Corporate governance under Solvency II: the other side of the coin

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State of play on Solvency II

- Solvency II Framework Directive was adopted on 29 November 2009
- Omnibus II Directive amending the Solvency II Directive was adopted on 16 April 2014 (financial crisis, powers of EIOPA, transitional measures, long term guarantees, proportionality, equivalence)
- Level 2 implementing measures to be proposed by EC in September 2014 subject to 6 months scrutiny from Council and European Parliament. Legal form: Regulation (Delegated Act)
- Level 3 implementing measures under preparation by EIOPA: Implementing Technical Standards, Recommendations, Guidelines
- EIOPA is presently consulting on draft Guidelines concerning Pillar 1 issues (own funds, internal models, group solvency, technical provisions, contract boundaries), Pillar 2 issues (system of governance, ORSA, SRP) and Equivalence
Date of application of Solvency II

- All EU (re) insurance undertakings must apply the Solvency II requirements from 1 January 2016
- EU Member States must implement the Solvency II Framework Directive as amended by Omnibus II by 31 March 2015
- Some Solvency II provisions already apply from 1 April 2015:
  - Procedure for the approval of undertaking specific parameters, internal models, ancillary own funds, classification of own funds, special purpose vehicles;
  - MS need to decide on 1 April 2015 whether they will allow certain measures relating to long term guarantee products, such as the matching adjustment, the volatility adjustment and the transitional regimes concerning the applicable interest rate and the calculation of technical provisions
Interim Measures adopted by EIOPA

• In order for EU (re) insurance undertakings to prepare themselves for Solvency II, EIOPA has adopted on 27 September 2013 a number of Guidelines which apply from 1 January 2014. The guidelines deal with three areas:
  o System of Governance, including risk management
  o Forward looking assessment of the undertaking’s own risk (based on the Own Risk and Solvency Assessment principles)
  o Submission of information to National Competent Authorities
  o Pre-application for internal models
Solvency II: 3 pillars and a roof

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)

Group supervision & cross-sectoral convergence
Groups are recognised as an economic entity => supervision on a consolidated basis (diversification benefits, group risks)
Can pillar 1 exist without pillar 2?

- Experience with Basel I
- Not everything can be quantified
- It is not just about capital: most insurance failures are not due to a lack of capital but to a lack of proper governance
- Every ship needs a captain
- Supervisory review process and the dialogue between the supervisor and the supervised entities is crucial
- The standard formula and/or the internal model can only be approximations of the reality
- Supervisors need an appropriate toolkit
Can pillar 2 exist without pillar 1?

• Imposing proper governance and good risk management does not necessarily bring about the right amount of capital
• It is important for insurers to have a benchmark against which they can test their capital needs
• Only by imposing capital requirements can one ensure a level playing field between insurers
• A solvency regime without fixed capital requirements is impossible to enforce
• Capital requirements make the entrance to insurance more difficult for unprofessional operators
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Governance requirements
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 AMSB and persons effectively running the business must be fit and proper
Governance functions

• General principles
  o Written policy
  o Prior approval by AMSB
  o Regular review (annually or in case of significant changes)

• Functions
  o Risk management
  o Internal control and compliance
  o Internal audit
  o Actuarial
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.
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.
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:
  o Underwriting and reserving
  o Asset-liability management
  o Investment, in particular derivatives and similar commitments
  o Liquidity and concentration risk management
  o Operational risk management
  o Reinsurance and other risk-mitigation techniques
Role of AMSB in risk mgt system

- The AMSB 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 AMSB of the responsible entity 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
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 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 AMSB
• Must report to the AMSB 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 AMSB
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 TP 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
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
  
  o NO SEPARATE CONSIDERATION OF RISK AND CAPITAL
  
  o 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
Basic requirements

• The ORSA is part of an insurer’s risk management system
• The ORSA forms an integral part of the business strategy and must be taken into account on an ongoing basis in the strategic decisions of the insurer
• The ORSA must be performed by each insurer regularly and without delay following any significant change in the risk profile
• The ORSA must be communicated to the supervisory authority as part of the regular supervisory reporting
• The ORSA does not require the development of an internal model nor shall it serve to calculate a capital requirement
Contents of the ORSA

• The assessment shall include at least:
  o the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking
  o the compliance, on a continuous basis, with the capital requirements (SCR – MCR) and with the requirements regarding technical provisions
  o the significance with which the risk profile of the insurer deviates from the assumptions underlying the SCR (standard formula / partial or full internal model)
Forward looking perspective

• The assessment should be forward looking
• Capital needs should be projected over the insurer’s business planning period, which may differ between undertakings
• Identification and consideration of external factors that might have an adverse impact on the insurer’s overall solvency needs or its own funds
• Capital management plans and capital projections require the undertaking to consider how it might respond to unexpected changes in external factors
Supervisory powers
Supervisory powers

• Supervisory authorities must have the power to take any necessary measures, including where appropriate, those of an administrative or financial nature, with regard to insurance undertakings and the members of the AMSB

• Supervisory authorities must have the power to require all information necessary to conduct supervision

• Supervisory authorities must have the power to develop quantitative tools under the SRP to assess the ability of insurance undertakings to cope with possible events or future changes in economic conditions that could have unfavourable effects on their financial standing
Supervisory powers (continued)

• 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
• Supervisory authorities must respect proportionality
• Outsourcing of critical or important functions only possible with prior notification of supervisory authorities
Supervisory review process

- Supervisory authorities must review and evaluate compliance with the following:
  - The system of governance, including the ORSA
  - The technical provisions
  - The capital requirements
  - The investment rules
  - The quality and quantity of own funds
  - On-going compliance with the requirements for partial or full internal models
Supervisory tools

• Supervisory ladder of intervention
• Stress test
• Off-site activities and on-site inspections
• Capital add-on (strictly regulated)
• Transfer of portfolio
• Early warning indicators
• Restrictions on distribution of dividends
• Replacement of management
• Extension of recovery period for the SCR
Concluding remarks

• Solvency II puts more emphasis on the responsibility of each individual undertaking
  o Investment strategy (prudent person)
  o Asset-Liability management
  o Governance functions
  o Own risk and solvency assessment

• Solvency debate often too much based on capital
• Need to focus more on risk management and governance
• EIOPA will be a key player in the further development of Solvency II
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