

Solvency II – the third round of consultation papers

In November 2009, the Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”) issued its third set of consultation papers (CPs63-79) on the Solvency II Level 2 text. The consultation period ended on 11 December 2009 for all except CP78 where the closing date is 5 February 2010. The following provides a summary of the papers with a few thoughts on issues and next steps to take.

Advice on Partial Internal Models, SCR Standard Formula Correlation Parameters and Undertaking-Specific Parameters

- CP65 Draft L2 Advice on partial internal models
- CP74 Draft L2 Advice on SCR Standard Formula – Correlation Parameters
- CP75 Draft L2 Advice on SCR Standard Formula – Undertaking Specific Parameters

As CEIOPS’s first consultation paper dealing specifically with partial internal models, CP65 sets out the approval criteria for partial internal models. The paper indicates that the standards to gain approval for a partial internal model are no less rigorous than for a full internal model. Also, firms are required to fully integrate the partial internal model into the standard formula, which could be challenging.

CP74 proposes some increases to correlation parameters used in the standard formula SCR calculation. Market correlations have been increased significantly following the post-credit crunch experience, and higher-level correlation factors have also increased between Life, Non-Life and Health Underwriting modules, and between Market and Counterparty Risk modules. Compared to QIS4, CEIOPS estimate that Basic SCRs will increase on average by 13% for non-life insurers and 24% for life insurers.

CP75 sets out the standards for undertaking-specific parameters in the Non-Life Underwriting Risk module. The key standards are that the data should be relevant, accurate and complete, and the methodology documented.

Advice on Calibration of SCR Standard Formula and MCR

- CP69 Draft L2 Advice on SCR Standard Formula – Design of the Equity Risk Sub-Module
- CP70 Draft L2 Advice on SCR Standard Formula – Calibration of Market Risk
- CP71 Draft L2 Advice on SCR Standard Formula – Calibration of Non-Life Underwriting Risk
- CP72 Draft L2 Advice on SCR Standard Formula – Calibration of Health Underwriting Risk
- CP73 Draft L2 Advice on MCR – Calibration

In CP69 and CP70, several market stresses in the SCR standard formula have been increased as a result of the credit crunch and associated market turmoil; a new SCR component is also introduced to capture the risk of a shift in equity volatility. CP71 and CP72 alter Non-Life and Health SCR standard formula parameters such that capital requirements are increased across the board. The MCR calibration is of less consequence, now that the MCR is constrained to lie between 25% and 45% of the SCR.

We suggest that the increasing onerousness of the SCR standard formula should prompt all firms to consider if using the standard formula is the best route to assess their capital requirement given the increase in the factors proposed in these papers.



Advice on Simplifications

- CP76 Draft L2 Advice on Technical Provisions – Simplifications
- CP77 Draft L2 Advice on SCR Standard Formula – Simplifications
- CP79 Draft L2 Advice on simplifications for captives

CP76 and CP77 set out the criteria by which a firm may be entitled to use the simplifications, with the watchword being that methodologies should be proportionate to the nature, scale and complexity of the risks. Further simplifications for captives are set out in CP79. These proposals may encourage smaller firms to simplify their products and operations in order to avoid having to carry out more complex capital requirement calculations.

Advice on Group Level and Solo Level Assessments

- CP66 Draft L2 Advice on the group solvency for groups with centralised risk management
- CP67 Draft L2 Advice on SCR Standard Formula and Own Funds – Treatment of Participations
- CP68 Draft L2 Advice on SCR Standard Formula and Own Funds – Treatment of Ring Fenced Funds

CP66 considers the supervision of groups benefiting from a centralised risk management function. This paper sets out minimum standards to which the centralised risk management function must conform, and sets out proposals as to how supervision at subsidiary level can incorporate the existence of the centralised function.

CP67 consults on the treatment of participations in subsidiary insurers or other financial institutions for the determination of own funds. The objective is to develop the implementing measures so as to avoid allowing a parent entity to double-count capital invested in a participation to support that participation's capital requirements as an investment holding that can then also support the parent entity's own capital requirements.

CP68 sets out the proposed treatment of ring-fenced funds (RFFs) with regard to assessment of the SCR. The advice is that RFFs should have separate SCR calculations, and firms should not assume that funds can be transferred out of RFFs to support the firm's SCR arising outside the RFFs. The RFF is not clearly defined as to whether it applies only to funds with a strict legal or contractual separation (and is therefore narrow in its focus), or more broadly to any fund where there are barriers to restrict transferring out capital.



