



## Full speed ahead for Solvency II

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**Following lengthy negotiations, the European Parliament and European finance ministers agreed at the end of March on new rules for insurance supervision in Europe, thus passing an important milestone on the road to stability in the financial markets. Member states are required to implement the new regulations by the end of 2012. The aim of the new supervisory regime is to provide more protection for policyholders and to increase the international competitiveness of European insurance companies. Now that the Directive has been adopted, CEIOPS can at last concentrate on the implementing measures at level 2 of the Lamfalussy process and in fact published several consultation papers in March of this year.**

### Current developments at EU level

The group of experts commissioned by the European Commission (the Larosière Group) and the insurance industry have been pressing for months for the early adoption of the new Directive, which will replace 14 existing EU Directives. The first "trilogue" meeting between the Commission, the European Parliament and the Council of Ministers took place in January, and the Parliament and the Council agreed on a common position on 26 March 2009. The Czech presidency must now concentrate on finding compromises on the issues of group support and the measurement of equity risk. The insurance industry has submitted a

number of proposals on both. The European Commission's proposal for parent companies to be able to provide capital guarantees for their subsidiaries did not receive support, and under the new supervisory rules subsidiaries will have to hold the full amount of capital required for solvency purposes themselves. However, this issue is to be examined again three years after the new Directive comes into force. Despite strong opposition from the other EU states, France succeeded in pushing through special rules for French insurers. Unlike insurers in the other EU countries affected by Solvency II, they will be able to smooth equity risk over several years, though this exception will also be subject to review three years after the entry into force of the Directive. The Parliament adopted the Directive on 22 April 2009, the Council on 5 May 2009.

### CEIOPS: Current developments

#### First consultation papers forming basis for implementing measures

The Directive on insurance supervision confines itself to high-level principles, but the new rules are intended to create a system that can adjust quickly to changes in market conditions and external factors. This also applies to international developments such as the reform of accounting standards. For this reason, the four-level Lamfalussy system was introduced. It ensures that, in addition to the principles decreed at level 1 under Solvency II that apply

equally to all insurers, implementing measures will be proposed at level 2, and the European Commission had already asked CEIOPS in July 2007 to submit its proposals by the end of 2009.<sup>1</sup>

To this end, CEIOPS published the first 12 consultation papers in March, based on issues papers that had already been published in 2008. The consultation papers are:<sup>2</sup>

- Consultation Paper No. 26  
Valuation methodologies (including approximations and simplifications) for the calculation of best estimates in accordance with Article 85(a)
- Consultation Paper No. 27  
Segmentation of insurance liabilities into homogeneous groups to calculate technical provisions in accordance with Article 85(e)
- Consultation Paper No. 28  
Measurement of the default risk using the standard formula, with the emphasis on calibration of parameters and the determination of appropriate risk-mitigation techniques and default probabilities in accordance with Article 109
- Consultation Paper No. 29  
Criteria for ancillary own funds recognised by supervisory authorities under Article 92
- Consultation Paper No. 30  
Treatment of future premiums in the calculation of technical provisions in accordance with Article 85
- Consultation Paper No. 31  
Recognition of risk-mitigation instruments in the standard formula
- Consultation Paper No. 32  
Assumptions about future management decisions in the calculation of technical provisions in accordance with Article 85a

- Consultation Paper No. 33  
Requirements for systems of governance under Article 49
- Consultation Paper No. 34  
Requirements of supervisory authorities as regards transparency, accountability and access to information in accordance with Article 30
- Consultation Paper No. 35  
Valuation of assets and “other liabilities” in accordance with Article 74
- Consultation Paper No. 36  
Regulatory treatment of special purpose vehicles under Article 209, with the emphasis on licensing, requirements and the scope of supervision
- Consultation Paper No. 37  
Procedure to be followed for the approval of an internal model under Article 112(1)

Hence, the consultation phase is far from over. CEIOPS will publish more consultation papers in the course of this year.

## Challenges for the insurance industry

Even the standard approach to measuring future solvency capital requirements will pose a challenge for insurance companies. We look at a number of issues below relating to the calculation of best estimates, measurement of the default risk, the recognition of risk-mitigating techniques and the certification of internal models.

