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Solvency II - The Story To Date

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Structure of presentation

- Why are solvency margins needed?
- History
  - Solvency Margins in Europe
  - Solvency II
- The Lamfalussy Framework
- Solvency II details
  - Three Pillars
  - Risks addressed
  - Other items covered in Solvency II directive
- Next steps in the Solvency II process
- Legal Developments in Gibraltar
- Learning Points

Why are solvency margins needed?

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- To provide policyholder protection
- Policyholders buy a promise
- Insurers' accounts contain estimates:
  - Expected premium adequacy
    - Claims costs
    - Claims frequency
    - Other costs
  - Claim reserve adequacy
    - Claims cost
    - Settlement patterns
- Other risks

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History of Solvency Margin Requirements in Europe

- 1973 Non-Life Directive
- 1979 Life Directive

- 1992 Third life and non-life directives

- 2002 – Solvency I

- 2012 – Solvency II

- Elsewhere
  - Australia RBC
  - Swiss Solvency Test
  - UK ICAS
  - USA NAIC RBC

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History of Solvency II

- 2004 and 2005 – the Commission issued three waves of Calls for Advice to CEIOPS
- July 2007 – Commission adopted the Solvency II proposal
- February 2008 – Commission adopted an amended proposal
- Quantitative Impact Studies:
  - QIS1 (Late 2005)
  - QIS2 (Summer 2006)
  - QIS3 (Summer 2007)
  - QIS4 (Summer 2008).
- May 2009 – Directive adopted
- 2009 – Level 2 Advice
- Implementation set for 31 October 2009

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The Lamfalussy Framework

- Process for the development of regulations in financial services

1. Broad Principles

2. Implementing Measures

3. Supervisory Convergence

4. Enforcement

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The Three Pillars

- Pillar 1 – Quantitative Aspects of Solvency
- Pillar 2 – Qualitative Aspects of Solvency
- Pillar 3 – Disclosure Requirements

Risks that Solvency II addresses

- Underwriting Risk
  - Life
  - Non-Life
  - Health
- Market Risk
- Operational Risk
- Credit Risk

Pillar I

- Valuation of Assets and Liabilities
- Valuation of Technical Provisions
- Own Funds
- Solvency Capital Requirement (SCR)
- Minimum Capital Requirement (MCR)
- Investments
  - Prudent Person
  - Freedom to Invest

Own Funds

- Own Funds
  - Basic Funds
    - Excess of assets, excluding own shares
    - Subordinated liabilities
  - Ancillary Funds
    - Unpaid share capital
    - Letters of credit and Guarantees
    - Other legally binding commitments
  - Both are subject to Tiers and Limits

Own Funds – Tiers and Limits

- Tiers
  - Tier 1 – Basic Funds only – Subordinate, Loss Absorbing and Permanent
  - Tier 2 – Substantially Subordinate and Permanent
  - Tier 3 – All other
- Limits
  - At least one third Tier 1
  - No more than one third Tier 3
  - MCR covered by Tiers 1 and 2, Tier 1 being at least 50%

SCR and MCR

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- Solvency Capital Requirement (SCR)
  - A level of own funds that will enable an insurer to absorb unexpected losses over a one year period with a 99.5% confidence that policyholder payments will be made as they fall due. The SCR is a ‘going concern’ measure.
  - If an insurer's eligible own funds fall below the SCR, supervisors are to take action with the aim of restoring the insurer's own funds to the level of the SCR as soon as possible.
  - If the financial situation of the insurer continues to deteriorate, then the level of supervisory intervention will be progressively intensified.
- Minimum Capital Requirement (MCR)
  - A level of capital below which an insurer's ability to remain in operation will be compromised. The MCR is the ultimate buffer to protect policyholder interests in case of a run-off scenario.
  - Breaching the MCR will trigger the most severe supervisory intervention, which will result in the withdrawal of the insurer's authorisation to conduct insurance operations, unless it can be quickly remedied.

Solvency Models

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- Standard Model
  - One size fits all
- Full Internal Model
  - Reflects insurer's own risk profile
  - May be required by the supervisor
  - Subject to a 'Use Test'
  - Subject to supervisory approval
- Partial Model
  - As Full Internal Model
  - No selective amendments purely for capital relief

Systems of Governance Requirements Imposed by Solvency II

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- Maintain effective:
  - Risk Management system
  - Internal Control system
  - Internal Audit function
  - Actuarial function
- Conduct an Own Risk and Solvency Assessment (ORSA)

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Own Risk Solvency Assessment

- CEIOPS has defined the ORSA as:

  "the entirety of the processes and procedures employed to identify, assess, monitor, manage and report the short and long term risks an insurer faces or may face and to determine the own funds necessary to ensure that the insurer's overall solvency needs are met at all times"

Public Disclosure Requirements Imposed by Solvency II

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- Annual report on the solvency and financial condition
  - Description of business
  - Description of system of governance
  - Description of risk exposures
  - Description of the basis for valuing assets and liabilities
  - Description of the capital management
- Supervisory authorities to provide an annual report to CEIOPS by type of insurer
  - Average capital add-ons
  - Distribution of capital add-ons

Some additional contents of the Solvency II Directive

- Licensing
- Supervisory objectives – Protection of policyholders and beneficiaries
- Supervisory cooperation and information sharing
- Changes of Control
- Regulatory Reporting
- Passporting of Services and Branches
- Supervision of Group Solvency
- Third country equivalence
- Reorganisation and winding up

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Legal Implications

- Gibraltar and EU Directives

- Many earlier EU Directives repealed
  - In whole
  - In part

- All jurisdiction will have to fundamentally review and replace their legal and regulatory frameworks

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Immediate next steps in Solvency II

- Pillar 1
  - Third set of Level 2 advice – January
  - Partial internal models Advice – January
  - Internal models – Pre application guidance – January
  - Advice on Third Country equivalence – March
  - QIS5 Technical Specifications – March
  - QIS5 Exercise – Summer
  - QIS5 Report - November
  - Internal models approval procedure guidance –2011
- Pillars 2 and 3
  - 2011 onwards

Key learning points

- Solvency II reflects a move from a Factor Based to a Risk Based calculation
- Risks extend beyond Underwriting related risks and include Operational, Credit and Market risks
- Solvency II is not just about setting capital adequacy rules. There will be a key foci on:
  - Risk Assessment and Management and Governance; and
  - Public Disclosure
- Models
  - The standard SCR model is an average model. To set more appropriate capital levels a full or partial internal model is almost certainly required
  - Internal models will incur a cost. An insurer has to be able to demonstrate that it reflects the risks of the firm and is used to drive business decisions

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