Solvency II

A new framework for prudential supervision of insurance companies

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Solvency II implemented on 1 January 2016.

1 January 2016 marks the introduction of Solvency II, a new framework for the prudential supervision of insurers. This is a huge step forward for insurance supervision. Solvency II is the product of a prolonged international negotiation process. The new supervisory framework comprises European rules on the taking-up and pursuit of the business of insurance and reinsurance, the supervision of insurance and reinsurance groups, and the reorganisation and winding-up of insurance companies. Its purpose is to protect policyholders. Key principles in Solvency II are the introduction of risk-based capital requirements and the Mark-to-market approach for balance sheet items. Although the new framework still does not provide comprehensive guarantees, it helps insurers and supervisors identify risks at an earlier stage and take action where needed. Furthermore, Solvency II strengthens insurers' risk management and introduces further harmonisation at the European level, thereby promoting a level playing field, which is a step towards creating a more European market.

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Why replace Solvency I?

The existing Solvency I framework dates from the 1970s and is in urgent need of replacement. The key downside to Solvency I was that it did not tailor capital requirements to the actual risks that insurance companies are exposed to, providing insufficient incentives for responsible risk management. Solvency I also did not allow for acquiring full transparency on the current financial position of insurers nor the risk sensitivity of that position, which left it uncertain whether they would be able to meet their commitments. In addition, from a European perspective the framework did not afford clear and uniform policyholder protection, did not allow for adequate harmonisation of supervision across Europe, and provided only limited supervision at group level.

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To which insurance companies does the new framework apply?

Solvency II, the new supervisory framework harmonised at a European level, applies to medium-sized and large insurance companies.[1] Small insurance companies and funeral expenses and benefits in kind insurers are subject to Solvency II Basic, a simplified supervisory framework at a national level. This regime is built up along the lines of Solvency II, but is less extensive in scope, in view of proportionality. In practice, this means that the Basic framework has been adjusted to make the requirements easier and simpler for small insurance companies to comply

1 Medium-sized and large insurance companies are those whose gross premium income exceeds EUR 5 million and/or whose technical provisions exceed EUR 25 million and/or whose reinsurance activities and/or activities abroad are non-negligible.

with. The smallest insurers – with premium income and technical provisions not exceeding EUR 2 million and EUR 10 million, respectively, and whose maximum sum insured is EUR 12,500 – are exempt from DNB's supervision.

Insurance companies may voluntarily choose to subject themselves to a stricter supervisory framework: exempt insurers may opt for Solvency II Basic and insurers governed by Solvency II Basic may opt for Solvency II.

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How is Solvency II structured?

Groups
Supervisory review process
Collaboration between supervisory authorithies

Pillar 1

Risk quantification

- Mark-to-market balance sheet valuation
- Solvency capital requirement (SCR)
- Minimum capital requirement (MCR)

Pillar 2

Risk management

- Governance requirements
- Own Risk and Solvency Assesment (ORSA)

Pillar 3

Transparency

- Report to the supervisor
- Public disclosure
- Accountability

Solvency II is based on three pillars, setting out risk quantification, governance and transparency requirements.

Pillar 1 contains quantitative requirements, including markt-to-market balance sheet valuation and quantification of market risks and insurance technical risks. Insurers must value their balance sheet items based on current market prices and measure their risks using either a standard formula or an internal model. These two methodologies serve to calculate the buffer they must maintain.
The standard formula is the risk measurement 1 Medium-sized and large insurance companies are those whose gross premium income exceeds EUR 5 million and/or whose technical provisions exceed EUR 25 million and/or whose reinsurance activities and/or activities abroad are non-negligible. methodology established at European level. Insurers must be able to demonstrate that the standard formula is suitable for them. If the standard formula does not match their specific risks, they must use a full or partial internal model or company-specific parameters. These internal models must be drawn up by the companies themselves and approved by DNB.

Pillar 2 concerns the governance of insurance companies. In concrete terms, an effective system of governance includes four key functions: risk management, compliance, actuarial, and internal audit. This pillar also imposes fit and proper requirements on directors, managers, and holders of these key functions. In addition, insurers themselves must review their policies, strategy and risk appetite on a regular basis in an own risk and solvency assessment (ORSA) and report their findings to DNB.

