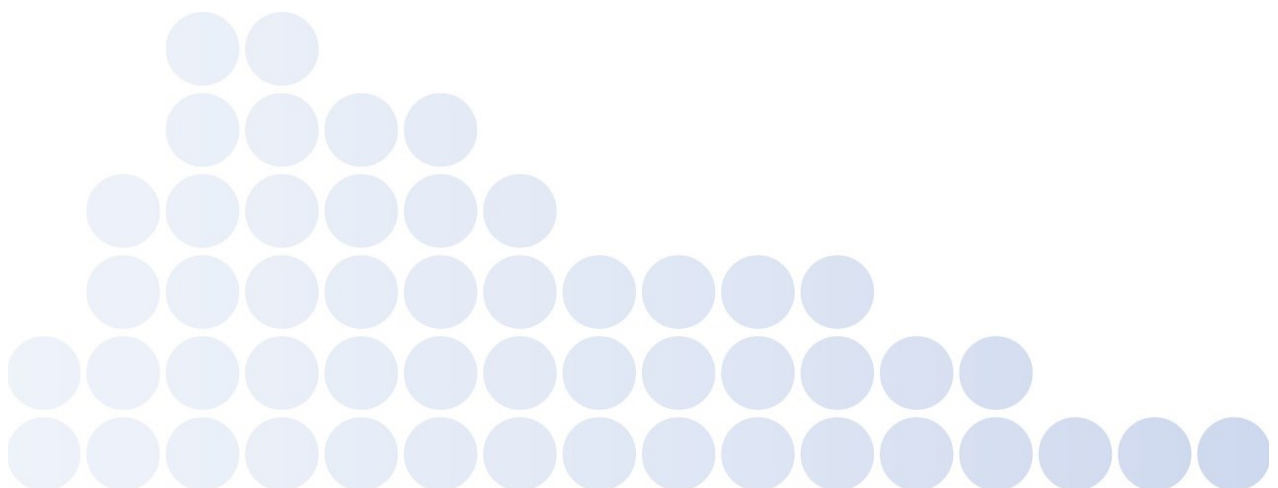
As part of the embedding process, the FSC expects that all Third Party Agreements in place will be reviewed in line with the [FSC guidance note 2 on Outsourcing](#), and the firm's own Outsourcing Policy. There is little evidence contained in either the information received from firms in their SoG self-assessments or their Solvency 2 plans to suggest that this important process has been undertaken so far.

In several submissions, firms have commented that their policies will reflect a "degree of proportionality" agreed with the FSC. These comments were particularly prevalent in the Compliance, Audit and Actuarial responses. The FSC has provided guidance on these areas recently in the [FAQ](#) section of its website. Where further clarification is required, firms are encouraged to contact the FSC via a dedicated Solvency 2 email ([s2@fsc.gi](mailto:s2@fsc.gi)).

During the review of the FLAORs submitted, it was noted that the involvement of the Boards in the review of the firm's Risk Management system was variable. Firms are encouraged to revisit their preparations for the Role of

the Board in the Risk Management system (2.13 in [GN14](#)) to ensure that the Board fully understands its responsibilities in this area which will, in turn, flow through to the 2015 FLAOR exercise. We will shortly be hosting a webinar for Directors in which we will explore this further.

In some cases, where local firms are part of a group, insufficient local adaptation of material produced by the group's central Solvency 2 project team was observed when the self-assessment was submitted. Reference was made to structures and controls that did not operate locally, reducing the credibility of the submission and leading the FSC to question the true state of readiness of the local entity. In such cases, further work has been requested to clarify the position.

