FACING THE IMPLEMENTATION CHALLENGES OF THE SOLVENCY II DIRECTIVE

CIUMAŞ Cristina[1], ONIGA Alexandra[2], COCA Ramona Alexandrina[3]

"Babeş-Bolyai" University, Cluj-Napoca, Romania

Abstract

This paper aims to bring together different perspectives and challenges that insurance companies will have to face when the Solvency II Directive will have to be implemented in January 1st 2016. Starting with the quantitative requirements described in Pillar 1 of the Directive, a good risk management to support the insurers strategy and decision-making process and the implementation of the supervisory reporting, through partially or fully automated processes, this will all lead to a fundamental reform in insurance supervision and reach a new level of transparency, both for the authorities and the public.

Keywords: *risk, capital requirements, implementation, transparency*

JEL classification: *G22*

1. Introduction

The Solvency II Directive is cause for constant discussion while trying to meet its objective of a healthy insurance industry. As it is already widely noted, Solvency II is very similar in structure to the Basel II regulation for the banking industry. As they are both built on a 3 pillar structure, this will bring

[1] *Professor, Faculty of Economics and Business Administration/Department Finance, cristina.ciumas@econ.ubbcluj.ro*

[2] *Ph.D. student, Faculty of Economics and Business Administration/Department Finance, alexandra.oniga@econ.ubbcluj.ro*

[3] *Ph.D. student, Faculty of Economics and Business Administration/Department Finance, ramona.coca@econ.ubbcluj.ro*

insurance and reinsurance regulation more in line with the regulation applied to the banking industry.

In both cases the three pillars include quantitative and qualitative requirements as well as market discipline, and focus on capital requirements, risk management, supervision by a competent body, and disclosure, both to supervisors and the public. However, it is important to acknowledge that banking and insurance are distinctly different industries, therefore, the implementation process for Solvency II will not just mirror that of Basel II.

To meet the new capital requisites insurers will have to find a way to quantify the solvency capital requirements using either the standard model, or an internal model that further offers the opportunity to integrate the model in the internal control process of the insurer, which is also of high relevance in the context of the insurer's own risk and solvency assessment (ORSA) as required in Solvency II's Pillar 2. (Gatzert N., Martin M., 2012)

Solvency II is very much a living process and continues to evolve through valuable consultation, feedback, and cooperation between the insurance industry and regulatory bodies. In spite of the recent adoption of the Omnibus II Directive, which represents a big step towards the implementation of Solvency II, much still needs to be accomplished to accommodate the vast changes and potential impact to insurance companies, governments, and rating agencies within the EU and beyond.

2. From Solvency I to Solvency II requirement

The Solvency I Directive was implemented to harmonize the essential rules on insurance. They provide for a common prudential framework, single license and exclusive prudential supervision by the competent authorities in EU countries, ensure that insurance undertakings may operate in any other EU country, confers the protection of insured persons and policyholders, in particular by determining the law applicable to insurance contracts concluded in the EU and clarifies what information must be provided to policy holders before and during a contract.

The Solvency II Directive is focused on requiring insurers to concentrate on managing all of the risks facing their organization. It offers European insurers a real opportunity to improve their risk-adjusted performance and operational efficiency, which will improve policyholders' trust, support the insurance industry, and the European Union economy as a whole.

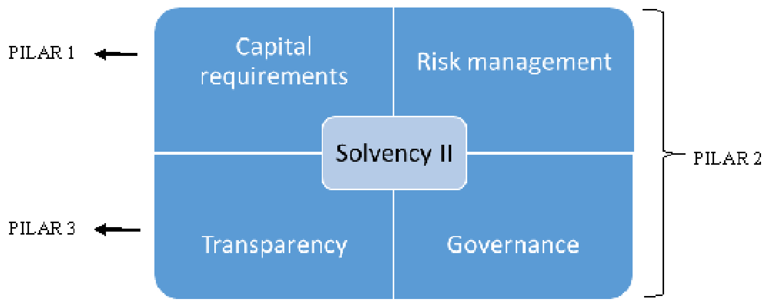
According to the European Commission, the new Directive aims to "take account of current developments in insurance, risk management, finance techniques, international financial reporting and prudential standards, etc., streamline the way that insurance groups are supervised and recognizes the economic reality of how groups operate, strengthen the powers of the group supervisor, ensuring that group-wide risks are not overlooked and ensure greater cooperation between supervisors. Groups will be able to use group-wide models and take advantage of group diversification benefits."

