Link between Pillar 1 and Pillar 2

XXIV International Seminar on Insurance and Surety, November 2014, Mexico City

Olaf Ermert, BaFin
Content

• Introduction
• Own Risk and Solvency Assessment
• Actuarial function
• Outlook
Link between Pillar 1 and Pillar 2

Content

- Introduction
- Own Risk and Solvency Assessment
- Actuarial function
- Outlook
## Introduction

### The Three-Pillar-Approach under Solvency II

<table>
<thead>
<tr>
<th><strong>Pillar 1</strong></th>
<th><strong>Pillar 2</strong></th>
<th><strong>Pillar 3</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantitative Requirements</td>
<td>Qualitative Requirements</td>
<td>Reporting &amp; Disclosure</td>
</tr>
<tr>
<td>Valuation of assets and liabilities for solvency purposes</td>
<td>General governance requirements</td>
<td>Supervisory reporting</td>
</tr>
<tr>
<td>Determination of available own funds</td>
<td>Risk management including ORSA</td>
<td>Public disclosure</td>
</tr>
<tr>
<td>Regulatory capital requirements – SCR and MCR</td>
<td>Actuarial Function</td>
<td></td>
</tr>
<tr>
<td>Investment rules (prudent person approach)</td>
<td>Internal control system</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Internal audit</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Outsourcing</td>
<td></td>
</tr>
</tbody>
</table>

XXIV International Seminar on Insurance and Surety
Why we should have a strong link between Pillar 1 & 2

- Pillar 1 should not be a “black box” owned by the actuaries
- Instead, Pillar 1 should contribute to and be part of insurer’s risk management
- Assessment and validation of Pillar 1 under Pillar 2 is key
- Strong links between Pillar 1 and Pillar 2 enhance quality of supervisory reporting and public disclosure under Pillar 3
- Supervisory review process works best where Pillar 1, Pillar 2 and Pillar 3 are closely intertwined
Introduction

Some areas where link is particularly relevant

- ALM Management
- Investment Management
- Use of risk mitigating instruments
- Own Risk and Solvency Assessment (ORSA)
- Actuarial function
- Internal Models (use test)
- Capital add-ons
Introduction

Some areas where link is particularly relevant

- ALM Management
- Investment Management
- Use of risk mitigating instruments
- Own Risk and Solvency Assessment (ORSA)
- Actuarial function
- Internal Models (use test)
- Capital add-ons
Link between Pillar 1 and Pillar 2

Content

- Introduction
- Own Risk and Solvency Assessment
- Actuarial function
- Outlook
## Components of the ORSA

<table>
<thead>
<tr>
<th>Component</th>
<th>Questions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own solvency needs</td>
<td>• What are my own economic solvency needs?</td>
</tr>
<tr>
<td>Compliance with regulatory requirements</td>
<td>• Can I continuously comply with:</td>
</tr>
<tr>
<td></td>
<td>• regulatory SCR/MCR requirements?</td>
</tr>
<tr>
<td></td>
<td>• requirements on technical provisions?</td>
</tr>
<tr>
<td>Sufficiency of regulatory capital requirements</td>
<td>• Does my own risk profile deviate significantly from the assumptions</td>
</tr>
<tr>
<td></td>
<td>underlying the calculation of the SCR?</td>
</tr>
</tbody>
</table>
Continuous compliance with regulatory requirements

- Assessment of capital requirements at the time and how they may change going forward
- Needs to reflect internal planning and possible external factors
- Volatility of the SCR may require that insurers hold more capital than necessary to cover the SCR
- “Best Estimate” assumptions not sufficient → need for Stress & scenario testing
- Need for contingency plans for adverse scenarios
Deviation of own risk profile from SCR assumptions

- Insurer has to assess whether its own risk profile deviates from the assumptions underlying the SCR calculation
- Insurer has to assess whether these deviations are significant
- Where significant, deviation has to be quantified

To facilitate such assessments, EIOPA has published information on the assumptions underlying the Solvency II SCR standard formula (eiopa.europa.eu/publications/technical-specifications/index.html)
Deviation of own risk profile from SCR assumptions

- Purpose of the assessment is to identify material, quantifiable risks not (sufficiently) covered by the SCR calculation
- Where such risks have been identified, further steps need to be considered:
  - Change of insurer’s risk profile (e.g. de-risking)
  - Use of undertaking-specific parameters
  - Use of (partial) internal model
  - Capital add-on
## Benefits and challenges

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivers comprehensive assessment of insurer’s risk position</td>
<td>Needs significant additional analysis – increases complexity and costs</td>
</tr>
<tr>
<td>Requires forward looking capital management and planning</td>
<td>Reliability of necessary projections of solvency position through time</td>
</tr>
<tr>
<td>Gives valuable insight in current and potential future vulnerabilities</td>
<td>Underlying assumptions of SCR calculation often not fully transparent</td>
</tr>
<tr>
<td>Helps to assess sustainability of insurer’s business strategy</td>
<td>Supervisory review of quality of insurer’s assessment demanding</td>
</tr>
</tbody>
</table>
Content

- Introduction
- Own Risk and Solvency Assessment
- Actuarial Function
- Outlook
Actuarial Function

- Key function in the new governance system under Solvency II
- Important task of coordination and validation of calculation of technical provisions
- Has to inform management about reliability and adequacy of the calculation considering:
  - Appropriateness of methods and assumptions
  - Sufficiency and quality of input data
  - Back testing results
- Also has to express an opinion on insurer’s underwriting policy and reinsurance arrangements

Successful implementation of Actuarial Function key to ensure that valuation of technical provisions is reliable and “fit for purpose”
Link between Pillar 1 and Pillar 2

Content

- Introduction
- Own Risk and Solvency Assessment
- Actuarial Function
- Outlook
Europe-wide phase of preparation for Solvency II launched on 1 January 2014

Supported by Preparatory Guidelines published by EIOPA in following areas:

- Governance including Risk Management
- Internal models (pre-application phase)
- Reporting

BaFin issues supplementary announcements and has initiated structured dialogue with insurers on preparation for Solvency II

In life insurance, BaFin recently conducted comprehensive quantitative solvency assessment

1see [www.bafin.de/EN/Supervision/InsuranceUndertakingsPensionFunds/Solvency2Preparation/solvency2_preparation_node.html](http://www.bafin.de/EN/Supervision/InsuranceUndertakingsPensionFunds/Solvency2Preparation/solvency2_preparation_node.html)
Thank you for your attention.

Dr. Olaf Ermert  
Federal Financial Supervisory Authority - BaFin  
Insurance Supervision  
Dreizehnoroughweg 13-15  
53175 Bonn  
Germany  
Fon: +49[0]228-4108-7263  
mailto:olaf.ermert@bafin.de