Solvency II

The non-financial challenges for insurers

Presentation to AILO

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Solvency II – the three Pillars

~~PILLAR I~~	PILLAR II	PILLAR III
~~Measurement of Assets, Liabilities and Capital~~	Supervisory Review Process	Market Discipline
~~Eligible capital~~ ~~Technical provisions~~ ~~Capital requirements~~ ~~Asset & liability valuation~~	Corporate governance Internal control Risk management ORSA	Public disclosure Supervisory reporting

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Pillar II

Measurement of Assets, Liabilities and Capital

- Eligible capital
- Technical provisions
- Capital requirements
- Asset & liability valuation

PILLAR I

Supervisory Review Process

- Corporate governance
- Internal control
- Risk management
- ORSA

PILLAR II

Market Discipline

- Public disclosure
- Supervisory reporting

PILLAR III

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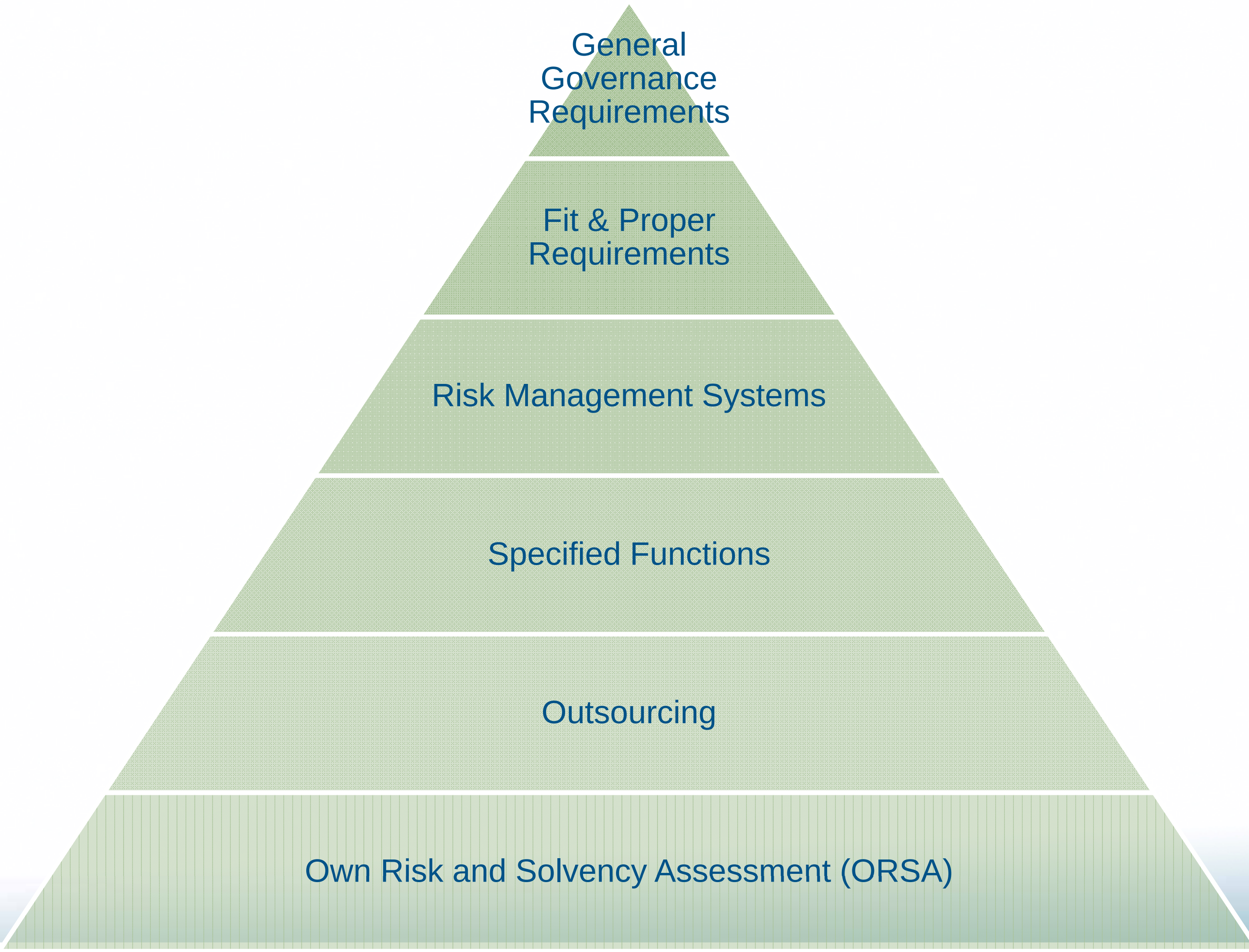
Pillar II

