Institute and Faculty of Actuaries

Solvency II – Examining "Maximum Harmonisation"

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Concept of Maximum Harmonisation

- Key objective of Solvency II is to address the regulatory arbitrage that existed under Solvency I
- Concept of harmonisation is referred to several times in recitals of Directive:
  - **"Capital requirements should be harmonised throughout the Community"**
  - **"The principles and actuarial and statistical methodologies underlying the calculation of those technical provisions should be harmonised throughout the Community in order to achieve better comparability and transparency"**
  - **"Internal models should be subject to prior supervisory approval on the basis of harmonised processes and standards"**

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Concept of Maximum Harmonisation

Level 3 Guidelines to aid harmonisation

- Purpose of the Level 3 guidelines is to aid supervisory convergence in the application of the Solvency II regime
  - → **"aim of ensuring the common, uniform and consistent application of Union law as well as with a view to establishing consistent, efficient and effective supervisory practices"**
- Some countries choosing to implement Guidelines into national law whilst others are choosing not to do so
- EIOPA has been clear that regardless of whether transposed into national law full compliance with the guidelines is expected

Concept of Maximum Harmonisation

EIOPA Feedback on consultation on Level 3 Guidelines

However….

"While the Solvency II Directive is to a large extent about maximum harmonization, this is not the case for the whole Directive. There are still a number of areas where Member States may keep or introduce stricter requirements as and where appropriate."

Areas Analysed

DISCRETION	GOLDPLATING	INTERPRETATION

DISCRETION

- Where the Directive allows Supervisors to exercise discretion in how they implement specific areas

GOLDPLATING

- Where have Supervisors introduced additional requirements seemingly outside Solvency II requirements

INTERPRETATION

- Where different interpretations of the same rules have arisen
- Implications for groups

Areas of Discretion (1) – Volatility Adjustment

- Solvency II market consistent approach can lead to volatile results
- Insurance industry argued that the use of ALM techniques means that this volatility is somewhat artificial i.e. the volatility does not reflect changes in the financial position or risk exposure of the insurers.
- This lead to the introduction of the "illiquidity premium" in QIS5 which was surrounded in controversy
- This has now developed into the Matching Adjustment ("MA") and Volatility Adjustment ("VA")
- Pre-approval is required for MA but it is at the discretion of Supervisors whether they seek approval for use of VA

Areas of Discretion (1) – Volatility Adjustment

Supervisory position on use of VA

Country	Pre-Approval for VA
France	No
Spain	No
Netherlands	No
Portugal	Yes
Ireland	Yes
UK	Yes
Germany	Yes

- Where approval is being sought the process can vary considerably

Areas of Discretion (1) – Volatility Adjustment

- Also different approaches in the use of VA i.e. should it be fixed or dynamic in the stressed scenarios
- PRA have expressed the view it should be fixed whilst acknowledging that
  - **"there is another school of thought, favoured by some others in Europe, which is that if the purpose of an internal model is to forecast changes to a firm's balance sheet in a 1-in-200 stress, then it is illogical to isolate this one element and hold it fixed."**

Source: Speech of Sam Woods, Executive Director of Insurance Supervision, Bank of England to ABI 3rd November 2015

Areas of Discretion (2) – Quarterly Reporting Exemptions

- Article 35(6) of Directive permits exemption from quarterly reporting in certain circumstances:
  - **Where provision of the information would be disproportionate**
  - **Where provided annually**
- Article 35(6) permits exemption from quarterly reporting for up to 20% of the market
- Some Supervisors appear to have taken a more lenient approach than others in this regards

Areas of Discretion (2) – Quarterly Reporting Exemptions

Supervisory position on use of Quarterly Reporting Exemptions

Country	
France	Exemption under certain size: €8bn for life companies
Spain	Exemption applied to 20% of market
UK	Exemption for category 4 and 5 firms
Germany	Exemption applied to 20% of market - companies informed by Supervisor
Ireland	Very limited exemptions: e.g. look-through template for low/medium-low rated companies
Netherlands	No direct exemption to market
Portugal	No direct exemption to market