Pillar 3 safeguards transparency by means of the solvency and financial condition report (SFCR), which is public, and the regular supervisory report (RSR), which is confidential. The public report is published annually and contains information about an insurer's activities and results, operations, risk profile, the principles used to value its assets, technical provisions and other liabilities, and capital management. Insurers are also required to publish quantitative reporting forms, which constitute the confidential report, together with a descriptive section. This descriptive section is identical to the public report in terms of structure but contains additional, confidential supervisory information. The confidential report also comprises the ORSA of pillar 2. In addition to these three pillars, Solvency II elaborates on three key themes: improving group supervision, the supervisory review process, and cooperation between supervisory authorities. Group supervision will be substantially enhanced under Solvency II. In practice, this means that supervision will be exercised not only on individual insurers as part of a group but also on the group as a whole. Another overarching element of the Solvency II framework is the supervisory review process (SRP), which defines the reviews, evaluations and assessments to be conducted by the European supervisory authorities. Lastly, the new framework harmonised at a European level should encourage international collaboration between supervisory authorities within the European Insurance and Occupational Pensions Authority (EIOPA).

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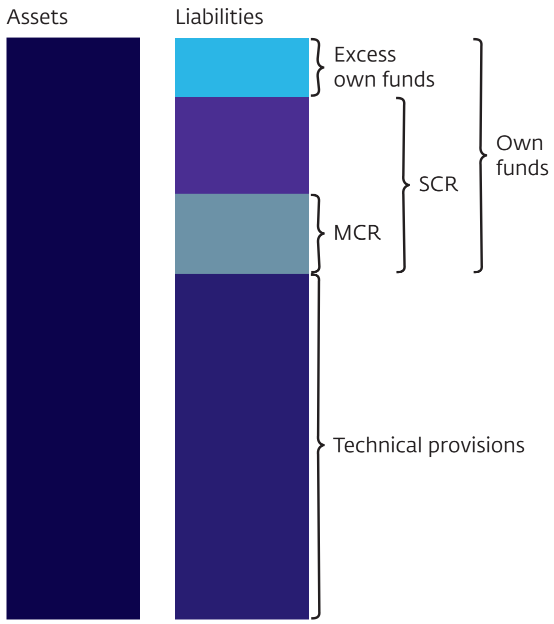
How to interpret and calculate solvency ratios under Solvency II?

It is essential to fully and accurately grasp the Solvency II ratio before issuing an opinion on an insurer's financial position. This is because a solvency ratio of 100% under Solvency II is something altogether different from a solvency ratio of 100% under Solvency I, due to differences between the calculation methodologies underlying the two ratios. Unlike Solvency I, Solvency II takes account of the actual risks that insurers assume in calculating their solvency capital requirements. Under Solvency II, the solvency ratio is the ratio of eligible own funds to required own funds.

$$\text{Solvency ratio} = \frac{\text{Own funds}}{\text{Solvency capital requirement (SCR)}}$$

Required own funds, also referred to as the solvency capital requirement (SCR), constitute a risk-based buffer, based on the actual risks on the balance sheet. This means that insurers with higher-risk investments, such as equities, must maintain a higher buffer than those investing in lower-risk assets, such as government bonds. In addition to the SCR, Solvency II applies the minimum capital requirement (MCR), also referred to as minimum required own funds. A Solvency II ratio of 100% means that an insurer's capital is such that it will still be able to meet its obligations in the event of a severe shock that is expected to occur once in every 200 years. The target confidence level for insurers has been set at 99.5% over a one-year horizon.



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What is DNB's objective for Solvency II ratios?

The statutory supervisory standard under Solvency II is 100%, including ultimate forward rate (UFR) and other adjustments. Insurers failing to comply will face formal recovery actions imposed by DNB. In addition, insurers are setting internal standards above 100%, for example to ensure continuous compliance with the statutory standard and avoid having to prepare a recovery plan immediately following adverse events. DNB welcomes these practices. Solvency II does more justice to an insurer's actual risk profile, which is why DNB expects many companies to use target solvency ratios that are closer to the statutory supervisory standard, compared with Solvency I.