- Requirement for effective <u>System of Governance</u>
  - Proportionate to nature, scale and complexity of company

- Pillar II also covers the Supervisory Review Process (SRP)

Solvency II Governance Framework



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General Governance (1/2)

- Directive says:
  - *“administrative or management body” (the Board) is ultimately responsible*
  - *Written policies will be required “in relation to, at least, risk management, internal control, internal audit and, where relevant, outsourcing”.*

- CEIOPS Advice:
  - The organisational structure, reporting lines, skills, decision making process and record keeping should be appropriate.
  - At least two people should run the company
  - Potential conflicts of interest should be identified and managed.
  - The required written policies should clearly set out relevant responsibilities, goals, processes and reporting procedures.
  - Contingency and business continuity plans should be in place.

General Governance (2/2)

- Additional explanatory text comments of interest

Remuneration policies should be in line with business strategy, risk profile and objectives and should avoid potential incentives for unauthorised or unwanted risk taking.

There should be an assessment of the effectiveness of the system of governance and reports drawn up at least annually, consistent with the principle of proportionality, to the Board. This report should include conclusions drawn from the ORSA process.

Subject to national laws, companies should consider whether there should be sub-committees of the Board including audit, risk, investment or remuneration committees.

Internal audit can't be combined with other functions and must be objective and independent from other functions.

Fit & Proper Requirements

- Directive says:
  - *Insurance and reinsurance undertaking shall ensure that all persons who effectively run the undertaking or have other key functions at all times fulfil the following requirements:*
    - *(a) …[fit]*
    - *(b) … [proper]*

- CEIOPS Advice:
  - Should apply to all persons who effectively run the company including senior management and Board members.
  - Board members should collectively be able to run the company soundly and prudently.

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Risk Management System (1/3)

- Risk Management System, as distinct from Risk Management Function
- Directive says:
  - *Board is responsible for ensuring that the implemented risk management system is **suitable**, **effective** and **proportionate** to the nature, scale and complexity of the risks inherent in the business.*
- CEIOPS Advice specifies minimum requirements for an effective risk management system including:
  - A clearly defined risk management strategy (which should be approved by the Board)
  - Adequate written policies (by senior management) to support the implementation of the risk management strategy
  - Appropriate processes & procedures for identifying and reporting on risks.
  - Appropriate reporting & feedback loops
  - Reports to the Board
  - A suitable Own Risk & Solvency Assessment (ORSA) process.

Risk Management System (2/3)

- Directive says that written policies are required in respect of <u>at least</u>:
  - *Underwriting and reserving;*
  - *Asset–liability management;*
  - *Investment, in particular derivatives and similar commitments;*
  - *Liquidity and concentration risk management;*
  - *Operational risk management;*
  - *Reinsurance and other risk mitigation techniques.*

- CEIOPS Advice
  - CEIOPS-DOC-29/09 sets out CEIOPS views on what should be covered in the written policies for the asset liability management and investment policies.
  - CEIOPS plans to expand on written policies for the other risks at a later date (through “Level 3” guidance.)

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Risk Management System (3/3)

- Other points of interest from explanatory text

Although “prudent person” principle applies, quantitative limits and asset eligibility criteria may be developed under level 2 in the future by the Commission.

Companies should understand and be able to value their own investments according to Solvency 2 valuation principles e.g. will be necessary to independently verify tracker bond prices supplied by the asset issuer.

