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International Center for Insurance Regulation

Solvency II, linking risk with capital

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, security…
- **Conclusion: the insurance sector will be the sector of the future if it can offer solutions for these challenges**

Insurance and regulation

- Present insurance regulation is boring: try to explain to an outsider the calculation of the solvency margin under Solvency I
- Insurers are often perceived by regulators as people who sell just about anything
- Insurance regulation is highly prescriptive and paternalistic
- Insurance regulation is very legalistic and does not reflect the economics of the insurance business model
- Insurance regulation is more concerned with policyholder protection than with insurance

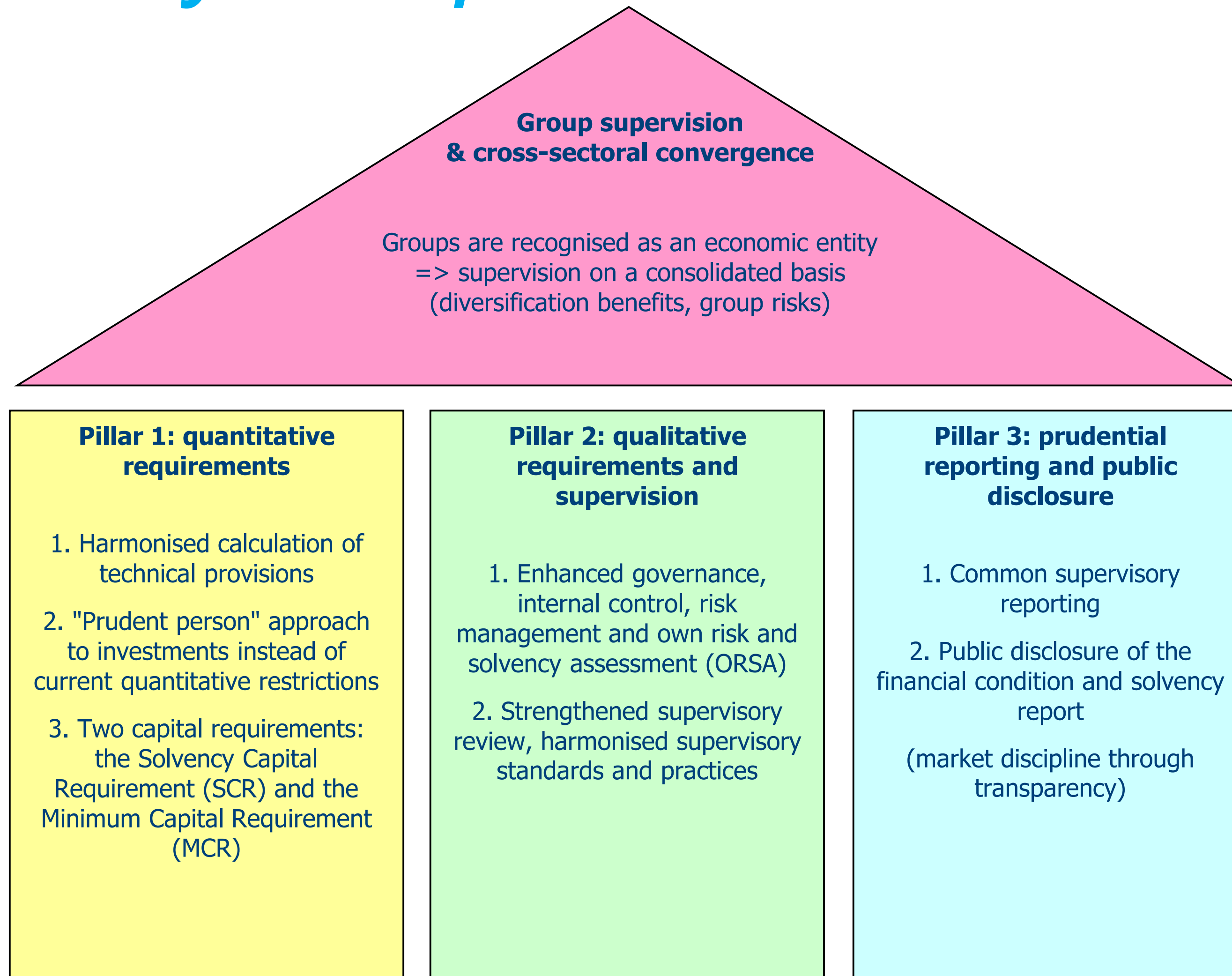
Behaviour of the insurance industry

- Industry representatives are rarely capable to explain to outsiders in simple terms what insurance is all about
- Although the introduction of a risk based solvency regime has been announced for a long time, many insurers have still not changed their behaviour
- The introduction of long transition periods is therefore necessary to organise a smooth transition from Solvency I to Solvency II
- 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 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



Main characteristics of Solvency II

- Market consistent valuation of assets and liabilities based upon IAS/IFRS
- Total balance sheet approach
- Two capital requirements: SCR with confidence level of 99,5% VaR over a one year time horizon and MCR with absolute floor
- Possibility to calculate the SCR using an internal model approved by the supervisor
- Three pillar approach introduced by Basel II for banks
- Extended and fully harmonised supervisory powers
- Group supervision on equal level with solo supervision

Brief history of Solvency II

- Start at the beginning of this century (2000 -2001)
- Project in 4 stages, initiated by the EC and prepared technically by insurance supervisors (EIOPA) in close cooperation with stakeholders
- Framework Directive adopted in 2009 and amended after the financial crisis in 2014 (level 1)
- Implementing measures finalised in 2014-2015 (level 2)
- Implementing technical standards (level 3) and supervisory guidelines (level 4) issued in 2015
- Start date: 1 January 2016
- Scope: 31 European countries / 4000 (re) insurers

Need to know

- Solvency II is not a zero fail regime, i.e. it is not impossible for an insurer not to meet the solvency requirements
