CEA
Insurers of Europe

Solvency II

Frequently Asked Questions

First Release, February 2007

Scope and aim of the document

There are many Solvency II stakeholders raising a number of questions on the process and content of the future Framework. Everyone has a different perspective, represents different interests or has a different role to play in the construction of Solvency II. It is impossible for the CEA to answer all questions from all required angles. This document tries to focus on the most frequently asked questions and provides the best answer possible given the current development of the project. As such, it aims to explain the underlying concepts and core issues to a non-expert audience. It considers in particular the latest insights delivered by the CEA industry survey on the Solvency II Impact Assessment (below cited as 'CEA Impact Assessment'). It should be seen as a follow-up document to the previously published Introductory Guide to Solvency II, a joint publication of the CEA and Tillinghast Towers Perrin (June 2006).

This document is dynamic and will try to incorporate new questions and developments as they evolve. If you have questions you do not find answered in this document, we invite you to submit these to the CEA Secretariat (Ido Bruinsma, at Bruinsma@cea.assur.org).

1. How has risk management evolved since Solvency I?

Align capital requirements with the underlying risks

The current Solvency framework, introduced in the early '70s, defined new capital requirements for insurers by specifying requirements for solvency margins. Since then, the science of risk management has progressed considerably, new products have been launched, new risks have emerged but there are also innovative new forms of risk mitigation. As an example of the latter, we have seen in recent years the growth of the securitisation market in recent years, allowing insurance companies to pool some of their risks and sell them in the form of bonds on the capital markets, which shows the extent of progress in risk management over recent years.

2. Why did companies adopt new risk management practices?

Solvency I is often said to be not only a simple but also a simplistic approach to solvency assessment. The shortcomings of Solvency I are well documented: for example, as insurance prices fluctuate, a company can reduce its risk of insolvency by increasing its level of non-life premiums with no changes to the underlying risk profile and provisions, but Solvency I does not recognise this effect under given conditions.

In certain cases, current Solvency I rules are risk insensitive and can actually conflict with good risk management. Also, the Solvency I Directive does not cover all risks, focusing only on underwriting risk and not on market risk (e.g. a possible decrease in equity prices). As a result, many companies have adopted more stringent risk management rules.

The CEA Impact Assessment confirms that a majority of companies surveyed have either already implemented a risk-based economic approach to risk management or are in the process of improving their risk management tools.

3. Why did several European Member States adopt new supervisory rules beyond Solvency I?

Mainly for the same reason as companies have adopted new risk management practices, many national supervisors have set additional local requirements to the Solvency I rules or introduced own supervisory frameworks.

The most prominent models in discussion or implemented in the local legislation are probably the UK's ICAS model, the 'Traffic Lights' system in Denmark and Sweden, the Swiss Solvency Test (SST), or the proposed Dutch FTK model and the German GDV model.

It can be seen that the key principles underpinning the newer regimes are generally converging. In all cases, the regulation is based on using market prices, where available, to calculate the value of assets and liabilities, with capital requirements based on scenario tests or economic modelling. However, a variety of different approaches has been used with different trade-offs between sophistication and simplicity.

4. Why is Solvency II not the same as Basel II?

As with Basel II for the banking industry, Solvency II aims at building a new regulatory framework for the insurance sector. The three pillars developed under Basel II provide an obvious model for Solvency II, but the similarities are limited. The insurance industry's business model is very different to that of the banks, and it is developing its own set of principles to take into account the insurance specificities.

More information on the differences between Basel II and Solvency II can be found in the Solvency II Introductory Guide (click here).

5. Would a regime like Solvency II have been able to prevent failures that happened in the past?

This is always difficult to judge the situation a posteriori. But Solvency II, besides introducing a holistic approach to risk management based on 3 complementary pillars, shall follow principles that would have contributed to i) an early assessment of the true risk and realistic risk profile of the supervised entities with corresponding economic capital requirements and ii) a timely supervisory intervention, before the crisis situation occurred, thanks to a range of new preventive mechanisms.

A strong, effective policyholder protection

6. Will Solvency II prevent any failures of insurance companies to occur at all?

Probably not, the aim of the new Framework is not to establish a system with zero risk of failure but a system that overall reduces the risk of failures by better assessing the company's reality and thus offers a high level of confidence that insurers will meet their obligations even in adverse circumstances.