Others to note

- CP63 Draft L2 Advice on repackaged loans investments

CP63 concerns insurers investing in repackaged loans or similar instruments (effectively asset-backed securities). CEIOPS have effectively transcribed the principles applying to credit institutions, with the stated aim of ensuring cross-sector consistency. These principles impose strict criteria on both the firm and the originator, most notably a requirement that the originator must maintain a minimum 5% interest in the underlying assets.

- CP64 Draft L2 Advice on the extension of the recovery period – Pillar II dampener

CP64 sets out factors for authorities to consider when permitting an extension of recovery period in cases where the SCR has been breached. The recovery period in normal market conditions is at most nine months, but at the discretion of the supervisor, up to 21 additional months may be permitted in the event of exceptional market falls; CEIOPS have not defined normal and exceptional market conditions. The purpose of this extension is to avoid forcing insurers to sell assets when markets are depressed, or to raise capital when it is most expensive.

- CP78 Draft L2 Advice on technical criteria for assessing third country equivalence

CP78 sets out the criteria by which insurance supervisors should determine whether the regulatory regime of a territory outside the jurisdiction of Solvency II can be considered to be of equivalent strength to Solvency II. The criteria are slightly different depending on whether equivalence is being determined with regard to reinsurance operations, solvency regime or group supervision. In each case, the paper sets out the principles by which a regulatory regime will be considered equivalent to Solvency II, and the tests that should be performed to assess equivalence.

Further information

The FSA's Discussion Paper DP 08/4 "Insurance Risk Management: The Path to Solvency II" should be read by all board members and senior management. This sets out what the FSA is expecting of UK firms between now and the implementation date of Solvency II. CEIOPS are in the process of EU-wide consultation on the implementation of Solvency II and a further quantitative analysis, QIS 5, will be carried out later this year.

The volume of material being released is somewhat intimidating, but Barnett Waddingham can provide you with summaries tailored to your business. We can also compile reading lists, help you understand the potential implications for your business, and help you carry out a gap analysis and implement processes and controls required to meet the Solvency II regime.

Our Specialist Team

For more information on these services please contact:



Rajeev Shah – Partner

Email: rajeev.shah@barnett-waddingham.co.uk
Telephone: +44 (0)20 7776 2259
Mobile: +44 (0)7989 324322



John O'Neill – Partner

Email: john.o'neill@barnett-waddingham.co.uk
Telephone: +44 (0)20 7776 3884
Mobile: +44 (0)7590 735988



Richard Weatherill – Actuary

Email: richard.weatherill@barnett-waddingham.co.uk
Telephone: +44 (0)20 7776 2252

Switchboard: +44 (0)20 7776 2200

Barnett Waddingham - FEBRUARY 2010

Chalfont Court
Hill Avenue
Amersham
HP6 5BB
Tel: 01494 788100
Fax: 01494 788800

Rigby Hall
Rigby Lane
Bromsgrove
B60 2EW
Tel: 01527 559111
Fax: 01527 559222

St James's House
St James's Square
Cheltenham
GL50 3PR
Tel: 01242 538500
Fax: 01242 538501

163 West George Street
Glasgow
G2 2JJ
Tel: 0141 243 4400
Fax: 0141 243 4432

West Riding House
67 Albion Street
Leeds
LS1 5AA
Tel: 0113 394 3700
Fax: 0113 394 3760

Port of Liverpool Building
Pier Head
Liverpool
L3 1BW
Tel: 0151 235 6600
Fax: 0151 235 6640

Cheapside House
138 Cheapside
London
EC2V 6BW
Tel: 020 7776 2200
Fax: 020 7776 3800

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office.

Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), Barnett Waddingham Investments LLP (OC323081), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at Cheapside House, 138 Cheapside, London EC2V 6BW.

Barnett Waddingham LLP is authorised and regulated by the Financial Services Authority and is licensed by the Institute of Actuaries for a range of investment business activities. Barnett Waddingham Investments LLP and BW SIPP LLP are authorised and regulated by the Financial Services Authority. Barnett Waddingham Actuaries and Consultants Limited is regulated by the Institute of Actuaries in respect of a range of investment business activities.