The Solvency Framework For Insurance Undertakings Within the EU

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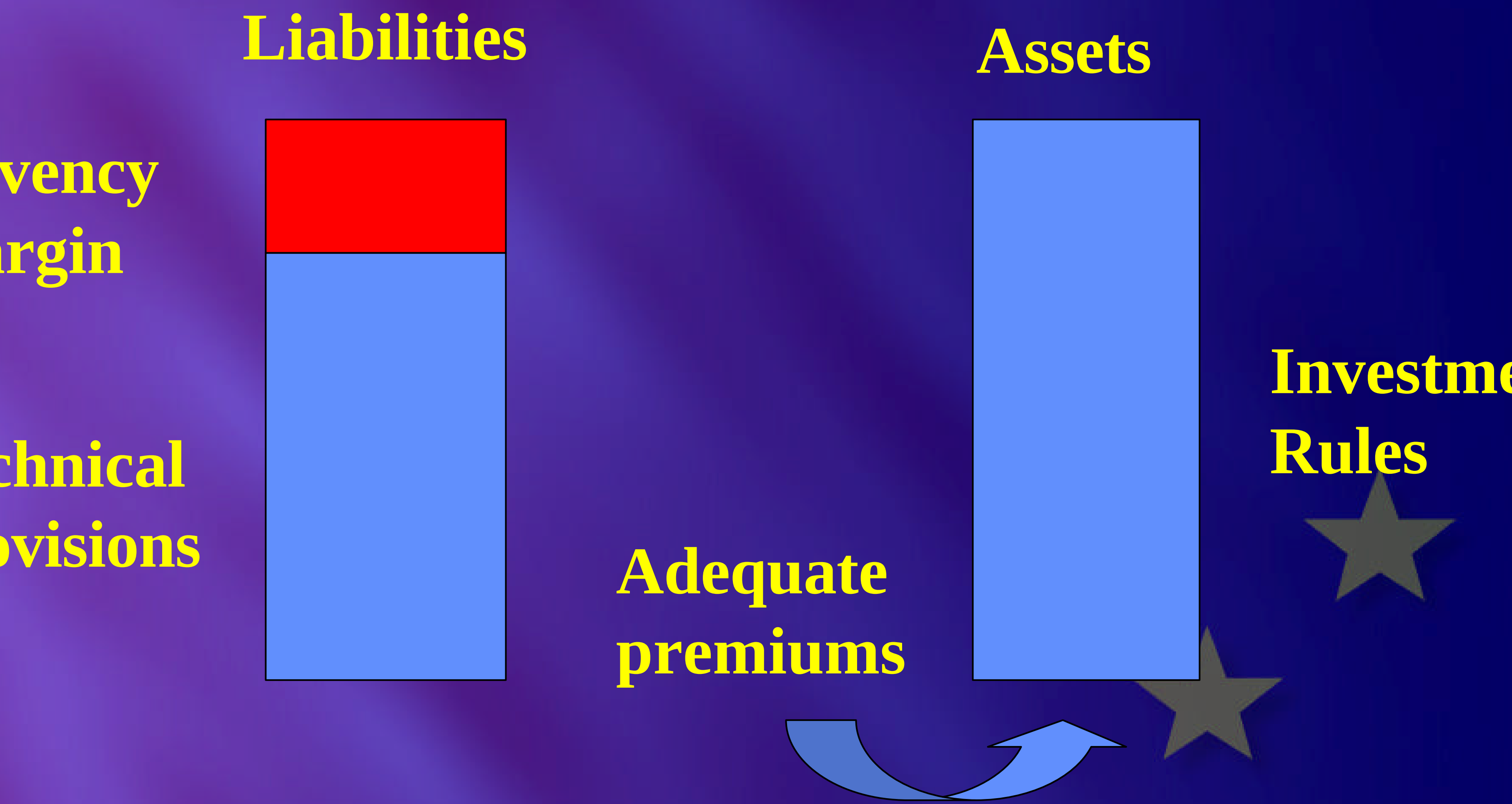
Presentation Outline

- The Current EU Solvency Regime
  - Solvency I Improvements
  - ALM
- The Future EU Solvency Regime
  - Solvency II (Objectives & Principles
  - ALM
  - The international dimension
- Conclusions

The Current EU Solvency Regime

Risk management and Control



Technical Provisions

Article 20 (1)
Directive 2002/83/EC (Consolidated Life)

The home Member State shall require every assurance undertaking to establish sufficient technical provisions, including mathematical provisions, in respect of its entire business.

General principles (prudence, bonuses, surrender values, options, expenses)

ASSETS (covering Technical Provisions)

Article 22

The assets covering the technical provisions ***shall take account of the type of business*** carried on by an assurance undertaking in such a way as to secure the safety, yield and marketability of its investments, which the undertaking shall ensure are diversified and adequately spread.

