



Solvency II implementing measures

Taking Solvency II to the next level

On 5 May 2009 the Solvency II Directive was officially adopted. However, whilst the 'Level 1' Directive sets out the regulatory principles that will apply to insurers from November 2012 much of the detail will be set out in 'Level 2' implementing measures which will specify how the principles of the directive must be applied in practice. 'Level 3' guidance will also be produced to seek to ensure consistent application, in practice, of the Level 1 and Level 2 requirements.

Under the process adopted for implementing Solvency II (the Lamfalussy Process), the European Commission is responsible for developing the Level 2 implementing measures on the basis of advice received from the Committee of European Insurance and Occupational Pensions Supervisors ('CEIOPS').

As a consequence, in March 2009, following approval of the Level 1 text of the directive, CEIOPS released the first twelve in a series of Consultation Papers ('CPs') setting out advice on the Level 2 implementing measures for Solvency II.

CEIOPS requested comment from stakeholders on the CPs to inform the Level 2 measures that will be submitted for consideration by the European Commission for formal adoption in 2010.

The first twelve CPs (CP 26 to CP 37) cover a range of topics of interest to the industry across three key areas, both technical and non-technical. CEIOPS will only provide technical guidance where it has been directed to do so in the Level 1 text. Accordingly there will be no guidance concerning areas where it has not been directed (for example, on the form and content of the ORSA).

Processes and governance: CPs 33, 34 and 37

These CPs are important papers covering the system of governance, the transparency and accountability of the regulator and the procedure to be followed for approval of an internal model.

Capital and capital resources: CPs 28, 29, 31 and 36

These CPs cover factors relevant to the calculation of the capital requirement and capital resources including criteria for approval of ancillary own funds, treatment of counterparty default risk and financial mitigation techniques in the standard formula and use of special purpose vehicles.

Valuation of assets and liabilities: CPs 26, 27, 30, 32 and 35

These CPs provide guidance on certain valuation principles to be applied for assets and liabilities including technical provisions, assets and non-technical liabilities. Consistency with IFRS is an important objective for these papers although ongoing debate over the future of IFRS at the IASB may force CEIOPS to re-consider this area.

PricewaterhouseCoopers has responded to these CPs and our responses are available on our website.¹ The CPs themselves are available on CEIOPS' website.² This paper provides a summary

of the twelve consultation papers issued to date and the key views contained in PricewaterhouseCoopers responses.

CP 26: Technical provisions – Methods and statistical techniques for calculating the best estimate

CP26 provides advice on actuarial and statistical methodologies to be used for calculation of the best estimate. The CP provides some useful guidance on requirements for valuation techniques and techniques that are considered appropriate, but arguably could go further in providing practical guidance on their application.

CP27: Technical provisions – Segmentation

CP27 sets out the segmentation required to be used in calculating technical provisions. CEIOPS aims to provide advice on a minimum level of segmentation to recognise that further sub-segmentation will be appropriate to individual businesses. However, the level of segmentation advised may prove too prescriptive or inappropriate for some who do not manage their business along the mandated segments.

CP28: SCR standard formula – Counterparty default risk

CP28 gives advice on the treatment of counterparty default risk in the standard formula, including the scope of the counterparty default risk module and the calculation details. The calculation remains complex and may prove difficult to implement for insurers without extensive modelling expertise, and many points of calibration remain to be clarified.

¹ PricewaterhouseCoopers responses to the CEIOPS CPs are available at www.pwc.co.uk/solvencyii

² www.ceiops.org.

CP29: Own funds – Criteria for supervisory approval of ancillary own funds

CP29 sets out a framework for approval of ancillary own funds. The detailed criteria in this paper are helpful for the industry although the requirement for annual re-approval of ancillary own funds may prove onerous and introduce uncertainty around future capital for many insurers, especially those funded by letters of credit. This CP (and a number of others) would benefit from some examples being provided of how CEIOPS sees a principle set out in the directive (for example, for the provision of an ORSA, or the application of the principle of proportionality to systems of governance) being applied in practice.