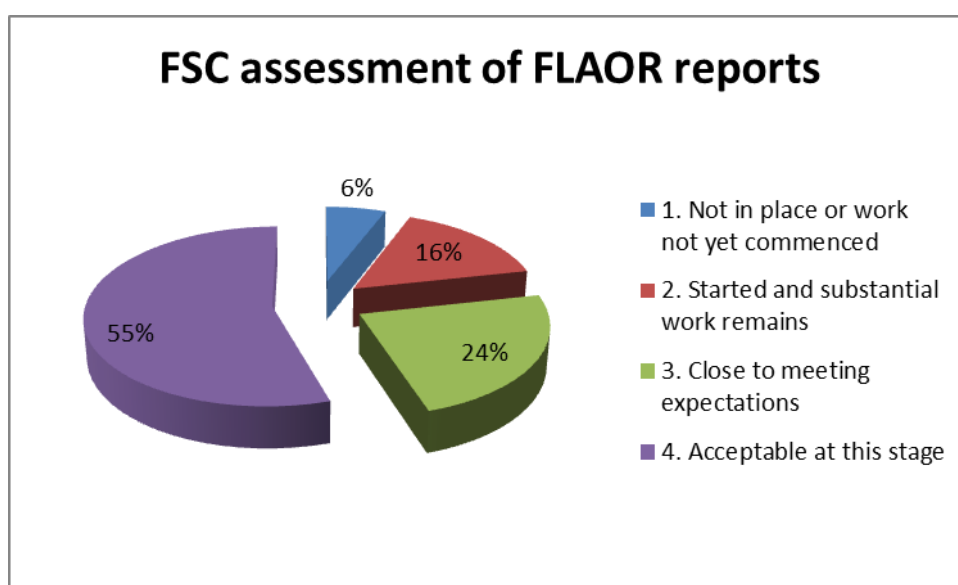


## 2.5 FLAORs

The purpose of the FLAOR is to enable management to better understand and manage its risks and capital needs. It will assist management to refine business planning and make informed decisions regarding strategy which will define the solvency needs of the business.

The request for the submission of the initial FLAOR report was seen by the FSC as an important milestone for firms in demonstrating progress towards developing appropriate processes and techniques to enable them to carry out ORSAs that are fit for purpose by 2016.

Not all firms submitted the FLAOR by the year-end deadline, as was required by EIOPA, although in some cases an extension was granted to allow for the report to be reviewed by their Boards in early 2015. Reminders and further explanation had to be sent including answering the question “What is a FLAOR”? Given that this had been originally flagged in a [“Dear CEO”](#) letter of 15 November 2013 and then highlighted in the October data request, this was particularly disappointing, and the FSC will be expecting an improved response for the 2015 FLAOR.



Generally, the reports received were seen as an adequate initial response, although a greater emphasis on forward-looking aspects had been expected. Also, a better balance between the quantitative and the qualitative aspects of the FLAOR is required. A wide range of submissions were reviewed, ranging from a short set of interlinked spreadsheets with very little explanatory text to a 200-page report. We expect FLAORs to be a bespoke planning tool that is regularly used by the Board.

Another area requiring improvement in future FLAORs is to carry out a fuller analysis of the root causes where a future capital shortfall was forecast. Too many firms appear to be planning to inject further capital, without thought being given to whether a change in business direction or structure would be more appropriate. For example, where underwriting losses have been reported we would expect a fundamental review of that portfolio notwithstanding any further capital that may have been committed by the shareholders. Otherwise, it is a reasonable assumption that similar results will be reported in the future and yet more capital required. Such a review may well have been carried out but the text provided does not evidence this in all cases and calls into question the credibility of their forecasts.

Whilst some reports clearly reviewed the business implications of each risk included in the firm’s risk register and assessed the capital impact (if any) for that risk, other firms appear to have operated at a higher level, assessing perhaps only what they believe to be in their 3 top risks, and in some cases, only their highest risk.

Similarly, in several cases stress-testing carried out by some firms was unconvincing, with the focus almost entirely on underwriting or reserving risk. Other risks, whilst detailed in the company’s risk register and shown as

having significant potential impact, were often collectively classified as secondary risks with consequent minimal impact predicted.

A number of FLAORs included a summary of the firm's history and present business strategy which helped to position the risk review and forward-looking assessments. Where this approach had been adopted, the submissions were in general simpler to follow and ultimately, more convincing.

The level of Board engagement was not always clear from the submissions, with several FLAORs appearing to be an academic exercise carried out for the benefit of the FSC, rather than a true own risk assessment carried out to deliver benefit to the company through assisting the Board to make more informed decision-making through a fuller understanding of capital and risk implications of decisions taken.

In a few cases, Boards conducted internal workshops to gain a fuller understanding of the risks facing the business, the capital implications, future remodelling options and their impact. The value of this approach was clear in the high quality of these submissions and their clear commitment to embed the process into ongoing management of the business.

