

Gearing up for Solvency II: The new business environment*

A summary of the key features and commercial implications
of the draft framework Directive

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Executive Summary

July saw the launch of the European Commission's (EC) draft framework Directive for the rationalisation, harmonisation and modernisation of insurance regulation in the European Union (EU). The Directive includes ambitious and far-reaching proposals for a new, principles-based and risk-sensitive solvency regime ('Solvency II').

Solvency II's primary objective is to strengthen policyholder protection by aligning capital requirements more closely with the risk profile of the company. It seeks to instil risk awareness into the governance, operations and decision-making of the business. The Directive forms part of the drive towards a European single market for insurance, with more open competition and greater policyholder and investor scrutiny.

'This is an ambitious proposal that will completely overhaul the way we ensure the financial soundness of our insurers.'

Charlie McCreevy, European Commissioner for Internal Market and Services, speaking at the launch of the Solvency II draft framework Directive.

Solvency II is a key component of the EC's Financial Services Action Plan. Solvency II will introduce an entirely new, harmonised EU-wide solvency regime, while recasting 13 existing EU insurance directives setting out the regulation of life insurance, non-life insurance, reinsurance, insurance groups and the winding up of insurance entities.

Market consistent valuation

Assets and liabilities will be valued on an 'economic' market-consistent basis. This is conceptually in line with the latest proposals for a new International Financial Reporting Standard for insurance contracts ('IFRS Phase II').

The implementation date for Solvency II is set to be 2012, with a similar timescale currently expected for the introduction of IFRS Phase II. There may be potential synergies for insurers reporting under IFRS and Solvency II, including opportunities to develop integrated information systems and more streamlined and efficient back-office functions.¹ However, important differences do currently exist and a number of hurdles would have to be overcome to fully align the numbers. Moreover, economic valuation will be a challenge for many

European insurers, bringing potential volatility into the balance sheet and, in many cases, requiring a significant upgrade of modelling capabilities, analysis and communication.

Convergence of regulatory and economic capital

The introduction of a more risk-sensitive approach to supervision will help to align regulatory capital requirements with enterprise-wide risk management (ERM).

Companies will be required to conduct their own risk and solvency assessment (ORSA). The assessment must include compliance on an ongoing basis with the Solvency Capital Requirement (SCR) and with the requirements for technical provisions, taking into account the company's specific risk profile.

To calculate the SCR, companies can either use the European Standard Formula ('standard formula') or, if approved by their supervisor, the entity's own internal model. As they seek to gain supervisory approval for the use of an internal model under Basel II, banks are finding the process to be challenging, costly and time-consuming; a task not to be underestimated.

The challenge under Solvency II will be to demonstrate that the model meets exacting statistical standards (including data quality, calibration, validation and documentation requirements) and is trusted by the business as an integral part of its risk management and strategic decision-making process (the 'use' test).

In most companies, using an internal model could lead to lower capital requirements than under the standard formula. Another important potential benefit is the credibility that the ORSA and internal modelling process will provide in discussions with rating agencies.

The Directive also sets out a Minimum Capital Requirement (MCR), though the calculation method is as yet undecided. Falling below the MCR will result in immediate supervisory intervention with potential suspension of new business or possible winding up.

Among the most significant changes ushered in by Solvency II is the recognition of risk mitigation techniques such as securitisation or the use of financial derivatives,

¹ For more information about the potential synergies with IFRS please see 'Get set for IFRS Insurance Phase II: The planned changes, the business implications and what you should consider doing now' (www.pwc.com/insurance).

which can be used to achieve more efficient capital allocation. Use of these techniques will be permitted as long as companies consider and appropriately manage any associated risks.

Solvency II is also set to remove many of the rules on the nature and extent of admissible assets. In their place comes the principle of the 'prudent person'. Although the EC expects the impact of solvency criteria on investment choices to be limited, it anticipates some movement away from equities among non-life (re)insurers.

Governance and organisation

Critically, 'Solvency II is not just about capital. It is a change of behaviour', as Thomas Steffen, Chairman of the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), a key advisor to the EC, said at the launch of the draft Directive.

Companies will be expected to formalise their system of governance, risk management and operational control to ensure sound and prudent management of the business. This will include transparent organisational structures with clearly defined allocation of responsibilities, and the requirement to maintain certain core functions, including risk management, compliance, internal audit and actuarial units. Companies must demonstrate that risk and capital management is integral to their strategic decision-making process. In addition, key personnel including executives will need to meet 'fit and proper' standards of integrity and professionalism.

Public disclosure

The draft Directive proposes that companies will be required to provide annual, publicly available reports on their solvency and financial condition. The reports should include information on the risk profile, governance systems, nature and performance of the business, along with the approaches to capital management.

The disclosure could open up the risk profile and capital efficiency of the business to intense scrutiny at a time when analysts, rating agencies and other key stakeholders are taking an ever-keener interest in the quality of risk and capital management.

The extent of public disclosure under Solvency II continues to be a controversial area and companies may wish to consider engaging in the debate.

Group supervision

The draft Directive sets out proposals for streamlining group supervision, allowing a single authority to take the lead in the oversight of European groups. This could potentially reduce compliance costs and lower capital charges by enabling companies to take account of group-wide risk diversification.

While the draft Directive proposes a concept of 'equivalence' for non-EU ('third-country') supervisory regimes, it is not yet clear how this will operate in practice. If the benefits of streamlined supervision are not open to non-EU-based groups, they may seek to set up EU-domiciled holding companies to take advantage.

The streamlining of group supervision is a radical and controversial move that does not have unanimous backing across Europe, and is therefore expected to result in considerable debate.

Supervisory evolution

The move to a principles-based approach to supervision will transform the relationship between supervisors and regulated entities in many Member States. Companies are likely to find themselves working more closely with regulators as part of a more hands-on system of review, in particular when seeking internal model approval. This is likely to be a steep learning curve for both.

With Solvency II seeking to impose a harmonised regulatory regime across the EU, supervisors will face the challenge of harmonising many different approaches to supervision.