- Solvency II will more quickly show when an insurer is experiencing difficulties (for instance, caused by the low interest rate environment)
- Moving from Solvency I to Solvency II made it necessary to introduce transitional provisions as Solvency I was not sufficiently risk based
- Solvency II requires a different relationship between insurance undertakings and insurance supervisors

Early lessons from Solvency II

- Remarkable improvement of risk management in most insurance undertakings
- Increased professionalism in the discussions between supervisors and insurance undertakings
- First time availability of relevant data on the European insurance industry
- Insurance and insurance supervision/regulation is taken more seriously (also by banking supervisors!)
- Supervisory colleges are playing an important role in furthering a single European rulebook

Challenges from operating Solvency II

- Are insurers and supervisors capable of applying a solvency regime that has become increasingly complex?
- How will the market react upon the publication of the first SCR and MCR amounts?
- Is it helpful to change the calibration in the standard formula before the revision in 2018?
- Is there a need to review parts of Solvency II before 2020?
- What to do with insurers that are not able to meet the MCR?
- Do we need an EU regime for recovery and resolution and for insurance guarantee schemes?

EIOPA: a reality

- Technical adviser of the EC and the EP with leadership role for technical issues concerning insurance supervision (RTS and ITS)
- Represented in all (92) colleges of supervisors
- Responsible for developing common supervisory culture
- Binding mediation, peer reviews
- Cooperation with ESRB
- Clear mandate to further develop market conduct rules
- Assisted by two stakeholder groups (IRSG and OPSG)

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To remember

- Solvency II has been developed as a uniform regulatory regime for the EU:
  - Important transfer of regulatory powers to EU and de facto to EIOPA
  - Gold plating only allowed to a limited extent
  - Cross-fertilization of supervisory practice through the colleges of supervisors
  - More limited role for supervisors in host Member States
  - Imposing unnecessary local rules and requirements will have to be paid for by local policyholders

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
Theodor-W.-Adorno Platz 3, D-60323 Frankfurt am Main
VanHulle@finance.uni-frankfurt.de

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