By contrast, apparently "textbook" FLAORs, particularly those produced by external consultancies, were technically sound but lacked overall credibility as there was insufficient evidence that the Board had been involved in, or had considered, the report's findings. It is possible that there had been full involvement by the Board throughout the process but it was not evidenced by the submission.

There were also instances where the firm's future plans, and therefore their assessment of future risks and capital requirements, did not include reference to new business initiatives such as moving into new classes of business or new territories, which are currently under separate review by the FSC. This suggests that the firm's Board should improve co-ordination between all parts of its operations.

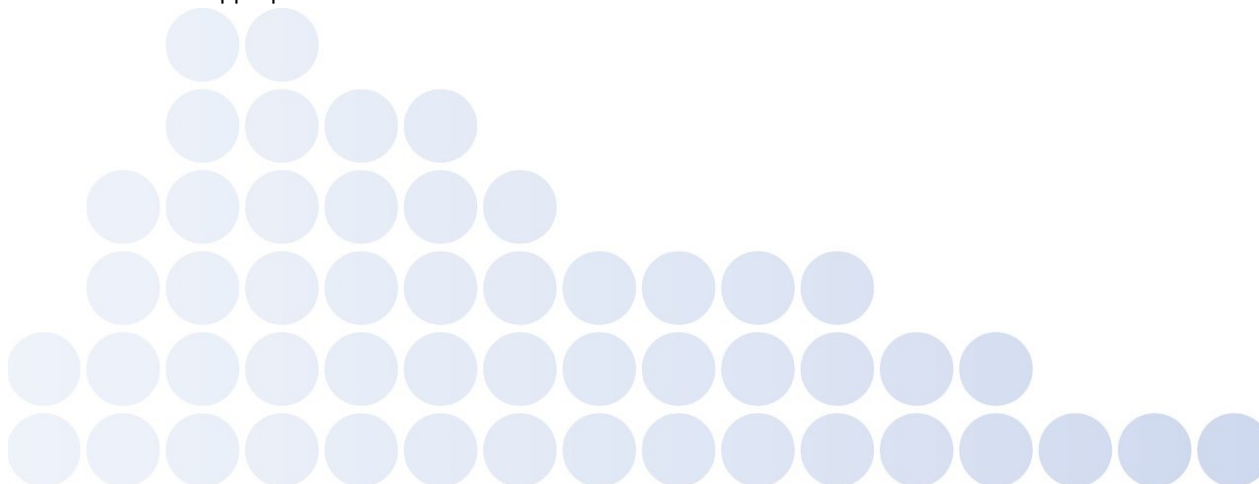
A number of firms had not previously completed an assessment of alternative strategies on Investments and Reinsurance, ahead of commencing the FLAOR exercise, even though the potential capital charges involved are well known.

Some firms highlighted an issue they had been experiencing in securing timely and high-quality data from Investment Fund managers, particularly those outside the EU. This in turn limited the amount of re-modelling they had been able to carry out. The FSC would welcome feedback from any firms experiencing similar issues.

Few companies have included in their FLAORs a statement of their capital appetite policy in relation to their future plans, but where it was included, it added weight to the credibility of their report. For example, to maintain a specified buffer above the SCR, expressed as a percentage of the SCR.

The FSC will be expecting a more rigorous approach to be taken for the 2015 FLAOR. This will include building on systems and policies developed to date, but also preparing for the more extensive ORSA requirements.

For those firms identified as part of the top 80%, as set out in our letter to firms of 15 November 2013, we expect the 2015 report to include all of the items set out in the FLAOR guidelines, including for example an assessment of the appropriateness of the standard formula.

