Abstract

This paper presents an overview of the new insurance supervisory regime Solvency II. It identifies the main components and changes compared to the previous insurance supervision system. It also discusses key challenges in the implementation process of Solvency II, namely different valuation approaches, the application of the proportionality principle, complexity of new regulation and the difficult market environment. Furthermore, future developments and necessary adjustments are presented.

Key Words: Insurance Supervision, Low Interest Rate, Proportionality, Solvency II, Transitional Measures

1. INTRODUCTION

The European Union (EU) project Solvency II is a vivid example of the challenges in reforming insurance supervision. Solvency II is a highly modern, risk-based insurance supervisory system that applies in the EU since 2016. The main intention behind this regulatory project is to harmonise insurance supervisory systems in Europe and to protect insurance policy holders against adversities from insurance undertakings unable to cope with major crises. The entry into force of Solvency II at the beginning of 2016 marks the end of a long implementation process. Solvency II is an early warning system, combining the own fund requirements of a company with its risk exposure. It recognizes both the risk of financial market losses, insurance-specific and operational risks. Solvency II also includes more detailed requirements regarding the organisation of the insurance business. The scope of reporting is more extensive compared to the previous insurance supervision.

This paper provides an overview of Solvency II and its main components. Solvency II is a very complex insurance supervision framework based on three pillars with capital requirements, governance requirements and reporting requirements. Because the regulatory framework of the insurance industry is currently subject to fundamental changes, the transition process to the new insurance supervisory system produces several challenges to all stakeholders. In this paper, we hence also identify five such key challenges: different valuation approaches, the difficult market environment, the necessity of transitional measures, complexity of new regulation and the application of the proportionality principle. Furthermore, future developments and necessary adjustments are presented.

This paper is structured as follows. First we provide a brief overview on risks and risk management in insurance business. Section 3 explains the characteristics of Solvency II. Section 4 discusses key challenges of the new insurance supervisory system. Finally, Section 5 concludes.

2. RISK MANAGEMENT

Insurance is a means of protection against financial loss in a case of a previously defined incident. Because individual households and companies can only imperfectly hedge against all possible risks, they use insurance as a means to do so. Insurance undertakings can collectively take on these risks from households and companies by contracting an aggregation of risks from several parties (for further discussion, see GDV (2015b)).

Insurance undertakings face several different risks which can be categorized in two groups: First, there are investment risks such as overall market development, counterparty defaults and such. Second,
there are liability risks such as underwriting risks, risks from catastrophes, longevity, lapse and such. Third, operational risks affect both the asset side and liabilities side. Insurance undertakings use their expertise in risk assessment to deal with these risks.

Risk management is the process of identification, assessment and governing of risks. Each insurance undertaking needs to have a strategy how to cope with the aforementioned different risks. Hence, risk management is a critical process for insurance undertakings. It can be divided into several sub-processes: First, a large part of the work is the identification of risks. Second, risks need to be measured and analysed with thorough quantitative means. Third, insurance undertakings need an active risk controlling to manage their business. The appropriateness of the risk management is bound and also verified by insurance regulation and supervision.

Due to the great importance for the economy and society as well as the peculiarities of the insurance products itself, insurance undertakings are traditionally among the most regulated businesses. Currently, the regulation of insurance undertakings is heavily influenced by European legislation. The legal foundations of EU insurance regulation can best be described by a four-level system:

– Level 1: Directives are established and agreed upon by the EU-Council, the European Parliament and the European Commission. These include fundamental decisions on how insurance regulation is supposed to work and set the framework for which goals are pursued. An implementation into national law is necessary for directives.

– Level 2: Delegated Acts are drawn up by the European Commission and EIOPA. These are legally binding specifications of directives and as such do not need implementation into national law.

– Level 3: Implementing Technical Standards and Guidelines are created by EIOPA. They serve the purpose of harmonisation of insurance supervision across the EU. They are not legally binding in the strict sense, but provide a strong enforcement for national supervisory authorities to obey. Implementing Technical Standards become legally binding when they are amended and published by the European Commission as an Implementing Regulation.

– Level 4: National regulation and specifications are established by national supervisory authorities. These are technical specifications to account for national peculiarities. They are legally binding for the respective national insurance markets.

