

SOLVENCY REQUIREMENTS FOR EU INSURERS

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Solvency II is Good for You

Karel VAN HULLE



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*“Not everything that can be counted,
counts, and not everything that
counts can be counted”*

Albert Einstein

FOREWORD

On 1 December 2004, I met Karel Van Hulle for the very first time at a meeting of the so-called Insurance Committee in Brussels. Shortly before – in November 2004 – Karel became the Head of the Insurance and Pensions Unit of the European Commission’s Directorate General for Internal Market and Services.

It was also the penultimate meeting of the Insurance Committee before the European Insurance and Occupational Pensions Committee (EIOPC) – the Level 2 committee of the Lamfalussy process – replaced it on 13 April 2005. I was representing Portugal.

The meeting agenda was rich and full: introducing the draft Work Program for 2005, Karel (the Chairman of the Committee) stressed that Solvency II would be the Committee’s main work focus in 2005. The need for an impact assessment meant that formally, it would not be possible to table a proposal of Solvency II in 2005, but a draft proposal would be prepared by the end of the year.

Furthermore, Karel announced that 2006 was the target date for any proposal on insurance guarantee schemes. All delegations who took to the floor stressed the importance, scale and ambition of the Solvency II project, the complexity even exceeding that of Basel II, the project of the banking sector.

In fact, what I remember most of Karel from that meeting was the impression he made on the insurance experts from the very first day, by mentioning that in his first contact with insurance, one thing is taken for granted: insurance is by far more complex than banking.

From that day in December 2004, until February 2013 when Karel left the European Commission, I had the privilege of working very closely with him in various capacities.

On 10 July 2007, the European Commission presented its proposal for the Solvency II Directive. At that time, Portugal held the European Union Presidency and the Portuguese government asked me to chair the Council working group in charge of the Member State negotiations.

The headline of the European Commission’s press release read: “Solvency II: European Union to take global lead in insurance regulation”. The European Commission proposed a ground-breaking revision of European Union insurance law to improve consumer protection, modernise supervision, deepen market integration and increase the international competitiveness of European insurers. Under the new system, insurers would be required to take account

of all types of risk to which they are exposed and to manage those risks more effectively. In addition, insurance groups would have a dedicated “group supervisor” that would enable better monitoring of the group as a whole. The European Commission aimed to have the new system in operation by 2012, which was good news for consumers, for the insurance industry and for the economy of the European Union as a whole.

During the second half of 2007, Karel and I worked very closely to ensure that good progress was made during the Solvency II discussions. After intensive negotiations between the European Commission, the European Parliament and the European Council, the three European legislative institutions agreed on a compromise text for the Solvency II Framework Directive. On 22 April 2009, the European Parliament’s plenary session adopted the Directive, which finally became Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

Over the years, I learned to trust and respect Karel. Karel represented the European Commission in the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and in the International Association of Insurance Supervisors (IAIS). Most of the time, we agreed and were of the same opinion. And, when we disagreed, I always appreciated Karel’s pragmatic way of finding a good compromise and moving forward.

This book tells the story of Solvency II through the lens of one of its major architects. Karel always understood that a major reform like Solvency II had to be built on extensive consultation and debate, and ultimately benefits from the contributions of many dedicated people from both the public and the private sectors. This is what makes Solvency II a unique piece of legislation in the financial sector.

History will look positively on Karel’s commitment and passionate work in the area of insurance regulation. He was instrumental in driving Solvency II through difficult waters in times of crisis. He did so because he essentially believed in sound principle- and risk-based regulation. I am sure that at the end of the book, which makes for pleasant reading, the reader will agree: “Solvency II is good for you!”

Gabriel Bernardino
Chairman, European Insurance and
Occupational Pensions Authority (EIOPA)

PREFACE

One might be alarmed, looking at the length of this book: so many pages to convey the message that “Solvency II is good for you”. Can this be right? I think it is. It is precisely because I believe that “Solvency II is good for you” that I decided to write this book. I had not expected it to be so long, but the length of the book is the result of complexity added to the initial principles-based text, because of both the financial crisis and the reluctance in the insurance world and in the supervisory community to leave too many questions unanswered.

I was privileged to have been made responsible for the development of a new, risk-based solvency capital regime for (re)insurance undertakings in the EU. However, at the start, it seemed an almost impossible task. Carrying out such a profound change in a naturally conservative sector sounded like a daring proposition. However, I was wrong. The enthusiasm with which the insurance industry, the supervisory community, finance ministries and stakeholders in general approached this project was impressive. The support for this project was such that it led me to conclude my presentation on the objectives of Solvency II at a conference organised by Confrontations Europe in the European Economic and Social Committee in Brussels on 8 March 2007 with the words: “Solvency II is good for you”.

