

# CEIOPS pushes on with Solvency II implementation

While politicians have been debating the final wording of the Solvency II Directive, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has been pressing ahead with its advisory and consultation programme.

It produced a report 'Lessons learned from the crisis (Solvency II and beyond)' that examined some of the implications of the global economic downturn on how the Directive might be implemented.

Principal among the report's conclusions were:

## **Solvency II should be adopted - since when it has**

At the time of writing, the European Parliament had voted to approve the Directive and the Council of Ministers was expected to ratify the decision. This will help to achieve CEIOPS objective of more transparent risk-oriented information on the financial soundness of insurers.

## **Dependency structures underlying the standard formula may need to be strengthened**

CEIOPS is concerned that the volatility and connectedness of recent economic events should be reflected in the way the standard formula method for calculating capital requirements is constructed. This is likely to affect the dependency structures underlying the standard formula and will require companies to demonstrate a better understanding of what constitutes high quality assets and any domino effects associated with its investment policies. Even for companies that are proposing to adopt the standard formula for calculating solvency capital, this is likely to be extremely challenging in our view without the aid of a partial or full integrated financial model.

## **Governance, risk management and internal controls are a potential weak point**

CEIOPS places responsibility for this firmly on the shoulders of the Board and senior management. The conclusion reinforces the point we have been making that Solvency II is about much more than quantifying risk and is likely to involve a business culture change.

## **Own risk assessment is crucial and may need reinforcing within the implementing measures**

CEIOPS reflects on the lessons learned from insurers investing in assets they didn't really understand and also not validating the opinions of credit rating agencies. The ORSA (Own Risk Solvency Assessment) has, in our view, always been the crucial element of the Directive. Recent events only confirm the need for management to urgently get on top of how models and risk management processes will arrive at a true picture of a company's risk exposure.

## **The scope of regulation for groups needs to be rethought**

CEIOPS argues for better supervision of insurers at a group level. We agree with this wholeheartedly but as we now know, the group support elements of the Directive have been dropped and are unlikely to be revisited for at least three years after adoption. Closer cooperation between national supervisory bodies has been promised and we hope that this will be the case.

## **A point in time assessment of solvency will entail some element of cyclicality**

CEIOPS suggests that the SCR will need to be complemented by a rigorous stress testing requirement, perhaps involving some element of 'dynamic' reserving. Insurers need to contemplate how they might deal with and resource this requirement.

The full copy of the report is available at <http://www.ceiops.eu/media/files/publications/reports/CEIOPS-SEC-107-08-Lessons-learned-from-the-crisis-SII-and-beyond.pdf>

## Consultation papers

The report was closely followed with the publication of 12 consultation papers relating to the proposed Level 2 implementing measures. All of these, with one exception, have a June deadline for responses.

The papers are:

- CP 37 - Draft Level 2 Advice on the Procedure to be followed for the approval of an internal model
- CP 36 - Draft Level 2 Advice on Special Purpose Vehicles
- CP35 - Draft Level 2 Advice on Valuation of Assets and 'Other Liabilities'
- CP34 - Draft Level 2 Advice on Transparency and Accountability
- CP33 - Draft Level 2 Advice on System of Governance
- CP32 - Draft Level 2 Advice on Technical Provisions - Assumptions about future management actions
- CP31 - Draft Level 2 Advice on SCR Standard Formula - Allowance of financial mitigation techniques
- CP30 - Draft Level 2 Advice on Technical Provisions - Treatment of Future Premiums
- CP29 - Draft Level 2 Advice on Own Funds - Criteria for supervisory approval of ancillary own funds
- CP28 - Draft Level 2 Advice on SCR Standard Formula - Counterparty default risk
- CP 27 - Draft Level 2 Advice on Technical Provisions - Segmentation
- CP 26 - Draft Level 2 Advice on Technical Provisions - Methods and statistical techniques for calculating the best estimate

All of the papers can be accessed at <http://www.ceiops.eu/content/view/14/18/>. There is a lot to read here and we suggest you read the CEIOPS advice or 'blue' sections of the papers at a minimum. Those papers with more wide-ranging implications include CP37, CP26 and CP33.

From our initial reading of these documents, we have noted, for example:

- Simulation, deterministic and analytical techniques, or a combination thereof, will be considered to be appropriate valuation methodologies. Assumptions will have to be validated and the results must be capable of being audited
- The supervisor will be able to require an alternative valuation technique to be applied where, in their opinion, that better achieves the objective
- Companies will have to have models approved by the supervisory authority before they can use them to calculate the SCR. Approvals may be subject to terms and conditions. Rejected applications to use an internal model may be subject to a 'waiting period' before a reapplication can be made
- 'Limited approval' will permit companies to use an internal model to calculate SCR for only specific parts of their business
- Supervisory bodies will reserve the right to publish a decision about the rejection or approval of a company's internal model
- There will be a rigorous process regarding the outsourcing of services used to comply with Solvency II
- CEIOPS expects that, subject to the proportionality principle, firms with more complex risk profiles may appoint a Chief Risk Officer
- CEIOPS has proposed options relating to the mandatory tasks applicable to the actuarial function and standards to be applied to these tasks

This burst of output from CEIOPS, and the political voting consensus just being reached, point to the fact that the implementation timetable is back on track for October 2012. It is also expected that in June 2009, there will be considerably more output than just received from CEIOPS in terms of Level 2 and 3 consultation papers. The clock is now ticking slightly louder for companies to prepare themselves.

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Mike has over 20 years' experience of working with the insurance industry across a wide range of sectors, assisting clients to develop and implement strategic change initiatives. In recent years, he has focused on assisting clients to assess the impact and implementation of risk based regulatory change, such as ICAS, Basel II and Solvency II as well as dealing with the broader issue of Enterprise Risk Management. Mike works closely with both business and actuarial teams to address the increasingly important issue of integrating qualitative and quantitative risk approaches.

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