Art. 23 Categories of authorised assets

Art. 24 Rules for investment diversification
(eg max 5% shares/bonds from same borrower)

SOLVENCY MARGIN
NON-LIFE

Higher of:

- 16 % premiums
- 23 % claims (plus increase in technical provisions)

- Max reduction for reinsurance : 50%

SOLVENCY MARGIN
LIFE

4% of Technical provisions

1% of Technical Provisons

(if no investment risk, man. expenses fixed

0.3% capital at risk

Max reins. reduction : 15% life / 50% risk benefi

- Current EU solvency margin system is

- Simple
- Robust
- Easy to understand and use
- Inexpensive to administer
- Has worked well in practice

SOLVENCY I IMPROVEMENTS

SOLVENCY I : Main improvements

- Minimum harmonisation
  - (Member State can increase solvency margin)
- Minimum solvency margin increased
  - (2 or 3 million euro)
- Special supervisory powers
  - (When policyholders rights threatened because financial position is deteriorating, can require higher solvency margin)
- Reinsurance improvements
  - (Decrease reinsurance reduction if nature or quality of reinsurance programme changed or no significant risk transfer)
- "Class enhancement approach"

Class enhancement approach

- Problem for long term, long tail, Non-Life risks
- Keep simplicity of current method
- but increase by 50% current solvency margin for “risky” classes (11, 12, 13) of business.

ASSET LIABILITY MANAGEMENT

- No formal reference to Asset Liability Management,

- But a series of indirect requirements…………

ALM- Technical Provisions

Article 20 (2) (iv)

the method of valuation for the technical provisions must not only be prudent in itself, ***but must also be so having regard to the method of valuation for the assets covering those provisions;***

ALM- Assets

Article 24 (Rules for investment diversification)

The home Member State shall lay down more detailed rules fixing the conditions for the use of acceptable assets. In particular it shall ensure, in the determination and the application of those rules, that the following principles are complied with:

(i) assets covering technical provisions must be diversified and spread in such a way as to ensure that there is no excessive reliance on any particular category of asset, investment market or investment;

ALM- localisation and currency matching

Article 20(3) ***(localisation)***

The home Member State shall require every assurance undertaking to cover the technical provisions in respect of its entire business by matching assets, in accordance with Article 26. In respect of business written in the Community, these ***assets must be localised within the Community***. Member States shall not require assurance undertakings to localise their assets in a particular Member State. The home Member State may, however, permit relaxations in the rules on the localisation of assets.

Article 26 ***(currency matching)***

Currency matching rules for at least 80% of assets backing technical provisions

ALM-Traditional "with profits" with interest guarante

Article 20 (1) B (a) (i)

when contracts contain an interest rate guarantee, the competent authority in the home Member State shall set a single maximum rate of interest. It may differ according to the currency in which the contract is denominated, provided that it is ***not more than 60 % of the rate on bond issues by the State in whose currency the contract is denominated***

ALM-Index or unit linked contracts

Article 25

Where the benefits provided by a contract are directly linked to the value of units in an UCITS or to the value of assets contained in an internal fund held by the insurance undertaking, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in the case where units are not established, by those assets.

The Future EU Solvency Regime

SOLVENCY II

Why Solvency II ?

Solvency I good, but……….

Size effect (law of large numbers) ?

Volatility of different risks ?

Diversification ?

Quality of internal controls & risk management

Non-life : capital requirement for assets ?

Rules for assets backing solvency margin ?

Why Solvency II ?

- Increased competition
- "Shareholder value" pressures
- Convergence between sectors – financial conglomerates
- Developments of risk analysis methods
- International developments (IAIS & IAS)

Solvency II: Objectives

- Fundamental review of EU insurance prudential framework
- Create a prudential framework more appropriate to the risks facing insurance companies
- Incentives for companies to know & manage own risks
- Take into account the different needs for harmonisation (European level, international level, convergence of financial sectors)

Solvency II: Objectives

- Consistency between sectors:
  - avoid arbitrage: identify the areas where quantitative standards must be similar
  - coordination with Basle rules
- Open and transparent project
- Flexible and efficient regulatory framework

Solvency II – General Principles

- Risk-oriented approach
- Overall solvency assessment
- Basle-type “3 pillars” structure
  - 1st pillar: quantitative requirements
  - 2nd pillar: supervisory review process
  - 3rd pillar: market discipline (disclosure)

Solvency II – Pillar I

- Technical provisions (based on IASB)
  - life:
    - risk free market rate for discounting
    - adequate prudential margin/resilience test
    - valuing embedded options/guarantees
  - non-life:
    - quantitative benchmark
- Clarify the role of capital requirements:
  - create a regulatory notion of "target capital" / economic capital / standard model
  - use of internal models / partial models (incentives)
  - safety net capital

Solvency II – Pillar 2

- **Internal control and risk management**
  - develop internal control principles
  - develop principles for sound risk management
  - undertakings should draw up plans for:
    - investment policy
    - asset-liability matching
    - reinsurance programme
    - fair attitude to policyholders