3. SOLVENCY II: KEY POINTS

Solvency II is the new insurance regulatory and supervisory regime in the EU. It includes capital requirements, requirements for the governance of insurance undertakings, requirements for reporting and disclosure, group supervision as well as supervisory conduct (see Figure 1). The main goals of Solvency II are the improvement of consumer protection, the modernisation of insurance supervision and the deepening of EU market integration. The EU-directive establishing Solvency II was adopted in 2009 and amended in 2014. Solvency II went live on January 1, 2016 and replaced Solvency I. The new system will be a major step towards harmonisation of European insurance supervision.

There are three cornerstones of the new insurance supervision system:

– Risk Orientation: The assessment is based on the risk profile of the respective insurance undertaking and not on the nature of the business. This includes a prudential identification, analysis and valuation of all risks aggregated in one insurance undertaking. Hereby, less risk means less capital requirements for undertakings.

– Based on principles: Solvency II sets specific goals and not parameters. Insurance undertakings can decide how to reach the goals. This provides bigger discretionary decisions for both regulated and regulating parties.

– Proportionality: Insurance regulation is applied proportional to the risk profile of the insurance undertaking, the volume and the complexity of undertaking-specific risks. That means that no excessive demands are put on small and medium-sized insurance undertakings.

Solvency II includes a number of complex quantitative and qualitative rules (for details, see GDV (2015a)). We will sketch them in the following. Pillar 1 includes quantitative requirements for insurance undertakings. This comprises of three elements: First, insurance undertakings must hold available solvency capital. The basis for the amount of solvency capital is the risk profile of the undertaking. It incorporates the prerequisite that the yearly probability of insolvency for the undertaking must not exceed 0.5 percent, which is determined according to a standard formula or an internal model which are verified by the national supervisory authorities. Two key parameters exist, namely the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). Second, the valuation of assets and liabilities is now based on market values whereas previously, valuations from commercial
law where present. This means that the liabilities side of the balance sheet is subject to a completely new valuation. Market values are the basis for calculating the aforementioned capital requirements. Third, insurance undertakings are required to hold own funds in order to meet the aforementioned capital requirements. Own funds are divided into three groups, called tiers, according to quality and are calculated from financial statements. They are also used to calculate the key parameter in the analysis of insurance undertakings: The solvency ratio is defined as the ratio of eligible own funds to SCR. Hence, insurance undertakings are “solvent” if the ratio exceeds 100 percent.

Pillar 2 includes the requirements for governance and risk management. This comprises of four elements: First, Solvency II specifies four governance functions (also called key functions) to be separately available within each insurance undertaking:

– Risk Management Function,
– Actuarial Function
– Compliance,
– Internal Auditing.

These functions must be operationally and functionally independent. In addition, “fit and proper” requirements create criteria to determine the eligibility of managers to run insurance undertakings. One side is “fit” and aims at employment qualifications and experience. Another side is “proper” and aims at personal reliability. These requirements apply to persons holding key functions as well as managing directors of undertakings. They also include necessary notifications to the insurance supervisor. Third, there exist special regulations for the outsourcing of key functions and other critical functions. They are a prerequisite for the spin-off of functions and services. Fourth, the Own Risk and Solvency Assessment (ORSA) includes an undertaking-specific risk evaluation comprised of an appraisal of the internal risk profile and an estimation of the adherence to capital requirements at least yearly.

Pillar 3 includes reporting, disclosure and transparency requirements. Again this comprises of four elements: First, regular supervisory reporting includes narrative and quantitative information on business activities, governance and the risk situation determined to be reported to the insurance supervisor. Very high demands for details and content are enforced in an undertaking-specific reporting cycle. Second, the Solvency and Financial Condition Report is aimed to inform the public on an annual basis. It especially displays the risk situation and the capital management, in particular own funds and solvency capital. In addition, it provides an overview of business activities. Third, reporting templates enclose special requests by insurance supervisory for additional quantitative information. This could be the composition of the asset side or liabilities side, own funds, profits and loss, capital requirements and such. This information is quarterly and yearly reported. Fourth, other reporting

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Figure 1: The Three Pillars of Solvency II
(Source: GDV (2015a))
includes information gathered for financial stability purposes or additional reports for ECB statistics.