Commercial impact

The EC has itself recognised that there may be ‘short-term side effects’² with the implementation of Solvency II. For example, taking account of the ‘true economic cost’² of some types of policies such as traditional financial guarantees may lead to a reduction in coverage. Equally, greater transparency may reduce cross-subsidies and therefore increase the prices of some more risk- and capital-intensive lines of business. More generally, Solvency II will encourage companies to consider the efficiency of their group structures, along with the profitability and viability of individual portfolios. The impact on entry costs for new players and existing niche sectors such as captives will need to be monitored.

Solvency II is designed to be ‘proportionate’, particularly in the demands placed on smaller companies. However, larger, better-resourced and more broadly spread companies may be better equipped to realise the benefits of risk diversification and advanced information systems. This may sharpen the differentiation between sophisticated and less sophisticated companies. The EC has said that by applying the principle of proportionality and including virtually all insurers in the regime, irrespective of size, it is seeking to avoid putting smaller insurers at a ‘competitive disadvantage’.³ However, it remains to be seen how this will affect the market.

Next steps

The draft Directive sets a deadline of 31 October 2012 for Solvency II implementation. While the direction of the Directive and commitment of EC are clear, Solvency II is now entering a period of debate, which may alter some of the key principles and requirements. Companies need to assess the proposals and weigh up the cost/benefit of starting to address some of the future requirements now, along with how best to influence the debate.

‘...the initial net cost of implementing Solvency II for the whole EU insurance industry will be €2-3bn. However these costs will be outweighed in the long run by the expected benefits.’

Source: European Commission Solvency II Impact Assessment, 10.07.07.

The experience of Basel II shows that early preparation not only smoothes the way to compliance (including control of costs), but also helps to ensure that potential business benefits are realised. For banks, securing high level buy-in, the early establishment of project teams and clear goals for implementation, were often critical in ensuring the success of their Basel II projects. The experience of banks also highlights the huge challenge that is likely to arise from data management.

Companies will need to define their ambition for Solvency II. A key consideration is deciding whether this is primarily a compliance project or an opportunity to embed ERM techniques more closely into the fabric of the business. While implementation is set to be a costly and complex challenge, Solvency II could provide the means to promote and demonstrate best practice in governance and risk management, and deliver more efficient use of capital.

This paper provides an overview of Solvency II (from page 4), along with a checklist of readiness and milestones (see ‘The way forward’ from page 7) to help companies carry out an initial impact assessment and prepare implementation plans. The final section (‘Making the change’ from page 10) looks in more detail at nine key themes and their operational as well as strategic implications. This could be of particular use for individual work streams and functional areas. Finally there is a quick reference guide to the Directive (Appendix from page 18).

² Solvency II: Explanatory Memorandum, section 2b.

³ Solvency II: Frequently Asked Questions, 10.07.07.

Overview

Solvency II introduces a new, harmonised risk-based solvency regime across all EU Member States and recasts 13 existing directives.

Objectives for Solvency II⁴

- Deepen the integration of the EU insurance market;
- Enhance the protection of policyholders and beneficiaries;
- Improve the competitiveness of EU insurers and reinsurers; and
- Promote better regulation.

Who is covered?

- EU (re)insurers with annual premiums of more than €5 million (smaller entities can choose to opt in);
- EU branches and subsidiaries of non-EU-based groups;
- Coverage is neutral in respect of the legal form of the (re)insurer. In particular, no special provisions are made for captives; and
- Reinsurers in run-off before 10 December 2007 will be exempt in full.

Timescales

Solvency II is intended to come into force in 2012 (see Figure 1). Companies need to assess the proposals, and highlight their concerns as quickly as possible if they wish to influence the debate before the Directive is adopted.

Enactment and implementation

Solvency II is being enacted using the EU's Lamfalussy Process (see Figure 2). The draft framework Directive adopted by the European Commission in July 2007 is a Level 1 Directive, i.e. a Directive of the Council and the European Parliament. The details required for application of the principles set out in the Level 1 Directive will be developed and formulated as part of the Implementing Measures (Level 2).

Figure 1 – Solvency II timescales

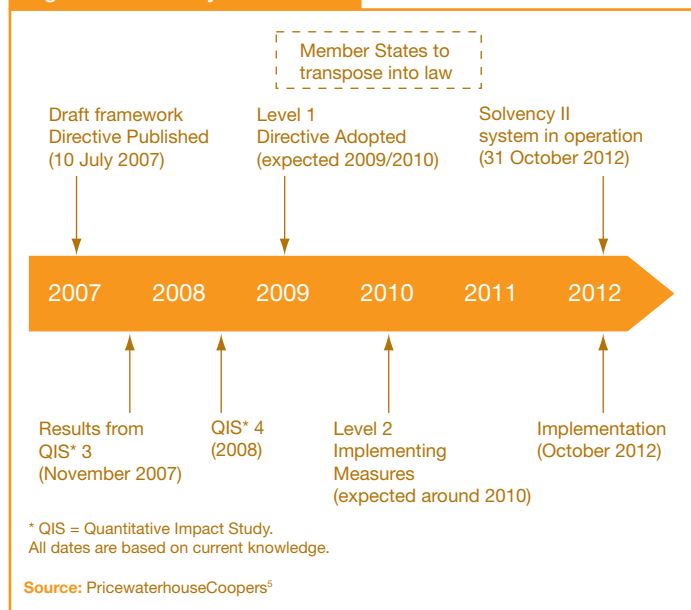


Figure 2 – The Lamfalussy Process

- Level 1:** 'Framework Directive' setting out basic enduring principles, or political choices, underpinning the solvency system.
- Level 2:** 'Implementing Measures' formulating more detailed, technical rules.
- Level 3:** 'Supervisory Standards' setting out guidelines for national supervisors to ensure a consistent interpretation and application.
- Level 4:** 'Evaluation' enables the European Commission to monitor compliance and enforcement.

Source: PricewaterhouseCoopers

⁴ Solvency II: Impact Assessment Report, page 15.

⁵ PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Foundations

The foundation of the new regime will be three pillars, which are conceptually comparable to Basel II (see Figure 3).