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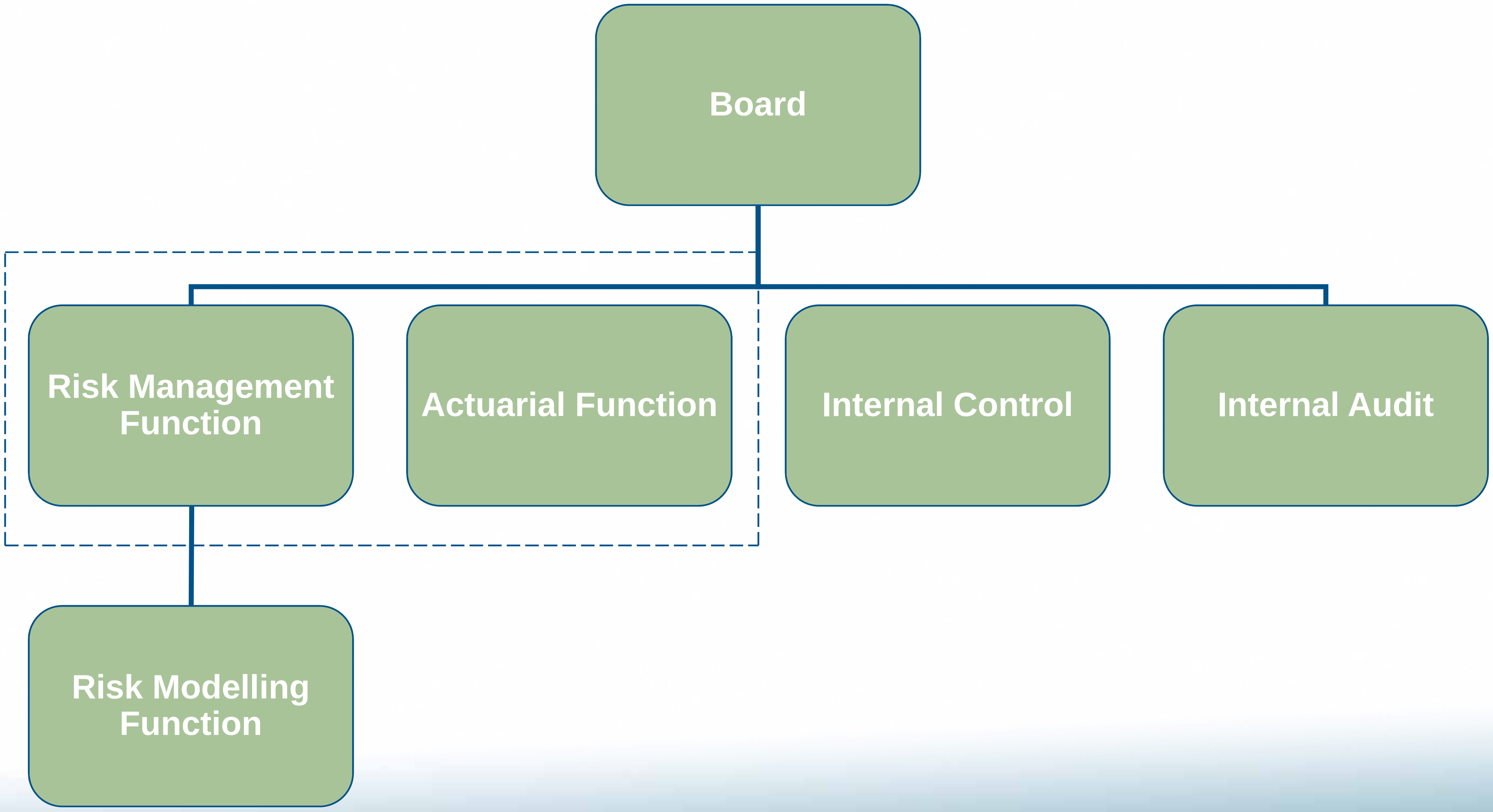
Specified Functions



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Risk Management Function

- CEIOPS Advice
  - Should be organised so that it can be objective and not be responsible for the results of the operational business.
  - Should assist the Board and management in the effective operation of the risk management system.
  - Responsible for integration of the internal model with the risk management system and the day to day functions of the company.

- CEIOPS additional comments
  - CEIOPS believes that at least one member of the Board should be designated to oversee the risk management function
  - Also acknowledges that in larger companies and companies with more complex risk profiles, the person responsible for the Risk Management Function is sometimes designated as a Chief Risk Officer (CRO).

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Internal Control Function

- Effectively a control and compliance function.
- Will be necessary to document a compliance plan setting out all the intended compliance activities.
- The function will have to report any major compliance issues promptly to the Board.

Internal Audit Function

- Should have an appropriate standing in the company to ensure its independence
  - Be free to audit any area of the company, with unrestricted access to information and people, and be free to express its opinions.
- An audit plan should be documented taking a risk based approach to deciding priorities.
- A written report should be presented to the Board at least annually.

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Outsourcing (1/2)

- Directive says:
  - *Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.*

- CEIOPS Advice
  - Written policy should consider impact on the business and the reporting and monitoring arrangements that should be put in place.
  - For outsourcing within a group, reasonable to take into account extent to which company controls or can influence service provider.
  - CEIOPS specifies minimum criteria
    - For choosing a service provider for any critical or important functions.
    - For inclusion in written agreement with the service provider.
  - Outsourcing of any critical or important functions or activities should not lead to a material impairment of the quality of the company's governance system .