Solvency II is good because it moves risk management to the forefront. It fosters a holistic and forward-looking appreciation of risk and enhances market forces by increasing transparency and disclosure. Solvency II has created a more transparent, more professional and thus more secure insurance market. That became clear when the financial crisis also hit the insurance industry. The importance attached to risk management and the careful preparation of the project, with consultations, quantitative impact studies, workshops and seminars, created an environment that helped the insurance industry to survive one of the worst possible scenarios that could have been imagined: a prolonged low interest rate environment, which hits both sides of the balance sheet and makes it difficult to continue to offer long-term guarantees. As can be seen from the last stress test carried out by EIOPA, the insurance industry is not only well capitalised, but it is also capable of withstanding very severe natural catastrophe scenarios.

Solvency II is not only good, it is also good *for you*: as a *policyholder or beneficiary*, because it increases the level of security, making it less likely that an insurer will fail; as a *(re)insurer*, because it rewards professionalism, making the industry more attractive to young professionals; as a *supervisor*, because it delivers the right supervisory tools, making it easier to carry out forward-looking

supervision; as an *actuary*, because it puts the actuarial function on the map, making full use of the actuarial profession's expertise; as a *risk manager*, because it adopts the newest techniques in risk management, giving proper recognition to the importance of risk management; as an *insurance intermediary*, because it brings transparency and a customer focus, making it easier to advise clients on the best insurance solution; as an *academic*, because it provides detailed data on the insurance industry, allowing for evidence-based research; and as a *consumer*, because it delivers better-designed products, making life easier by better responding to customer demands.

Solvency II is good for society as a whole because it strengthens an industry the importance of which is probably the best-kept secret in the world. However, without an insurance industry that is strong and well managed, our society will not be able to meet the challenges that face us, such as climate change, increased longevity, health care, pension financing, and so on.

Of course, Solvency II is not perfect. It was never meant to be. And Rome was not built in a day. A review is planned for 2020/2021. This review should be carried out very carefully. It should provide better treatment for long-term business, with appropriate recognition of the insurance business model. Learning from our experience and from that in other parts of the world, we should improve the system where we can, but do so with full respect for the principles of a risk-based solvency regime, which creates a link between risk and capital and which aims at protecting policyholders and beneficiaries.

In the first part of this book, I explain the origins of Solvency II. The project was inspired by developments both within Europe, particularly in Germany, the Netherlands, Switzerland and the UK, but also outside Europe, in countries such as Australia, Canada and the USA, and in international bodies, such as the Basel Committee, the IASB and the IAIS. Valuable input was obtained from the actuarial profession and from the risk management community.

Like all EU legislation, Solvency II is not the work of anonymous "Brussels". The Solvency II framework was extensively consulted on and debated. It took more time than expected, in part because of the financial crisis. Many people contributed to the project: a small team of civil servants and national experts at the EC, in close cooperation with supervisors organised within CEIOPS/EIOPA and with experts from the (re)insurance industry. They were helped by actuaries, chief risk officers, policy advisers, experts in finance ministries, consumers and civil society in general. The ultimate decisions were taken by the EC and by the co-legislators: the EP and the Council. Although the negotiations were sometimes difficult and challenging, one should not forget that Solvency II is a European project and that – by producing Solvency II – we Europeans showed that we are capable of carrying out a major reform that is in the interest of the EU, its undertakings and its citizens, and that has, right from its inception, influenced similar reforms in many other parts of the world, as well as within the IAIS.

The second part of this book contains a detailed description of the Solvency II regulatory framework. It shows that solvency is not just about capital. It is about people, about risk management and about a dialogue between supervisors and supervised entities in an atmosphere of trust. This second part has been written without too much technical detail. I have tried to give a holistic picture of Solvency II, how it fits into the European single market, what its main characteristics are and how it relates to other parts of EU legislation that are relevant for the (re)insurance industry. I have also provided some examples and identified good practices. As insurance is technically complex, solvency regulation is not easy to understand. Nevertheless, I have written this book so that non-experts can also understand what this is all about. That may be a disappointment for experts, who might have wanted more technical detail. I have however learned from experience that even experts sometimes lose their way. This book might help them to get back on the right track.

I have not covered a number of topics that certainly merit more attention, such as a comparison between the US Risk-Based Capital model and Solvency II, and between Solvency II and the International Capital Standard that is being developed by the IAIS and that will hopefully see the light of day as planned by the end of 2019. A discussion of these topics would have made the book even longer.

I could not have written this book without the help of many people. As a non-expert in insurance, most of what I know I have learned from others: my colleagues at the EC, especially the national experts seconded to the EC, my colleagues at KU Leuven and at Goethe University in Frankfurt, and my many friends in the supervisory community, in EIOPA, in the actuarial profession, in the communities of risk managers and insurance intermediaries, and in the (re)insurance industry. I would like to thank so many people by name, but I am afraid that if I do so, I might miss out people who deserve to be mentioned.