Valuation of assets and liabilities

Assets and liabilities will be valued on a market-consistent basis. Technical provisions are split between risks that can be hedged (valued on a 'mark-to-market' basis) and those that cannot (valued as a discounted best estimate plus a risk margin using a 'cost-of-capital' method) (see Figure 4). Technical provisions will be valued using a 'current exit value' approach that is conceptually in line with the recent proposals for IFRS Phase II.

Capital requirements

- The standard SCR will be based on a 99.5% confidence level of remaining solvent within the next 12 months;
- The SCR evaluation should include all material risks facing the company: underwriting risk (including reserving risk), credit risk, market risk and operational risk (including legal risk, but not the risks arising from strategic decisions). The evaluation should take into account risk mitigation techniques (allowing for credit risk) and risk diversification across product lines, asset classes and risk categories;
- Companies can use either the European Standard Formula ('standard formula') or an internal model (subject to supervisory model approval) to calculate the SCR. For most companies the latter is expected to result in a lower regulatory capital requirement;
- Falling below the SCR will require companies to restore their capital ('eligible own funds') to the SCR level or reduce their risk profile (to ensure the own funds are sufficient) within six months;
- The safety floor will be the MCR. Falling below the MCR would elicit immediate intervention by the supervisor and possible closure; and
- Available capital is divided into three tiers, depending on the characteristics of the items representing it. There are also limits on the amounts of lower tier capital that can be used to cover the SCR. The MCR is to be supported entirely by Tier 1 and Tier 2 capital.

Figure 3 – The three-pillar approach

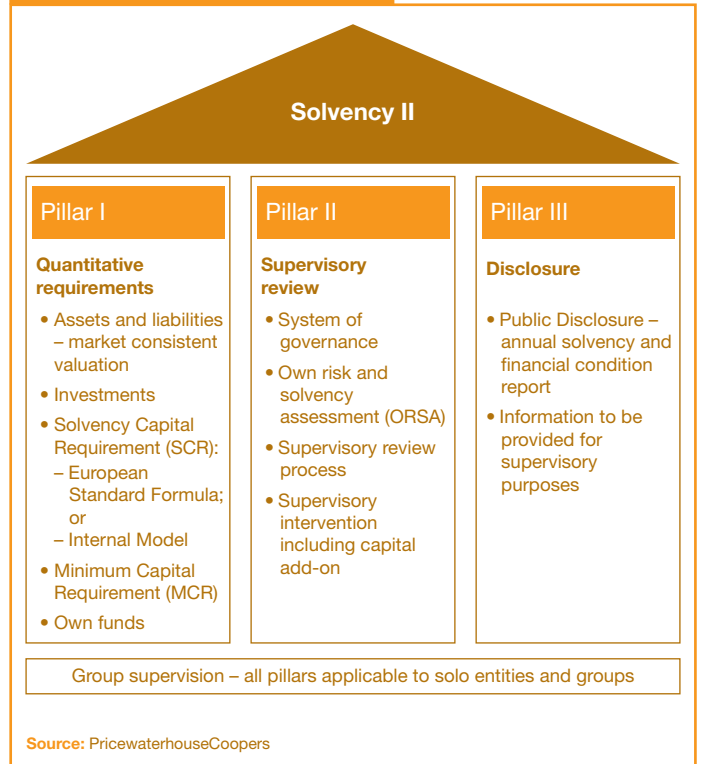
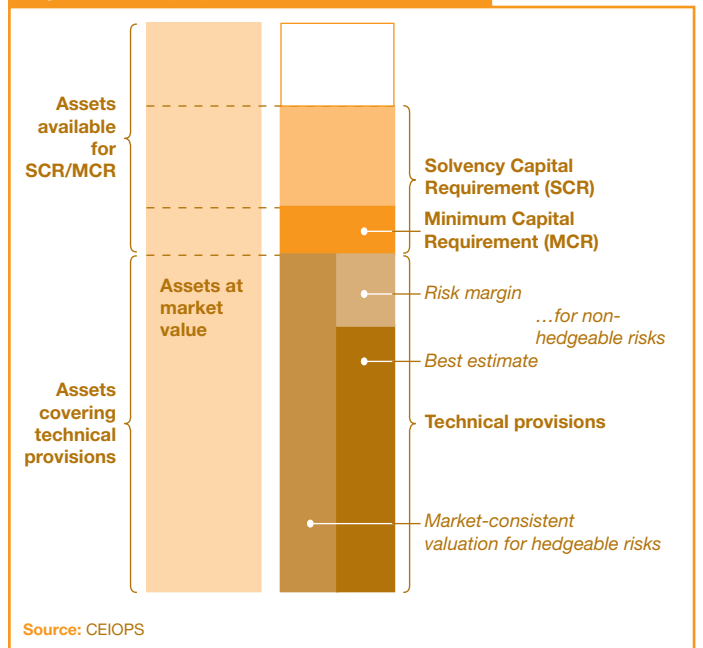


Figure 4 – The proposed framework for Pillar I



Changing behaviour

The draft Directive seeks to ensure that effective risk management and policyholder protection is embedded into the governance, operations and decision-making of the business.

Mechanisms include:

- The requirement for firms to complete an own risk and solvency assessment (ORSA) of overall solvency needs, taking into account their risk profile and approved risk tolerance. The results of the ORSA must be incorporated into the firm's strategic decision-making and must be disclosed to the regulator;

- The supervisory review process (SRP), which could lead to sanctions including capital add-ons in exceptional cases;
- Public disclosure of detailed annual solvency and financial condition reports will open companies up to the discipline of market scrutiny; and
- The proposal to streamline the approach to group supervision with the introduction of a dedicated group supervisor and potential allowances for group diversification for cross-border groups.

See 'Making the change' (from page 10) for more details about the requirements and their operational and strategic implications.



The way forward

Solvency II is set to be enforced in 2012. What should companies consider doing now?

Companies need to establish their ambition for Solvency II. The immediate question is how much time and resources to commit at this stage. With the recent announcement of the postponement of introduction to 2012, some companies might be minded to hold back, let others lead the debate and wait for a finalised framework before stepping up preparations. However, this could result in companies falling behind and passing the initiative to their competitors. The experience of implementing Basel II suggests that undue delay in engaging in the process could expose companies to significant extra cost and operational disruption.