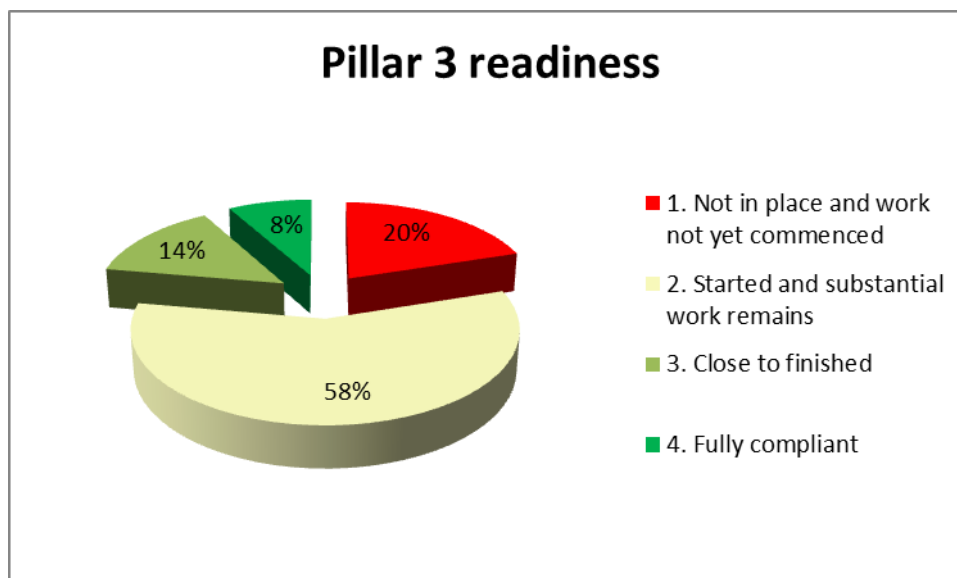


### 3. Pillar 3

#### 3.1 FSC's Expectations of Firms

*"Dry run firms should have appropriate policies and procedures in place in advance of providing data. Other firms should plan to reach a similar stage by end 2015 and are encouraged to participate in the dry run process. In any event, testing will be required before go-live. FSC expects all firms to understand the FSC's approach to data reporting technology"*

#### 3.2 Analysis



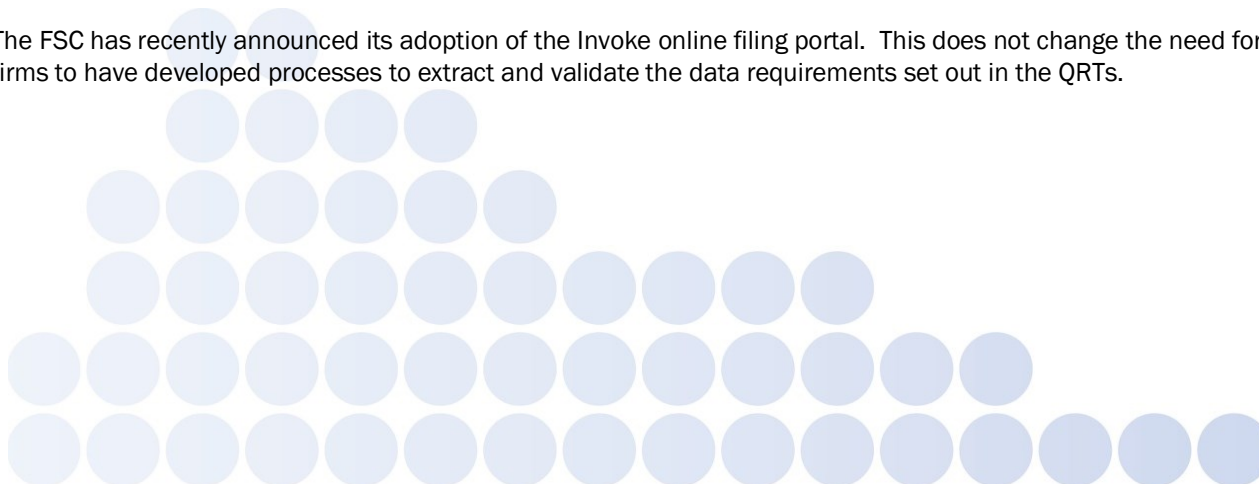
It is clear from the above chart that the pace needs to be picked up, given that 80% of firms self-assessed as only 1 or 2 (out of 4). Firms that are due to submit data later this year in the dry run are on the whole better prepared. But even here, management attention is required.

Examples of reasons for not completing work on Solvency 2 include the following:

- Deferral of consideration of the issues as they were for example 'waiting for FSC' or 'final rules from EIOPA' (the FSC has made clear that firms should plan on the basis of material already available from EIOPA);

Apparent confidence in the firm's ability to deliver even though the firm had not undertaken the analysis of what was required.