7. What are the main articulations of the supervision under Solvency II?

While Solvency I mostly relies on quantitative capital requirements, the new supervision approach builds on three pillars interacting with each other. The new Pillar I defines the financial resources that a company needs to hold in order to be considered solvent, the Pillar II defines more qualitative requirements and generally grants more powers to the supervisors, and finally Pillar III addresses risk disclosure requirements introducing control by the market and the consumers.

8. What do the mechanisms of prevention of failure look like in the future Framework?

The so-called 'ladder of intervention' is one example of an efficient mechanism of prevention of failure. The mechanism foresees an intensification of supervisory intervention between the two levels of capital requirements, the Solvency Capital Requirements - SCR and the Minimum Capital Requirements - MCR, into different levels with corresponding guidance on the recommended actions for companies and supervisors.

This mechanism has the advantage of allowing for a timely but also proportionate intervention of the supervisors to ensure that corrective measures are taken sufficiently early .

The Pillar II requirements for internal risk management also fulfil an important prevention and risk mitigation role. CEA believes that effective internal control and risk management, as part of daily routine and practice embedded within a company's operation, is the best insolvency protection for insurance companies.

More information can be found in the CEA Working Paper on the MCR and Proposed Ladder of Intervention (click here).

9. What are the quantitative requirements ensuring a strong policyholder protection?

Pillar I of the future Solvency II Framework shall introduce two measures of capital requirements with different purposes, the 'Solvency Capital Requirements' (SCR) and the 'Minimum Capital Requirements' (MCR).

The level of the MCR reflects a level of capital below which ultimate supervisory action will be triggered. Its purpose is to set a control level where assets still exceed the value of policyholders' liabilities by a sufficient margin to ensure that the business can continue in the short-term, for a sufficient time to enable the book of business to be transferred to another entity, or for the company to re-capitalise, fully preserving in both case the policyholders' interests.

The SCR represents the normal, target level of capital that enables an institution to absorb significant unforeseen losses, and provides reasonable assurance to policyholders that the company will be able to fulfil its obligations (to the defined 1-in-200 confidence level). Companies able to cover the SCR are in a strong position and should have the freedom to manage their business without undue restriction or intervention from supervisors, outside the routine supervision process.

10. What is the scope of Solvency II? Does it include small firms and pension funds?

A proportionate, risk-based approach to supervision for the entire insurance industry

Solvency II introduces a new regulatory Framework for all European insurance and reinsurance companies independent of their size or legal form. It will not cover pension funds.

However, the current exemptions available for very small mutual companies are expected to be maintained.

11. How much will Solvency II cost for the industry in terms of implementation and reporting costs? Will it be bearable for all actors?

The question of financial and administrative burden of Solvency II for the industry is a key issue for the European Commission but also for all market actors. The answer is not trivial as much will depend on the final form of the Framework.

The CEA strongly believes that the implementation should be proportionate also in terms of costs. By developing a Standard Approach for calculating the Solvency Capital Requirements, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) concretely contributes to developing a cost-efficient solution enabling companies to become compliant without a large outlay in terms of systems and processes.

On request of the European Commission, the CEA is currently conducting an analysis to provide a preliminary view on the costs and administrative impact of Solvency II.

12. What are the implications of Solvency II for small insurance companies?

Solvency II will have consequences for all stakeholders, including small insurance companies.

The CEA, in close cooperation with the representative organisations of mutual insurers, the AISAM and the ACME as well as with the credit insurers represented by the ICISA, works hard to include in the future Framework principles and mechanisms that will be beneficial for all insurance companies. Of course proportionality of requirements is integral to the approach CEA is advocating. But in the end the Framework shall remain risk-driven, i.e. the risk profile and not the size of the company will determine the future solvency assessment by the supervisory authority.

To a large extent, the implications for small and very small insurers today are still unknown. Not only did they not contribute to the CEIOPS' Quantitative Impact Studies (QIS) but also only a limited number contributed to the CEA Impact Assessment (203 on a total of 306 non-life companies and 200 on a total of 271 life companies).

However, the results of the CEA Impact Assessment show that the surveyed small companies answered in line with the rest of the industry emphasising the industry's overall strong commitment to the Solvency II project. This commitment is strengthened by the great homogeneity between all replies, from small, medium-sized and large insurance and re-insurance companies, mutual insurers and joint-stock companies.

13. How are the concerns of the Small and Medium-sized Enterprises (SMEs) being taken into account by Solvency II (in particular in relation to implementation and administrative burden and their competitive position compared to large insurance companies)?