In contrast, early engagement could help companies to influence the debate. This could be especially important for smaller insurers, many of whom have yet to make their views count.

Making use of this extra time could also help insurers to develop and embed a more systematic and cost-effective approach to implementation that both smoothes the changeover and helps to realise the full benefits as quickly as possible. By 2012, early movers could be at the front of the pack in being able to demonstrate the efficiency and effectiveness of their governance, risk management and deployment of capital to investors, rating agencies and other key stakeholders.

Stepping up preparations now would in particular give companies more time to develop their internal modelling capabilities and prepare the validation and embedding needed for supervisory approval. Other applicants may not leave enough time to secure accreditation by 2012 and could potentially find themselves stuck with what may be higher capital charges under the standard formula until they catch up.

However, an early mover approach is not without risk. It requires companies to commit resources upfront. Will this yield returns in the long run? Moreover, while the direction of the Directive and commitment of the EC are clear, Solvency II is now entering a period of political debate, which may alter some of its key principles and requirements.

Basel experience

Banks' experience of implementing Basel II highlights the importance of high-level sponsorship in ensuring adequate investment, promoting embedding and providing the commitment and direction needed to realise the benefits. It also underlines the need for a realistic project plan in ensuring sufficient lead times and efficient use of resources. For example, many companies which wanted to use internal models from the outset found that after a lot of effort and expense they had not actually allowed enough time to prepare and were forced to revert to straightforward compliance.

Strategic objectives

A key consideration in defining companies' ambition for Solvency II is deciding whether this is primarily a compliance project or an opportunity to embed ERM techniques more closely into the fabric of the business.

The objectives need to draw on a consideration of how the Directive will affect the company operationally and strategically, including any particular threats or opportunities, and how it should respond in the most effective and proactive way. Figure 5 sets out some of the critical questions that organisations will need to address.

Figure 5 – The critical questions for CEOs, CFOs, CROs and Chief Actuaries to consider

What is the impact of the new valuation basis on our balance sheet and solvency position?

Will we need to raise capital?

How will this impact on my daily activities?

Are all Solvency II key business risks captured in our internal risk assessment?

Can I manage and continuously report on risks at an individual and aggregate level?

What is the potential impact on the operational and organisational structure of the business?

What will it take for public disclosure of:

- Governance system;
- Risk profile, mitigation and sensitivity; and
- Solvency and financial condition.

What are the implications for our corporate structure?

Are there implications for my business strategy for growth in/outside EU?

What will Solvency II implementation cost?

How can I manage costs effectively?

When should we establish the project team?

Source: PricewaterhouseCoopers

While effective planning and the exploitation of potential synergies could reduce implementation costs, this is still likely to be an expensive exercise for many companies. The key question is how to realise the payback on this investment by using Solvency II as an opportunity to strengthen the governance, operations and competitive potential of the business.

Where are you now?

Figure 6 outlines the key elements of compliance and what steps will be needed to achieve it. It provides not only a benchmark for companies' own preparation plans, but also enable them to compare their readiness to their competitors.

Figure 6 – Readiness for Solvency II

| Key Areas | Typical Base | Next Steps | Full Compliance |
|--|---|--|--|
| Own risk & solvency assessment (ORSA) | <ul style="list-style-type: none"> • Own risk profile well understood • Material risks identified, documented and quantified in a risk register | <ul style="list-style-type: none"> • Develop internal assessment framework for: <ul style="list-style-type: none"> – Solvency needs – Risk profile – Compliance with capital requirements – Managing and reporting continuously individual and aggregate risks, and interdependencies | <ul style="list-style-type: none"> • ORSA forms integral part of strategic business decisions • Used on an continuous basis |
| Quantitative Requirements | <ul style="list-style-type: none"> • Solvency I and local supervisory solvency requirements | <ul style="list-style-type: none"> • Quantify potential impact of SCR standard formula on solvency position • Reconcile and explain internal model results (if used) with SCR standard formula | <ul style="list-style-type: none"> • Quarterly calculation of MCR • Annual calculation of SCR • Ability to manage and monitor solvency position on continuous basis |
| Technical Provisions | <ul style="list-style-type: none"> • Booked reserves under local GAAP contain implicit margin for prudence • Actuarial/statistical methods not always used | <ul style="list-style-type: none"> • Aware of impact of new valuation basis on balance sheet, solvency and profit & loss | <ul style="list-style-type: none"> • New reserving basis 'business as usual' • Technical provisions incorporate best estimate, discount and risk margin |
| Internal Model | <ul style="list-style-type: none"> • Models used for specific purposes, e.g. pricing, reinsurance purchase, capital management • Models may be partially integrated with business • Models may not be used | <ul style="list-style-type: none"> • Prepare for supervisory approval process • Document and demonstrate compliance with: <ul style="list-style-type: none"> – Use test – Calibration and validation test – Statistical quality test • Develop internal governance, validation and audit procedures | <ul style="list-style-type: none"> • Internal model widely used in system of governance and in strategic decisions • Model approved by supervisor • Regular cycle of model validation and control |
| Disclosure | <ul style="list-style-type: none"> • Communication privately to regulator • Limited information | <ul style="list-style-type: none"> • Collate information • Prepare policy on public disclosure • Synergies with IFRS | <ul style="list-style-type: none"> • Annual public disclosure • Solvency and Financial Condition Report |

Source: PricewaterhouseCoopers



Making the change

The impact of Solvency II is likely to vary from company to company and country to country and this is reflected in our assessment of the key commercial and operational implications of the Directive.

Governance and organisation

Key requirements

Companies will be required to formalise their systems of governance to demonstrate sound and prudent management. The system of governance should include a clear allocation of responsibilities and effective reporting lines, underpinned by thorough documentation and internal review.

Companies are required to have risk management, compliance, internal audit and actuarial functions. They must also meet requirements for and have written policies on risk management, internal control, internal audit and, where applicable, outsourcing. The system of governance should be proportionate to the nature, scale and complexity of the operations.

All those with responsibility for running the business or key functions will need to conform to ‘fit and proper’ standards of integrity and professionalism.

‘ Robust governance requirements are a prerequisite for an efficient solvency system. Some risks may only be addressed through governance rather than by setting quantitative requirements.’

