

Solvency II
Understanding the Process

February 2007

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1. Introduction and objective of this paper

Solvency II will have significant impact on the European insurance and reinsurance industry. This paper provides a brief introduction to Solvency II for those who are interested in the project but have not yet started to participate in the debate. To that end, it describes the key elements of Solvency II and provides an overview of the important stakeholders in the debate. Also, it highlights the timeframe and main topics of discussion. Also it discusses the key role played by CEA, the European insurance and reinsurance federation, in this strategic debate.

This paper complements CEA's earlier publication "Solvency II – Introductory Guide", which is available at the CEA website (www.cea.assur.org). Also this paper could be helpful to readers of the Frequently Asked Questions who are not familiar with the Solvency II debate.

2. What is Solvency II?

Solvency II is the proposed new EU legislation which will govern the capital requirements of insurance companies. The current solvency framework, Solvency I, was introduced in the early 70s and defined capital requirements by specifying simple, blanket solvency margins. These were intended as a buffer to absorb potential risks, to act as a policyholder protection measure, but they were quite simplistic in design and did not always reflect the true risks in a given portfolio of insurance business.

In some cases, current rules can actually conflict with good risk management. Solvency II is an opportunity to improve insurance regulation and supervision by bringing regulation up to date with the significant advances in risk management in insurance that have taken place since the 1970s, introducing a risk based economic approach.

Solvency II is based on three 'Pillars':

- Pillar I, which focuses on quantitative requirements: valuing assets, liabilities and capital
- Pillar II, which focuses on supervisory activities: which provides qualitative review through the supervisory process including a focus upon the company's internal risk management processes
- Pillar III, which addresses supervisory reporting and public disclosure of financial and other information by insurance companies

Solvency II will redesign financial regulation of insurance companies in the EU

The industry is in favour of a risk based economic approach to Solvency II

The insurance industry is in favour of an economic risk based approach to Solvency II. This requires:

- Market consistent valuation of assets and liabilities. Assets and liabilities are to be held at market consistent values. For many assets and some liabilities, market data is readily available. However, for certain asset and liability components, there is no readily available deep and liquid market. In such cases appropriate proxies and market consistent valuation techniques should be used. Market consistent valuation will improve transparency for the insurance industry and result in harmonised principles throughout the EU;
- Solvency Capital Requirement (SCR), a level of capital that enables an insurance firm to absorb significant unforeseen losses and that gives reasonable assurance to policyholders and beneficiaries.¹ When an undertaking does not fulfil the SCR, it will be required to restore the amount of capital covering the SCR in due time, based on a concrete and realisable plan, approved by the supervisor;
- Minimum Capital Requirement (MCR), reflecting a level of capital below which ultimate supervisory action may be triggered, e.g. closing the firm to new business and run-off of the existing portfolio or transfer of the portfolio to a rational and well diversified third party;
- Risk mitigation and diversification are fully recognised as fundamental elements in the insurance business;
- There will be an option for companies to use either a Standardised Approach or a company specific Internal Risk Model to calculate the capital requirements. This gives insurance companies the choice of building upon the risk management practices developed internally or to use a standard approach to estimate underlying risks. Firms choosing to use an internal model would need to have this validated by their supervisor before using it to calculate regulatory capital requirements.

¹ *The capital requirements are expected to be calibrated to a 1 in 200 probability of ruin over one year and based on a comprehensive analysis of risks taking into account both risk mitigation and diversification.*

3. Who are the important stakeholders in the Solvency II debate?

The decision making for the design and implementation of the new Solvency II framework relies heavily on a consensus building process. Many stakeholders participate in the debate.

The Solvency II debate involves many stakeholders

The European Commission drafts the European legislation, with advice provided by CEIOPS² who compile detailed analysis according to a framework of calls for advice prepared by the European Commission.