However, I would like to make a few exceptions. I want to thank in particular Lieve Lowet (Schuman European Affairs), who has not only been a source of inspiration but also agreed to read and reread many of my drafts and whose comments have been very valuable. I would also like to thank Ben Carr (Aviva), former national expert in my Solvency Technical Team at the EC, who reviewed the Pillar 1 chapter of this book, and Ivo van Es (member of the ECON Secretariat), former member of the Solvency Technical Team at the EC, who provided insights from a EP perspective.

Finally, I want to thank my wife, Greta, for her patience and understanding. It has at times been difficult, but she knew that this book was important to me and she gave me the time and the support to finish it.

Karel Van Hulle
30 April 2019

CONTENTS

<i>Foreword</i>	vii
<i>Preface</i>	ix
<i>List of Abbreviations</i>	xxvii

PART I. EU INSURANCE REGULATION AND THE BIRTH OF SOLVENCY II

Chapter 1. Introduction	3
1. What is Insurance?	3
2. The Insurance Business Model	5
3. Why Do Insurers Need to be Regulated?	9
3.1. Objectives of Insurance Regulation and Supervision	9
3.2. Insurance Regulation in the EU	12
3.2.1. Principle of Authorisation	12
3.2.2. Supervisory Authority	17
3.2.3. Freedom of Establishment and Freedom to Provide Services	18
3.2.4. European Passport	22
3.2.5. Brexit	23
3.2.6. Liberalisation and Coordination	29
Chapter 2. Insurance Solvency	33
1. Solvency I	33
2. Deficiencies of Solvency I	34
3. Origins of Solvency II	38
3.1. Müller Report	40
3.2. KPMG Report	40
3.3. Sharma Report	41
4. The Three-Pillar Approach	41
5. A Project in Stages	43
Chapter 3. Development and Adoption of Solvency II	49
1. Development of Solvency II	49
1.1. Framework for Consultation	49
1.2. Specific Calls for Advice	56

1.3.	Quantitative Impact Studies	58
1.4.	Development of the Commission Proposal	65
2.	Negotiation in the Council and in the European Parliament	68
2.1.	Discussions in the Council	68
2.2.	Discussions in the European Parliament	71
2.3.	Trilogue Negotiations	72
2.4.	Political Agreement	74
2.5.	Review Clauses	75
3.	Reform of the European Supervisory Architecture	76
4.	Omnibus II	78
4.1.	Objectives	78
4.2.	Negotiation in the Council and in the European Parliament	80
4.2.1.	Discussions in the Council	80
4.2.2.	Discussions in the European Parliament	82
4.2.3.	“Quick-Fix Directive”	85
4.2.4.	Trilogue Negotiations	86
4.2.5.	Impact Assessment Carried Out by EIOPA	91
4.2.6.	Second “Quick-Fix” Directive	97
4.2.7.	Political Agreement	98
4.3.	Changes Brought about by Omnibus II	102
4.3.1.	Long-Term Guarantee Measures	102
4.3.2.	Transposition and Application Dates of Solvency II	106
4.3.3.	Phasing-In of Solvency II	107
4.3.4.	Proportionality	108
4.3.5.	Transparency	110
4.3.6.	Specific Tasks for EIOPA	113
4.3.6.1.	Power to Draft RTS and ITS	113
4.3.6.1.1.	Regulatory Technical Standards (RTS)	114
4.3.6.1.2.	Implementing Technical Standards (ITS)	116
4.3.6.2.	Guidelines	117
4.3.6.3.	Binding Mediation	118
4.3.6.4.	Further Strengthening of the Powers of EIOPA ..	119
4.3.6.5.	Technical Input to be Provided by EIOPA	120
4.3.6.5.1.	Application of the LTG Measures	120
4.3.6.5.2.	Recovery of the SCR in the Event of Exceptional Adverse Situations	121
4.3.6.5.3.	Equivalence Assessment of Third-Country Solvency Regimes	122
4.3.7.	Overreliance on External Credit Ratings	122
4.3.8.	Transmission of Information to Central Banks, Monetary Authorities, Payment Systems Overseers and the ESRB	123

