The New Solvency II Regime: A French Perspective

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Introduction

Over its forty years of existence, the Solvency I regime showed structural weaknesses. It was not risk-sensitive, and a number of key risks, including market, credit and operational risks were usually not captured in capital requirements.

As a consequence, it did not manage to lead to an accurate assessment of each insurer's risks, did not ensure accurate and timely intervention by supervisors and did not entail an optimal allocation of capital, i.e. an allocation which is efficient in terms of risk and return for shareholders. Furthermore, the former Solvency system was far from being adapted to the significant development of financial markets, leading to a large discrepancy between the reality of insurance business today and its ageing regulation.

Therefore, the European Commission undertook during 2004 and 2005 a review of EU insurance law in order to improve consumer protection, modernize supervision, deepen market integration and increase the international competitiveness of European insurers and reinsurers.

This review finally led to the adoption of the Solvency II Directive 2009/138/EC on 25 November 2009 that codifies and harmonizes the EU insurance regulation. Primarily the reform concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency. The rules also lay down the principles that should guide insurers' overall risk management so that they can anticipate any adverse events and handle such situations more effectively. Often called "Basel for insurers", Solvency II is somewhat similar to the banking regulations of Basel II.

The Solvency II Directive was then amended by the Omnibus II Directive 2014/51/EU. The amendment became necessary because a new European authority for insurance supervision (EIOPA) had been established during the financial crisis. The functions and powers of this authority had to be incorporated into the Solvency II Directive. Moreover, the Omnibus II Directive provides supplementary provisions on the assessment of long term guarantees which, together with several transitional provisions, were incorporated into the Solvency II Directive. Solvency II as amended by Omnibus II replaces 14 existing directives commonly known as Solvency I.

According to the Lamfalussy process, the Directive lays down many empowerments for the Commission to adopt delegated acts, and for the EIOPA to draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS), in accordance with its founding regulation n° 1094/2010. In anticipation of the definitive timetable the EIOPA issued preparatory guidelines aimed at assisting national regulators in assessing firms' preparedness for the new regime. The guidelines notably cover system of governance, forward looking assessment of the undertaking's own risk (based on the ORSA principles), submission of information and pre application for internal models. The Autorité de Contrôle Prudentiel et de Résolution (ACPR) proposes applying the guidelines in a proportionate, risk-based manner according to the nature, scale and complexity of the business.

Moreover, a delegated Regulation n°2015/35 was adopted on 10 October 2014. It specifies several provisions of the Directive and is directly applicable in France.

After almost a decade in the making, provisions to implement Solvency II rules into national law needed to be passed by 31 March 2015. The Solvency II regime has thus been implemented in France throughout three texts: an "ordonnance" n° 2015-378 on 2 April 2015, a decree n° 2015-513 on 7 Mai 2015 and a ministerial order on 7 Mai 2015. Eventually, the regime will become fully applicable on 1 January 2016 in France, at which time the Solvency I regime will cease to apply.

Solvency II is based on a three pillar framework. The pillar system originates from the approach taken in the Capital Requirements Directive, which followed the international Basel II Accord for banks and investment firms. Pillar 1 deals with quantitative requirements (**1.**), Pillar 2 is about qualitative requirements such as

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governance and supervision (**2.**) and Pillar 3 eventually relates to information requirements (**3.**). All these three pillars tend towards the same objectives (**4.**).

Pillar 1: Quantitative Requirements

The Pillar 1 covers the capability of an insurer to demonstrate that it has adequate financial resources in place to meet all its liabilities and consists of the quantitative requirements like the amount of capital an insurer should hold. It is thus all about the calculations, models and capital requirements.

Capital requirements under Solvency II are forward-looking and economic, i.e. they are tailored to the specific risks borne by each insurer, allowing an optimal allocation of capital across the EU. They will be defined along a two-step ladder, including the solvency capital requirements (SCR) and the minimum capital requirements (MCR) in order to trigger proportionate and timely supervisory intervention.

The Solvency Capital Requirement

Firstly, insurers must adhere to the Solvency Capital Requirement (SCR), which is a level of financial resources that enables them to absorb significant losses and gives reasonable assurance to policyholders and beneficiaries that payments will be made as they fall due.

