

Introduction to European Solvency II

2008 NAIC Financial Summit

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International Insurance Organizations



- International Association of Insurance Supervisors (IAIS)
- International Actuarial Association (IAA)
- International Accounting Standards Board (IASB)



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NAIC International Involvement

- IAIS/IASB/IAA & Other International Involvement
- New International Insurance Relations (EX) Leadership Group (IIRLG)
- International Relations (G) Committee
 - Chaired by Cmsr. Steve Goldman (NJ)
 - Vice Chair of Europe: Cmsr. Al Gross (VA)
- International Solvency and Accounting (E) Working Group -- Chaired by Ramon Calderon (CA)



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Why Study Solvency II?

- Some U.S. Companies
 - Do business in the EU or have EU parents
 - Compete against EU companies
- Mutual Recognition – Reinsurance, etc.
- The EU is promoting the Solvency II system to other countries' regulators
- Solvency Modernization Initiative



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Introduction to European Solvency II

- European Union (EU) & Decision Makers
- Solvency I
- Solvency II Objectives
- Solvency II Issues



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European Union (EU)

- The European Union (EU) is a family of democratic European countries, committed to working together for peace and prosperity.
- It is not a State intended to replace existing States, nor is it just an organization for international cooperation.
- The EU is, in fact, unique. Its member states have set up common institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level.



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European Union (EU) Member States and Candidate Countries



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European Union (EU) Member States and Candidate Countries

➤ “EU” & “Europe” are not synonymous

Four Western European Countries are NOT in the EU:

- Switzerland
- Norway
- Liechtenstein
- Iceland

Plus many Eastern European countries



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European Union (EU) – How Organized

- Council of the European Union (ministers from the national governments of all the EU countries)
- European Parliament (elected by people)
- European Commission (one from each country)

Council & Parliament pass European laws and approve the EU's budget.

Proposals for new laws come from the European Commission → Solvency II.



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Solvency II: Key Decision Makers & Stakeholders

- Council of the European Union & European Parliament
- European Commission, Internal Market, Financial Services: European Insurance Occupational Pensions Committee (EIOPC)
- Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

Consults market participants, consumers, and end users and drafts recommendations

- Comite Europeen des Assurances (CEA)
- Groupe Consultatif Actuariel Europeen



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Lamfalussy Process



1. Legislative

Commission adopted formal proposal on general rules/principles: Framework Directive in the Council /Parliament adoption process

2. Technical Implementation

Commission -- Requests Advice -- avoids over-prescriptive regulation

3. Implementation & Convergence

Desire for coordinated implementation of EU law, regulatory & supervisory convergence.

4. Enforcement

Commission checks member state compliance; may take legal action



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Solvency I

- Not Risk Focused
 - Increase Premium with No Increase to Risk, Results in Higher Capital
- Out of Date
- Some Countries Strengthened Regulation, but Not Uniformly
- MAJOR Need for Improvement!



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Solvency I

- Capital Requirements are Simplistic:
 - Life: Multipliers of Liabilities and the sum at risk (or the amount payable on death minus the provision held)
 - P&C: Multipliers of Premium and Reserves
- Asset Valuation: Market or Historic (but Market if lower)
- Liabilities
 - Life: Discounting, some limitations on rates
 - P&C: Some restricted discounting



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Solvency II in a Nutshell



- On http://www.naic.org/committees_e_isawg.htm
 - find a draft comparison of US Solvency to EU Solvency II
- Enterprise Risk Management
- Capital Requirements – Risk-based, Internal Models, Stochastic
- Group solvency
 - Lower capital required to be held for group, plus don't have to hold much capital in individual companies.