### Calculation of best estimates (Consultation Paper No. 26)

The results of the quantitative impact studies showed that the economic valuation of technical provisions will pose a challenge for many companies. In future it will be necessary to perform a valuation consistent with all other items in the balance sheet. The expected payment obligations arising out of in-force insurance business will have to be estimated and discounted and a safety margin added (the “risk margin”), because the “best estimate” of the future cash flows is based on a number of uncertain factors. The purpose of CEIOPS’ recently published Consultation Paper No. 26 is to formulate implementing measures. For example, the Paper illustrates possible valuation methods, differentiating between the various simulation techniques and analytical and deterministic procedures. There will be no generally applicable procedure, because companies’ insurance portfolios differ. Companies must therefore be able to demonstrate that the procedure they have chosen will enable them to calculate an economic valuation of their portfolio.

<sup>1</sup> Online at: <http://www.ceiops.eu/media/files/requestsforadvice/2007-07-19ECtoCEIOPS-SII.pdf>.

<sup>2</sup> Online at: <http://www.ceiops.eu/content/view/14/18/>.

### Measurement of the default risk (Consultation Paper No. 28)

The counterparty default risk is the risk arising from an unexpected default or deterioration in the credit standing of an insurance company's counterparties or debtors. The factor-based measurement of this risk using the European standard approach as tested in QIS4 is proving very time-consuming, particularly where companies work with a number of counterparties.<sup>3</sup> The time and effort required is disproportionate to the actual capital requirements, which according to QIS4 constitute on average in Europe around 4% of the basic solvency capital requirement.<sup>4</sup> In Consultation Paper No. 28, CEIOPS proposes an alternative method of measurement, which breaks default risks down into two categories based on the type of exposure, which are measured separately:

– Type 1:

This includes contracts arising out of reinsurance agreements, securitisations, derivatives, bank deposits, deposits retained on assumed reinsurance business up to a defined limit, guarantees, letters of credit and indemnities.

– Type 2:

This covers amounts due from intermediaries and all other credit risks not included in Type 1.

To calculate the capital requirement for default risk for Type 1 exposures, the dependencies between the default probabilities for the counterparties concerned are first analysed with the help of stress scenarios. To arrive at the capital requirement, instead of estimating the portfolio's loss distribution as is generally the practice, the standard deviation is estimated and multiplied by a prescribed factor.

The calculation of the capital requirement for a Type 2 credit exposure is considerably easier: the market value of the credit exposure to each counterparty is determined and multiplied by a prescribed factor.

However, the procedure for fixing the parameters to be used is still under discussion and it is planned to hold consultations on the subject at a later date.

### Risk-mitigating techniques (Consultation Paper No. 31)

The Directive requires that the solvency capital requirement reflect the actual risk situation. Instruments used by an insurance company to transfer a part of its risks to a third party – both traditional reinsurance and alternatives such as the securitisation of risks – must therefore be taken into account.

The results of the last impact study showed that the standard approach does not yet guarantee that this is the case.<sup>5</sup>

CEIOPS has therefore again stressed the fundamental importance of risk-mitigating techniques in Consultation Paper No. 31 and also makes reference to the work in the context of the third level of the Lamfalussy procedure, where a working group is currently developing solutions which are to be tested in the fifth impact study.

Consultation Paper No. 31 also stipulates high hurdles for the recognition of alternative risk-transfer solutions. For example, an insurance company must have the competence necessary to independently analyse and continuously monitor all risks arising out of complex transfer transactions.

### Certification of internal models (Consultation Paper No. 37)

According to the Directive, insurance companies are permitted to use full or partial internal models to calculate their solvency capital requirement, as they are capable of depicting the real risk situation better than is possible with the standard approach. Before an internal model is used, it must be certified by the supervisory authority. The application for approval submitted to the supervisory authority must demonstrate that the model complies with the use test, the statistical quality standards, the calibration standards, the validation standards and the documentation standards. The supervisory authority must approve or reject the application within six months of receipt of a complete application. There are additional requirements if a partial model is to be used. Companies are obliged to observe the general principles of the Directive for approvals of partial models and furthermore, they must

- be able to justify the limitation of the model to a particular area of use,
- demonstrate that the partial model will depict the risk situation in the area it covers better than the standard formula,

<sup>3</sup> The capital requirement for default risk amounts to 3% of the solvency capital requirement for life insurers, 5% for personal accident insurers and 4% for health insurers. Cf. CEIOPS' Report on its fourth Quantitative Impact Study (QIS4) for Solvency II, p. 189 ff. Online at: <http://www.ceiops.eu/content/view/118/124/>.