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Outsourcing (2/2)

- Other points of interest from explanatory text

Possible to outsource to non-EU service providers

Different supervisory notification arrangements are not necessary.

In principle all functions and activities can be outsourced provided the Board remains ultimately responsible for discharging its obligations.

CEIOPS will expand further on what might or might not constitute outsourcing in Level 3 guidance.

Companies required to notify the supervisor prior to outsourcing of critical or important functions or activities

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ORSA – Own Risk & Solvency Assessment

- ORSA is the **“entirety of processes and procedures”** used to
  - Identify, assess, monitor, manage and report the short and long-term risks the company faces
  - Determine level of capital necessary to ensure that the company’s overall solvency needs are met at all times
- Should encompass all material risks
  - Take account of external factors
- Should be forward looking, taking account of business plans
  - Projections of capital requirements versus available capital resources
- Integral part of business strategy
  - Must inform regulator of results
  - Key part of Supervisory Review Process

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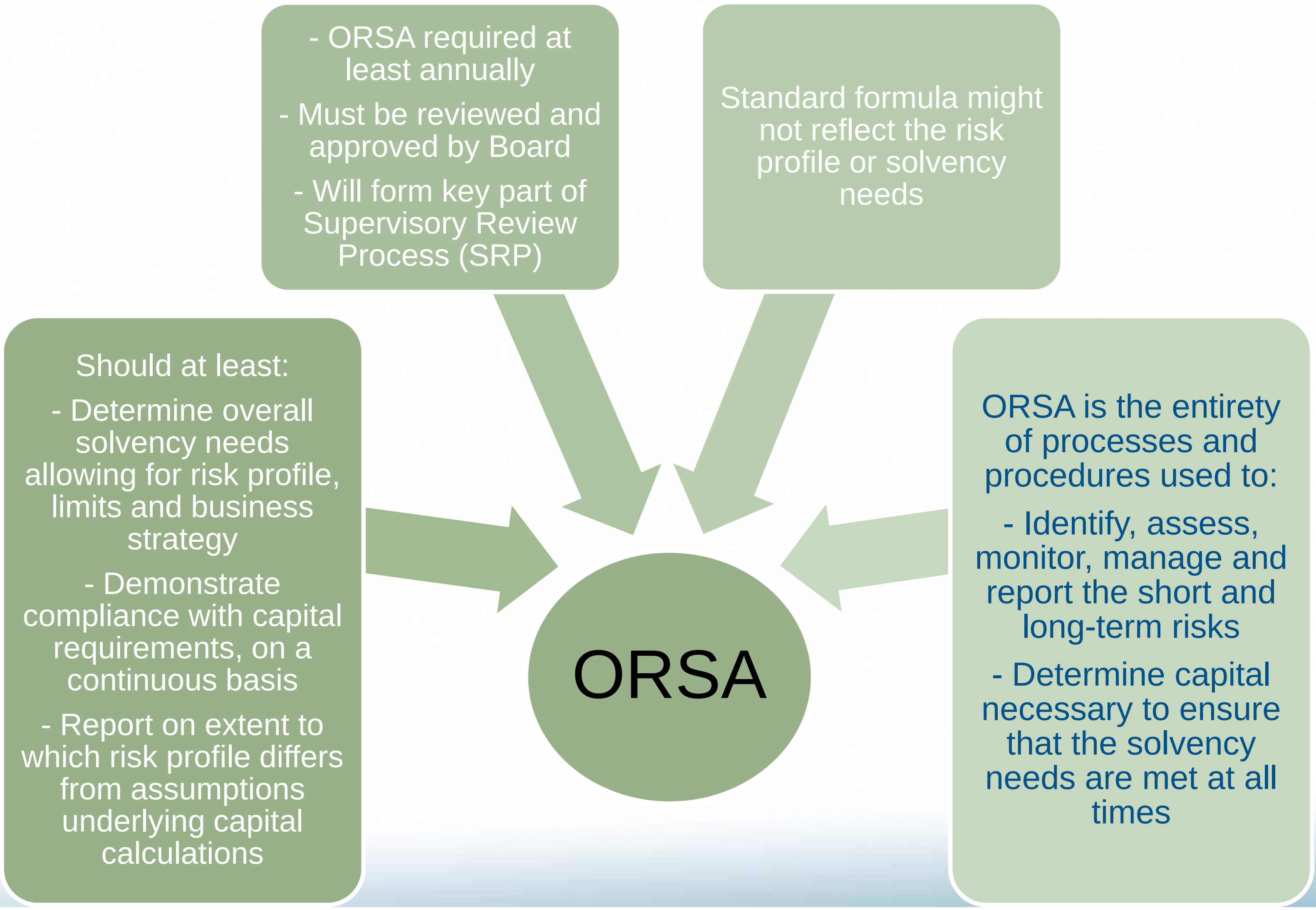
ORSA