Solvency II is split into 3 Pillars, to better comprehend the changes brought to Solvency I and facilitate the implementation of the new requirements. EIOPA (The European Insurance and Occupational Pensions Authority) defines the three pillars as a way of grouping Solvency II prerequisites, which aims to provide for a greater capital adequacy, covering all the quantitative requirements, promote transparency in the decision-making process imposing higher standards of risk management and governance within a firm's organization, and enhance the review process by rising the levels of transparency for supervisors and the public. This is to be achieved through the implementation of a holistic approach that addresses better risk measurement and management, improves processes and controls, and institutes an enterprise-wide governance and control structure. (KPMG, 2011)

What does Solvency II actually mean and how can insurers structure the implementation process?

The implementation date of the new Directive was pushed yet again, the 1st January 2016 being the new deadline to which the insurance companies can plan their implementation methods.

Figure 1: Solvency II requirements and the 3 Pillar structure



Source: Author's own elaboration

Regarding Pillar 1, Solvency II requires an assessment of the balance sheet's ability to withstand a 1-in-200-year event, so the economic balance sheet (EBS) becomes the cornerstone of all Solvency II reporting. Technical provisions in respect of insurance liabilities will in the future be based on discounted best estimates of expected future cash flows, with assets and noninsurance liabilities included on a market consistent value. This comprises the EBS against which the components are stressed to assess the SCR requirements.

The quantitative requirements under Pillar 1 can effectively be broken down into six components (KMPG, 2011):

- Valuation of assets and liabilities
- Technical provisions
- SCR (Solvency capital requirement)
- MCR (Minimum capital requirement)
- Own funds
- Investments

Pillar 2 is concentrated on enforcing high standards of risk management and governance within a firm's organization. The qualitative aspects of a firm's risk management and internal control systems will be subject to closer evaluation from the supervisors, in order to challenge firms on risk management issues.

A good risk management system under Solvency II will be based on core strategic issues like leadership for risk management, risk strategy linked to a good business strategy and management and control of the risk-bearing capacity of the company.

It will not be sufficient for insurance companies to simply execute their core competency, regarding the management of their retained risk. Under the new Directive, all the processes relating to management of the business environment have to be documented and formalized in order to be communicated to a supervisory authority.

Pillar 3's goal is to achieve greater levels of transparency to their supervisors and the public. This pillar focuses on disclosure requirements to ensure the transparency of the regime, disciplined actions from the insurers' side and that supervisors have the necessary information to ensure compliance with Solvency II. All previous returns will be replaced by reports containing core information that firms will have to provide to the regulator on a quarterly and annual basis. This ensures that the firm's represented by an overall better financial position and includes information that is up-to-date.

From a practice perspective, the scope of tasks under the Pillar 3 umbrella ranges from defining and updating company disclosure policy and technical requirements, to completing documentation of Solvency II procedures and the implemented reporting cycle run. (KMPG, 2011)

3. Technical challenges under Solvency I

Insurance companies will be facing a greater reporting burden which will be imposed by Solvency II's Pillar 3's reporting requirements. Firms in the European Union have typically been required to create and publish around 30 reports annually, but Solvency II will require them to supply as many as 100 reports a year to supervisors, many of which will be produced quarterly. Of particular concern to insurers are the tight timescales within which companies must report. Insurers will have to produce reports within 14 weeks for annual reports and five weeks for quarterly reporting.

This compliance exercise presents an opportunity for firms to re-examine their data and reporting systems and consider how those might be improved. Technology sits at the heart of Pillar 3 projects. Choices about the technology deployed now could make the difference between projects that run and those that leave firms unable to report to regulators on time and in the required format. (Invoke, 2013)

Solvency II will change the European insurance industry, creating a harmonized rule book across all the countries where it applies. Pillar 3 also requires all firms to report in the same format – XBRL[1], a reporting language with great potential but very few firms know well. Thus, firms are finding gaps both in their data and expertise relating to Pillar 3.

The recent delay of implementation of the Directive until January 2016 should be seen as an opportunity for firms to prepare fully rather than a chance to slow their plans, since the preparation for Pillar 3 has been complicated by the repeated delays in Solvency II's legislative process. To encourage the process of preparation, EIOPA is developing interim guidelines

[1] XBRL is a computer language created for the electronic communication of standardized financial and business data. It is a royalty-free open data standard developed by the XBRL International Consortium, a not-for-profit collective of companies and agencies.

which national supervisors will implement from 2014. EIOPA's guidelines are intended to encourage firms to identify difficulties in full compliance when the Directive comes into force.