Solvency II – Pillar 2

- Supervisory Review Process:
  - harmonise at EU level but still allow tailoring to individual companies
  - common framework for corporate governance
  - early warning indicators, stress tests
  - not static, assess ongoing position, continuity
  - minimum criteria for on-site inspections

Solvency II – Pillar 2

- coordinated supervisory action in times of crisis (dangers of forced selling, pro-cyclicality)
- intervention powers and responsibilities defined
- transparent supervisory action (criteria publicly disclosed)
- peer review process

Solvency II – Pillar 3

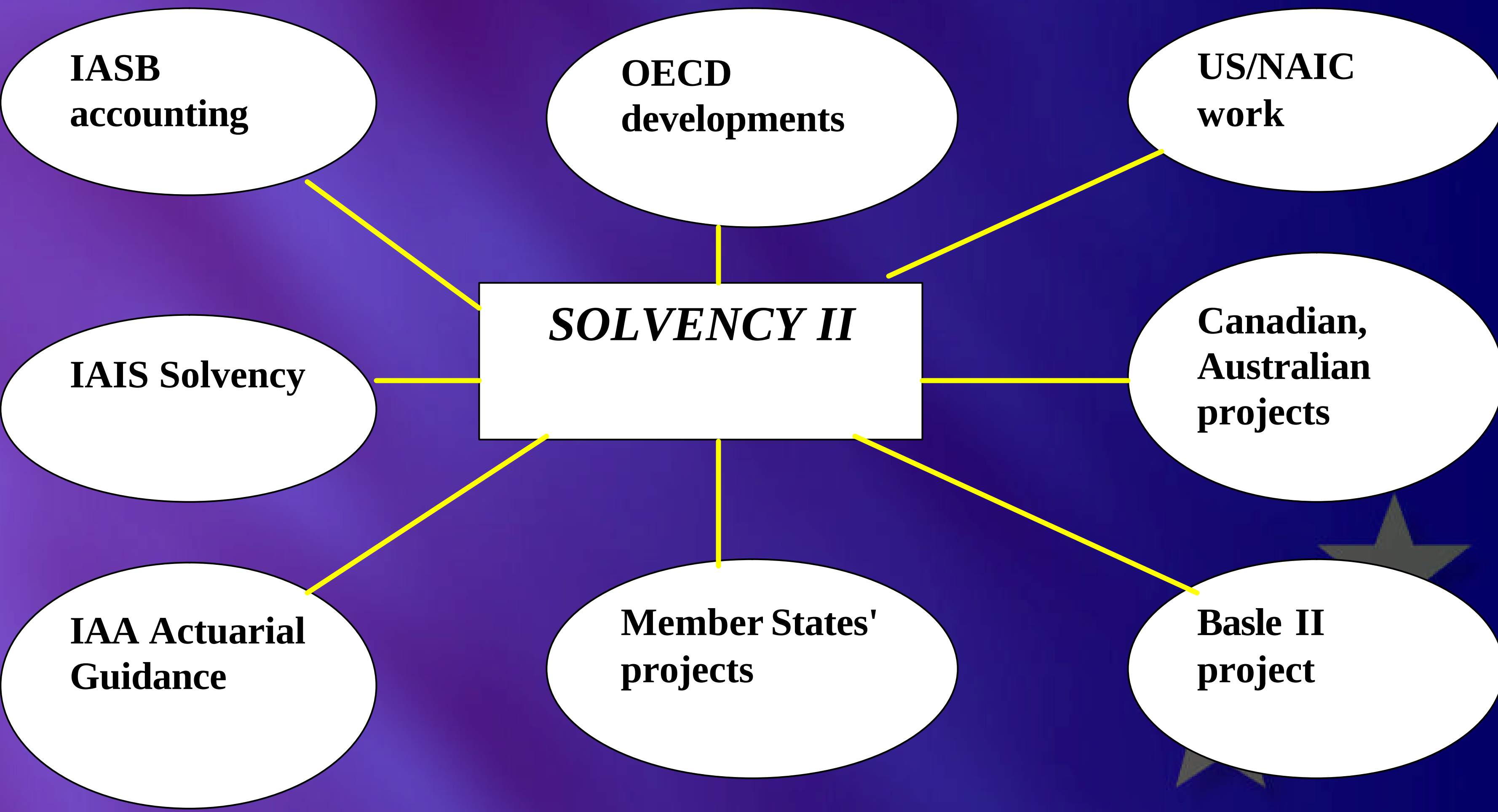
- **disclosure reinforces market mechanisms and risk-based supervision**
- **coordinate reporting burden**

  (ECOFIN wish to reduce administrative burden)

BUT

- **difficult**
- **disclosure can aggravate problem**

Solvency II and the international dimensio



Conclusions

- Solvency I
  - Evolutionary improvements
  - ALM : indirect requirements
- Solvency II
  - Fundamental Review, More risk sensitive
  - ALM : direct requirements
    - Specific legal requirement
    - ALM plan

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