- Proportionality
  - Less complex risk profiles may use less sophisticated tools
  - ORSA “should not be too burdensome”
- Demonstrate processes to identify and assess risks
  - Appropriately documented
- Regular assessment of process by independent persons
  - Internal or external auditor
  - Conclusions reported to Board
- Internal capital may be different to SCR
  - Different confidence level e.g. for credit rating
  - Risk profile different to assumptions underlying SCR
  - If so, need to explain reasons why
  - Higher capital might not mean capital add-on
  - Lower capital will not result in capital release

ORSA



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Supervisory Review Process (SRP)

- Supervisor will review and evaluate
  - System of governance (ORSA key part of review)
  - Technical provisions & Capital requirements
  - Investment rules
  - Quality and quantity of own funds
- Establish minimum frequency and scope of reviews
- May in exceptional circumstances set a capital add-on
- Possibility of Group Supervision
- Frequency and depth of interaction with supervisor likely to be significantly greater under Solvency II

Pillar III

Measurement of Assets, Liabilities and Capital	Supervisory Review Process	Market Discipline
Eligible capital Technical provisions Capital requirements Asset & liability valuation	Corporate governance Internal control Risk management ORSA	Public disclosure Supervisory reporting
PILLAR I	PILLAR II	PILLAR III

Pillar III requirements

- Annual “Solvency and Financial Condition Report” (SFCR)
  - Public document
- “Report to Supervisors” (RTS)
  - Contains additional confidential and proprietary information
  - Frequency of full qualitative RTS linked to intensity of SRP
- Both contain qualitative report and quantitative reporting templates
- More details on next slide ...

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Pillar III requirements

	SFCR	RTS	Quantitative Templates (included with SFCR and RTS)
Frequency	Annual	Annual for companies subject to detailed assessment under the SRP. Less frequently for others (min. once every 5 years)	Quarterly and Annual
Public?	Yes	No	Some yes; some no.
Deadlines	First report (early 2014) within 20 weeks of year-end; subsequent reports within 14 weeks of year-end	First report (early 2014) within 20 weeks of year-end; subsequent reports within 14 weeks of year-end	Annual: first submission (early 2014) within 20 weeks of year-end; subsequent reductions to 14 weeks. Quarterly: first submission (early 2013) within 6 weeks of quarter-end; subsequent reductions to 4 weeks
Standard Format?	Yes (developed by CEIOPS)	Yes (developed by CEIOPS)	Yes (developed by CEIOPS)
Board sign-off needed?	Yes	Yes	Yes

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SFCR – contents include ...

- SFCR contains some things you would expect ...
  - Basic company information
  - Summary of & commentary on recent performance
  - Information on company's system of governance
    - Structure
    - Functions
  - Information on company's risk profile
  - Information on company's risk management system
  - Summary of Solvency II balance sheet
    - Reconciling Solvency II numbers with IFRS numbers
  - Summary of Solvency II capital position
    - Showing available capital resources ("free assets")
    - Showing capital requirements

- And some you might not ...
  - Information on remuneration policies and practices (incl. criteria for bonuses etc.)

- Remember, this is a public document
  - First time that solvency position will be publicly disclosed?

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Recap & summary

- Pillars II and III just as important as Pillar I
  - Financial Regulator strongly of this view
  - Lessons from implementation of Basel II for banks

- Pillar II
  - Governance
    - Framework
    - Fit & Proper
    - Risk management system
    - Specified functions
    - Outsourcing
  - ORSA
  - Supervisory Review Process

- Pillar III
  - Public reporting
  - Reporting to supervisor

What does it mean for me?

- Need to ensure that your Solvency II project plan properly covers Pillars II and III
  - Don't just focus on the Pillar I stuff
- Conduct a "gap analysis" on Pillar II and Pillar III topics
  - Identify what needs to be done over next couple of years …
  - … to ensure appropriate governance and risk management framework in place by end-2012
- Ensure that Board of Directors are properly up-to-speed on what this will mean for them
  - Financial Regulator planning to hold session for non-execs?
  - Financial Regulator planning to require Solvency II to be a standing board agenda item?
- Don't delay!
  - End-2012 is not tomorrow, but it is the day after tomorrow
  - Most companies wishing they had more time before D-Day!