Concerns and issues specific to SMEs are an integral part of the work on Solvency II. The intense discussions between the CEIOPS and the industry on the structure and the calibration of the future Standard Approach to calculate capital requirements primarily address the needs of SMEs.

Particularly for very small companies with a very low risk profile, Commissioner McCreevy in his intervention at the CEA Solvency II conference in November 2006 also acknowledged that the European Commission was considering granting exceptional rules. At the joint AISAM/ACME congress in Autumn 2006, Mr. McCreevy confirmed: 'we certainly don't want to push small firms out of the market. Their specificities will be taken into account: the smallest firms will be granted an exemption from the Solvency II regime. As for those which exceed the limits for exemption, but are still relatively small, simplifications may apply, when necessary and appropriate. Finally, internal models that take into account the specificities of small firms will be allowed.'

14. What is a 'lead supervisor'? Why is it necessary to pursue an efficient supervision of Insurance Groups?

The principle of 'lead supervisor' is the key to align the supervision practice with the way internationally active insurance and reinsurance groups manage their risk.

Most internationally active insurance and reinsurance companies are organised in a Group structure where solo legal entities report to headquarters located in a distinct jurisdiction. In this arrangement, risk management is typically performed and co-ordinated centrally. This includes capital requirement calculation, definition of the risk appetite and risk limits, responsibility for risk management organisation and decision on the asset and liability management.

The industry believes that the supervision of such groups must follow a similar approach with a central role and specific responsibilities and powers given in principle to the supervisory authority of the jurisdiction in which the Group is headquartered, as 'Lead Supervisor' among peers authorities of jurisdictions in which solo legal entities/subsidiaries of the Group are based.

This reflects the economic benefits of diversification across a group and enables groups to manage their financial assets in the most efficient way possible. The 'lead' supervisor would be best placed to understand how the whole group operates, the key risks and dependencies, making it better placed to ensure appropriate policyholder protection across the whole group and avoiding the risks of 'silo supervison'.

The CEA currently works on a document to analyse the role and responsibility of the 'Lead Supervisor' in greater depth.

It should be noted that the mutual insurance sector supports the concept of lead supervision but regrets at the same time that the concept of a mutual group does not exist on a European level (an earlier initiative by the European Commission for a Statute for a European Mutual Society has been withdrawn).

15. Why is the Standard Approach for the calculation of Solvency II capital requirements a step forward to the existing Solvency I rules?

Incentives to adopt more sophisticated risk monitoring and risk management tools

Whilst the Solvency I capital requirements are very easy to calculate, fitting a book-value accounting system, this results in a substantial simplification and distortion of the calculation of capital requirements. This over-simplistic 'one-size-fits-all' rule-based approach cannot cope with the variety of insurance companies risk profiles and the new developments of the risk management practices.

Accurately measuring a company's own risk profile is best done with an internal model but may be disproportionately burdensome and/or overly complex for certain companies with a low risk profile, so it is important that there is a robust and risk-sensitive Standard Approach based on sound economic risk-based principles, available to firms who choose not to develop their own internal model from the start.

16. What are the differences between the Standard Approach and Internal Models?

An increasing number of companies have developed (or are in the process of developing) internal models to better measure the risks they take. Internal models are customised to the company's risk profile and a central tool for the company's risk management.

The Standard Approach is intended to be a simple and cost-efficient alternative that provides some of the benefits of risk weighting of internal models for those firms who cannot or choose not to develop their own bespoke internal model.

As a trade-off to the lower compliance costs, the Standard Approach aims at capturing the risk profile of an average company. This lack of customisation may in certain cases – in particular if companies are writing high or complex risk business - induce a slightly more conservative risk assessment, which in turn may represent a 'cost' in terms of needing more capital.

The Standard Approach and Internal Models also share a lot of principles. Most important of all, an equivalent calibration of the calculation of the capital requirements makes sure that both approaches should deliver the same level of protection to the policyholders. In addition, as mentioned above, the Standard Approach is being built on similar principles as Internal Models, for example taking into account the relevant diversification and risk mitigation effects.

According to the CEA Impact Assessment, about 21% percent of the companies surveyed are already using risk-based models (13% for SMEs and 38% for large companies) while additional 41% are in the process of implementing or improving their model.

17. What are 'partial internal models'?

As the name says, 'partial internal models' combine elements of internal models customised to the company's risk profile with elements of the Standard Approach, using generally defined parameters.