4.3.9.	Review of the Standard Formula for the SCR	124
4.3.10.	Increase of the Absolute Floor for the Calculation of the MCR	126
4.3.11.	Equivalence	126
4.3.12.	Lisbonisation	130
4.3.12.1.	Procedure for the Adoption of Delegated Acts . . .	132
4.3.12.2.	Sunrise Clause	133
4.3.13.	Date Changes	133
4.3.14.	Transitional Measures	134
4.3.14.1.	Insurers in Run-Off (Art. 308b (1)–(4) FD)	135
4.3.14.2.	Deadline for Submitting Information (Art. 308b (5)–(8) FD)	136
4.3.14.3.	Grandfathering for Tier 1 and Tier 2 Capital (Art. 308b (9) and (10) FD)	136
4.3.14.4.	Investments in Securitisations (Art. 308b (11) FD)	137
4.3.14.5.	Exposure to Member States’ Central Governments or Central Banks Denominated and Funded in the Domestic Currency of Another MS (Art. 308b (12) FD)	137
4.3.14.6.	Calculation of the Equity Risk Sub-Module (Art. 308b (13) and (17) FD)	137
4.3.14.7.	Relief for SCR Non-Compliance for an Initial Period of Two Years (Art. 308b (14) FD)	137
4.3.14.8.	Occupational Pension Business (Art. 308b (15) FD)	138
4.3.14.9.	Application for the Approval of an Internal Group Model (Art. 308b (16) FD)	139
4.3.14.10.	Transitional Measure on the Risk-Free Interest Rate (Art. 308c FD)	139
4.3.14.11.	Transitional Measure on Technical Provisions (Art. 308d FD)	140
4.3.15.	Review Clause on LTG Measures and Measures on Equity Risk	140
4.3.16.	Powers of Investigation of the European Parliament	141
5.	Commission Delegated Regulation of 10 October 2014	141
5.1.	A Long Gestation	141
5.2.	Proportionality	143
5.3.	Long-Term Investments and Securitisations	143
5.4.	Eligibility of Own Funds and Limits Applied to Tiers 1, 2 and 3 . . .	145
5.5.	Remuneration Policy	147
5.6.	Amendments to the Delegated Regulation	148
5.6.1.	Capital Requirements for Several Categories of Assets	148

5.6.2. Qualifying Infrastructure Corporate Investments	149
5.6.3. Securitisations and Simple, Transparent and Standardised Securitisations	149
5.6.4. Review of the Standard Formula.	149

PART II. SOLVENCY II: REGULATORY FRAMEWORK

Chapter 4. Scope of Application 159

1. General Principle	159
2. Exclusion of Very Small Insurance Undertakings	160
3. Mutual Insurance Undertakings.	162
4. Reinsurance Undertakings	163
5. Captive (Re)insurance Undertakings.	163
6. (Re)insurance Undertakings in Run-Off.	164
7. Occupational Pension Funds.	165
8. Financial Conglomerates.	168

Chapter 5. Proportionality 171

1. Elements of the Principle of Proportionality	171
1.1. Nature of the Business	173
1.2. Complexity	174
1.3. Scale	175
2. Examples	175
2.1. Examples of Proportionality in Pillar 1.	178
2.2. Examples of Proportionality in Pillar 2.	181
2.3. Examples of Proportionality in Pillar 3.	183
3. Proportionality: An Unfinished Debate.	184

Chapter 6. Pillar 1: Quantitative Requirements. 187

1. Solvency Balance Sheet	188
2. Valuation Rules	194
2.1. Valuation Principles.	194
2.2. Valuation of Assets and Liabilities Other than Technical Provisions	198
2.3. Valuation of Technical Provisions	202
2.3.1. Insurance Products with Long-Term Guarantees.	209
2.3.2. Extrapolation of the Relevant Risk-Free Interest Rate Term Structure.	212
2.3.3. Matching Adjustment to the Relevant Risk-Free Interest Rate Term Structure	214

2.3.4.	Volatility Adjustment to the Relevant Risk-Free Interest Rate Term Structure	216
2.3.5.	Proportionality and Simplifications	219
2.3.6.	Transitional Measures.	219
3.	Own Funds	222
3.1.	First Step: Identification of Available Own Funds	223
3.1.1.	Basic Own Funds	224
3.1.2.	Ancillary Own Funds	224
3.1.3.	Surplus Funds	226
3.1.4.	Participations.	227
3.2.	Second Step: Classification of Own Funds into Tiers	228
3.2.1.	Ring-Fenced Funds.	233
3.2.2.	Transitional Measures.	233
3.3.	Third Step: Quantitative Limits	234
4.	Capital Requirements.	235
4.1.	Two Capital Requirements: SCR and MCR	240
4.2.	Solvency Capital Requirement	243
4.2.1.	General Principles.	243
4.2.1.1.	Frequency of Calculation	246
4.2.1.2.	Supervisory Reporting and Public Disclosure.	246
4.2.1.3.	Non-Compliance with the SCR	247
4.2.2.	Standard Formula	252
4.2.2.1.	General Principles and Structure.	252
4.2.2.1.1.	General Principles	252
a.	Undertaking-Specific Parameters.	257
b.	Look-Through Approach	258
c.	Risk Mitigation	259
d.	Risk Diversification	269
4.2.2.1.2.	Structure of the SCR	273
4.2.2.2.	Basic SCR	274
4.2.2.2.1.	Non-Life Underwriting Risk Module	275
a.	Non-Life Premium and Reserve Risk Sub-Module (Arts. 115–117 and Annexes II–IV DA)	276
b.	Non-Life Catastrophe Risk Sub-Module (Arts. 119–135 and Annexes V–XII DA)	277
c.	Non-Life Lapse Risk Sub-Module (Art. 118 DA)	280

