**Solvency Modernization Initiative**
**Country Comparison Analysis**
**November 2009**
*(Note: Portions excerpted directly from FSA and Swiss Re materials.)*

# Country: Solvency II

## 1. Background Description

Solvency II is designed to replace Solvency I, and differs from Solvency I in that it is intended to (a) be more consistent with best market practice; (b) be better harmonized across Europe, rather than just setting minimum standards; and (c) more fully apply modern risk management, actuarial, accounting and governance standards.

## 2. Solvency Regulation Description

Solvency II consists of three pillars. Pillar I is concerned with minimum capital requirements (such as reserves, minimum capital requirements, solvency capital requirements, and funds eligible as capital to cover the requirements). Pillar II's scope is supervisory review (including review of an insurer's Own Risk and Solvency Assessment or ORSA), and Pillar III deals with public transparency and market discipline through public reporting standards, disclosure and other tools (e.g., publication of the annual Solvency and Financial Condition Report (SFCR) as well as confidential information to regulators). The Solvency II regime is intended to achieve a high degree of convergence in regulatory standards across Europe, although some flexibility is allowed to each country in adapting it to their own market. It is *principles-based*.

## 3. Minimum Capital Standards

The Minimum Capital Requirement (MCR) is a linear function of some or all of the following variables (net of reinsurance):

Technical provisions (or reserves)
Written premiums
Capital at risk
Deferred tax
Administrative expenses.

The MCR is to be calibrated to the Value-at-Risk of the insurer's funds to a confidence level of 85 percent over a one year period. There are restrictions on the capital that can be counted as an insurer's funds for purposes of meeting the requirement.

The MCR is subject to a corridor such that it can be no less than 25% of the SCR nor no more than 45% of the SCR.

## 4. Solvency Capital Requirement (SCR)

The Solvency Capital Requirement (SCR) is based on the economic capital needed at a certain ruin probability (0.5% ruin probability) over a one year time horizon. Insurers may compute the SCR using a standard model, an internal model, or a combination of the standard and internal model.

The standard model is a risk-factor based model that takes into account nonlife, life, and health underwriting risk; market risk; credit risk, and operational (including legal) risk. It does not cover strategic risk, liquidity risk or reputational risk.

Use of an internal model requires supervisory approval. In order to obtain supervisory approval the insurer must meet certain requirements such as documented, well functioning risk management and governance systems, statistical quality standards, calibration standards, validation standards, documentation standards, and a "use" test for the model (see CEIOPS Consultation Paper 37).

Scenario testing is required whether the firm uses the standard model or an internal model.

A prudent person investment rule replaces the quantitative investment limits and asset eligibility criteria under Solvency I.

A capital-add on may be required for a firm if its governance system is perceived as inadequate or if the assumptions of the standard model do not fit the firm well.

(There are restrictions on the capital that can be counted as an insurer's funds for purposes of meeting the requirement.)

## 5. Peer Review

Under the Directive, each firm must have an internal audit function.

Under the directive, each firm must have an actuarial function, and article 47 of the Directive indicates the roles that the actuarial function is required to undertake.

## 6. Reporting

Market consistent values of liabilities and assets are used in all reports.

The annual Solvency and Financial Condition report (SFCR) (to be made public) – requires the firm to provide financial information and to give complete information about

governance and indicates the main drivers and trends that may affect the firm (either positively or negatively) over the firm's planning horizon. For different, significant risks faced by the firm, the firm must indicate the risk exposure, concentration, mitigation and sensitivity of the firm to the exposure.

Public disclosure of internal models is not required, nor is other confidential information that insurers are required to supply or file with the regulator such as the Own Risk and Solvency Assessment (ORSA) report. Details of what will be contained in the ORSA report have not been released.

## 8. On-Site Examinations

## 9. Off-site Analysis

Supervisors review the proposed internal model before it can be approved.

## 10. Capital Definition

The firm's capital is divided into three tiers according to the extent to which it can be counted on when the firm is in financial distress. The full details concerning what constitutes each tier are unknown at this time.