The advantage of recognising partial internal models is that it enables companies to incrementally improve their risk measurement. It is indeed unlikely that companies will be in a position to 'jump' from the Standard Approach to the use of full internal models. Rather, they would transition from simple factors to scenarios to partial models i.e. first for the major products, then for the major risk types and finally on to full internal models. This would be of particular value to the small and medium sized companies where the risk measurement development is likely to be incremental.

18. What are mutual insurers? Do they need special treatment in Solvency II?

A harmonised approach to supervision across all EU markets

Insurers can be organised as joint-stock companies, whether listed or unlisted on a stock exchange, mutual societies and cooperative societies. Mutual insurers have no shareholders' equity. Instead of having shareholders, mutuals have members. This has implications on the type of own funds mutual insurers use to fulfil their solvency position (eligible elements of capital).

Mutual insurers are not necessarily small in size. Some mutual insurers count even amongst the leaders in their market (e.g. in Sweden, in Belgium or in France).

CEA advocates a harmonised approach to supervision across all EU markets with common standard of protection to all consumers, regardless of the insurers' legal form, size and location.

19. What are the benefits of Solvency II for insurers?

Increase competition within EU insurance markets and the global competitiveness of EU insurers

The benefits are threefold:

1. the alignment of capital requirements with underlying risks allowing for achieving optimal capital allocation;
2. the reduction or removal of unnecessary regulatory constraints, and;
3. a coherent application of Solvency II across jurisdictions and over time.

From these three elements, the coherent application of Solvency II is deemed to be crucial to enhance the competition within the EU insurance markets.

A survey carried out in 2005 by the Italian Insurance Association (ANIA) put the light on the importance of Solvency II as a driver for innovation. Indeed, 85% of the surveyed companies considered the project as an opportunity for innovation.

20. What are the benefits for consumers?

The main advantage for the consumers (policyholders and beneficiaries) will come in the form of an adequate level of protection against the risk of failure, by ensuring that the capital held is appropriate to the risks underwritten and also by promoting better risk management.

The increased competition within the EU insurance markets will also provide more choice and a better deal (i.e. correct prices in line with the design of the product) for EU consumers.

The CEA Impact Assessment confirms a trend to greater product innovation and increased opportunity for Europe-wide offerings, whilst complete withdrawals of product lines where capital requirements are justifiably increased are seen as unlikely. Insurance companies will rather adjust pricing, product design and features like guarantees and take appropriate risk mitigation measures.

21. What are the key principles and elements that should be taken into account to achieve the objective of establishing a true economic risk-based model?

Built on a true risk-based economic approach

A risk-based economic Framework implies an increased accuracy of the Solvency assessment, closer to the true risk profile of one insurance company. Such a Framework shall introduce consistent solvency measures also across all types of business, taking into account both the quality of risk management and the accuracy of risk assessment.

The main principles of a true economic risk-based model are:

- A Total Balance Sheet approach
- Recognising prudence in accounting values
- Addressing diversification and specialisation effects
- Addressing risk mitigation effects
- Addressing the risk absorption features of the liabilities

22. Isn't an economic risk-based model too far from the operational reality of the insurance business? What are the tangible advantages of such a model?

An economic approach has several advantages:

- It can be calibrated to provide a better balance between protection to policyholders and encouraging efficient operations of companies;
- it is transparent and will avoid arbitrage opportunities;
- Frameworks that confuse the prudence, in excess of an market consistent valuation, and capital requirements are more opaque and likely to lead to double counting of risks and capital requirements;

- It aligns regulatory capital requirements with best practice internal risk management processes;
- It can cope with evolution in financial environment, increasingly sophisticated product design and capital markets innovation.

23. What is the Total Balance Sheet approach?

Both Solvency I and II use the Balance Sheet of an insurance company as a starting point for the Solvency assessment. But where Solvency I is mainly based on statutory figures reported in the financial statements and focuses on liabilities, Solvency II aims at capturing the true economic value of the balance sheet items. This approach is independent of the statutory accounting and considers next to the liabilities also the asset side of the balance sheet.

To achieve this, the Industry proposes using a 'Total Balance Sheet Approach'. Implications of this approach are that:

- Available solvency capital is given as the difference between the market-consistent values of assets and liabilities and
- Solvency capital requirements are calculated based on a comprehensive analysis of risks taking into account the interaction between assets and liabilities, risk mitigation and, where applicable, diversification.