More precisely, the SCR is a risk responsive capital measure calibrated to ensure that each insurer will be able to meet its obligations over the next 12 months with a probability of 99.5%. Basically the SCR is the amount of capital needed to leave a less than 1 in 200 chance of capital being inadequate over the forthcoming year. If this level of capital is not reached it will likely result in regulatory intervention and require remedial action.

The SCR can be calculated by using a standard formula or an internal model. An internal model can be implemented fully or partially if it satisfies the tests and requirements of the supervisors, which is only recommended for the largest firms. Indeed, the smallest undertakings (typically, undertakings that are not part of a group and write less than EUR 5 million in premiums per year) will be exempted from the new rules, although they may choose to apply them if they wish.

The Minimum Capital Requirement

Secondly, insurers must also adhere to a Minimum Capital Requirement (MCR) which is a lower, minimum level of security below which the amount of insurers' financial resources should not fall, otherwise supervisory authorities may withdraw authorization. More precisely, MCR is designed to be the lower solvency calculation, corresponding to a solvency level, below which policyholders and beneficiaries would be exposed to an unacceptable level of risk, if the insurer were allowed to continue its operations.

The MCR is intended to correspond to an 85% probability of adequacy over a one year period and is bounded between 25% and 45% of the SCR. If the MCR is breached supervisory action will likely be taken.
The Directive requires that insurers and reinsurers invest their assets in accordance with the “prudent person” principle and they should invest in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

Pillar 2: Governance and Supervision

The Pillar 2 sets out requirements for the governance and risk management framework that identifies and measure the risk against which capital must be held as well as for the effective supervision of insurers.

Furthermore, in accordance with the Solvency II Directive, national competent authorities must ensure that the undertaking appropriately implements the following key functions: risk management function, compliance function, internal audit function and actuarial function. New obligations are also set in terms of outsourcing and regarding the people who effectively run the firm.

Compliance function

The compliance function must identify, assess, monitor and report on a firm’s compliance risk exposure, tracking any changes in the environment that could affect compliance risk, as well as monitoring the appropriateness of compliance procedures.

The compliance function shall include advising the AMSB on compliance with the laws, regulations and administrative provisions adopted pursuant to the Directive. It must include a compliance policy, defining the compliance function's responsibilities, competencies and reporting duties, and where appropriate, a compliance plan.

Risk management function

The risk management function must monitor and assist in the effective operation of a firm's risk-management system and maintain an entity-wide view of the firm's risk profile. It must provide detailed reporting on risk exposures and advise on risk-management matters, including strategic affairs such as corporate strategy, mergers and acquisitions, major projects and investments.

As part of this function, an insurance firm must conduct an ORSA at least annually, and also following the occurrence of any significant change in its risk profile. The ORSA must include an assessment of the following:

- the firm's overall solvency needs, taking into account their specific risk profile, approved risk tolerance limits and business strategy; and,

- the firm's ability to continuously comply with Solvency II regulatory capital and technical provisioning requirements and determine the significance with which the risk profile of the firm deviates from the assumptions underlying the solvency capital requirement.

Firms should ensure that they integrate their ORSA into their risk and capital management, and use the results of the ORSA as part of their strategic decision-making, including business planning and product development.

On this matter, EIOPA points out that proportionality is a key feature of the ORSA and insurers should develop tailored processes to fit their own organizational structure and risk management systems. In addition, the undertaking's administrative, management or supervisory body (AMSB) needs to take an active role in the ORSA, particularly in relation to steering how the assessment is to be performed and challenging the results.

On this point, member States shall ensure that the AMSB of the insurance or reinsurance undertaking has the ultimate responsibility for the compliance, by the undertaking concerned, with the laws, regulations and administrative provisions adopted pursuant to the Solvency II Directive.

Internal audit function

The internal audit function must evaluate the adequacy and effectiveness of the internal control system and other elements of governance. It must be objective and independent from the operational functions (to help ensure objectivity and manage conflicts of interest in the execution of internal audit activities) be able to take its own initiative in all areas of the business, and be free to express its opinions and disclose findings to the firm's governing body. The persons carrying out the internal audit function shall not assume responsibility for any other function.