Considering the deadline for the full implementation of the Directive, companies will need programs in place during 2015 to gather the required information to report. Those will need to be built and tested no later than 2014. Thus, insurers should consider now how far they are able to automate the reporting processes. Strategies must also be developed for managing data across the enterprise, followed by a thorough risk preparation through actuarial and accounting teams for the new requirements.

Some elements of Solvency II remain undetermined and timelines unclear. At the same time, insurers might wish to enhance systems when more funds become available. Firms must plan so that changes to systems in future remain possible without abandoning infrastructure already put in place.

4. The Omnibus II Directive

The Omnibus II Directive aims to complement the Solvency II Directive, creating a modern risk-based regulatory and supervisory framework for the insurance sector[1]. According to a statement issued by the European Commission, "the draft Directive is called Omnibus II because an earlier Directive, known as "Omnibus I" enacted technical amendments to 11 Directives incorporating into banking and securities directives references to the European Supervisory Authorities (the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA)), thus operationalizing their powers as granted in their founding directives. Omnibus II does the same for the insurance sector, operationalizing the powers of the European Insurance and Occupational Pensions Authority (EIOPA) via changes to the Solvency II Directive. However, it was decided in the course of the legislative process to also include in Omnibus II elements changing some substantive aspects of the Solvency II regime."

Omnibus II, which was adopted on the 11th of March 2014, contains a set of amendments to the Solvency II Directive. These amendments include the provision of specific tasks for EIOPA. In particular, it clarifies the role of EIOPA in ensuring harmonized technical approaches for the calculation of

[1] Directive 2009/138/EC

technical provisions and capital requirements. According to the EU, the Directive will also:

- define the appropriate areas in which EIOPA will be able to propose technical standards as an additional tool for supervisory convergence and a view to developing a single rule book;
- detail how EIOPA will act in case of settling disagreements between national supervisors in a balanced way, in those areas where common decision-making processes or cooperation between national supervisors already exist in sectorial legislation.

The European Parliament and the Council agreed that the Solvency II Directive (including the amendments introduced by Omnibus II) should apply as of 1 January 2016. This would constitute the next step after the adoption by the European Parliament of Omnibus II.

5. Conclusion

The focus on risk management has dramatically increased. To this end, regulatory bodies pay a lot of attention to setting minimum capital levels to different kind of financial institutions, in order to promote stability. By aligning the Solvency II requirements to the already implemented Basel II Directive for the banking system, the European Commission is looking to fundamentally reform the insurance supervision and reach a new level of transparency.

Since the Omnibus II Directive, the legislation underpinning Solvency II, was recently adopted, the transition from the current Solvency I regime will be smoother. The new Directive contains enhanced requirements for risk management, the supervisory review process, public disclosure and the possibility to ensure prudence and transparency. Moreover, the European Insurance and Occupational Pensions Authority can now consult on the detailed implementing measures.

The new regulation will impose risk-based capital requirements for insurance companies. To calculate the solvency capital requirements, insurers have the option to choose between different methods. Besides the standard formula provided by the regulator, the SCR can be calculated by using the standard model with a partial internal model, with undertaking-specific parameters, with simplifications, or by modeling the insurers' risks with a full internal model approved by the supervisors.

A risk-based approach should also be adopted for supervisory reporting. An automated process can provide a greater level of comfort in the quality of the numbers that management can discuss with supervisors and the market. Alongside the reporting challenge facing insurers is the matter of data governance. Insurance companies will need to gather data for the quarterly reporting templates that is appropriate, complete, and accurate. The speed with which risk data must be available reflects the ambition at the heart of the Solvency II Directive that companies become fully risk-aware in their approach to management.

6. References

- Butaci C. (2012) - *Solvency II: Solvabilitatea societăților de asigurare*
- CEA (2011) - Insurers of Europe Report, *Solvency II - Making it workable for all*
- Gatzert N., Martin M. (2012) - *Quantifying credit and market risk under Solvency II: Standard approach versus internal model*, Insurance: Mathematics and Economics 51 (2012) 649–666
- Invoke Special Report (2013) - *How insurers are facing the reporting challenge of Solvency II*, November 2013
- KPMG (2011) Report - *Solvency II - A closer look at the evolving process transforming the global insurance industry*
- The Solvency II Directive – DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF
- Van Laere E., Baesens B. (2010) - *The development of a simple and intuitive rating system under Solvency II*, Insurance: Mathematics and Economics 46 (2010) 500-510