The FSC has recently announced its adoption of the Invoke online filing portal. This does not change the need for firms to have developed processes to extract and validate the data requirements set out in the QRTs.



## 4. Solvency 2 Plans

### 4.1 FSC's Expectations of Firms

The data request in October 2014 requested firms to send a copy of their Solvency II plans as follows.

*“The plans should address all aspects of Solvency 2 preparations and not be limited to the corporate governance work streams. Those firms that were previously asked to send us a copy should send an updated plan”.*

### 4.2 Analysis

Disappointingly, not all firms responded to this request and several reminders were needed. Not all firms have provided their plans to date, and the FSC has contacted these firms to obtain the required information.

The review of plans highlighted that the majority of firms anticipate completing their SoG programme not later than 30 June 2015. This includes for several firms plans for testing of procedures during Q215, and the start of the “embedding process” ahead of their 2015 FLAOR. All other aspects of the programme, especially Pillar 3 preparations, are scheduled to run throughout 2015.

As with all other aspects of the data submitted, there was a wide variety of Solvency 2 plans submitted. Only a few provided the level of detail or granularity expected. Plans ranged from simple task lists (with limited detail on resources, individual steps, risk analysis and mitigation, or sign-off procedures) to integrated MS Office submissions.

One common problem identified in the review is an apparent disconnect between deadlines or actions included in the responses to the SoG questionnaires and those shown in the Solvency 2 plans. This suggests that either project management skills, or the control of the project from the Board, could be improved. Or both. An example of this is where the SoG self-assessment scores as 2 the status of a guideline, yet in the plan that item was shown as completed.

Another weakness highlighted was the lack of sign-off procedures built into plans, some of which did not even provide Board dates despite those firms’ SoG submissions anticipating a January Board sign-off.

In the first FSC [feedback paper](#) (1 October 2014), common elements in a “best practice” plan were identified as follows.

1. Board ownership with regular reporting mechanisms and a standing item at Board meetings;
2. Delegated, dedicated resource, working across a number of different business streams according to skill sets;
3. Gap analysis used as the basis to formulate action plans;
4. Separate budget with appropriate authorities within Project team;
5. Deadlines with priorities, milestones, owners and review dates. A simple “RAG” (Red/Amber/Green) monitor was often used;
6. Communication programme, addressing all stakeholders.

This guidance still applies and very few plans adopted even a proportionate response to this approach. A few plans, prepared with the assistance of group project resources, did however provide this level of granularity and credibility.

Firms need to demonstrate they have credible plans in place, and the FSC will be requesting a revised Solvency 2 project plan, incorporating many of the above features, in Q2 2015.

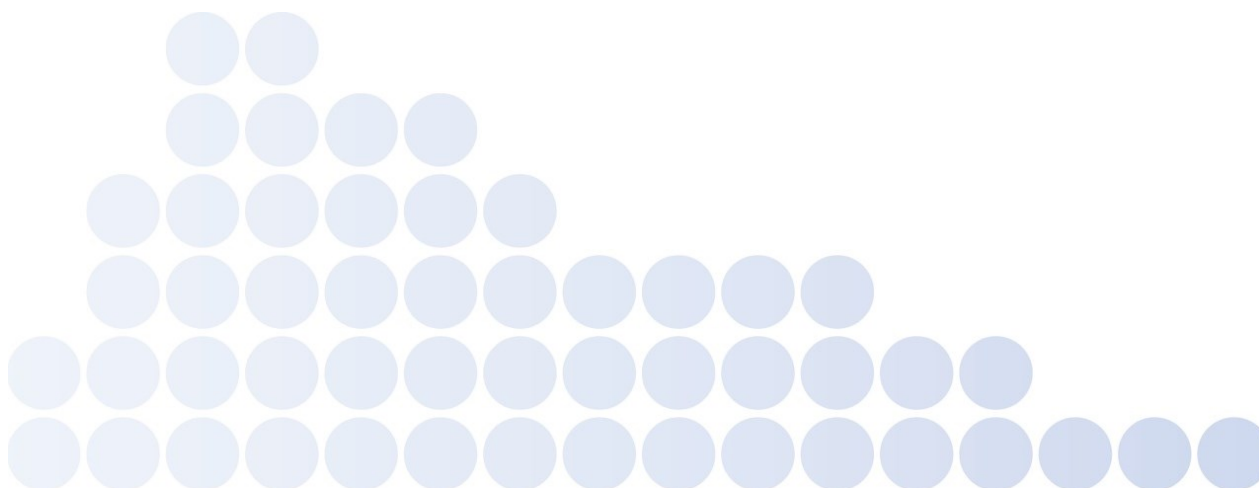
## 5. Next Steps

It was originally envisaged that a third SoG self-assessment exercise would take place during Q2 2015. However, following the review of data gathered to date, a more focussed approach to assessing the state of readiness of the market in respect of SoG will be taken. This revised approach is outlined below.