The European Commission will then publish a Solvency II Framework Directive to be approved by the European Parliament and European Council. This will set out the broad principles and outcomes to be achieved under Solvency II. This is called 'level 1' under the Lamfalussy process.

Once the Framework Directive is agreed the EIOPC³ – a committee consisting of national ministries of finance or equivalent – will prepare so-called implementing measures which provide the detailed specifications required to apply the measures described in the Directive. These are the 'level 2' measures under the Lamfalussy process.

The day-to-day supervision of insurance undertakings will be performed by national insurance supervisors, who may prepare common guidelines to apply the standards set out in level 1 and level 2. They achieve this through a committee of supervisors, called CEIOPS. This is 'level 3' of the Lamfalussy process.

When Solvency II will be implemented, the European Commission will ensure Solvency II compliance in the member states, which is the level 4 of the process.

TABEL 1 | Solvency II – Lamfalussy process

	What is it?	What does it include?	Who develops?	Who decides?
Level 1	Solvency II Directive	Overall framework principles	European Commission	European Parliament, European Council
Level 2	Implementing measures	Detailed implementation measures	European Commission	EIOPC
Level 3	Supervisory standards	Guidelines to enhance supervisory convergence	CEIOPS	CEIOPS
Level 4	Evaluation	Monitoring compliance and enforcement	European Commission	European Commission

² CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors

³ EIOPC = European Insurance and Occupational Pensions Committee

The industry participates to the Solvency II debate through various bodies including the CEA

The European insurance and reinsurance industry is involved in the Solvency II Project through a number of industry bodies at the EU level, such as:

CEA⁴	representing the European insurance and reinsurance industry through national insurance associations in each European Union Member State and 8 other countries.
AISAM / ACME⁵	representing mutual insurers and cooperative insurance companies on a global basis.
ICISA⁶	representing the European credit insurers
CRO Forum⁷	representing 14 large European insurance groups, focussing on risk management
CFO Forum⁸	representing 20 large European insurance groups, focussing on financial reporting
Groupe Consultatif⁹	representing the actuarial profession in Europe

CEA and the Solvency II debate

CEA together with other industry bodies has led the industry work on Solvency II. CEA supports the objective of a Solvency II framework that is based on a sound economic risk based approach. By building industry consensus, CEA has developed a coherent economic risk based approach to the various issues tackled in the preparation of the Framework Directive and has communicated these to key stakeholders such as the European Commission, EIOPC and CEIOPS. The CEA Solvency II steering group liaises with other important industry bodies on a continuous basis. Also, CEA has a strong link to the insurance industry through its national association members in the various EU Member States.

⁴ CEA = Comité Européen des Assurances

⁵ AISAM = Association Internationale des Sociétés d'Assurances Mutuelle

ACME = Association of European Cooperative and Mutual Insurers

⁶ ICISA = International Credit Insurance & Surety Association

⁷ CRO = Chief Risk Officer. Most CRO Forum companies are also represented in the CFO Forum.

⁸ CFO = Chief Financial Officer. The CFO Forum mostly focuses on financial reporting requirements, but this is interrelated with Solvency II.

⁹ Groupe Consultatif = Groupe Consultatif Actuarièl Européen)

