



Solvabilität
Solvabilité
Οικονομική φερεγγυότητα
Solvibilità
Vakavaraisuus
Solvencia
Fizetőképesség
Solvabilitéit
Zdolność płatnicza
Solvabilidade
Lahustamisvõime
Solvens
Maksätspēja
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Mokumas

Solvency II Newsletter

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Current developments

Second wave of calls for advice

European Commission

In autumn 2004, the European Commission submitted a draft of the paper MARKT/2515/04 to interested third parties for consultation. As soon as the paper is available in its final version at the end of 2004, the second wave of calls for advice on Solvency II will commence. This relates to the content of Pillar I, i.e. the future quantitative requirements of the new supervisory system. The questions in the second wave of calls for advice follow on directly from the discussion points in the first wave in July of this year.

The second wave of calls for advice will cover the following main points:

- underwriting reserves in life and non-life,
- quantitative models for calculating risk capital (standard formula and internal models),
- overarching issues, like the question of how standard formulas and internal models can take adequate account of risk reduction through reinsurance.

Discounted reserves with safety margin

In both the life and the non-life sector, it is expected that any underwriting reserves set up will in future have to be discounted, albeit with a certain safety margin.

On the life side, the main question is how best-estimate reserves can be clearly defined in a form that is compatible with IAS/IFRS, and how both relevant risk factors and the methods for calculating safety margins can be established. It will also be necessary to discuss how a risk-free market rate for discounting future cash flows is to be determined and how reserves for the investment-oriented portions of life insurance contracts can be established (for example, guarantees, bonuses and options).

On the non-life side, the question is how the discounting rate will be determined in future. Here, too, it has to be clarified how reserves are to be established with



a prescribed safety level, and what actuarial methods will have to be applied for this. The EU Commission intends to introduce an obligatory yearly report that must provide information on the development of the reserves and on the actuarial and economic assumptions behind the valuation methods used. In order to satisfy long-term solvency criteria, too, thought is being given to maintaining a compulsory equalisation mechanism (along the lines of today's claims equalisation reserves). What this compulsory equalisation mechanism will actually look like, however, has yet to be discussed.

Quantitative models – MCR and SCR

Besides the reserves that are to be set up with a certain safety loading, Solvency II will essentially be based on capital requirements. There will be a robust, easy-to-apply lower threshold in the form of a minimum capital requirement (MCR) that will also be limited by an absolute lower limit (equivalent to the previous minimum guarantee fund).

Alternatives: standard formula or internal model

Above the MCR, a solvency capital requirement (SCR) will be introduced. This will be set at a level that guarantees policyholders robust protection that is the same right across the EU. In order to calculate the solvency capital, insurance companies will in future be able to choose whether to use a standard formula or an internal model. In this regard, the EU Commission considers it a matter of urgency to receive answers to questions like: What categories of risk should be included? What are the relevant possibilities for modelling risks mathematically, and how can dependencies between risks be adequately represented?

Reinsurance – Key tool for reducing risk

The draft of the MARKT/2515/04 paper talks of reinsurance as "the key risk-management tool in insurance, [...] used in particular to mitigate certain volatile or extreme insurance risks". The mitigating effects of reinsurance should therefore be taken into account in both of the aforementioned possibilities for calculating the solvency capital, i.e. both in the future standard formula and in internal models. In particular, the effects of reinsurance should be represented in a way that is more commensurate with the risk than is currently the case under Solvency I. Discussions will focus on the extent to which the mitigating effect of reinsurance can be quantified sufficiently easily as part of a standard formula, and at the same time with sufficient reliability. For internal models, this discussion will also involve other risk-reducing tools like the hedging of investment risks.

CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors)

Impact of IAS/IFRS introduction on insurance supervision

At the end of November, CEIOPS published its CEIOPS-CP-03/04 consultation paper analysing the impact of IAS/IFRS accounting rules on supervisory returns in Member States. Since IAS/IFRS accounting standards were not primarily developed for supervisory purposes, it is of the utmost importance to examine the implications associated with the introduction of new accounting standards that will be compulsory for various insurers and reinsurers from 2005. It is therefore probably necessary to apply "prudential filters" to process IAS/IFRS accounting data for supervisory matters. This is also an issue, as there are currently different accounting rules in place in the Member States.

The main impact of IAS/IFRS accounting standards on solvency calculations will be for consolidated accounts. For individual financial statements, some jurisdictions allow the application of IAS/IFRS or alternatively local GAAP. In these jurisdictions the impact will depend on the insurance companies' decisions.

The introduction of IAS/IFRS accounting standards may produce interdependencies with the Solvency II project on the following issues:

- measurement of provisions,
- coverage of technical provisions with appropriate assets,
- calculation of the solvency margin.

According to insurers, the main aim of implementation is compliance with just a single set of accounting rules and a limited amount of "prudential adjustments".

Supervisors expect the transition to IAS/IFRS to result in the increased harmonisation of accounts at the European level. Finally, it should be mentioned again that not all insurance companies have to apply the IAS/IFRS accounting standards, but may continue to comply with their local GAAP standards instead.

Groupe Consultatif

Opinion on MARKT/2515/04

The European actuarial association, Groupe Consultatif, has already voiced its opinion on the aforementioned draft of the MARKT/2515/04 paper. As requested by the EU, the opinion does not yet contain any answers to the questions raised by the EU Commission; the Groupe Consultatif has on the other hand endeavoured to round off and complete topics such as the calculation of reserves, establishment of the risk classes to be taken into account in the solvency capital, and the future role of actuaries under Solvency II.

Cooperation between CEIOPS and Groupe Consultatif

A close exchange has been established between the Groupe Consultatif and CEIOPS that is geared to the subjects covered by the EU Commission's MARKT papers but also allows a technical discussion that went beyond these terms of reference. The fact that the subjects covered by the Groupe Consultatif's working groups mirror those of the five CEIOPS working groups facilitates cooperation.

Life – Reserves and market risks

The first two working groups deal with Pillar I of Solvency II, i.e. with the quantitative measurement of risks by means of a standard formula and internal models. Group 1 focuses on the life side, where a number of complex questions are currently under discussion, such as: How can the products of the various European insurance markets be evaluated uniformly and in a way that is compatible with IAS/IFRS? How can safety margins be determined adequately, and how should statistical parameters (portfolio-specific mortality, longevity) and any changes in them be handled in the future?

Non-life – Estimating correlations

The Groupe Consultatif's second working group deals with the question of risk measurement on the non-life side. The discussion currently revolves around detailed questions regarding the drafting of a European standard formula for measuring solvency capital. In this respect, Group 2 focuses in particular on the question of how the dependencies between various classes of risk and types of business can be adequately represented in a standard formula.

Pillars II and III

The future functions of actuaries, the requirements for actuaries set by the supervisory authority, and the choice of actuarial methods as part of qualitative regulations (Pillar II) are subjects that the Groupe Consultatif's Working Group 3 is currently addressing. Working Group 4, on the other hand, is focusing on the relations between Solvency II and IAS/IFRS, i.e. especially on the future of the claims equalisation reserves within the context of the equalisation mechanism suggested by the EU Commission, but also on the discussion of future disclosure requirements.

Group solvency

Working Group 5 is devoted to the discussion of topics that go beyond the insurance sector, or that relate to the activities of insurance groups and financial conglomerates. This includes, for instance, the question of what the relationship should be between group solvency and the solvency of member companies. Another important field of work is that of drawing up proposals on how supervisory arbitrage can be avoided, i.e. how Solvency II and Basel II can be harmonised so that equal risks lead to equal capital requirements for banks and insurance companies alike.