Areas of Discretion (3) – Unit Linked Assets

- Article 133(3) of Directive permits Member States to apply restrictions on the assets to which unit linked benefits can be linked
  - → **provided no more onerous than rules in UCITS Directive**
- Some Member States choosing to maintain their permitted links rules – with some modifications

Areas of Discretion (4) –Others

- Disclosure of Capital add-on
- National Specific Templates
- Reporting exemptions line-by-line basis

Gold Plating (1) – Grandfathering of Capital

- Transitional arrangements exist for classification as Tier 1 capital
- Some firms actively engaged in issuing such cheaper capital forms in order to benefit from the grandfathering arrangements
- PRA has stated “it will object to insurers issuing regulatory capital instruments that are deliberately structured to meet the letter but not the spirit of these criteria”.

Gold Plating (2) – Investment Restrictions

- Solvency II does not place any direct restrictions on investments – “Prudent Person Principle” applies
- Germany currently (under Solvency I) has asset restrictions limiting investments in certain asset classes as do other countries
- German insurers claim that a paper exists from BAFIN (German Regulator) proposing that such asset restrictions will be maintained under Solvency II

  (Source: Article Callum Tanner, Insurance Risk 12th October 2015)

Gold Plating (3) – Head of Actuarial Function

- Although not explicitly required in Directive a number of Member States require a single individual with overall responsibility for Actuarial Function
  - → **e.g. Chief Actuary (UK), Head of Actuarial Function (Ireland), Responsible Actuary (Germany)**
- However, duties of individual varies
  - → **E.g. CBI in Ireland requires an Actuarial Opinion on Technical Provisions to be submitted to the CBI (as opposed to Board) and also requires an opinion on ORSA to be submitted to Board**

Issues of Interpretation

- Areas of discretion and gold-plating are more simple to identify but the real impact is likely to be in how the same rules are actually interpreted
- For example, issues where application of Solvency II rules are uncertain
  - → **Contract Boundaries**
  - → **Derivation of expenses in a company closed to new business**
  - → **Treatment of deferred tax asset**
  - → **Allowance for management actions**
- Also, what standards will the regulator apply in assessing:
  - → **Approvals**
  - → **Internal Models**
  - → **ORSA**

Group Perspective: Maximum Harmonisation

Solvency II's group supervision regime is transformational for the insurance industry

- Gabriel Bernardino, Chairman of EIOPA, said: "*Supervisory convergence is an essential element in the implementation of Solvency II and is a high priority on EIOPA's agenda. With this Opinion, EIOPA intends to achieve a level playing field for the EU insurance groups by securing consistent practices by National Competent Authorities (NCAs)*".

Group Perspective: Maximum Harmonisation

But….

Is proving challenging for Groups spread across different regulatory regimes especially where there are divergences in those regimes

Although…

The Colleges of Supervisors have been set up to support in this respect with "the collective purpose of enhancing efficient, effective and consistent supervision of financial institutions operating across borders."

But…

There are still some potential practical concerns

Group Perspective: Areas Analysed

INTERNAL MODELS + MODEL CHANGE POLICY	ORSA	SOLVENCY RATIOS
Considering both how to manage consistency in internal models and also model change policy	Balance between Group and Local ORSA requirements	How Groups are approaching the Solvency Ratio

Group Perspective: Internal Models

- For Groups the challenge is to manage the expectations and specific requirements in the different Member States where they operate.
- In theory the issue should be addressed by the College of Supervisors
- However some regulators have taken a more strict view in some aspects of the Internal Model compared with other National Supervisors