From Solvency II: Explanatory Memorandum, section 5

‘ It should be noted that in the “Solvency II” context “governance” is used in a broad sense, encompassing aspects of corporate governance, as well as the concept of risk management.’

From Solvency II: Frequently Asked Questions, 10.07.07

More details on governance systems, requirements for functions and conditions for outsourcing are expected in the implementing measures.

Comment and analysis

While well-run companies would argue that this is what they do already, the formalisation and documentary verification of these procedures could be a considerable challenge. Companies that have faced comparable regulatory documentation and verification requirements will understand the demands on time and resources, though they should be able to leverage some of their existing arrangements. However, the new requirements may require senior executives to oversee what could be a complex and unfamiliar infrastructure of information and control, and ensure that it is embedded into the decision-making processes of the business, most particularly in the risk management area.

For smaller operations, organisational structures may need to change and new functions may need to be created or outsourced (the latter requires prior regulatory approval). Once operations are outsourced, companies will need to demonstrate that their duty of responsibility is being retained and enforced. If necessary, the outsource company will need to provide the supervisor with unrestricted access.

New obligations on actuaries to assess overall underwriting policies and the adequacy of reinsurance arrangements may require additional skills.

The prize of a more systematic approach to governance is a more informed and assured basis of operational control and strategic execution. On the flipside, failure to comply may result in supervisory enforcement procedures and possibly even additional capital requirements. Such action could not only be costly in itself, but could also jeopardise the credibility of the company with stakeholders.

Valuation approach and synergies with IFRS Phase II

Key requirements

Solvency II will use a market-consistent ‘economic’ approach to the valuation of assets and liabilities.

Assets will be fair valued (mark-to-market). The technical provisions will be based on their ‘current exit value’ (market transfer price). To achieve this the technical provisions will be broken down into those that can be hedged (mark-to-market valuation) and those that cannot (discounted best estimate, plus a risk margin using a cost-of-capital approach). Economic valuation will be a challenge for many European insurers, bringing potential volatility into the balance sheet.

The Solvency II technical provision valuation rules are conceptually in line with the latest proposals for a revised IFRS for insurance contracts (IFRS Phase II), though it is important to note that Solvency II would apply more widely than IFRS.⁶

Figure 8 – Comparison of Solvency II with IFRS Phase II

| Technical provisions | Key similarities with IFRS | Potential differences from IFRS |
|----------------------|---|---|
| | <ul style="list-style-type: none"> • Market consistent • Best estimate • Discounted • Risk margin | <ul style="list-style-type: none"> • Definition of insurance • Risk margin – method • Service margin • Diversification • Guaranteed insurability • Credit standing of liabilities |

Source: PricewaterhouseCoopers

‘Valuation standards for supervisory purposes should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden.’

From Solvency II: Introductory note 28

Comment and analysis

While much of the detail is yet to be finalised, clear parallels between Solvency II and IFRS Phase II are emerging.

The EC aims to ‘reduce as far as possible’⁷ costs for insurers reporting under both systems, by aligning accounting and prudential reporting standards to the extent that this is appropriate. There are also synergies in the current planned timetables for Solvency II and IFRS Phase II (see Figure 7).

Both frameworks share the core principle of basing the valuation of technical provisions on the current exit value. Moreover, the building blocks making up the current exit value proposals are fundamentally the same under both frameworks: a best estimate of projected future cash flows, taking into account the time value of money, plus a risk margin.

In practice, however, there are important distinctions between the two frameworks (see Figure 8). These reflect the inherent differences in the scope and objectives of prudential regulation and financial reporting.

The IFRS proposals only apply to insurance contracts that transfer significant risk, irrespective of their regulatory status (‘substance over form’). Solvency II focuses on the solvency of the legal entity as a whole. As a result, policies that do not meet the IFRS definition of an insurance contract, including many types of pension and savings schemes sold by life insurers, would still fall under Solvency II.

Further differences are emerging at a more detailed level. Discussions continue in both the Solvency II and IFRS arenas about the credit given for cross-portfolio diversification

Figure 7 – Comparative timetable for IFRS Phase II and Solvency II

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|-------------------------------------|------|-------------------------------|------|---------------------|------|
| Solvency II | | | | | |
| Draft Framework Directive Published | | Framework Directive Published | | Full Implementation | |
| Phase II | | | | | |
| Discussion Paper | | Exposure draft | IFRS | Implementation | |

All dates are estimated based on current knowledge.

Source: PricewaterhouseCoopers

⁶ IFRS has a global reach, but currently in Europe only listed companies are required to report under IFRS. Solvency II applies to most European insurance undertakings (see Overview section page 4).

⁷ Solvency II: Frequently Asked Questions, 10.07.07.

within the technical provisions, though Solvency II would give full allowance within the capital requirements. Although both frameworks would include a risk margin to reflect any uncertainty in future cash flows, the draft Solvency II framework Directive explicitly specifies that a cost-of-capital approach should be applied.⁸ In addition, IFRS proposals draw a distinction between a margin for the provision of services and a margin for bearing risk, while Solvency II only refers to a risk margin.

IFRS also introduces the concepts of ‘guaranteed insurability’, which limits future premiums that may be included in the estimation of future cash flows to those that a policyholder must pay in order to maintain insurance cover at the agreed premium. The draft framework Directive for Solvency II does not introduce this restriction. In addition, IFRS proposes an adjustment for the credit standing of the insurance liabilities, reflecting both the own credit standing of the insurer (explicitly excluded in the draft framework Directive) and other factors such as the regulatory environment.

Although there is likely to be some divergence in the two frameworks, the EC has said that it wants to ensure compatibility, ‘to the extent possible’.⁹ This will open up opportunities for valuable synergies in finance and actuarial systems, operations and disclosure for insurers reporting under both frameworks.

With the publication of the draft framework Directive, companies would be well advised to assess the potential impact of the new valuation bases on their financial reporting and ultimately their systems.

Investment strategy

Key requirements

Solvency II is set to remove many of the limits on the nature and extent of admissible assets. In their place comes the principle of the ‘prudent person’, a concept that has been largely borrowed from the Reinsurance Directive, though it applies to all assets, not just those backing technical provisions.