Other supervisory models

While discussions on the technical details of Solvency II are just starting, some regulatory authorities have already submitted more-developed plans for future supervisory systems. These plans will have an influence on the further development and later implementation of the Europe-wide Solvency II project. For this

reason, three plans for future solvency systems are presented below, namely the British model, the Swiss model (Swiss Solvency Test) and the model produced by the Dutch supervisory authority.

UK – FSA PS04/16

Changes in statutory capital requirements for UK non-life insurers

In Policy Statement PS 04/16, the Financial Services Authority in the United Kingdom (FSA) introduced its new statutory capital requirement regime. The Individual Capital Adequacy Standards (ICAS) apply to all UK based (re)insurers and will come into effect on 31 December 2004. Among other things, it includes the results of the FSA Consultation Papers 190, 97 and 143 which define a substantially different approach for the calculation of statutory capital requirements for non-life insurers. The existing Solvency I requirements, which are based on EU regulations, still apply as a minimum capital requirement (MCR).

ICA – Self-assessment of insurers' risk situation

According to the ICAS framework it is compulsory for companies to carry out a self-assessment of their risk situation and derive capital requirements by means of the Individual Capital Assessment (ICA). Proper ICAs, which are mainly based on scenario tests, individual risk models etc., should become usual for the majority of the market participants at least in the medium to long term. Bigger companies already undertake their own scenario analyses or have developed their own risk models. The FSA reviews the firms' assessments afterwards and makes the ultimate decision as to how much capital a company is required to hold. The aim is for firms to be aware of the complete spectrum of risks (market, credit, underwriting, liquidity, operational risk) that they take and ensure at any point in time that their projected assets are sufficient to pay their projected liabilities as they fall due. Within the ICA framework, (re)insurers must carry out regular assessments in order to identify and quantify their exposure to major risk categories.

ECR – Factor-based model to assess financial stability

Companies are also required to calculate their Enhanced Capital Requirement (ECR) as part of the ICA. The ECR is intended to provide a risk-responsive but standardised method for assessing the financial stability of the entire (re)insurance sector and for benchmarking non-life firms' capital requirements. It will be reported privately to the FSA. The ECR is a factor-based model with countrywide factors and represents an aggregation of

- insurance-related capital requirements (net written premium and net technical provisions are subject to a capital charge which differs according to line and type of business); plus
- asset-related capital requirements (assets are subject to a capital charge which differs according to asset class).

For the time being, the ECR is not a binding capital requirement but this will be reviewed in 2006. Nevertheless, the ECR will serve as an indication that certain companies need closer scrutiny by the FSA than others.

SST – Swiss Solvency Test

Combination of analytical model and scenarios

The Swiss Solvency Test (SST) was expressly conceived by the Swiss Federal Office of Private Insurance to fit (as far as foreseeable to date) into any future Solvency II framework and to avoid any competitive disadvantage arising for Swiss insurance companies. Two values for risk capital are accordingly calculated as the core elements of the SST – a minimum value and a target value (comparable to the MCR and the SCR in Solvency II). However, the basic concept of the SST provides not only for these two values as the result of a risk capital calculation but also for a more informative probability distribution on the probable size of the risk-bearing capital.