CP30: Technical provisions – Treatment of future premiums

CP30 provides advice on the treatment of future premiums in the assessment of technical provisions, including the recognition and boundaries of insurance and reinsurance obligations. The CP requires future premiums giving rise to losses to be included in technical provisions, but does not allow credit to be taken for future premiums which give rise to profits. This difference in treatment will prove onerous for the industry and is not aligned with current developments in the IASB's insurance contracts project.

CP31: SCR standard formula: Allowance of financial mitigation techniques

CP31 develops the qualitative treatment of financial mitigation techniques in the standard formula. The advice in the paper is not fully developed and requires clarification, particularly around timing mismatches between the capital assessment period and the period covered by the financial mitigation technique. We understand that CEIOPS will be issuing more detailed advice in due course.

CP32: Technical provisions – Assumptions about future management actions

CP32 considers the circumstances in which it is appropriate to take account of future management actions in the calculation of technical provisions. The paper is well considered, setting out conditions of objectivity, realism and verifiability to recognise future management actions.

CP33: System of governance

CP33 expands the principles and requirements for the system of governance, including requirements around general governance, fit and proper requirements, risk management system, internal control, required functions and outsourcing. Overall CP33 is logical and clear and reflects best practice, although clarification is required in certain areas.

CP34: Transparency and accountability

CP34 sets out the requirements for transparency and accountability of supervisory bodies. The CP sets out some sound principles although achieving supervisory equivalence across the EU is expected to be challenging.

CP35: Valuation of assets and 'other liabilities'

CP35 provides measures on the valuation of assets and liabilities other than technical provisions. The intention of CP35 is to align valuation with the principles of fair value under IFRS; this may be impacted by revisions to significant accounting standards by the IASB. In a number of important areas CEIOPS has not yet concluded on the most appropriate treatment and is considering a number of options – these areas include: adjustments for illiquidity and model risk in asset valuation; valuation of subsidiaries and associates; allowance for own credit risk in the initial measurement of financial liabilities; and whether to use IAS 19 to measure post employment benefits. In addition, the tentative conclusion to use an IAS 12 model to measure deferred tax (based on temporary differences with no discounting) with no credit taken for tax loss assets, may attract comment from those who feel this approach does not reflect an economic valuation of deferred tax balances.

CP36: Advice on special purpose vehicles ('SPVs')

CP36 considers the treatment of SPVs under Solvency II, including authorisation, mandatory contractual conditions, governance requirements, supervisory reporting and solvency requirements. The paper does not deal with the basis of valuation by insurers of business ceded to SPVs. Whilst the Level 1 requirements in respect of SPVs are similar to the existing requirements of the Reinsurance Directive, the Level 2 measures may not reflect how that directive has been implemented in individual states. It should be noted that pre-existing SPVs at the time of the implementation of Solvency II are outside

the scope of this CP as those SPVs will continue to be subject to previous national regulation.

CP37: Advice on the procedure to be followed for the approval of an internal model

CP37 sets out the procedure to be followed for the approval of a full or partial internal model. Group models are not considered and CEIOPS intends to issue an addendum to CP37 covering group internal model approval as part of the next round of CPs. CEIOPS has taken a principles-based approach in CP37 which should avoid the systemic risks of an overly prescriptive regime. The FSA's approach to internal model approval in the UK is currently consistent with this CP. Where a full internal model is rejected, simultaneous partial model approval is possible. The requirement for independent verification of the model may create challenges for a typical risk management or internal audit function (which may lack the requisite skills to do this). Provision is made in CP37 for a distinction between major and minor changes to the model and the extent to which they need to be approved.

Future developments

On 4 June 2009 CEIOPS released its timetable for the publication of CPs covering further important implementation measures.³ Thirty one further CPs are due to be released with a consultation period of July to September 2009 with a further thirteen CPs being released for consultation in the final two months of the year.

During 2010 a fifth quantitative impact study (QIS 5) is scheduled to test the advice on Level 2 implementing measures. In addition, during 2010 and into early 2011, CEIOPS will work on developing Level 3 guidance.

If you would like to discuss any of the areas covered in this paper as well as the implications for yourself and your firm, please contact:



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³ <http://www.ceiops.eu/media/files/consultations/consultationpapers/2009-06-02-CEIOPS-List-of-Advice-on-SII-second-and-third-set.xls>.