While EU insurance regulation sets the framework at a European level, it is necessary to implement Solvency II at a national level also. Hence, the German Insurance Act (VAG) has been reformed to incorporate the transition towards the new insurance supervisory system. In addition, national insurance provisions were also changes to adapt to Solvency II. The legal process was finalised in early 2015. Moreover, also national regulations concerning the VAG had to be changed to adapt to Solvency II. In particular, further technical specifications to account for day-to-day insurance activities were needed. Finally, national supervisory authorities like the BaFin in Germany introduced minimum requirements and announcements to foster the dialogue with insurance undertakings. These provisions explain how to deal with the guidelines issued by EIOPA.

Furthermore, BaFin created a preparatory phase which started at the beginning of 2014 after initiative from EIOPA. This phase served the purpose to first screen insurance undertakings for shortcomings in fulfilling the requirements for governance, risk assessment and reporting. Also, BaFin ran surveys to monitor preparations quantitatively. Concurrently, the German Insurance Association (GDV) also ran several tests and studies to check up on the preparations. In general, German Insurance Industry is well prepared for Solvency II after this preparation phase. Insurance undertakings make use of transitional measures and temporary adjustments stipulated in the Solvency II system and show the required levels of own funds.

### 4. CHALLENGES OF THE NEW SYSTEM

After the start of the new insurance supervisory system Solvency II, many challenges still lay ahead for all stakeholders. In the following, we will discuss five key challenges that insurance undertakings face even after the implementation of Solvency II and the start of the new insurance supervisory system.

First, a new system of EU insurance supervision leads to different ways to define key parameters (see table 1). Solvency II and its principles changed the way how to interpret key figures about insurance undertakings. The challenge for all stakeholders involved in insurance business is to properly understand the new system. One has to note that the same results for the same parameters cannot necessarily be interpreted the same way. For instance, solvency ratios depend on market values while they previously depended on book values, making way for more fluctuations in the parameter.

Second, since the final implementation phase of Solvency II insurance undertakings have been facing a very difficult market environment. Due to rising economic and financial uncertainty in the EU and across the emerging markets, insurance undertakings have to deal with persistent low interest rates and high market volatility. The European Central Bank (ECB) has taken several monetary measures so that many government bonds approximate to close to zero percent interest. Because of business-related and regulatory purposes, insurance undertakings heavily rely on fixed income securities. Hence, their business models are under scrutiny to adapt to the market environment or seek product or business innovations while at the

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<th>Old: Solvency I</th>
<th>New: Solvency II</th>
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<td>Valuation of Assets and Liabilities</td>
<td>Valuation from Commercial Law</td>
<td>Valuation based on market values</td>
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<td>Calculation of Required Own Funds</td>
<td>According to Size of Business</td>
<td>According to Present Risks</td>
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<td>Risk Management</td>
<td>Key are Underwriting Risks</td>
<td>Prudential Evaluation of all Risks to an Undertaking, e.g.</td>
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<td>– Market Risks</td>
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<td>– Operational Risks</td>
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<td>Disclosure of Information</td>
<td>Limited past-oriented Information to Supervisors at Reference Date</td>
<td>Comprehensive up-to-date Information to Supervisors and the Public including Forecasts</td>
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Table 1: Differences between Solvency I and Solvency II
Source: GDV (2015a)
Fourth, implementing a new insurance supervisory regime across the EU inevitably requires great efforts and entails high bureaucratic costs for all insurance undertakings concerned because of the system's high complexity. Solvency II includes a great number of different regulatory levels which produce considerable unnecessary costs. The individual regulatory levels are not sufficiently harmonised and sometimes even contradict each other or overlap. In some cases, the quality of legislation is impaired by the vast number of provisions. One of the key tasks is thus to identify and remove existing redundancies, unnecessary specifications and contradictions in insurance supervision. Stakeholders should constantly be aware of the importance of coherent regulation. Suitable legal instruments should be chosen and the level of detail and the number of regulatory levels should be kept as low as possible. The responsibilities and competences of the different institutions active in insurance regulation and supervision should also be clearly defined. The goal is to clearly distinguish the areas of responsibility of e.g. EIOPA and national supervisory authorities. Ensuring legal clarity and avoiding unnecessary bureaucratic costs are of vital importance to make Solvency II run successfully.