More information can be found in the CEA Working Paper on the Total Balance Sheet Approach (click here)

24. What are diversification effects?

Diversification is based on the principle that not all risks will crystallise at the same moment – provided that the underlying sources of risk, i.e. the risk drivers or triggers, are independent. The larger the number of risks underwritten by a company, the more likely it is that the actual level of losses can be predicted based on experience, i.e. the level will be close to expectations with reduced effect of random fluctuations (known as the 'law of large numbers').

Diversification effects occur on different levels: for example between individual risks within a portfolio, between different types of risks within a portfolio, between different geographical regions and finally between legal entities in a group company.

25. What are concentration effects or accumulation effects?

Concentration and accumulation effects are the opposite effect to diversification, when the sources of risk tend to show a certain level of dependency between each other.

Concentration is used in a market risk context, typically if an equity portfolio is invested into very few positions.

Accumulation effects are used typically for certain insurance risks, in particular catastrophe risk.

26. What are typical risk mitigation measures? And what are they used for?

Risk mitigation is a crucial element of an efficient risk management strategy and part of the industry's best practice in this respect. It can be used for all types of risk, insurance and also market risks.

The most common risk mitigation measure relative to insurance risk is the retrocession (or transfer) of a part, or all, of a risk portfolio usually to a reinsurance company. In such transactions, risks can either be shared on a proportional basis or only risks above a certain threshold (e.g. peak catastrophe risks) can be covered.

Another common type of risk mitigation is the protection against financial market risk, e.g. a possible decrease in equity prices, with so-called hedging instruments mostly provided by large investment banks.

In recent times new innovative forms of risk mitigation have emerged, such as securitisations (i.e. risks are bundled and structured in the form of bonds and passed to the financial markets) or swaps (i.e. portfolios of risks are swapped between two insurance companies mainly with the intention to increase the level of risk diversification).

27. Which EU regulation will be changed as a result of the codification through Solvency II?

A holistic approach to policyholder protection

The Solvency II Project primarily aims at developing a new Solvency Directive replacing the current Life and Non-Life Insurance directives (including the Solvency I directive). At the same time, the European Commission Services work on the new systematic codifications of all 17 insurance-related Directives, simplifying the structure so that all the relevant measures appear in one Directive with common definitions and scope, whilst preserving in tact the original requirements of these other directives.

28. A specific issue in the Equitable Life case (which the European Parliament is currently investigating) is the clarity of designation of responsibility. Will this be specifically targeted in Solvency II?

Pillar II is a cornerstone of the Framework, bringing insurance industry and supervisors closer to each other

An entire 'Pillar' of the future Framework will be dedicated to the requirements for company-internal risk management process. Pillar II will introduce a supervisory review process which will ensure that the risk management function within companies is appropriately organised, with clear split of responsibility. In addition, Pillar II will also define the powers and responsibilities of the supervisors.

29. Solvency II is said to become a principles-based Framework. What does it mean and what is the difference with a rules-based system?

The way companies manage their business today and tomorrow

A solvency assessment model is referred to as principles-based if the computation of the risk capital follows principles. The more detailed methodology is however left to the description of the insurer as long as it is consistent with the principles set out.

An example of this is the UK-FSA's requirement for insurance companies to arrive at the Individual Capital Assessment (ICA) using internal models that comply with the principles put forward in UK-FSA Policy Statement 04/16.

A solvency assessment model is referred to as rules-based if the computation of the risk capital follows clear guidelines and rules.

The industry advocates the implementation of a framework based on true economic principles developed in the Framework Directive (Level 1). Principles will then be complemented by implementing measures on Level 2 legislation.

30. When will Solvency II be implemented?

In line with the Lamfallussy approach, the Solvency II implementation (including the development of specific guidelines by the national supervisors through CEIOPS) is expected to start after the adoption by the European Commission of the implementation measures, foreseen for the beginning of 2010.

The major milestones in the Solvency II process are:

- The presentation of the Framework Directive (Level 1) proposal by the European Commission - expected in July 2007
- The final outcome of European Parliament and Council of Ministers (co-decision) - expected in first half 2009
- The presentation of implementation measures (Level 2) by the European Commission - expected for the Summer 2009
- A decision by the national financial regulators through EIOPC on the implementation measures – expected towards the end of 2009.

The deadline for the first milestone, the presentation of a Directive proposal, was confirmed on several occasions by Commissioner Mc Creevy. At the current stage, the project is led with intense time pressure on all stakeholders but remains 'on track'.