4.2.2.2.2.	Life Underwriting Risk Module.	281
a.	Mortality Risk Sub-Module (Art. 137 DA)	282
b.	Longevity Risk Sub-Module (Art. 138 DA)	282
c.	Disability–Morbidity Risk Sub-Module (Art. 139 DA)	283
d.	Life-Expense Risk Sub-Module (Art. 140 DA)	284
e.	Revision Risk Sub-Module (Art. 141 DA)	284
f.	Lapse Risk Sub-Module (Art. 142 DA)	285
g.	Life Catastrophe Risk Sub-Module (Art. 143 DA)	286
4.2.2.2.3.	Health Underwriting Risk Module	286
a.	NSLT Health Underwriting Risk Sub-Module (Arts. 145–150 DA)	287
b.	Health Equalisation Systems (Art. 109a (4) and (5) FD and Art. 149 DA)	287
c.	SLT Health Underwriting Risk Sub-Module (Arts. 151–159 DA)	288
d.	Health Catastrophe Risk Sub-Module (Arts. 160–163 DA)	289
4.2.2.2.4.	Market Risk Module	291
a.	Interest Rate Sub-Module	291
b.	Equity Risk Sub-Module	292
c.	Property Risk Sub-Module	301
d.	Spread Risk Sub-Module	302
(i)	Securitisations	308
(ii)	Sovereign Bonds	313
e.	Currency Risk Sub-Module	316
f.	Market Risk Concentration Sub-Module	316
4.2.2.2.5.	Counterparty Default Risk Module	318
4.2.2.2.6.	Intangible Asset Risk Module	320
4.2.2.3.	Capital Requirement for Operational Risk.	321
4.2.2.4.	Adjustment for the Loss-Absorbing Capacity of Technical Provisions and Deferred Taxes	322
4.2.2.5.	Simplifications in the Standard Formula	324

4.2.3.	Internal Model	328
4.2.3.1.	Risk Management Approach	330
4.2.3.2.	Conditions to be Satisfied	334
4.2.3.2.1.	Use Test	334
4.2.3.2.2.	Statistical Quality Standards	336
4.2.3.2.3.	Calibration Standards	341
4.2.3.2.4.	Profit and Loss Attribution	343
4.2.3.2.5.	Validation Standards	343
4.2.3.2.6.	Documentation Standards	345
4.2.3.3.	Partial Internal Model	346
4.2.3.4.	Policy for Changing a Full or Partial Internal Model	347
4.2.3.5.	Approval of a Full or Partial Internal Model	348
4.2.3.6.	Reversion to the Standard Formula	351
4.2.3.7.	Non-Compliance with the Internal Model	352
4.2.3.8.	Public Disclosure and Supervisory Reporting	352
4.3.	Minimum Capital Requirement	353
4.3.1.	General Approach	353
4.3.2.	Calculation of the MCR	354
4.3.3.	Supervisory Reporting and Public Disclosure	356
4.3.4.	Non-Compliance with the MCR	356
5.	Investment Rules	360
5.1.	Background	360
5.2.	Prudent Person Principle	361
 Chapter 7. Pillar 2: Qualitative Requirements		369
1.	Supervisory Powers	369
1.1.	Objectives of Supervision	370
1.2.	General Principles of Supervision	372
1.2.1.	Risk-Based and Proportionate Supervision	372
1.2.2.	Forward-Looking, Preventive and Proactive Supervision	372
1.2.3.	Challenging, Sceptical and Engaged Supervision	373
1.2.4.	Comprehensive Supervision	373
1.2.5.	Conclusive Supervision	374
1.3.	Scope of Supervision	374
1.4.	Transparency and Accountability	375
1.5.	General Supervisory Powers	381
1.6.	Supervision of Outsourced Functions and Activities	383
1.7.	Professional Secrecy, Exchange of Information and Promotion of Supervisory Convergence	385