4. Where are we in the Solvency II project?

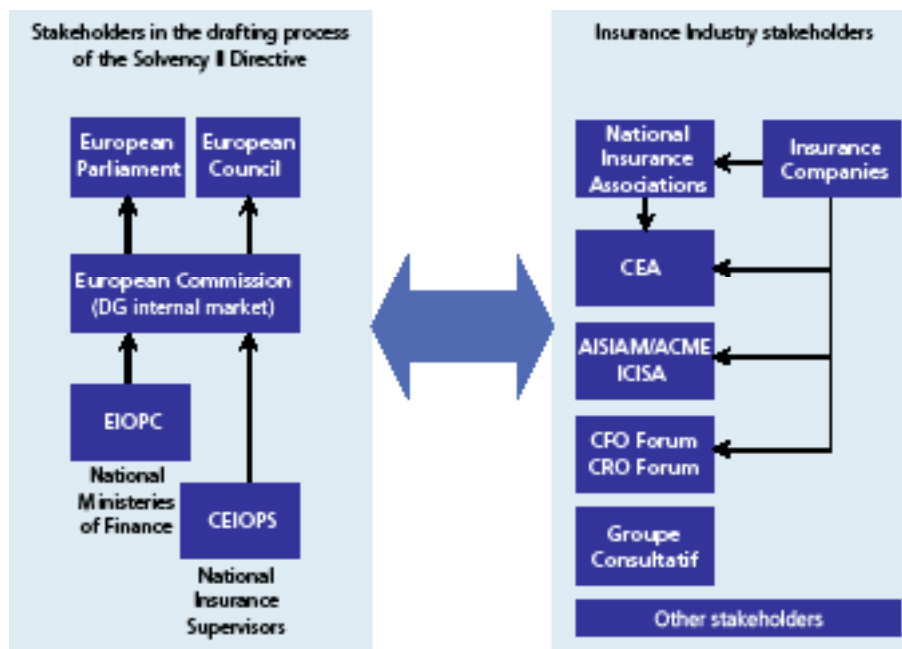
The first preparations for Solvency II started in 2002. The proposed Solvency II Framework Directive will be available for discussion in European Parliament and European Council in Summer 2007. As the Solvency II Framework Directive will be relatively high-level, it is likely that in certain detailed elements will be further specified by CEIOPS, such as the final set of formulae and requirements. As a result, all elements of the Solvency II regulation will only become available over time. Figure 2 drafts the timeline of the Solvency II project.

Throughout the preparation for the Framework Directive proposal, the European Commission regularly asks CEIOPS to advise on certain issues. While developing their answers CEIOPS consults with the insurance industry through consultation papers and public hearings. The industry responds to these consultations, partly in a unified way provided by bodies such as the CEA in an effort to come to a clear and co-ordinated set of views.

The Solvency II debate started in 2003

Supervisors consult the industry through Consultative Papers and Hearings

FIGURE 1 | Solvency II Stakeholders



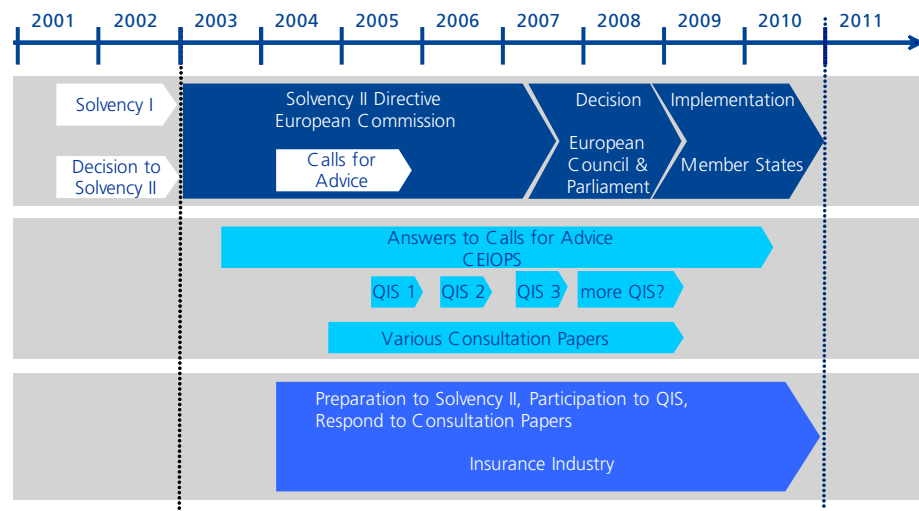
As a preparation for Solvency II, CEIOPS launched a number of Quantitative Impact Studies (QIS) in order to investigate the effect on the proposals on the company and industry levels. Companies participating to QIS fill out extensive pre-defined Excel spreadsheets. The QIS1 was launched in November 2005 and focused on the valuation of the technical provisions. QIS2 took place in Summer 2006 and investigated the valuation for technical provisions and a potential standard approach for capital requirements. QIS3 will focus on the total framework and is planned for Spring 2007. The participation of companies in the various QISs increased over time, reflecting rising involvement of industry participants as the Solvency II project approaches its implementation date. Additional QIS may be commissioned in the future.

