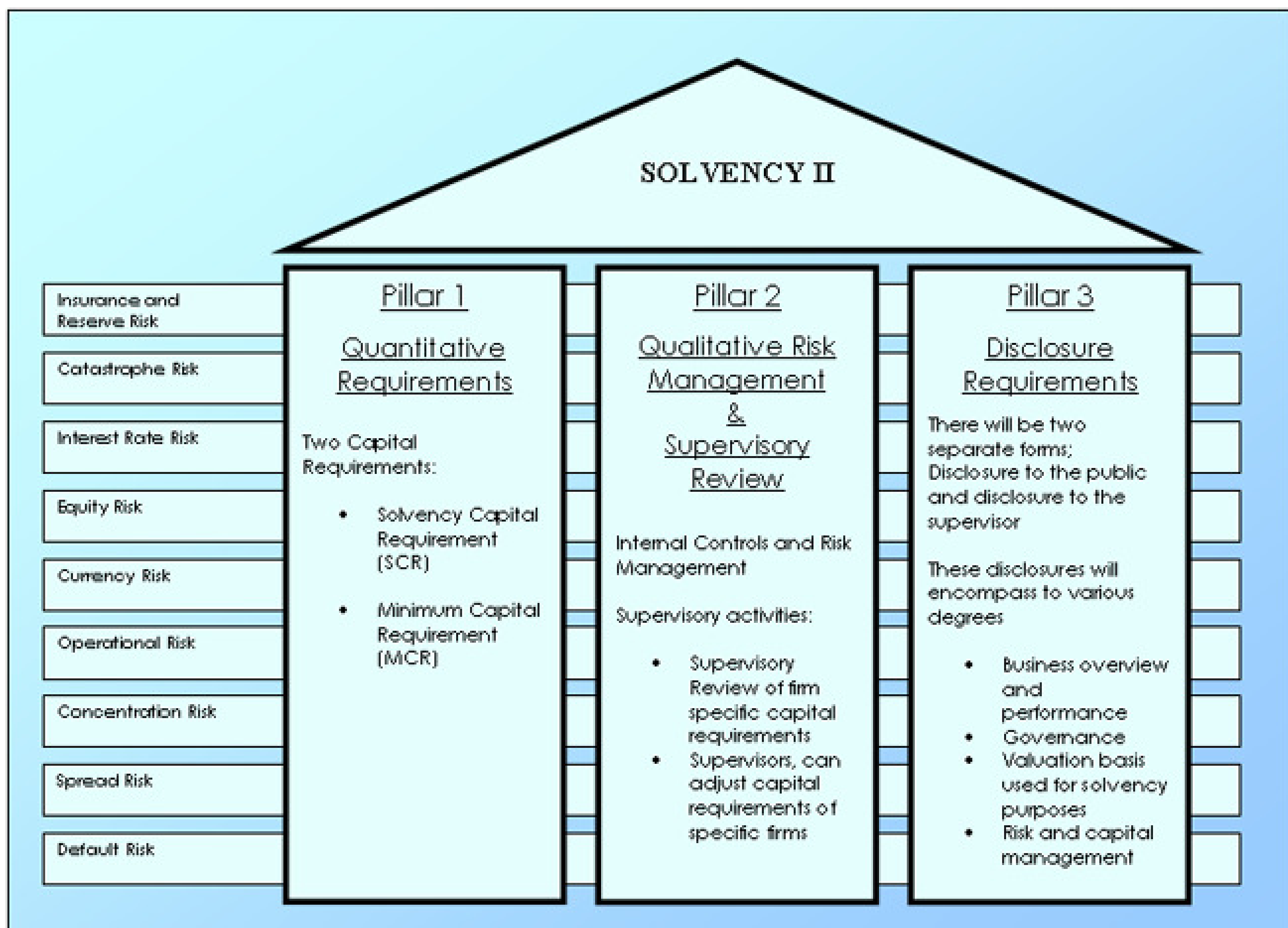
Solvency II - Overview

Solvency II is the new EU wide insurance regulation being created to replace the current structure, Solvency I. It is being designed to provide a focused risk based analysis of insurance companies' capital adequacy as well as promoting a culture of capital and risk management throughout the industry.

The Structure

The structure adopted in Solvency II has embraced a 3 pillar approach:

- **Pillar 1** – Quantitative Requirements (Implementation)
- **Pillar 2** – Qualitative Risk Management and Supervisory Review (Control)
- **Pillar 3** – Disclosure Requirements (Transparency)



In effecting this approach Solvency II sets new Minimum and Solvency Capital Requirements (MCR and SCR). The MCR being the absolute minimum threshold where, should a company fall below this level, they will be forced to cease writing business. A company with Own Funds between its MCR and SCR is subject to a "Ladder of Intervention", where regulatory action will become stronger the closer they get to their MCR.

The SCR represents the normal target level of capital for an insurer. Entities have a choice with regards to which model they use to calculate this capital requirement.

The Models

Standard Model – This is default formula currently being constructed and will be available for all companies to use.

Internal Models – Are firm specific calculations designed to maximise capital efficiency. They will encompass all the risks present in the standard model, however will be structured to capitalise on the entity's' unique composition and inherent risk diversification. As these internal models are produced by the firms themselves, they require regulatory sign-off before they can be used. This ensures they capture all the risks within the standard model to an adequate degree.

Partial Model – Due to the potentially prohibitive costs of constructing an entity specific internal model (particularly for smaller companies), the partial model is an amalgamation of the above. A firm can choose to use the standard model, but on certain risk modules it can provide its own calculations. As in the internal model these specific areas will require local regulatory permission.

The Risks

All the formulae used to calculate the SCR will include the following risks (with correlations between each risk being integrated into the calculations):

- **Insurance and Reserve Risk** - Risk arising from insurance contracts. It relates to the uncertainty about the results of the insurer's underwriting.
- **Catastrophe Risk** – Is a specific aspect of the above, but is particularly related to potential losses associated with major catastrophes.
- **Interest Risk** - Exists for all assets and liabilities of which the net asset value is sensitive to changes in the term structure of interest rates or interest rate volatility.
- **Equity Risk** - Arises from the level or volatility of market prices for equities and assets associated with these prices.
- **Currency Risk** – Covers the level or volatility of currency exchange rates.
- **Spread Risk** – Risk originating from financial instruments, explained by the volatility of credit spreads over the risk-free interest rate term structure.

The Quantitative Impact Studies

The European Commission tasked the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) with setting up multiple Quantitative Impact Studies (QIS) in order to access the potential impact of the new risk based regulatory regime being put together. There have so far been four QIS and each has offered a chance for participants to provide feedback on specific aspects of the changing Solvency II structure.

A fifth QIS (QIS5) is expected to be held in Q3 2010, with the full Solvency II regime to be put in force by October 2012.

For more information on Solvency II please visit our website – www.scandinaviancs.com

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