2.	Supervisory Review Process	387
2.1.	Definition	387
2.2.	Implementation	389
2.3.	Supervisory Ladder of Intervention	391
2.4.	Capital Add-On	394
2.4.1.	General Context	394
2.4.2.	Circumstances for Imposing a Capital Add-On	394
2.4.2.1.	Significant Deviation from the Assumptions Underlying the SCR (Standard Formula) (Art. 37 (1) (a) FD)	394
2.4.2.2.	Significant Deviation from the Assumptions Underlying the SCR (Internal Model) (Art. 37 (1) (b) FD)	395
2.4.2.3.	Significant Deviation from the Governance Standards (Art. 37 (1) (c) FD)	395
2.4.2.4.	Significant Deviation from the Assumptions Underlying the MA, VA or Transitional Measures (Art. 37 (1) (d) FD)	396
2.4.3.	Methods for Calculating a Capital Add-On	397
2.4.4.	Disclosure of a Capital Add-On	398
3.	Governance System	399
3.1.	General Principles	399
3.2.	The Four Key Governance Functions	407
3.3.	Fit and Proper Requirements	409
3.4.	Risk Management Function	413
3.4.1.	Risk Management System	416
3.4.1.1.	Underwriting and Reserving Risk Management	418
3.4.1.2.	Asset–Liability Risk Management	419
3.4.1.3.	Investment Risk Management	421
3.4.1.4.	Liquidity Risk Management	422
3.4.1.5.	Concentration Risk Management	423
3.4.1.6.	Operational Risk Management	423
3.4.1.7.	Reinsurance and Other Risk-Mitigation Techniques	427
3.4.1.8.	Loans and/or Mortgage (Re)insurance	428
3.4.1.9.	Qualifying Infrastructure Investments or Qualifying Infrastructure Corporate Investments	429
3.4.1.10.	Deferred Taxes	430
3.4.2.	Own Risk and Solvency Assessment	431
3.4.2.1.	Objectives and Characteristics	433

3.4.2.2.	Regulatory Requirements	434
3.4.2.2.1.	Assessment of the Overall Solvency Needs	434
3.4.2.2.2.	Continuous Compliance with Regulatory Capital Requirements and Technical Provisions	435
3.4.2.2.3.	Significant Deviations from the Assumptions Underlying the SCR Calculation	436
3.4.2.3.	Some Lessons Learned	437
3.4.2.4.	ORSA and Supervision	438
3.5.	Internal Control and Compliance Function.	438
3.6.	Internal Audit Function.	442
3.6.1.	Independence of the Internal Audit Function	442
3.6.2.	Tasks of the Internal Audit Function	444
3.7.	Actuarial Function	445
3.7.1.	Tasks of the Actuarial Function	447
3.7.1.1.	Coordination of the Calculation of Technical Provisions	447
3.7.1.2.	Ensuring Appropriateness of Methodologies	448
3.7.1.3.	Assessing Sufficiency and Quality of Data	448
3.7.1.4.	Comparing Best Estimates against Experience.	449
3.7.1.5.	Informing the AMSB.	449
3.7.1.6.	Overseeing the Calculation of Technical Provisions	449
3.7.1.7.	Expressing an Opinion on the Overall Underwriting Policy	449
3.7.1.8.	Expressing an Opinion on the Adequacy of Reinsurance Arrangements	450
3.7.1.9.	Contributing to the Effective Implementation of the Risk Management System	450
3.7.2.	Actuarial Function Report.	451
3.7.3.	Actuarial Standards.	452
3.8.	Remuneration	453
3.8.1.	Background	453
3.8.2.	Remuneration Policy	454
3.9.	Outsourcing	456
3.9.1.	Basic Principle.	457
3.9.2.	Written Outsourcing Policy.	458
3.9.3.	Outsourcing of Critical or Important Operational Functions and Activities.	459

3.10.	External Audit	464
3.10.1.	Principle	464
3.10.2.	Statutory Audit	466
3.10.3.	Audit Committee	469
3.10.4.	Relationship between the Statutory Auditor and the Supervisory Authority	471
Chapter 8. Pillar 3: Public Disclosure and Supervisory Reporting		477
1.	Public Disclosure	479
1.1.	Financial and Non-Financial Information	479
1.2.	Solvency and Financial Condition Report	482
1.2.1.	Publication of the SFCR	486
1.2.2.	Contents of the SFCR	488
1.2.2.1.	Summary Section	488
1.2.2.2.	Business and Performance	491
1.2.2.3.	System of Governance	493
1.2.2.4.	Risk Profile	496
1.2.2.5.	Valuation for Solvency Purposes	498
1.2.2.6.	Capital Management	501
1.2.3.	Non-Disclosure of Information	507
2.	Supervisory Reporting	508
2.1.	General Principles	508
2.2.	Elements of Regular Supervisory Reporting	509
2.2.1.	Solvency and Financial Condition Report	510
2.2.2.	ORSA Supervisory Report	510
2.2.3.	Regular Supervisory Report	511
2.2.3.1.	Business and Performance (Art. 307 DA)	511
2.2.3.2.	System of Governance (Art. 308 DA)	513
2.2.3.3.	Risk Profile (Art. 309 DA)	516
2.2.3.4.	Valuation for Solvency Purposes (Art. 310 DA)	519
2.2.3.5.	Capital Management (Art. 311 DA)	519
2.2.4.	Annual and Quarterly Quantitative Reporting Templates	522
2.3.	Deadlines and Means of Communication	523
2.3.1.	Regular Supervisory Report	523
2.3.2.	ORSA Supervisory Report	524
2.3.3.	Annual Quantitative Reporting Templates	524
2.3.4.	Quarterly Quantitative Reporting Templates	524
2.4.	Transitional Information Requirements	525
2.5.	Exemptions	525