Companies participate to QIS to analyse the impact of the proposals

The Solvency II Framework Directive will be available in Summer 2007

In summary, as at February 2007, the Solvency II Framework Directive is at the drafting phase. It is based on the various answers on the Calls for Advice and consultations that took place in the period 2004-2006. At the same time, CEIOPS' QISs have provided insight into the potential effects of aspects of the new solvency framework. Following publication of the draft Solvency II Directive in Summer 2007, the political decision-making process will commence in the European Parliament and European Council of Ministers.

FIGURE 2 | Timelines and Overview



5. How to get into the Solvency II Debate ?

A number of issues in the Solvency II debate have caused extensive discussions. Whilst in one sense all issues are important to ensure an economic risk based approach, the papers mentioned below are central to get acquainted with the fundamental elements of the Solvency II debate. These papers can be found free-of-charge on the CEA website (www.cea.assur.org) and more information about them is provided in Annex 1. A set of potentially interesting websites is provided in Annex 2.

CEA Papers could provide a useful overview of the relevant discussions with the ultimate aim of achieving a risk based economic approach

Overall Solvency II Framework

There is a natural debate on the potential consequences of Solvency II on the industry as a whole and on individual companies. CEA has performed a survey to assess the consequences of Solvency II on the industry including aspects such as pricing and reinsurance. This survey is called "CEA Industry Survey on the Impact of Solvency II" and was executed in 2006.

The document "Assessing the Impact of Solvency II on the Average Level of Capital" (16 October 2006) investigates how individual companies could analyse the impact of Solvency II on the capitalisation of the company. It describes that it is important that a holistic approach is taken when assessing the impact.

Pillar I - Quantitative Requirements

The industry is of the opinion that an economic risk based framework should be adopted in which assets, liabilities and capital elements are viewed in coherence. This is described in the Joint Paper of the CRO Forum and CEA called "Solutions to Major Issues for Solvency II" (17 February 2006). Also it describes principles underlying a market consistent valuation and the methodology to determine the SCR.

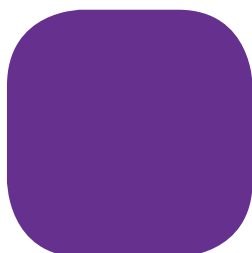
Valuation of the technical provisions is another important area of discussion. Solvency II aims for a market consistent economic approach for the technical provisions. This implies that the value of liabilities is sufficient to cover expected future claim payments. As an alternative to CEIOPS percentile approach, the industry proposed a valuation methodology called 'Cost of Capital approach.' This is further described in the paper "CEA Document on Cost of Capital" (12 April 2006)

The QIS2 exercise focussed on the Standard Approach. The discussion contained two elements, i.e. areas concerning the structure and design of the QIS2 exercise and areas concerning the numerical calibration of the formulae. Calibration refers to the process of fine-tuning the parameters with the objective of achieving the correct outcome. CEIOPS articulated that QIS2 included only a very tentative calibration. Therefore, the "CEA Preliminary Feedback from QIS2" (16 October 2006) is an interesting paper to read for those interested in the structure and design of QIS2.

Pillar II Supervisory Activities

The Supervisory Review Process of Pillar II is an important element. “CEA’s Pillar II Principles and Comments on Pillar II” (15 September 2006) could be of value for those interested in the industry’s views on both high-level principles for Pillar II and the detailed comments on CEIOPS’ Consultation Paper no 13, which focused on Pillar II.

