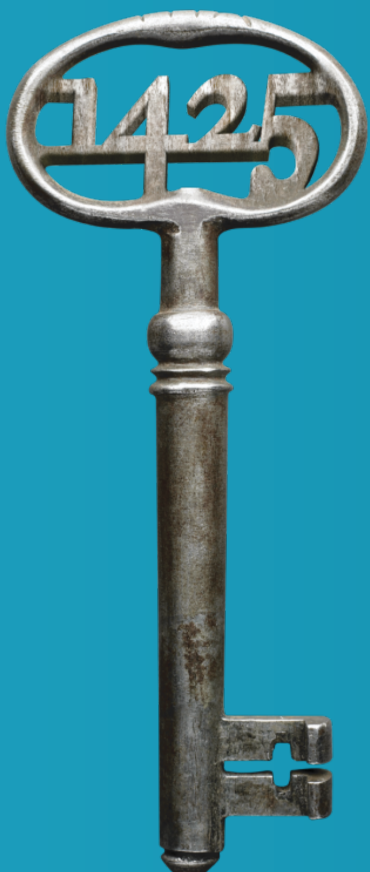

Solvency II: a risky business?

Prof. Karel Van Hulle
KU Leuven and Goethe University Frankfurt
Member IRSG – EIOPA

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Insurance is about risk

- People are naturally risk averse: they need to be reminded to protect themselves against risks
- Not all risks are equally important or should be insured
- Life would be unlivable if everybody would have to take care of all risks
- The insurance industry can help public authorities deal with major challenges that societies are confronted with, such as longevity, health, ageing, poverty, unemployment, natural catastrophes, cyber security…
- **Conclusion: the insurance sector will be the sector of the future if it can offer solutions for these challenges**

The reality: insurers' behaviour

- Not all major risks are insured
- Many insurance products are completely irrelevant
- Insurers often behave like bankers although they say that insurance is not banking
- Under Solvency I, risks were often not properly priced
- Insurers have difficulties to work with a principles based solvency regime because they are risk averse
- The absence of proper risk management and a well developed risk culture with the right tone from the top was an important reason for the delays on Solvency II

The reality: insurance supervision

- Under Solvency I, insurance supervision was often limited to a detailed scrutiny of a number of forms
- Form over substance – tick the box exercise
- Insurance supervisors rarely engage directly with supervised entities
- Insurance supervisors rarely have direct market experience: employment moves between supervision and industry or vice versa are often seen as suspect
- Insurance supervisors often prefer detailed rules rather than a principles based approach requiring judgment

Questions?

- Question 1 :

  What do you think insurance is?

- Question 2 :

  Do you feel comfortable with a principles based approach to regulation?

The birth of Solvency II

- For the EU, Solvency II is the most important change in insurance regulation since the last 30 years
- The birth of Solvency II was very much helped by the capital market crisis at the beginning of this century
- Crucial elements of Solvency II are:
  - The introduction of an economic risk based approach
  - The linkage between risk and capital
  - The crucial role to be played by risk management
- The need to move in the direction of a risk based solvency capital regime is now recognised throughout the world

Solvency II: 3 pillars and a roof

Group supervision
& cross-sectoral convergence

Groups are recognised as an economic entity
=> supervision on a consolidated basis
(diversification benefits, group risks)

Pillar 1: quantitative requirements

1. Harmonised calculation of technical provisions
2. "Prudent person" approach to investments instead of current quantitative restrictions
3. Two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR)

Pillar 2: qualitative requirements and supervision

1. Enhanced governance, internal control, risk management and own risk and solvency assessment (ORSA)
2. Strengthened supervisory review, harmonised supervisory standards and practices

Pillar 3: prudential reporting and public disclosure

1. Common supervisory reporting
2. Public disclosure of the financial condition and solvency report

(market discipline through transparency)

Questions?

- Question 3:

  Which of the three pillars is the most important one?

- Question 4:

  What is the most important risk?