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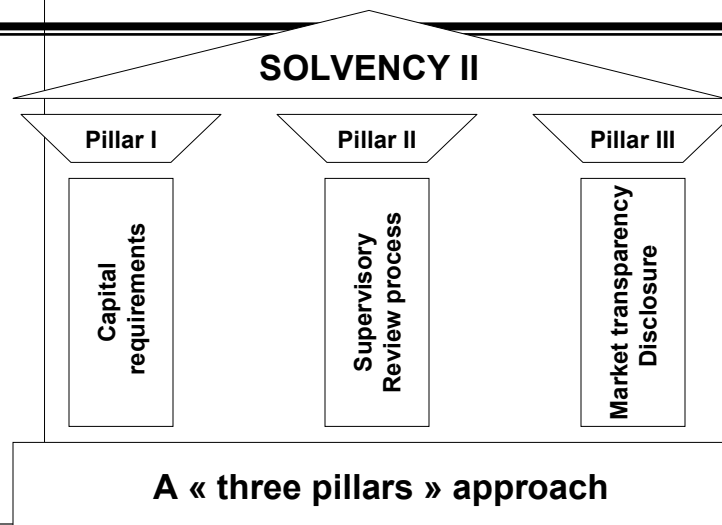
European Commission's Solvency II: Main Objectives

- Assess overall solvency
- Basel three-pillar approach, adapted to insurance
- Risk-sensitive approach
- Quantitative and Qualitative methods
- International convergence/compatibility (including IASB, IAIS, IAA, banking)



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Pillars – Similar to Basel II



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Pillar I: Financial Resources

- Quantitative
- Asset/Liability Valuation
- Capital Requirements: Risks Included, Measurement, Use of Models
- Eligible Capital



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Pillar II: Supervisory Review Process

- Increased Complexity of Supervisory Tasks
 - Validation of Internal Models
- Governance, Internal Controls
- Risk Management
- Capital Add-Ons – Need Powers



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Pillar III: Disclosure

- EU – wide
- Comply with IFRS & IAIS
- Transparency
 - Supervisory vs. Public Info.
- Comparability



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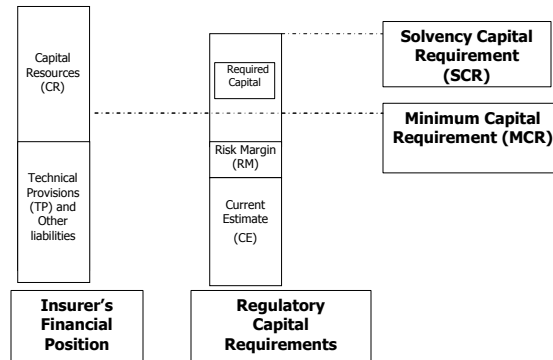
Enterprise Risk Management

- Company requirement
- Risk Tolerance Statement
- Own Risk and Solvency Assessment (ORSA); Economic Capital
- Supervisor will review insurer's risk management practices and its financial condition



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Capital: SCR & MCR Control Levels



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Capital: SCR & MCR Control Levels

- Solvency Capital Requirement (SCR)
(Minimum level before some regulatory action would be taken, with an anticipated ladder of regulatory intervention down to the MCR level)
 - Standard formulas (based on factors, probabilities, scenarios, or some combination) and/or internal modeling to be used
- Minimum Capital Requirement (MCR)
(Absolute floor requiring ultimate supervisory action)
 - Absolute Minimum \$ by type of company
 - Should be 25-45% of SCR



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SCR Calculations

- Standard Model with Modular Approach
- Standard, but Some Parameters Replaced with Entity-Specific
- Partial Internal Model
- Full Internal Model



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Internal Models

- Models Must be Pre-Approved
- Regulators provide overall safety level and time horizon (99.5% VaR over a 1-year time horizon)
- Insurer must pass tests, including Use Test
- Capital with Internal Models is Lower



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Standard Approach to Internal Models

- Standard Approach – given fundamental parameters, some credit for company's own experience, with credibility
- Capital Required is Higher (approx 25%) with a Standard Approach than with Internal Models
- Even a partial model could result in significantly lower capital
- Small companies don't have the needed data



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Group Issues

- Supervisory Communication Issues – Supervisory Colleges
- ERM & Internal Models, if controlled at the parent level, look at them as a group
- Group Supervisor
 - Who leads? Base on Location of Office or on Risks?
 - What happens to powers of solo-entity supervisors?