In addition to capital requirements (i.e. SCR and MCR) supervisors should have the power to intervene when an insurance company faces a crisis that might harm policyholders. The “CEA Working Document on the MCR and Proposed Ladder of Intervention” (16 October 2006) describes the industry’s views on how supervisors should intervene should a company’s available capital drop below the SCR.



6. What are the key messages provided by the industry

The insurance industry has provided 10 key messages for Solvency II. These are:

The 10 key messages of insurers in relation to Solvency II

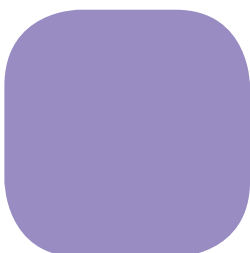
Objectives of the European Insurance Industry for Solvency II

1. To align capital requirements with the underlying risks of an insurance company.
2. To maintain strong, effective policyholder protection while achieving optimal capital allocation.
3. To develop a proportionate, risk-based approach to supervision with appropriate treatment both for small companies and large, cross border groups.
4. To provide incentives to insurers to adopt more sophisticated risk monitoring and risk management tools – this would include developing full and partial internal capital models and increased use of risk mitigation and risk transfer tools.
5. To achieve a harmonised approach to supervision across all EU markets – this will help to ensure there is a level playing field for all insurers and should provide a common standard of protection to all consumers regardless of the insurers' legal form, size or location.
6. To increase competition within EU insurance markets and the global competitiveness of EU insurers – reducing or removing unnecessary regulatory constraints and adopting a coherent 'lead supervisor' approach for pan-European Groups. This will provide more choice and a better deal for EU consumers, and also enable EU insurers to compete more effectively in global insurance markets, in line with the Lisbon agenda.

Our proposed approach to implement Solvency II

7. We believe Solvency II must be built on a true risk-based economic approach if the objectives above are to be met. Assets and liabilities, including those with options and guarantees, must be measured and valued as closely as possible to their true economic value and should be reconcilable to the values provided in the accounts. The solvency capital requirement (SCR) must underpin a high level of confidence that insurers will meet their obligations even in adverse circumstances.
8. Solvency II should introduce a holistic approach to policyholder protection: risk measurement by the firm in Pillar 1, qualitative review by supervisors in Pillar 2, and improved disclosure to the market and other stakeholders enhancing economic discipline in Pillar 3.

9. Pillar 2 is a cornerstone of the Framework, bringing the insurance industry and the supervisors closer to each other: Solvency II is a challenge to both parties who will need to work constructively as part of the supervisory review process and develop the necessary skills for the framework to be effective in assessing and encouraging robust internal controls and risk management. This qualitative review and any remediation measures proposed should be arrived at in a consistent manner across companies, jurisdictions and over time.
10. Solvency II should reflect the way companies manage their business today and tomorrow. In a truly risk based solvency system, due account should be paid to measures introduced to reduce and transfer risk, with full recognition of diversification effects.



Annex 1. Other aspects of Solvency II

CEA has released a range of publications covering a wide range of aspects of Solvency II. Indeed, it is important to note that the comments in this document should be considered in the context of other publications by the CEA as they constitute a coherent package. All CEA Solvency II work is published on the Solvency II section of the CEA website (www.cea.assur.org). Highlights include:

CEA material on Solvency II covers a wide range of aspects

- **Solvency II: Structural Issues** (1 March 2005)

This paper lays out a number of structural issues identified in an early stage of the Solvency II project. It includes areas such as assessing the acceptable level of capital, role of MCR and SCR, the understanding of unnecessarily conservative capital rules, unintended consequences, the balance between simple standard approach and sophisticated internal models, risk mitigation, government roles, and group issues.
- **Solvency II - Building Blocks for the Solvency II Project** (18 May 2005)