<sup>4</sup> The capital requirement for default risk amounts to 3% of the solvency capital requirement for life insurers, 5% for property-casualty insurers and 4% for health insurers. Cf. CEIOPS' Report on its fourth Quantitative Impact Study (QIS4) for Solvency II, p. 190 ff. Online at: <http://www.ceiops.eu/content/view/118/124/>.

<sup>5</sup> Cf. Munich Re, 2008: "The impact of reinsurance on risk capital – A practical example" [http://www.munichre.com/publications/302-05822\\_de.pdf](http://www.munichre.com/publications/302-05822_de.pdf).

– be in a position to fully integrate the partial model into the standard formula in order to calculate the overall solvency capital requirement.

These requirements are intended to prevent an insurance company using partial models only for those parts of its business where they have the effect of reducing the capital requirement. Companies should always base decisions to develop their own internal models on a cost-benefit analysis.

## Other current developments

### Quantitative impact studies

The insurance industry's proposal that a further Europe-wide quantitative impact study be carried out this year – on the basis of the QIS4 technical specifications – does not appear feasible. However, some EU states are already encouraging their insurers to determine future solvency requirements on the basis of the 2008 financial year, which would have the advantage that companies that had taken part in earlier studies would already have a complete series of Solvency II balance sheets when the new rules are introduced. They would also be in a position to better analyse stress situations in the capital market in the current financial crisis.

CEIOPS intends to carry out the fifth quantitative impact study throughout Europe in 2010. Work has already started on improving the standard approach and the discussions currently taking place in the context of the consultation phase will significantly influence developments.

### Impact of the financial crisis on the development of the future supervisory system in Europe

The recently published CEIOPS paper "Lessons learned from the crisis (Solvency II and beyond)"<sup>6</sup> raises the issue of which features of the future European supervisory system need to be readjusted to make the insurance sector even more able to withstand a crisis. The focus is on more stringent corporate management requirements (Pillar II). However, the current financial crisis has made it clear that the parameters for certain risk categories (e.g. market risks) need to be adjusted and complex corporate structures and investment strategies examined in detail.

With a view to preventing future crises in the capital markets, the European Commission in October 2008 requested a group of experts led by Jacques de Larosière, the former head of the IMF, to prepare proposals for the enhancement of European financial services supervision. Their report, presented on 26 February 2009, contains 30 recommendations, including closer cooperation between the three existing committees, CEBS, CEIOPS and CESR. The group recommends that, in addition to their existing responsibilities, the bodies be entrusted with the following tasks.<sup>7</sup>

- Legally binding intermediation between national supervisors
- Approval of binding supervisory standards
- In individual cases, approval of binding technical measures
- Leadership and coordination of the College of Supervisors
- Licensing and supervision of institutions operating throughout Europe (e.g. rating agencies)
- Binding cooperation with the European Systemic Risk Council (ESRC<sup>8</sup>), to guarantee uniformity of supervision
- Strong coordinating role in crisis situations

## Munich Re as a service partner

The changing environment will pose many challenges for the insurance industry. Companies will need to rethink the way they operate to cope with new accounting regulations and more stringent supervision, whilst at the same time facing the difficult conditions in the capital market. The imminent changes in supervisory law will mean higher capital requirements for many companies. Traditional risk-mitigating instruments such as reinsurance will take on new significance, not only as a way of reducing risks and capital requirements, but also as a general corporate management tool. As a result, reinsurance programmes will have to be even more individually designed.

<sup>6</sup> Online at: <http://www.ceiops.eu/media/files/publications/reports/CEIOPS-SEC-107-08-Lessons-learned-from-the-crisis-SII-and-beyond.pdf>.

<sup>7</sup> Cf. "De Larosière report on cross-border financial supervision released", online at: [http://ec.europa.eu/ireland/press\\_office/media\\_centre/feb09\\_en.htm#4](http://ec.europa.eu/ireland/press_office/media_centre/feb09_en.htm#4).

<sup>8</sup> The main objective of the European Systemic Risk Council (ESCR) is to decide on macro-prudential principles, set up early warning systems, monitor macro-economic developments and provide direction.