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Why impose capital requirements and buffers on insurance companies and how do they work?

Buffers protect institutions against significant changes in the financial markets and insurance risks, and help them meet their future obligations even in the event of setbacks. The targeted confidence level for insurers is 99.5% over a one-year horizon. The larger the risks, the higher the buffer required to maintain that confidence level. Insurers whose buffers are dwindling can take specific actions to restore them to the required level, including raising capital, reducing dividend payments and lowering their risk profiles.

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When does DNB intervene?

The new Solvency II framework provides several options for intervention. One of them is requiring insurers to submit a recovery plan if they fail to comply with the solvency requirement because their eligible own funds drop below the SCR. Such recovery plans, subject to DNB's assessment and approval, should help these companies meet the requirement again within six months. If an insurer's own funds drop below the MCR, DNB may appoint a secret receiver, impose a production stop or revoke the insurer's authorisation. DNB may also transfer insurance portfolios and adjust the policy conditions if it sees fit. Lastly, DNB may issue an instruction in the event of shortcomings in terms of governance.

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What does Solvency II imply for insurers' dividend policies?

Insurance companies are responsible for their own dividend policies as part of their overall capital policies. DNB believes that insurers would do well to take account of the impact of the UFR – which forms part of the actuarial interest rate – and other adjustments. In the context of adequate risk management under Solvency II, insurers are also expected to pay attention to this in their ORSA. Where needed, DNB will consider the UFR impact in assessing an insurer's capital and dividend policies. Insurance companies have a statutory obligation to seek DNB's approval before distributing dividends if they fail to meet their solvency requirements or foresee noncompliance within the next twelve months.

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When will the first figures and reports under Solvency II be published?

Insurance companies will be preparing both public and confidential reports under Solvency II. The first public Solvency II reports will concern the 2016 financial year. These reports must be publicly disclosed within 20 weeks after the end of the 2016 financial year. Group reports must be submitted within 26 weeks after the end of the 2016 financial year. Insurers are free to publish Solvency II figures before then, as some listed companies are already doing.

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To what extent are Solvency II figures and reports comparable across the EU?

A number of transitional measures have been designed to facilitate the changeover to Solvency II, most of which may be applied during the next 16 years. All other things being equal, companies using these measures will have higher solvency ratios, which must be kept in mind when comparing insurance providers in various countries. Dutch insurance companies are wellprepared for Solvency II, making little or no use of the transitional regime. As a result, the Netherlands applies a relatively "pure" variant of Solvency II. Some other European companies are making use of the transitional rules on a larger scale, however. This means that for the time being it will be difficult to compare the Solvency II figures of Dutch insurers with those of their counterparts elsewhere in the European Union. The effects of the transition regime will be visible from the reports that insurers must publish from 2017 onwards, which will make it easier to compare insurance providers across the European Union.

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How does the current low level of interest rates affect insurers?

The effect of low interest rates on insurance companies is only partially reflected in their financial reports, due to the use of the UFR in the supervisory framework. Under the UFR calculation method, the yield curve used to discount liabilities with maturities exceeding 20 years converges towards a fixed level. This is because there are relatively few products with similar long maturities available in the financial markets, which makes the related interest rates less reliable and more difficult to estimate. The UFR also contributes to the stability of the solvency calculation.
The gap between the fixed UFR and the current level of long-term interest rates has grown steadily over the past few years, however. EIOPA has announced that it will review the UFR methodology in 2016. To ensure a smooth transition to Solvency II, the calculation method will not be changed before the end of 2016. The gap between the fixed UFR and market interest rates is therefore expected to persist for the time being. This may lead to excessively high expectations among policyholders, unrealistic promises to policyholders and distorted incentives at institutions. The UFR impact on Dutch life insurance companies may be high by comparison with many other European countries because, on average, they have longer-term liabilities. DNB emphasises that insurers should be aware of this, taking it into consideration in their risk management and capital policies. This will allow them to, for instance, perform an analysis of measures (e.g. to lower their risk profile) when facing a deficit in the absence of the UFR impact.