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Group Capital Requirements

- Consolidated or Aggregation
- Diversification between legal entities
- Capital Requirements of Solo Entities – hold only the MCR if have legally-enforceable parental guarantees



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Uniformity

- Common Directive, but Common Supervisory Regimes?
 - Member State Options
 - Divergent Supervisory Approaches
- Uniformity often at the Price of Compromise
- Similar Uniformity Issues on Our Side of the Pond...



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Uniformity

Thomas Steffen, CEIOPS Chair

“It is essential that convergence based on a maximum level of harmonisation is kept in the legislative process limiting the room for national discretion and national options.”

July 2007



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Uniformity

- Some discussion of Supervisory Peer Review
- No Accreditation Process (yet) to increase uniformity (and improve quality) of different supervisory regimes
- Implementation Measures



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Third Country Equivalency

- Equivalency of other solvency regimes will be determined.
- The EC is granted the power to decide whether 3rd Countries are equivalent.
- The Framework is expected to say that U.S. states can't be individually equivalent, but the U.S. as a whole must pass (...without saying "U.S.")
- NAIC G Committee



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Market Conduct

- What's Market Conduct?
- No rate approvals
- No systemic insurance contract review
(although can do verifications of compliance in a non-systemic way)



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Financial Statement Reporting

- Some uniform reporting
- Not as extensive as in U.S.
- Not looking like there will be centralized data reporting, at least not to the extent of NAIC database



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Other Solvency Tools

- Reliance on Company – ERM, etc.
- SCR/MCR calculation
- Any Others?



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Quantitative Impact Studies (QIS)

- Prepares the Industry
- Provides Valuable Data to Calibrate the System
- QIS 3
 - technical provisions tended to decrease but capital requirements increased
 - 98% of companies met MCR, 84% met SCR
- QIS 4 – calibration of standard formula
- QIS 5/6/????



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Roadmap

- QIS 4 run earlier this year; report due soon
- Negotiations on the Framework Directive: hoped for 2008 completion
- Implementing Measures: 2011
- Level 3 Supervisory Guidance: 2011
- New EU Regime: **2012**

Is it Doable?



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Solvency II – The Details Remain

Thomas Steffen, CEIOPS
Chair

*“There might be risks in
the process. Details
still have to be worked
out and the devil often
is in the details.”*



July 2007



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Some of the Remaining Details...

- Proportionality
- Group Issues / Diversification
- Finalization of SCR & MCR formulas
- Implementing Measures & Supervisory Guidance



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But even more that we don't hear about...

- Accreditation
- Uniformity
- Other financial tools
- Appropriate level of reliance on companies' estimates
- Guaranty funds (explicitly will not be dealt with in SII)
- What else???



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Canada Capital vs. Solvency II

- CTE -- theoretically superior over VaR:
 - reflects the "fatness" of the tail
 - additive properties
- One Year Time Horizon, but Reflect Full Lifetime Post-Stress Risk Distribution
- Market Criteria – BUT also Intent (because of Stresses)
- Cost of Capital method is circular and therefore not simple, unless potentially material assumptions are made and approximations implemented



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Key Challenges to Solvency II

- Skills and Resources – Modeling
- Significant Changes to Processes
- Must Calibrate Correctly
- DATA!!!!
- Supervisory Teamwork
- Language



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Conclusion

- There's a lot of good work in Solvency II, but it is still UNTESTED.
- It may be premature to advance Solvency II outside of the EU until details are decided, and perhaps even until the EU has some experience with the system to determine whether it will work in practice.



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Questions????

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