The principle requires insurers to act in the best interests of their policyholders by seeking to maintain the security, quality, liquidity and profitability of their portfolios. Companies have to carefully monitor, manage and control their investment risks.

For assets covering technical provisions, companies will also need to ensure they are invested in a manner that adequately reflects the nature and duration of the liabilities, paying particular attention to the appropriateness of assets supporting guarantees.

‘Member States shall not require insurance and reinsurance undertakings to invest in particular categories of assets.’

From Solvency II: Article 130

Comment and analysis

As long as sufficient prudence, diversification and matching are maintained, the Directive aims to provide greater freedom in the choice of assets, subject to localisation requirements. This includes holding unlisted securities. Derivatives can also be used.

However, under the SCR requirements, the fact that capital charges will reflect the volatility of a particular class of assets may affect investment preferences. The EC’s Explanatory Memorandum states that the ‘impact of Solvency II on life insurers’ investment behaviour is not expected to be significant’. Nonetheless, a number of companies have indicated that the high risk and capital loadings highlighted by their quantitative impact studies may force them to switch much of their equity investment to bonds. It is certain there will be considerable lobbying around this issue, both as part of the legislative process and during the subsequent formulation of the implementation measures.

Insurers need to assess the potential impact of the new solvency rules on their current portfolios and asset management arrangements. Once in place, the new regime is likely to require a more active approach to asset management. Some companies may lack sufficient in-house expertise and may therefore choose to outsource investment management. Documentation will be required to demonstrate that the prudent person principle is being applied.

Solvency II is also likely to require closer cooperation between the asset and capital management functions, underpinned by integrated modelling and analysis. At the same time, companies will need to keep track of developments both in regulation and the underlying risk environment as the EC has reserved the right to impose temporary limits and asset eligibility criteria as circumstances dictate.¹⁰

⁸ Solvency II: Explanatory Memorandum, section 5e, 10.07.07.

⁹ Solvency II: Introductory note 28, 10.07.07.

¹⁰ Solvency II: Explanatory Memorandum, section 5e, 10.07.07.

Capital

Key requirements

Companies need to maintain sufficient capital ('eligible own funds') to meet SCR and MCR standards. The standard formula SCR is set at a 99.5% probability of solvency over 12 months (i.e. it would require a 1 in 200 year loss to risk insolvency).

Falling below the SCR would require companies to restore their own funds to the SCR level or reduce their risk profile (to ensure their own funds are sufficient) within six months. Breaching the MCR would invite rapid regulatory intervention and probable winding up or sale of the business. However, many companies operate with a higher 'target' level of capital ('economic capital'), in order to maintain an external credit rating.

The draft Directive sets out the broad categories of what would qualify as 'eligible own funds' for Solvency II purposes. Further clarification should be forthcoming as a result of the quantitative impact studies and eventual implementation measures.

Companies' eligible own funds are divided into basic items, such as the excess of assets over liabilities and ancillary items, such as calls on members or, notably, letters of credit from a bank (see Figure 9).

The capital is further divided into three tiers, depending on a range of criteria including its availability, permanence and efficacy in absorbing potential losses (see Figure 10).

Solvency II is further introducing limitations on the amount of Tier 2 and Tier 3 capital that can count towards the SCR. The MCR can be supported by Tier 1 and Tier 2 capital only.

Comment and analysis

The eligibility of ancillary own funds covering off-balance sheet items needs to be confirmed by the supervisor. Given the complex nature of some of these instruments, supervisory adjudication is likely to require a significant depth of expertise. Supervisors also need to work together to ensure harmonised criteria are used in their assessments.

Companies are likely to seek more innovative ways to manage capital efficiently and avoid tying up excess funds. This could spur further growth in areas such as securitisation, which could not only help to remove risk from the balance sheet, but may also qualify as Tier 1 capital. Naturally, the benefits need to be weighed against the costs and associated risks. Furthermore, the recognition of contingent capital may provide new opportunities for flexibility and innovation.

Figure 9 – Eligible own funds

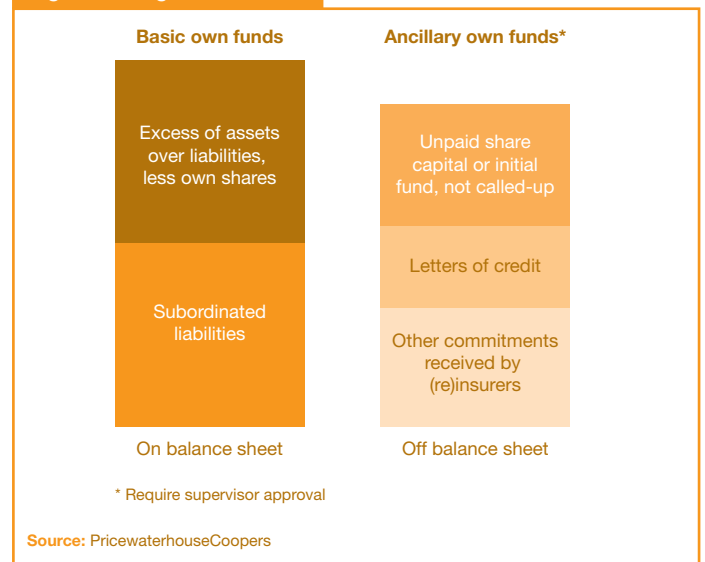


Figure 10 – Classification of own funds into tiers

| Quality \ Nature | On balance sheet (basic own funds) | Off balance sheet (ancillary own funds) |
|------------------|------------------------------------|---|
| | High | Tier 1 |
| Medium | Tier 2 | Tier 3 |
| Low | Tier 3 | |

Source: European Commission

Own risk and solvency assessment (ORSA)

Key requirements

Companies will be required to carry out their own 'regular' ORSA to assess their solvency needs with regard to their own risk profile and approved risk tolerance. In particular, the ORSA should focus on identifying 'whether the particular risk profile of an undertaking deviates from the assumptions underlying the regulatory capital calculation'.¹¹

The ORSA will be a key part of a company's risk management system and as such should form 'an integral part' of strategic decision-making. The ORSA must be forward-looking, taking into account long- and short-term risks facing the business and any factors that could affect the firm's future risk profile. The assessment should also include verification of compliance with requirements for the valuation of technical provisions, MCR and SCR.

