

European Commission: Insurance Solvency II

SOLVENCY I

Solvency I minimum capital requirements are developed quite simplistically using multipliers of liabilities and the sum at risk (or the amount payable on death minus the provision held) for life insurance and multipliers using premium and reserves for non-life insurance. Asset Valuation in Solvency I can be either at market or historic (but at market if lower). Life liabilities are discounted, with some limitations on the discount rates. Non-life liabilities have some restricted discounting permitted.

Obviously, Solvency 1 is not a risk-focused approach and uses outdated methodologies, so why is it important to continue to talk about Solvency I? Mostly to explain that when countries are operating under a Solvency I type system, there is great need to develop a better and more risk-oriented solvency system. In contrast, the U.S. already has a uniform risk-based capital system, standardized and extensive disclosure, and a well-established and uniform system of financial analysis and risk-focused examination. With that said, it is much clearer that there is not a need to develop an entirely new Solvency system in the U.S.

Does that mean the U.S. shouldn't care about international solvency and accounting work? No, not at all! There is much to be learned within the international debate and the U.S. should analyze new approaches and determine where the U.S. solvency system can be tweaked and improved, albeit with an eye toward practicality and cost/benefit analyses.

SOLVENCY II

The EU has embarked on their Solvency II initiative to create solvency requirements that utilize a risk-based approach, where the solvency requirement is better matched to the true risks of the insurance company, and to harmonize the financial reporting and establishment of technical provisions.

In July 2007, the European Commission (EC) published its Framework Directive which described the design of the solvency system at a high level and included an impact assessment report. This Framework Directive is but a first step in the political process. It is now time for the Council and Parliament to debate the issues and modify the directive prior to it becoming law.

Roadmap

Shortly after issuing the Framework Directive, the EC wrote a letter to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), outlining a potential roadmap towards final implementation of Solvency II:

- Quantitative Impact Study 3 (QIS 3) report: Nov. 2007
- QIS 4 draft specifications by end of year 2007; run QIS 4: Apr.-July 2008
- Final advice from CEIOPS: Oct. 2008
- QIS 4 report: Nov. 2008
- Negotiations on the Framework Directive: perhaps 2008 completion
- Implementing Measures: 2nd half of 2010
- Level 3 Supervisory Guidance 2nd half of 2010
- New EU Regime: 2012

Within CEIOPS' response they noted that "the expected deliveries, both in their scope and timing, are particularly challenging."

QIS Studies

A report on the results of QIS 3 is expected in Nov. 2007. There should be an impact statement on the industry and also for some individual lines of business. The QIS 3 report is expected to focus on the architecture and high level design of a European Standard Formula to determine the first level of supervisory action called the Solvency Capital Requirement (SCR), on the design of the final level of supervisory intervention called the Minimum Capital Requirement (MCR), and on pros/cons of different approaches to calculating the MCR.

The specifications for QIS 4 are not yet developed. Expectations are that the European Standard Formula would be tested within QIS 4, with focus on the valuation standards and calibration parameters.

Outstanding Issues

It is also important to note that while the core issues were defined by the EC, the details have not been decided. The details will be developed going forward, largely being shaped by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

Many important issues remain, including the following:

- What modifications should be made for smaller firms to achieve proportionality?
- How should groups be supervised?
- How should assets and liabilities be valued?
- How do you estimate market prices for non-traded insurance liabilities?
- How should a risk margin be calculated for the liabilities?
- How should capital requirements be calculated?
- How can a standard formula be developed so that all companies can determine capital requirements, perhaps without requiring advanced modeling techniques?
- What is the design of the SCR and how should it be calibrated?
- What is the design of the MCR?
- When should capital add-ons be allowed and how should those requirements get applied?
- How will regulators validate internal models used to determine regulatory capital?
- How will regulators approve the internal models?
- How will processes for partial models and full models be different?
- How should diversification affect the regulatory capital?
- What information should be reported to supervisors?
- What information should be publicly disclosed?
- What should be required for governance?
-and many more...

This list highlights many of the issues that would be at the core of a solvency system. It may be premature to advance Solvency II outside of the EU until these details are decided, and perhaps even until the EU has some experience with the system to determine whether it will work in practice.

Uniformity

The EU experiences are similar to the U.S. state regulatory system in that they have member states (albeit countries instead of states) who will work together to develop a uniform system. As should be expected, the EU is experiencing some difficulties with achieving uniformity amongst member states. Notably, as of August, there was only a limited degree of convergence between member states on the implementation of insurance directives, especially as they relate to having limits on the amount of each type of asset that could be counted and different accounting standards. There are also numerous disagreements on other issues, including on what should be included in the Framework Directive, and there is much to be debated before the Solvency II system is uniformly adopted.