2.6. Reporting for Financial Stability Purposes.....	528
2.7. Reporting to the ECB.....	530
Chapter 9. Group Supervision	533
1. Principles	537
2. Group Support: A Missed Opportunity.....	539
3. Definitions	546
4. When Does Group Supervision Apply?.....	552
5. Scope of Group Supervision	554
6. Levels of Group Supervision	556
7. Calculation of Group Solvency.....	558
7.1. General Principles	558
7.2. Calculation Methods	560
7.2.1. Method 1 (Default Method): Accounting Consolidation-Based Method.....	561
7.2.2. Method 2 (Alternative Method): Deduction and Aggregation Method.....	567
7.3. Group Internal Model	568
7.4. Group Capital Add-On	571
8. Groups with Centralised Risk Management.....	572
8.1. Conditions.....	572
8.2. Application Process	574
8.3. Calculation of the SCR of the Subsidiary	575
8.4. End of the Derogation for the Subsidiary.....	578
9. Risk Concentration and Intra-Group Transactions.....	579
9.1. Relevance and Key Concepts	579
9.2. Supervision of Risk Concentration	580
9.3. Supervision of Intra-Group Transactions.....	581
10. System of Governance	582
10.1. Principles.....	582
10.2. System of Governance at Group Level	583
10.3. Group ORSA.....	586
11. Group Supervisor	588
11.1. Designation of the Group Supervisor	590
11.2. Rights and Duties of the Group Supervisor	592
12. College of Supervisors	595
12.1. Composition of the College	595
12.2. Operational Functioning of the College	597
12.3. Supervisory Cooperation	600
13. Public Disclosure and Supervisory Reporting	604

13.1. Public Disclosure	605
13.2. Supervisory Reporting.	606
Chapter 10. Equivalence.	607
1. Principles	607
2. Group Solvency Calculation when the Group Includes a Subsidiary Situated in a Third Country	611
2.1. Full Equivalence	611
2.1.1. Principle	611
2.1.2. Assessment Criteria	613
2.2. Provisional Equivalence	616
2.3. Absence of Equivalence.	619
3. Group Supervision where the Ultimate Parent Undertaking is Situated in a Third Country.	620
3.1. Full Equivalence	620
3.1.1. Principle	620
3.1.2. Assessment Criteria	622
3.2. Temporary Equivalence.	626
3.3. Absence of Equivalence.	628
4. Third-Country Reinsurance Undertakings.	628
4.1. Full Equivalence	630
4.1.1. Principle	630
4.1.2. Assessment Criteria	631
4.2. Temporary Equivalence.	634
4.3. Absence of Equivalence.	636
5. Bermuda and Switzerland	637
5.1. Bermuda	637
5.2. Switzerland	640
6. Comments on the Equivalence Process.	643
6.1. Need to be More Proactive	644
6.2. Need to Adopt a Partnership Approach	645
6.3. Need for More Transparency	647
Chapter 11. EIOPA	649
1. From CEIOPS to EIOPA	649
2. Powers of EIOPA.	655
2.1. Regulatory Powers	656
2.1.1. Regulatory and Implementing Technical Standards	656
2.1.2. Guidelines and Recommendations.	660
2.2. Supervisory Powers	663
2.2.1. Representation in Colleges of Supervisors	663

2.2.2.	Development of a Common Supervisory Culture	665
2.2.3.	Supervisory Convergence	670
2.2.4.	Binding Mediation	675
2.3.	Reporting Obligations under Solvency II	682
2.4.	Financial Stability and Macro-Prudential Supervision	686
2.4.1.	Financial Stability Reporting	686
2.4.2.	Cooperation with the ESRB	686
2.4.3.	EIOPA Stress Tests	686
2.4.4.	Macro-Prudential Supervision	691
Chapter 12. Conclusion		697
<i>Bibliography</i>		709
<i>Index</i>		723

LIST OF ABBREVIATIONS

AAE	Actuarial Association of Europe
AD	Accounting Directive
AIFM	alternative investment fund managers
ALDE	Alliance of Liberals and Democrats for Europe (EP)
AMSB	administrative, management or supervisory body
AR	Audit Regulation
BCBS	Basel Committee of Banking Supervisors
BIS	Bank for International Settlements
BMA	Bermuda Monetary Authority
BoS	Board of Supervisors (EIOPA)
BSCR	basic solvency capital requirement (basic SCR)
CEA	Comité Européen des Assurances (now Insurance Europe)
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Pensions Supervisors
CEO	Chief Executive Officer
CESR	Committee of European Securities Regulators
CFO	Chief Financial Officer
Co-Co	Coordinating Committee
COM	(European) Commission (Services)
ComFrame	Common Framework for the Supervision of IAIG
COMP	Directorate-General for Competition (EC)
CoR	European Committee of the Regions
COSO	Commission of Sponsoring Organizations (Treadway Commission)
Council	Council of Ministers of the EU
CQS	credit quality step
CRA	Credit Rating Agency
CRD	Capital Requirements Directive
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
DA	Delegated Act