This CEA Working Document provides 9 important building blocks for Solvency II. The building blocks are: (1) Total Balance Sheet Approach; (2) Liability Valuation; (3) Interaction between prudence, total capital requirement and SCR; (4) Solvency Assessment Typology; (5) Risk Measure and Time Perspective (6) Risk Classification; (7) Risk Aggregation; (8) Risk Mitigation; and (9) Group Treatment
- **CEA's comments on the CEIOPS' Draft Answers to the 'First Wave' of Calls for Advice** (1 June 2005)

This paper provides the CEA comments on CEIOPS' Draft Answers to the 'First Wave' of Calls for Advice.
- **CEA's comments on the CEIOPS' Draft Answers to the 'Second Wave' of Calls for Advice** (30 September 2005)

This paper provides the CEA comments on CEIOPS' Draft Answers to the 'Second Wave' of Calls for Advice.
- **CEA's comments on the CEIOPS' Draft Answers to the 'Third Wave' of Calls for Advice** (9 Feb 2006)

This paper provides the CEA comments on CEIOPS' Draft Answers to the 'Third Wave' of Calls for Advice.
- **Solutions to Major Issues for Solvency II – Joint submission by the CRO Forum and the CEA** (17 February 2006)

This paper identifies the highest priority issues for Solvency II and provides a solution to the highest priority issue. It focuses especially on the principles of a sound economic risk based framework that is desired by the industry such as a market consistent valuation of liabilities and the definition of the SCR.

- **CEA working document on the standard approach for calculating the solvency capital requirement** (22 March 2006)

This paper aims to describe the potential differences between the economic framework supported by the CEA and the CEIOPS framework and highlight certain issues. Also it explains the reasons why the CEA believes that the cost-of-capital approach is coherent and consistent with the intended framework. Lastly, it shows in practice how the cost-of-capital approach could be used in a simple way under a standard approach like the “European Standard Approach” developed by CEA. It is accompanied by a spreadsheet example of the European Standard Approach.

- **CEA document on Cost of Capital** (21 April 2006)

This paper explains the cost-of-capital approach and shows in practice how the cost-of-capital approach could be used in a simple way under a standard approach like the “European Standard Approach” developed by CEA. The approach described is implemented in the spreadsheet of the European Standard Approach, provided with the above-mentioned paper.

- **CEA guidance on Quantitative Impact Study 2** (15 May 2006)

This paper provides guidance on the context of QIS2 and the application of QIS2 for national insurance associations and for companies. It also includes some key points of attention that are important to the industry. In the CEA objective to support the industry participating to QIS2, the paper also describes the support structure that CEA is putting in place to provide support and feedback for companies participating to QIS2.

- **Solvency II – Introductory Guide** (June 2006)

Provides a high level overview of the Solvency II framework, including an explanation of why Solvency II is necessary. It considers the impact of Solvency II on supervisors, the insurance industry and for policyholders.

- **CEA’s Pillar II Principles and Comments on Consultation Paper no. 13** (15 September 2006)

This paper is a response to CEIOPS’ Consultation Paper no. 13, which focuses on Pillar II of the Solvency II Framework. The CEA response to CP13 consists of 10 key principles and detailed comments to CEIOPS proposals. The key principles refer to the implementation of Risk Measurement and Management and the Supervisory Review Process.

- **CEA’s Comments on CEIOPS’ Consultation Paper no. 14** (15 September 2006)

This paper is a response to CEIOPS’ Consultation Paper no. 14, which focuses on Group Issues. The CEA response to CP14 highlights the importance of Group Supervision for insurance groups and it emphasises the existence of group diversification. Also, it urges a proportionate and harmonised approach to third country supervision.

- **Feedback on CEIOPS Consultation Paper 14 – Joint submission by the CRO Forum and CEA** (22 September 2006)

In addition to the CEA Response to CP14, the current paper is a Joint submission of the CRO Forum and CEA. CEIOPS' Consultation Paper no. 14 focuses on Group Issues. The Joint submission emphasised the need for group supervision for groups and reiterated the so-called concept of the Lead Supervisor that has a primary role in supervision of insurance groups.