31. Will we need a Solvency III after Solvency II? What are the key elements of the framework allowing for the framework to remain flexible over the long-term horizon?

There is no current expectation of a need to change immediately, provided that Solvency II follows true economic principles well anchored in the Framework Directive. These principles will determine the boundaries of a coherent Framework that may be expected to remain valid indefinitely. In line with the Lamfallussy approach, the Framework can then be complemented by more flexible future implementation measures and specific guidelines, taking into account future developments, innovation etc.

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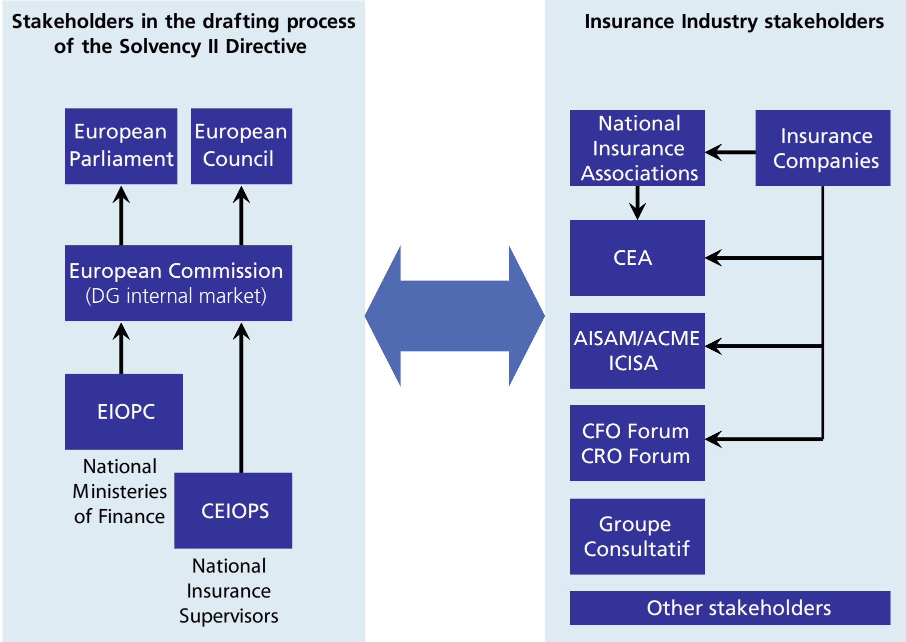
Appendix B: Who's Who in the Solvency II project?

FIGURE 1 | Solvency II Stakeholders



ACME	Association of the European Cooperative and Mutual Insurers
AISAM	Association Internationale des Sociétés d'Assurance Mutuelles
CEIOPS	Committee of European Insurance and Occupational Pensions Supvervirors
CFO Forum	Chief Financial Officer Forum
CRO Forum	Chief Risk Officer Forum
EIOPC	European Insurance and Occupational Pensions Committee
ESF	European Securitisation Forum
Groupe Consultatif	European Actuarial Association

Appendix B: References

The comments in this document should be considered in the context of other publications by the CEA. These can be found under the Solvency II section of the CEA website (www.cea.eu) and include:

- Solvency II: Structural Issues (March 2005)
- Solvency II - Building Blocks for the Solvency II Project CEA Working Document in Progress (May 2005)
- CEA's comments on the CEIOPS' Draft Answers to the 'Second Wave' of Calls for Advice (September 2005)
- CEA's comments on the CEIOPS' Draft Answers to the 'Third Wave' of Calls for Advice (February 2006)
- Solutions to Major Issues for Solvency II – Joint submission by the CRO Forum and the CEA (February 2006)
- CEA working document on the standard approach for calculating the solvency capital requirement (March 2006)
- CEA document on Cost of Capital (April 2006)
- CEA guidance on Quantitative Impact Study 2 (May 2006)
- CEA QIS 2 spreadsheet using the Cost of Capital approach (May 2006)
- Assessing the impact of Solvency II on the average level of capital (October 2006)
- CEA Working paper on the MCR and proposed ladder of intervention (October 2006)
- Solvency II – Understanding the process (February 2007)
- These documents together constitute a coherent package.

CEA

CEA is the European insurance and reinsurance federation. CEA's 33 national member associations represent more than 5,000 insurance and reinsurance companies. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €970bn, employ over one million people and invest more than €6,300bn in the economy.

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