Actuarial function

The actuarial function must coordinate the calculation of the technical provisions and ensure that underlying methodologies and assumptions used when calculating technical provisions are appropriate to the line of business. It must inform on the reliability and adequacy of technical provisions; and, provide an opinion on the underwriting policy and the adequacy of the reinsurance arrangements.

Two further important elements of the system of governance under Solvency II are the requirements related to outsourcing and people who effectively run the firm.

Outsourcing

Critical or important operational functions (including notably key functions, design and pricing of insurance products or claims handling) may be outsourced to an external service provider. This provider may be a regulated entity, an entity in the same group or otherwise.

A firm must ensure that the outsourcing of critical or important operational functions does not:

- materially impair the quality of their system of governance;
- unduly increase their operational risk; or

- impair the supervisor's ability to monitor the firm's compliance with its obligations.

The firm must establish an outsourcing policy if it proposes to outsource any functions or insurance or reinsurance activity and, in the case of critical or important functions, notify the supervisor. More specifically, insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations when they outsource functions or any insurance or reinsurance activities.

Person who effectively run the firm

Firstly, it arises from EIOPA's guidelines a "four-eyes principle" meaning that prior to implementing any significant decision concerning the undertaking at least two persons review any such decision and as such run the undertaking.

Secondly, all key function holders and all persons who effectively run the firm's business (notably the AMSB) must meet the fitness and propriety requirements. Fitness and propriety are ongoing requirements and the firm must notify their supervisor if there are changes to the individuals who are required to meet fit and proper requirements.

Assessing an individual's fitness will cover professional qualifications, knowledge and experience relative to the responsibilities of the role. Assessing propriety includes considering whether the individual is of good repute and integrity, including an assessment of their honesty and financial soundness.

Solvency II recognizes the need to consider the nature, scale and complexity of the firm's business when evaluating the fitness of certain persons to undertake their roles.

Eventually, Member States shall ensure that the administrative, management or supervisory body of the insurance or reinsurance undertaking has the ultimate responsibility for the compliance, by the undertaking concerned, with the laws, regulations and administrative provisions adopted pursuant to this Directive.

Pillar 3: Disclosure, Reporting and Transparency

Pillar 3 addresses transparency, reporting to supervisory authorities and disclosure to the public, thereby enhancing market discipline and increasing comparability, leading to more competition.

A new requirement is the "Supervisory Review Process" (SRP). The purpose of the SRP is to enable supervisors to better and earlier identify insurers which might be heading for difficulties. Under the SRP, supervisors evaluate insurers' compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive and its implementing measures.

Thus, insurers must annually submit a report on their solvency and financial condition, describing their activities and results, operations, risk profile, the principles used to value their assets, their technical provisions and other liabilities, and capital management. The report must also include various quantitative reporting forms. In specific circumstances, insurers must disclose information with greater frequency, for example if they fail to meet the minimum SCR to a significant extent.

As well as public disclosures, Solvency II requires insurers to compile a supervisory report for submission to the supervisory authority. This report comprises a descriptive section, together with various quantitative reporting forms. The descriptive section of the report is structured in the same way as the publicly disclosed report on the insurers' solvency and financial condition, but contains information that is considered either too detailed or too confidential for public disclosure. The information to be submitted to the supervisory authority also includes the ORSA. The quantitative reporting section comprises the reporting forms for the harmonized European framework and the national reporting templates, and relates both to solo insurers and groups.

The process of compiling public disclosures and supervisory reporting should be an integral part of the insurer's operations. The insurer's policy on public disclosures and supervisory reporting must be clearly defined. This will bring in "market discipline", which will help to ensure the soundness and stability of insurers, as market players will be able to exercise greater supervision over and offer greater competition to other insurers.

The Objectives of the New Solvency II Regime

The new rules will ensure a uniform and enhanced level of policyholder protection across the EU, reducing the likelihood that policyholders lose out if insurers get into difficulties. A more robust system will give policyholders greater confidence in the products of insurers.

Financial and regulatory objectives

As European insurers are the largest institutional investors in Europe's financial markets, it is crucial that prudential regulation should not unduly restrain insurers' appetite for long-term investments, while properly capturing the risks.