The results of the ORSA need to be disclosed to the supervisor. The EC's intention is that 'the ORSA, together with a robust supervisory review process, will introduce a new discipline to the industry that will help in ensuring the stability and long-term sustainability of the European insurance industry'.¹²

Comment and analysis

Although the ORSA occupies only a few lines of the overall Directive (Article 44), it is likely to be one of its most important elements. By looking beyond the capital numbers to the specific risk profile of the business, the ORSA can be seen as the vehicle for embedding the risk management principles of Solvency II into the organisation.

All companies will need to assess the impact on resources and who is responsible for planning, directing and monitoring the process. An ORSA will be required, irrespective of whether companies are using an internal model. The Explanatory Memorandum to Solvency II explains that the ORSA should be proportionate to the firm's risk profile and 'therefore not overly burdensome on smaller or less complex undertakings'.¹³

Although some companies may opt for a basic evaluation, a robust process that integrates the ORSA into the day-to-day risk management framework may prove more valuable. The challenge will be the development of processes capable of identifying changes in the firm's risk profile proactively (such

as new business plans, catastrophic events or changes in economic conditions). The key to making the process pay is ensuring that information from the ORSA is taken up by the business in strategic decisions and the effective management of risk and capital on the ground.

The ORSA will also form a key part of the information used within the supervisory review process (SRP). As such, the ORSA represents an opportunity to demonstrate to the regulator that the business is managed in a sound and prudent way.

'...the new framework will turn the spotlight on the accurate identification, measurement and management of risk. The new rules will spur insurers to raise their game in this area.'

Charlie McCreevy, European Commissioner for Internal Market and Services, speaking at the launch of the Solvency II draft Directive

Internal models

Key requirements

Companies with sufficiently sophisticated in-house modelling capabilities may be able to use them in calculating their solvency capital requirements, rather than using the standard formula. Partial models will be allowed on a risk module or business unit level, and apply to particular entities or the group as a whole.

To use internal models to calculate their solvency requirements, companies will need to seek approval from their supervisor. Supervisors will require assurance that the systems and the surrounding controls meet the required statistical, validation, calibration and documentation standards. They must also meet the 'use test', under which companies must provide documentation to demonstrate that their model plays a central role in the governance and decision-making of the organisation. Supervisors will have six months to respond upon receiving the completed application.

For the first two years following implementation, companies will need to provide supervisors with a parallel estimate of their solvency calculations using the standard formula. In circumstances where the standard formula does not capture the risk profile of the entity, supervisors may insist on the use of an internal model.

¹¹ Solvency II: Frequently Asked Questions, 10.07.07.

¹² Solvency II: Frequently Asked Questions, 10.07.07.

¹³ Solvency II: Explanatory Memorandum, section 5.

Comment and analysis

Using an internal model could potentially lower capital charges. However, gaining accreditation could prove a considerable challenge and companies may need to begin preparing now. Although the framework envisages that approval should take no more than six months, the experience from the implementation of Basel II indicates that preparation for accreditation, including model design, calibration and validation, can take several years.

The approval criteria, are likely to focus on the links between the solvency/capital model and the business plan and forecasting tools, in order to test consistency in the underlying assumptions. The ability to demonstrate the use and integration of the model with strategic decision-making is likely to be a key test under Solvency II.

A further challenge will be sourcing applicable and consistent data from around the company/group. The experience of Basel II also suggests that multiple models and considerable increases in computational capacity may be required to process what could be large quantities of data. Other issues include the potential 'demand surge' for suitably experienced IT, actuarial and asset modelling/financial analysis personnel in the lead-up to implementation.

Ultimately, meeting the use test could prove the greatest hurdle, not least in securing board and business buy-in for numbers that may be potentially unfamiliar or seen by some within the organisation as arbitrary. Gaining the input and support from business teams at the earliest possible stage will therefore be crucial.

Supervisory relationship

Key requirements

The supervisory review process (SRP) will assess the appropriateness and adequacy of the strategies, processes and reporting procedures in place to comply with the Directive. This includes examination of a company's approach to risk management, governance, controls, investment rules, quality and quantity of own funds, as well as the compliance with the evaluation bases for technical provisions and capital requirements.

The scope and frequency of supervisory review will be prospective and 'risk-based', reflecting the nature, scale and complexity of the insurer's activities. Supervision will be carried out both on- and off-site.

The supervisory authorities will have the power to require companies to take steps to remedy deficiencies and weaknesses. In 'exceptional' cases, they will also be able to impose a 'capital add-on'. Indeed, capital add-ons could apply to individual entities within centrally supervised groups (see page 17). Supervisors will be required to disclose details about the extent to which they require additional capital by industry sector and by Member State. Individual supervisors will be required to remove capital add-ons promptly when associated deficiencies have been rectified.

Comment and analysis

The demands of moving from a rules- to a principles-based approach to supervision cannot be underestimated.

Available supervisory resources and expertise are likely to come under intense pressure, especially in countries that have yet to make significant steps towards a risk- and economic-based system of solvency evaluation.

The relationship between supervisor and supervised will evolve as compliance moves to a process of demonstration and validation. The supervisory process will vary from country to country, given differing resource profiles and different markets, but should in general be more transparent and accountable than in the past. This will facilitate cross-border comparison of the approaches and processes.

It should also be borne in mind that the draft Directive has been drawn up by policymakers. Many supervisors therefore face comparable challenges to those they supervise in understanding the Directive and developing their systems and procedures. Companies and supervisors will need to work together to share knowledge and develop an effective modus operandi.

The Directive seeks equivalent powers for regulators in the EU, and at the same time introduces a legislative obligation for supervisors to cooperate. The technical advice provided by CEIOPS' work will naturally spill over into national implementation, helping to reduce inconsistencies in interpretation and application.

Public disclosure

Key requirements

Each year, companies will be required to provide publicly available reports on their solvency and financial condition at both a group and entity level (see Figure 11). Subject to the approval of the supervisor, a group may be able to disclose only one report, which includes all the group and subsidiary information.