General governance requirements

- From implicit to explicit governance
- Effective system providing for sound and prudent management
- Adequate and transparent organisational structure
- Clear allocation and appropriate segregation of responsibilities
- Effective system for ensuring transmission of information
- Proportionality principle
- Persons in charge of key functions, members of the Board and persons effectively running the business must be fit and proper

Governance functions

- General principles
  - Written policy
  - Prior approval by the Board
  - Regular review (annually or in case of significant changes)
- Key functions
  - Risk management
  - Internal control and compliance
  - Internal audit
  - Actuarial

Questions?

- Question 5:

  Which is the most important governance function?

- Question 6:

  Where are the three lines of defense?

Proportionality

- Account must be taken of the nature, scale and complexity of the operations of each (re) insurance undertaking. This means:
  - Regime should not be too burdensome for small and medium-sized undertakings
  - Proportionality should not only apply to the requirements imposed by law but also to the exercise of supervisory powers
  - Example: combination of governance functions
  - Proportionality also means that if the operations of an insurance undertaking are complex, more stringent rules might have to be applied
  - Proportionality is never about "if" but about "how". The result can never be zero.

Supervisory powers

- Supervisory authorities must have the appropriate means, methods and powers for verifying the system of governance and for evaluating emerging risks identified by (re) insurance undertakings which may affect their soundness
- MS must ensure that the supervisory authorities have the powers necessary to require an improvement and strengthening of the system of governance
- Outsourcing of critical or important functions is only possible with prior notification of supervisory authorities

Risk Management System and Risk Management Function as described in the Solvency II Framework Directive, the Delegated Act and the EIOPA Guidelines

Risk Management System: definition

- Must comprise strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis, the risks at an individual and at an aggregated level, to which an insurance undertaking is or could be exposed as well as their interdependencies
- Must be effective and well integrated into the organisational structure and in the decision-making processes of the insurance undertaking with proper consideration of the persons who effectively run the undertaking or have other key functions

Role of the Board in risk management

- The Board is ultimately responsible for ensuring the effectiveness of the risk mgt system, i.e. setting the undertaking's risk appetite & overall risk tolerance limits as well as approving the main risk mgt strategies and policies
- The Board is responsible for the effectiveness of the risk mgt of the whole group:
  - Strategic decisions & policies on risk mgt at group level
  - Definition of group risk appetite and overall risk tolerance limits
  - Identification, measurement, mgt, monitoring and reporting of risks at group level

Questions?

- Question 7:

  Does Solvency II require each member of the Board to have had some prior experience in insurance?

- Question 8:

  How can supervisors assess the capabilities of the Board to assume responsiblity for the risk management system?

Risk Management Policy

- The written policy must at least include the following:
  - Definition of the risk categories and the methods to measure the risks
  - Outline of how the undertaking manages each category, area of risks and any potential aggregation of risks
  - Description of the connection between the overall solvency needs assessment (ORSA), the regulatory capital requirements and the risk tolerance limits
  - Specification of the risk tolerance limits within all relevant risk categories in line with the undertaking's overall risk appetite
  - Description of the frequency and content of regular stress tests and the situations that would warrant ad-hoc stress tests

Risk management system: content

- Covers all risks included in the SCR as well as the risks which are not or not fully covered by the SCR
- Must cover at least the following areas:
  - 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

Role of external credit ratings

- External credit assessments can no longer prevail in internal risk management methodologies
- Internal risk management methodologies should not rely solely or mechanistically on external credit assessments
- Insurance and reinsurance undertakings are not exempted from additionally considering other relevant information even when there is an external credit assessment by an ECAI
- Insurance and reinsurance undertakings must take steps to verify the appropriateness of external credit assessments as part of their risk management

Prudent person principle

- Only invest in assets and instruments whose risks the undertaking can properly identify, measure, monitor, manage, control and report
- Assets must be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole
- Assets held to cover technical provisions must be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities and in the interest of policyholders and beneficiaries

Questions?