- **Assessing the Impact of Solvency II on the Average Level of Capital** (16 October 2006)

This paper assists stakeholders in making an informed comparison between the current capital position (under Solvency I) and the future position we hope to achieve with Solvency II. This is especially useful because under Solvency II both the available capital and the capital requirement are likely to change. The paper explains that overall, the industry is not thought to be undercapitalised

- **CEA Preliminary Feedback from QIS2** (16 October 2006)

This paper is a preliminary response to the QIS2 exercise in advance of the publication of CEIOPS' QIS2 Report. It highlights some of the CEA's key messages related to the QIS2 exercise as well as certain issues related to the structure and design of the Standard Approach that will be relevant for the future QIS. This paper builds upon the work done in the "CEA Working Document on the Standard Approach for calculating the Solvency Capital Requirement" (22 March 2006)

- **CEA Working Paper on the MCR and Proposed Ladder of Intervention** (16 October 2006)

The Solvency II framework will contain two capital requirements (SCR and MCR). This paper sets out a proposal for the methodology to determine the MCR as a percentage of the SCR. Also, it puts forward suggestions on how the supervisory dialogue might be developed in a structured manner via the so-called ladder of intervention for companies whose capital position was between the SCR and MCR.

- **CEA Working Paper on the risk measures VaR and TailVaR** (27 October 2006)

This paper explains the difference between the risk measures VaR and TailVaR as there is a discussion on which method would be preferred. After elaborating on the two risk measures, the paper explains the industry preference of the VaR measure.

- **Solvency II Glossary** (27 November 2006)

This paper is an overview of the important terms and definition in the Solvency II debate. It is a joint production of the Group Consultative and the CEA.

- **CEA Response to CEIOPS' Consultative Papers 15-19** (12 January 2007)
This paper is response to CEIOPS Consultative Papers no 15 up to 19. The topics covered in the CPs re of various elements in the future Solvency II regime.
- **CEA Response to CEIOPS' Consultative Paper 20** (19 January 2007)
This paper is response to CEIOPS Consultative Paper no 20. The topics covered in CP 20 are especially on Pillar I of the Solvency II framework. CEA produced a key messages paper and provided detailed comments to CP20 in a separate paper.
- **CEA Working Paper on the Total Balance Sheet Approach** (11 January 2007)
This paper is elaborates on the total balance sheet approach to Solvency II. This covers key aspects such as the eligibility of various balance sheet elements towards available capital; the treatment of future discretionary benefits under an economic approach; and the treatment of assets backing free surplus with respect to market risk.

Annex 2. Relevant websites

A number of industry players have published interesting Solvency II information on their websites. Examples are provided below.

European Commission

http://ec.europa.eu/internal_market/insurance/solvency2/index_en.htm

EIOPC

http://ec.europa.eu/internal_market/insurance/committee_en.htm

CEIOPS

<http://www.ceiops.org>

CEA

<http://www.cea.assur.org>

National Insurance Associations

links can be found on the CEA website, click 'Members'

CRO Forum

<http://www.croforum.org>

Groupe Consultatif

<http://www.gcactuaries.org>

Joint AISAM/ACME website

<http://www.insurance-mutuals.org>

ICISA

<http://www.icisa.org>

CEA

CEA is the European insurance and reinsurance federation. CEA's 33 national member associations represent more than 5,000 insurance and reinsurance companies. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €970bn, employ over one million people and invest more than €6,300bn in the economy.

www.cea.assur.org

CEA's publication 'Solvency II: Understanding the process' is available free-of-charge at CEA's website: www.cea.assur.org

Questions, comments and suggestions with regard to this publication should be addressed to: ecofin@cea.assur.org

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