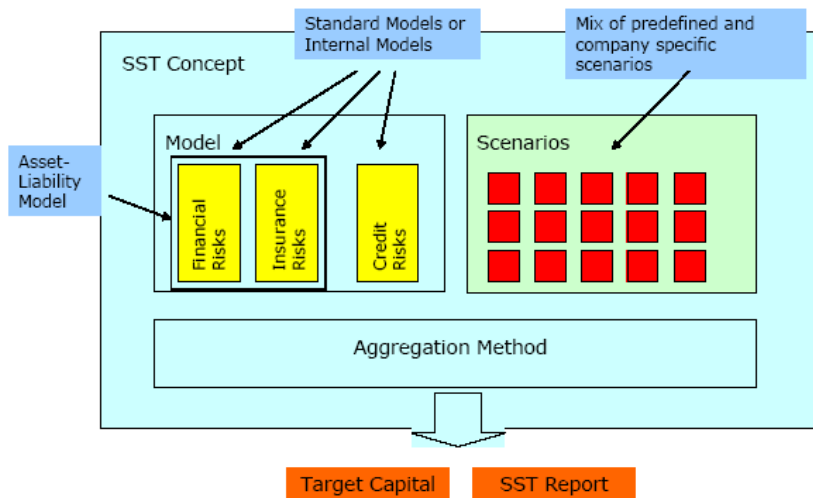
Market, credit and insurance risks are incorporated into the SST as relevant risks. There are standard models for each of these risk categories. It is also possible to use an internal model to calculate the target capital, in which case docu-

mentation of the model and its underlying assumptions are required (SST Report). For risks that are not part of standard models, and also for rare events, a scenario approach is used. The results of these scenarios are aggregated with the results of the standard models to give an overall probability distribution. To determine the target capital, the expected shortfall is used as a measure of risk in relation to the change in the risk-bearing capital; the period of observation is one year.

Market-consistent valuation

Within standard models or internal models, asset and liability items are valued in a way that is consistent with the market situation; here, the market-consistent value of liabilities from insurance business is fixed as the sum of the best estimate and a risk margin. Reinsurance is taken fully into account in the SST.

Schematically, the determination of an insurance company's capital requirement using the SST may be represented as follows¹:



For reinsurers: Use of internal models

In 2004, a first field test took place that was intended to demonstrate the usability of the SST as a simple supervisory model. The experiences from this field test are currently being processed in order to prepare for a further test run that will also include small and medium-sized insurance companies. This field test will be carried out in summer 2005 and will last about four months. The aims are to calibrate the SST model, adapt it to smaller insurance companies, too, and also to incorporate reinsurance companies. For reinsurers in particular, however, it is expected that the Swiss supervisory authority will use a principles-based approach on the basis of internal risk models.

General conditions for new supervisory model in the Netherlands

Dutch proposal for solvency regulation

The Financial Assessment Framework² of the Dutch Pensions and Insurance Supervisory Authority (PVK) – that was initiated in 2001– comprises three elements. The Minimum Test is retrospective and deals with insurers' liabilities and their adequate coverage with assets based on current balance sheet information. The analyses should be based on the market view, i.e. market values for assets and fair values for liabilities should be used.

Solvency test – Assessing the current risk situation

Principles for the Solvency Test were released in a 2003 PVK White Paper. The impact of credit, market, underwriting (life and non-life), operational as well as concentration risks will either be examined by a standard approach or by internal models. These have to comply with certain criteria (organisation of risk management, model input, model structure and risk control) specified by the PVK. The standard approach combines scenario analyses for market risks (interest

¹ Taken from: Swiss Federal Office of Private Insurance, *White Paper of the Swiss Solvency Test*, November 2004, page 10.

² For more information, see www.pvk.nl.

rate, equity, currency, real estate, commodity risks) and credit risks, as well as a factor-based approach for underwriting risks. The risk capital charge required is initially calculated separately for each risk category. For aggregation, the total amount is derived assuming complete independence for certain risk classes and partial dependence for others. The standard model is calibrated to a 200-year loss, i.e. a confidence level of 99.5%. The capital charge for operational and concentration risks is not derived statistically but rather added based on an individual assessment.

Continuity test – Assessing the future solvency situation

The Continuity Test – presented in a 2003 PVK White Paper – deals with long-term solvency considerations, i.e. a broader time horizon including new premiums and liabilities is considered. Within the test environment, insurers assess the qualitative impact of various adverse scenarios on their solvency position. At the same time, the test assesses the influence of management interventions and policy instruments and increases risk awareness. It is therefore intended to identify problems at an early stage.

Do you need more information? – If so, please contact any of the following direct:

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