- Question 9:

  What are key elements of a high quality risk management?

- Question 10:

  What are key qualities of a good CRO?

Risk management - internal model

- Additional tasks to be covered in the case of use of a partial of full internal model:
  - To design and implement the internal model
  - To test and validate the internal model
  - To document the internal model and any subsequent changes to it
  - To analyse the performance of the model and to produce summary reports thereof
  - To inform the Board about the performance of the models, suggesting areas needing improvement and updating the Board on the status of improvements

ORSA as part of risk management

- Compare specific risk profile of the undertaking with standard formula or internal model
- Assess the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking
- Ensure that business underwritten is supported by right amount of capital
- Integral part of the business strategy
- To be performed at least once a year and whenever a significant change in the risk profile

Objectives of the ORSA

- ORSA should ensure that an insurer does not engage in business for which it does not have sufficient capital
- ORSA should allow an insurer to assess the quality and quantity of financial resources available to it, relative to its needs

  - **NO SEPARATE CONSIDERATION OF RISK AND CAPITAL**
  - **ORSA IS THE DNA OF AN INSURANCE UNDERTAKING**

What should ORSA be?

- A continuous process to ensure that risk and solvency are key factors in the insurer's decision making

- A key component of an insurer's risk management culture

- A project that is supported by all key stakeholders, based on a clear plan and a clear allocation of responsibilities

What should ORSA not be?

- ORSA should not become a compliance reporting exercise (no box ticking)
- ORSA should not be performed solely for the benefit of the supervisor
- ORSA should not be seen or be used as a new capital requirement
- ORSA should not replace regulatory capital requirements

Risk Management Function

- One of the key functions under Solvency II Governance
- Person in charge must be fit and proper
- Need to consider the position of the CRO in the management structure of the undertaking
- Based on written policy which must be reviewed at least annually and is subject to prior approval by the Board
- Must report to the Board on risks that have been identified as potentially material
- Must report on other specific areas of risks both on its own initiative and following a request from the Board

Questions?

- Question 11:

  Should each insurance undertaking have a CRO?

- Question 12:

  To whom should the CRO report?

  - to the Chief Actuary?
  - to the Chief Financial Officer?
  - to the CEO?

Tasks of the Risk Mgt Function

- Assist the Board and other functions in the effective operation of the risk mgt system
- Monitor the risk mgt system
- Monitor general risk profile of the undertaking as a whole
- Report in detail on risk exposures and advise the Board on risk mgt matters, including in relation to strategic affairs such as corporate strategy, mergers and acquisitions and major projects and investments
- Design and implement the internal model
- Co-operate closely with the actuarial function

Reporting about risk management

- Solvency and Financial Condition Report
  - A description of the system of governance and an assessment of its adequacy for the risk profile of the undertaking
  - A description, separately for each category of risk, of the risk exposure, concentration, mitigation and sensitivity
- Regular Supervisory Reporting
  - Solvency and Financial Condition Report
  - Regular supervisory report (includes the undertaking's risk profile, with separate information on underwriting risk, market risk, credit risk, liquidity risk, operational risk and other material risks)
  - ORSA supervisory report
  - Annual and quarterly quantitative templates

Concluding remarks

- Solvency II puts more emphasis on the responsibility of each individual undertaking
  - Investment strategy (prudent person)
  - Asset-Liability management
  - Governance functions
  - Own risk and solvency assessment
- Solvency II recognises the strength and the weakness of human nature: more focus on risk management and governance
- Solvency II cannot work without a change in management and supervisory culture

Prof. Karel VAN HULLE
Research Center Insurance
Faculty of Economics and Business
KU Leuven
Naamsestraat 69 Box 3525, B-3000 Leuven
karel.vanhulle@kuleuven.be

International Center for Insurance Regulation
Faculty of Economics and Business Admin.
Goethe University – House of Finance
Grüneburgplatz 1, D-60323 Frankfurt am Main
VanHulle@finance.uni-frankfurt.de