Group Perspective: Internal Models

- One area where internal model is a source of divide is the treatment of sovereign risk
- There is a divide in terms of the regulators views with some regulators already asking companies with internal models to hold capital against sovereign risk
  - → **In statement in April 2015 EIOPA stated that sovereign risk should be considered but were not explicit on need to hold capital in this regards**
- Many Groups have chosen to hold capital against sovereign risk until the rules become clearer
- In October 2015 Bernardino (chairman of EIOPA) stated that he expected EIOPA to issue a supervisory statement in coming weeks to address such inconsistencies in internal models

Group Perspective: Model Change Policy

- Model Changes can be requested at both a Group Level and a solo level
- Validation will be required in both scenarios
- Role of Regulator
- Timing could be an issue

Group Perspective: ORSA

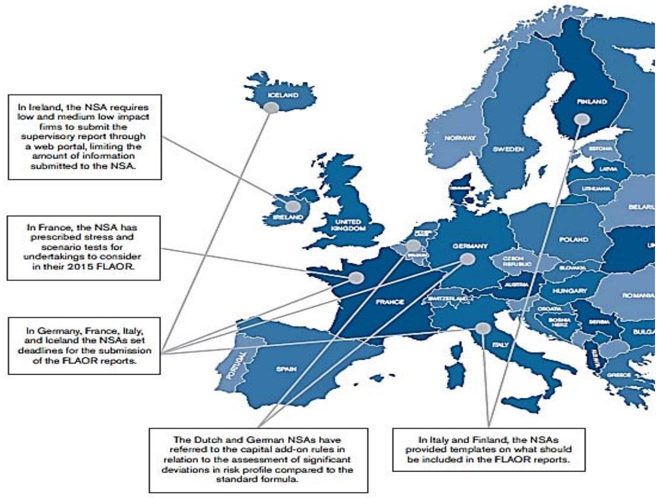
What does the Directive say?

- The Solvency II Directive requires every (re)insurance company to conduct its own risk and solvency assessment. In addition to this, insurance groups are also required to carry out an ORSA at group level which is subject to supervisory review by the group supervisor.
- However the Directive gives groups the option (subject to agreement of the group supervisor who will take into account the views of the members of the college of supervisors) to carry out the ORSA at the level of the group and at the level of the subsidiary at the same time and produce a single document covering all assessments (a group-wide ORSA).

Group Perspective: ORSA

- The Directive states that ORSA must be carried out at a Group and entity level
- Hence the entity should be able to trigger the ORSA on an adhoc basis
- However in reality ORSA scenarios have been set at a Group level resulting in the need to agree any changes in scenarios with Group

ORSA – Differences observed in FLAOR Assessments



Source – Milliman Report August 2015 – "Stepping Stones to ORSA"

Group Perspective: Required Solvency Ratios

- Gabriel Bernardino, chairman of EIOPA, says markets must adapt to naturally volatile solvency ratios and statements to the effect that "a company that had a solvency ratio of 100% would be insolvent" are
  - → **"definitely not true and [shows] a lack of understanding of how the regime works."**
- Karel van Hulle, chair of Insurance and Reinsurance Stakeholder group went further:
  - → **"Unfortunately some supervisors expect companies not to conform with the SCR but with a number 100% higher than the SCR, which is ridiculous."**
- However some Groups are applying a prudent approach and applying a buffer to the 100% Solvency Ratio in all solo entities which may/may not be appropriate depending on the individual circumstances.

How differences can/will be addressed

- Differences not necessarily a bad thing
  - **Different territories and products =>Different risk exposures**
  - **E.g. important to monitor specific risks**
- Requirement to disclose impact of transitionals and long term guarantee measures
  - **Analysts have stated that they will be "looking-through" to results without such measures**
- College of Supervisors
  - **Material differences between supervisors should be raised at the College of Supervisors and fed back to EIOPA**
  - **Discussions here likely to have implications for solo entities also**
- Increased guidance from EIOPA and local supervisors
  - **E.g. Supervisory statement from EIOPA on internal model differences**
- Increased guidance from professional bodies e.g. Actuarial Association of Europe