Fifth, Solvency II must not lead to a market shakeout. The basic idea of Solvency II is that insurance undertakings with a simple risk profile face lower requirements that insurance undertakings with a more complex risk profile (principle of proportionality). Hence, it is especially important that no excessive demands are put on small and medium-sized insurance undertakings. To do so, impractical and inefficient regulation should be eliminated. The challenge for all stakeholders is to put the principle of proportionality into effect without distortions of competition through unjustified bureaucratic burdens. Hence, a rigorous application of the proportionality principle is necessary to regulate insurance markets according to the risk profile of insurance undertakings, to the volume of business activities and to the complexity of undertaking-specific risks. For instance, the enormous implementation efforts for Solvency II are placing proportionately higher burdens on small and medium-sized insurance undertakings. Therefore, it is vital that the principle of proportionality and other flexibilities provided for in the Solvency II framework are consistently applied.

5. FURTHER DEVELOPMENTS

Although insurance undertakings and other stakeholders went through a long implementation phase and Solvency II has just started, further developments in the area of EU insurance regulation and supervision are already planned. Several regulatory areas are affected by this. On a European level, continuous efforts are made to drive the “Better Regulation”-initiative of the European Commission forward. Herein, directives and delegated acts will be put to scrutiny and carefully assessed and revised. For instance, an evaluation of the standard formula in Pillar 1 of Solvency II is planned until 2018. Moreover, EIOPA will continue to provide explanations and specifications where it seems fit. On a national level, an evaluation of the proportionality principle is planned until 2017. Also, national supervisory authorities will provide further technical specifications regarding different governance aspects of insurance undertakings.

Despite the already complex insurance regulation on a European and national level, a further level of international insurance supervision is currently being constructed. Especially internationally active insurance undertakings are faced with this development. The goal of the so-called Global Insurance Capital Standards (ICS) is to produce consistent provisions and capital requirements beyond the EU in order to harmonise
insurance regulation globally. Herein, a global regulatory level playing field enables more competition among international active insurance undertakings. But an additional regulatory level should be avoided. The ICS may make use of vital ideas of Solvency II without producing redundancies. The key is to not undermine the efforts of implementing Solvency II by the new international supervisory system.

In all future developments, stakeholders need to be aware of the costs and benefits of additional regulatory provisions. Insurance undertakings are making large efforts to run Solvency II. But continuing efforts and improvements are necessary. Also, institutions at European and national level are busy constructing a lean and efficient regulatory framework which reduces regulatory uncertainties. Following the start of Solvency II it is now time to first evaluate the results and draw reliable conclusions. Then further measures and modifications of the insurance supervisory system can be assessed with regards to their quantitative impacts. To not destabilise insurance markets it is crucial to slow down the pace of new regulation in the early application phase of Solvency II. Already, many review process are planned and many institutions already discuss proposals how to adjust the new supervisory system.

6. CONCLUSION

This paper provides an overview of Solvency II. We start by explaining what kind of risks exists in insurance business and why proper risk management is crucial. We then explain the main components of the new insurance supervisory system. Solvency II is a very complex insurance supervision framework based on three pillars with capital requirements, governance requirements and reporting requirements. We provide detailed descriptions of the logic behind the different requirements and the parameters used to evaluate the business of insurance undertakings. We also discuss the changes compared to the previous insurance supervision system.

A major part of this paper identifies five key challenges that all stakeholders face. Because the regulatory framework of the insurance industry is subject to fundamental changes, the transition process to Solvency II inevitably produces challenges to make the new insurance supervisory system run. In this paper we identify five such key challenges: different valuation approaches, the difficult market environment, the necessity of transitional measures, complexity of new regulation and the application of the proportionality principle. Furthermore, future developments and necessary adjustments are presented.

In all future developments, stakeholders need to be aware of the costs and benefits of additional regulatory provisions. While insurance undertakings are making large efforts to run Solvency II, European and national institutions are busy constructing a lean and efficient regulatory framework which reduces regulatory uncertainties. Following the start of Solvency II it is necessary to slow down the pace of new regulation. First, results need to be evaluated in order to draw reliable conclusions. Then modifications of the new insurance supervisory system can be assessed.

REFERENCES