- Face-to-face meetings will be arranged with all major insurers and with those where further clarification of the company's Solvency 2 plans, and in particular their capital plans, is required;
- The FSC will monitor that firms are complying with [GN14](#) guidelines as outlined in the November returns. In the next few weeks firms will be contacted to confirm that all remaining GN14 guidelines have now been completed, or to provide an explanation of alternative controls put in place.
- At the same time, FSC will be requesting a progress update from firms, including a request for information on how firms are embedding Solvency 2 into business as usual.
- A second FLAOR will be required for 2015 in line with Solvency 2 preparatory guidelines. For 2016 this will evolve into an ORSA and as such firms should familiarise themselves with the additional requirements associated with this.

Any feedback on enquiries should be directed to [s2@fsc.gi](mailto:s2@fsc.gi).

Given the content of this feedback paper, and the importance that the FSC attaches to this, the FSC would be grateful if a copy was brought to the attention of the Full Board of Directors.

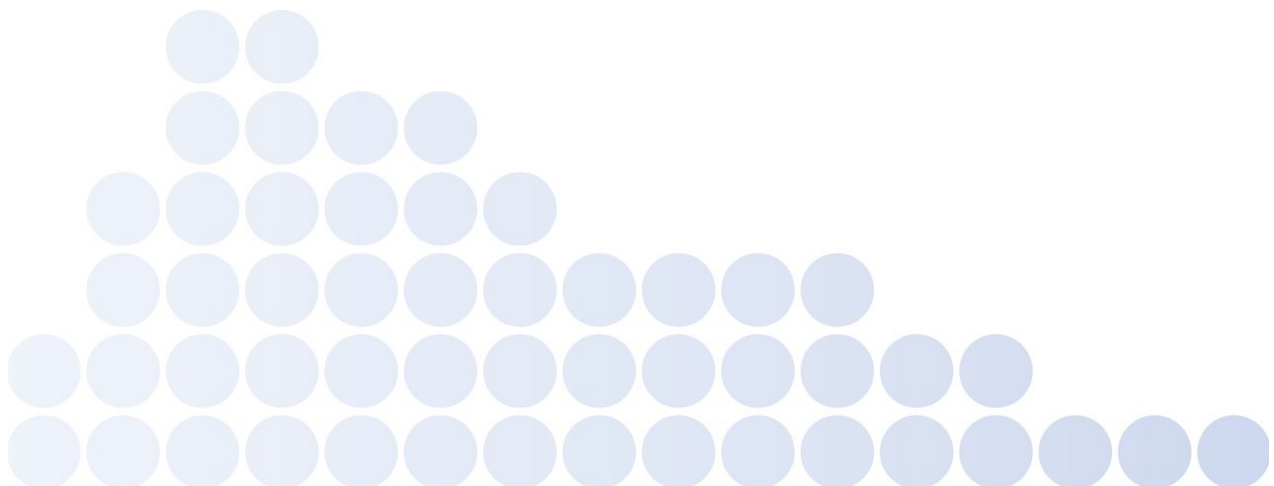




## Appendix

### Q3 2014 Data Requests

No.	Item	Submission Date
1	A forecast Solvency 2 balance sheet on a best endeavours basis	31 December 2014
2	An updated Systems of Governance self-assessment, including against GN14 guidelines	28 November 2014
3	Forward Looking Assessment of Own Funds (FLAOR)	31 December 2014
4	A self-assessment of firm's readiness to meet Pillar 3 reporting requirements	28 November 2014
5	A Solvency 2 project plan covering all Pillars	28 November 2014
6	Confirmation if firms were planning to apply for USPs or internal models	31 December 2014



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