- First, the capital requirements are designed to strongly incentivize insurers to match the duration of assets and liabilities. A perfect match in duration could reduce massively capital requirements.
- Second, Solvency II will repeal the investment limits imposed by Member States regarding certain investments, in particular less liquid ones such as infrastructure. Instead, insurers will be free to invest according to the "prudent person principle" and capital requirements will depend on the actual risk of their investments.

More tailored treatment of these assets has the added advantage of increasing the risk-sensitivity of the capital requirements and thereby promoting good risk management and supporting the prudential robustness of the overall regime. It will encourage insurers to invest in simpler securitizations, which are more transparent and standardized, thereby reducing complexity and risk and promoting sound securitization markets which are needed in the EU.

Still, an insurer will have to demonstrate that it has adequate financial resources in place to meet all its liabilities and consists of the quantitative requirements like the amount of capital an insurer should hold. It is thus all about the calculations, models and capital requirements.

It will also have to respect requirements for the governance and risk management framework that identifies and measure the risk against which capital must be held as well as for the effective supervision of insurers.

Last but not least, it will need to abide by the transparency, reporting to supervisory authorities and disclosure to the public requirements, thereby enhancing market discipline and increasing comparability, leading to more competition.

Better cooperation

The new regime will also promote greater cooperation between national insurance supervisors that oversee the subsidiaries of any given group, with a stronger role for the group supervisor. The European Insurance and Occupational Pensions Authority (EIOPA) is tasked with ensuring that the single rule book is applied consistently throughout Europe. EIOPA also has mediating powers in case disagreements emerge between national supervisory authorities when supervising cross-border groups.

Consumer protection

Solvency II will increase competition, especially for mass retail lines of business, such as motor and household insurance, putting downward pressure on prices. Product innovation will give consumers more choice.

Third party equivalence

Solvency II includes provisions for assessments of the solvency regimes and systems of group supervision of countries outside the EU (termed "third countries"). The purpose of theses assessments is to determine whether the regimes and systems assessed are equivalent to the comparable provisions of Solvency II.

If they are equivalent, then EU supervisors must take the assessment into account in their regulatory approaches. The overarching principle of equivalence is to ensure that a third countries supervisory regime ensures a similar level of policyholder and beneficiary protection as Solvency II.

The Directive allows the Commission to grant a third country temporary or provisional equivalence, if they meet criteria set out in the Directive, even if they do not meet the criteria for full equivalence. Temporary equivalence is until 31 December 2020 (reinsurance and group supervision) or for up to ten years. Conditions for temporary equivalence are essentially intended to ensure that the third country will move to be equivalent within the period specified. The Commission will be assisted by EIOPA in making these decisions.

On 5 June 2015, the European Commission adopted two delegated acts, covering:

- Switzerland – to be granted full equivalence for reinsurance, group supervision and group solvency.
- Australia, Bermuda, Brazil, Canada, Mexico and the USA – to be granted provisional equivalence (for 10 years) for group solvency (for Bermuda, this excludes captives).

The acts are subject to consideration by Council and Parliament, which may decide to reject them. They can only reject an act as a whole: they cannot suggest amendments.

Council has nevertheless confirmed that it will not object to either act. On 24 September 2015 the Commission Delegated Decision n° 2015/1062 was published confirming equivalence of the solvency and prudential regime for (re)insurers in Switzerland from 1 January 2016. For the other countries, the European Parliament extended the time for scrutiny of the provisional equivalence decision by an additional three months i.e. until 7 December 2015.

Review clause

Let us also point out the fact that the Omnibus II Directive includes a review clause inviting the Commission to review the methods, assumptions and standard parameters used when calculating the SCR with the standard formula within five years of application of the new regime (i.e. by end 2021). A recital in the delegated act brings this review forward to the end of 2018. The review should make use of the experience gained in the first few years of application of Solvency II.

Besides, the Directive mandates the Commission to report to the co-legislators by the end of 2020 on the impact of the so-called "long-term guarantees" package, in particular the functioning and stability of European insurance markets; the extent to which insurance and reinsurance undertakings continue

Conclusion

In a nutshell, Solvency II will radically change the supervision of insurers and reinsurers across Europe. Under the Solvency II Framework Directive, existing insurance directives will be amended and recast in order to introduce a consistent, risk-based, solvency regime which better reflects modern solvency and reporting requirements.