DG	Directorate-General (European Commission)
EBA	European Banking Authority
EC	European Commission
ECAI	External Credit Assessment Institution
ECB	European Central Bank
ECFIN	Directorate-General for Economic and Financial Affairs (EC)
ECIROA	European Captive Insurance and Reinsurance Owners Association
ECON	Economic and Monetary Affairs Committee (EP)
ECR	European Conservatives and Reformists (EP)
EEA	European Economic Area
EEC	European Economic Community
EESC	European Economic and Social Committee
EFR	European Financial Services Roundtable
EIB	European Investment Bank
EIF	European Investment Fund
EIOPA	European Insurance and Occupational Pensions Authority
EIOPC	European Insurance and Occupational Pensions Committee (EC)
EMAC	Economic and Monetary Affairs Committee (EP)
EMIR	European Market Infrastructure Regulation
EMPL	Directorate-General for Employment, Social Affairs and Inclusion (EC)
ENTR	Directorate-General for Enterprise and Industry (EC)
EP	European Parliament
EPIFP	expected profits in future premiums
EPP	European People's Party (EP)
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FD	Solvency II Framework Directive
FICOD	Financial Conglomerates Directive
FINMA	Swiss Financial Market Supervisory Authority
FISMA	Directorate-General for Financial Stability, Financial Markets and Capital Markets Union (EC)

FIN-USE	Forum of User Experts in the Area of Financial Services
FIO	Federal Insurance Office (Treasury Department USA)
FoE	freedom of (cross-border) establishment
FoS	freedom to provide (cross-border) services
FSA	Financial Services Authority (UK)
FSAP	Financial Sector Assessment Program
GAAP	generally accepted accounting principles
GDV	German Insurance Association
GNAIE	Group of North American Insurance Enterprises
GREENS	The Greens/European Free Alliance (EP)
G-SII	global systemically important insurer
GSP	group-specific parameters
GUE/NGL	European United Left/Nordic Green Left (EP)
IAA	International Actuarial Association
IAASB	International Auditing and Assurance Standards Board
IAD	Insurance Accounts Directive
IAIG	internationally active insurance group
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAS	Individual Capital Adequacy Standards (UK)
ICP	Insurance Core Principle (IAIS)
ICS	International Capital Standard (IAIS)
IDD	Insurance Distribution Directive
IFRS	International Financial Reporting Standards
IGD	Insurance Groups Directive
ILS	insurance-linked securities
IMD	Insurance Mediation Directive
IORP	institutions for occupational retirement provision
IORP I	IORP Directive (2003)
IORP II	IORP Directive (recast) (2016)
IRSG	Insurance and Reinsurance Stakeholder Group (EIOPA)
ISA	international standards on auditing
ITS	implementing technical standards
JLS	Directorate-General for Justice, Freedom and Security, Private Law and Criminal Law (EC)
JURI	Legal Affairs Committee (EP)

LAC-DT	loss-absorbing capacity of technical provisions and deferred taxes
LGD	loss-given-default
LTG	long-term guarantees
MA	matching adjustment
MARKT	Directorate-General for Internal Market and Services (EC)
MCR	minimum capital requirement
MiFID	Market in Financial Instruments Directive
MS	Member State
NAIC	National Association of Insurance Commissioners (USA)
NCB	national central bank
NSA	national supervisory authority
NSLT	health not similar to life techniques
NTNI	non-traditional non-insurance
OECD	Organisation for Economic Cooperation and Development
OEEC	Organisation for European Economic Cooperation
OJ	Official Journal of the European Union
ORSA	own risk and solvency assessment
PD	probability of default
PEIF	Pan-European Insurance Forum
QIS	quantitative impact study
QRT	quantitative reporting template
RSR	regular supervisory report
RTS	regulatory technical standards
S&D	Progressive Alliance of Socialists and Democrats (EP)
SANCO	Directorate-General for Health and Consumers (EC)
SCE	European Cooperative Society
SCR	solvency capital requirement
Sec Gen	General Secretariat (EC)
SFCR	solvency and financial condition report
SII	systemically important insurer
SLT	health similar to life techniques
SME	small and medium-sized enterprise
SPE	special-purpose entity
SPV	special-purpose vehicle
SRP	supervisory review process
SST	Swiss Solvency Test

STS	simple standardised and transparent securitisations
TFEU	Treaty on the Functioning of the European Union
UCITS	undertakings for collective investment in transferable securities
UK	United Kingdom
USA	United States of America
USP	undertaking-specific parameter
VA	volatility adjustment
VaR	value-at-risk