Figure 11 – Annual solvency and financial condition reports

Annual solvency and financial condition reports will need to contain information on:

- The nature and performance of the business;
- Governance systems;
- Risk management approach and risk profile;
- Valuation bases for assets and liabilities including technical provisions;
- Capital management including structure and quality of own funds, MCR and SCR amounts; and
- Non-compliance with MCR or SCR during reporting period.

Source: PricewaterhouseCoopers

Companies are required to have appropriate systems and structures in place, along with a written policy ensuring the ongoing appropriateness of any information disclosed. All financial condition reports have to be approved by the entities administrative or management body.

The enhanced disclosure requirements seek to open up the effectiveness and efficiency of risk and capital management to the discipline of market scrutiny.¹⁴ The required disclosure will eventually include any additional capital imposed by the supervisory authority, though this may remain confidential for an interim five-year period, following implementation. Supervisors may also allow companies to keep certain information out of the public domain if it could compromise commercial confidentiality or provide undue advantages for competitors. However, the reason for non-disclosure would have to be publicly explained. In the event of a major

development that would significantly affect the relevance of the disclosure, undertakings must disclose appropriate information about its nature and impact.

Companies will be permitted to make use of, or refer to, other public disclosures made, where the information is relevant in nature and scope. Companies may also disclose additional information or explanations related to their solvency and financial condition report on a voluntary basis.

Comment and analysis

While some of the necessary information may already be, or about to be, disclosed, under IFRS 4 and IFRS 7, or to meet other legal or regulatory requirements, the volume and detail required under Solvency II is likely to be far more extensive and could stretch data, analysis and reporting systems to the full. Companies also face the challenge of reconciling their Solvency II and financial reporting (see page 11).

Stakeholder communication under Solvency II is set to be a key competitive issue at a time when analysts, brokers, financial intermediaries and, indeed, some commercial policyholders are scrutinising the quality of risk management and the availability of free capital evermore closely. The Pillar III reporting will also allow analysts and investors to compare the efficiency of risk and capital management.

Companies therefore need to take a strategic and proactive approach to Pillar III disclosure. This includes identifying any information weaknesses, along with any unjustifiably capital-intensive areas of the business. They will also need to look at how to convey what could be complex information in a clear, concise and credible way. If effective, this exercise could provide an important opportunity to highlight the strength and sustainability of value creation within the business.

Companies may wish to engage in the ongoing discussions and lobbying, in particular on what part of the disclosures should be in the public domain and what should remain confidential matters between them and their supervisory authorities.

¹⁴ Solvency II: Frequently asked questions, 10.07.07.

Group supervision

Key requirements

The draft Directive places equal emphasis on group- and entity-level supervision, where previously the latter had held sway. The powers of the group supervisor will be extended to cover individual entities, enabling them to take the lead in the supervision of internationally operating groups.

‘The Commission’s proposal foresees that groups will be allowed to organise themselves in the most economically efficient way. A dedicated group supervisor will be appointed for each group, with real decision-making powers and coordination responsibilities.’

Charlie McCreevy, European Commissioner for Internal Market and Services, speaking at the launch of the Solvency II draft Directive

A system of waivers (‘derogations’) would allow individual entities to defer their SCR evaluation to their parent group, which would be able to take into account, group-wide risk diversification. The difference between an entity’s SCR and MCR could also be covered by parental ‘guarantees’. Other key areas that could be supervised at a group level include governance systems.

The waivers will only be granted if supervisors are satisfied that the parent’s risk management and internal control mechanisms cover the individual entities. While the group supervisor will ultimately be responsible for approval, it will need to work closely with local supervisors. Indeed, cooperation between supervisors, including mutual consultation, information exchange and coordination of decision-making through CEIOPS is enshrined in the draft legislation, rather than being left to supervisors to develop.

Group supervision can be applied at EU-wide, cross-national or individual state level. National supervisors may impose additional capital charges or insist that the entity calculates its SCR through the standard formula, if they believe its risk profile markedly deviates from that of the group. However, they must justify their decision to the parent and its group supervisor.

Group supervision as outlined above would only apply to groups parented in the EU. Non-EU-based groups could seek to be supervised at a group level through a ‘verification

of equivalence’, though the approval criteria are as yet unclear. In the absence of equivalence, non-EU groups will not benefit from the waivers, which would allow for group support and risk diversification. Moreover, supervisors can require that an EU subgroup be set up for the non-EU based groups.

Comment and analysis

Streamlining the approach to group supervision with the introduction of a dedicated group supervisor is a radical and controversial move. The power of the group supervisor over individual entities goes well beyond the role set out in Basel II.

Working with just one dedicated regulator could reduce compliance costs. Taking into account group-wide diversification and effectively pushing this down to entity level could significantly lower capital requirements. Some non-EU-based groups may seek to set up subgroups within the EU to realise the full potential benefits of group supervision.

‘Member State supervisors should co-operate closely, share information and jointly oversee the groups under their responsibility.’

Charlie McCreevy, European Commissioner for Internal Market and Services, speaking at the launch of the Solvency II draft Directive

Enshrining the need for cooperation between supervisors in legislation is a notable step. CEIOPS will play a key role in coordinating the various national bodies in line with the role of the Committee of European Banking Supervisors (CEBS) under Basel II.

While engaging with a single supervisor may be popular with larger groups, some smaller countries may argue that risks that may be relatively insignificant to a large international group may be critical to the financial health of their particular market. Allowing national supervisors to impose additional capital may assuage some of the concerns. However, caution will be needed to ensure that group supervision rules do not inadvertently create barriers to new entrants. The supervision of groups is likely to be one of the most contentious areas of political debate.

Appendix

Where to look

Want to know more about...

See draft framework
Directive – Article¹

See Solvency II FAQs²

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¹ See http://ec.europa.eu/internal_market/insurance/solvency_en.htm ('Proposal COM (2007) 361').

² See http://ec.europa.eu/internal_market/insurance/solvency_en.htm ('Frequently Asked Questions').

| Want to know more about... | See Article | See FAQs |
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