Solvency II: aplication in countries which do not belong to the European Economic Area EEA

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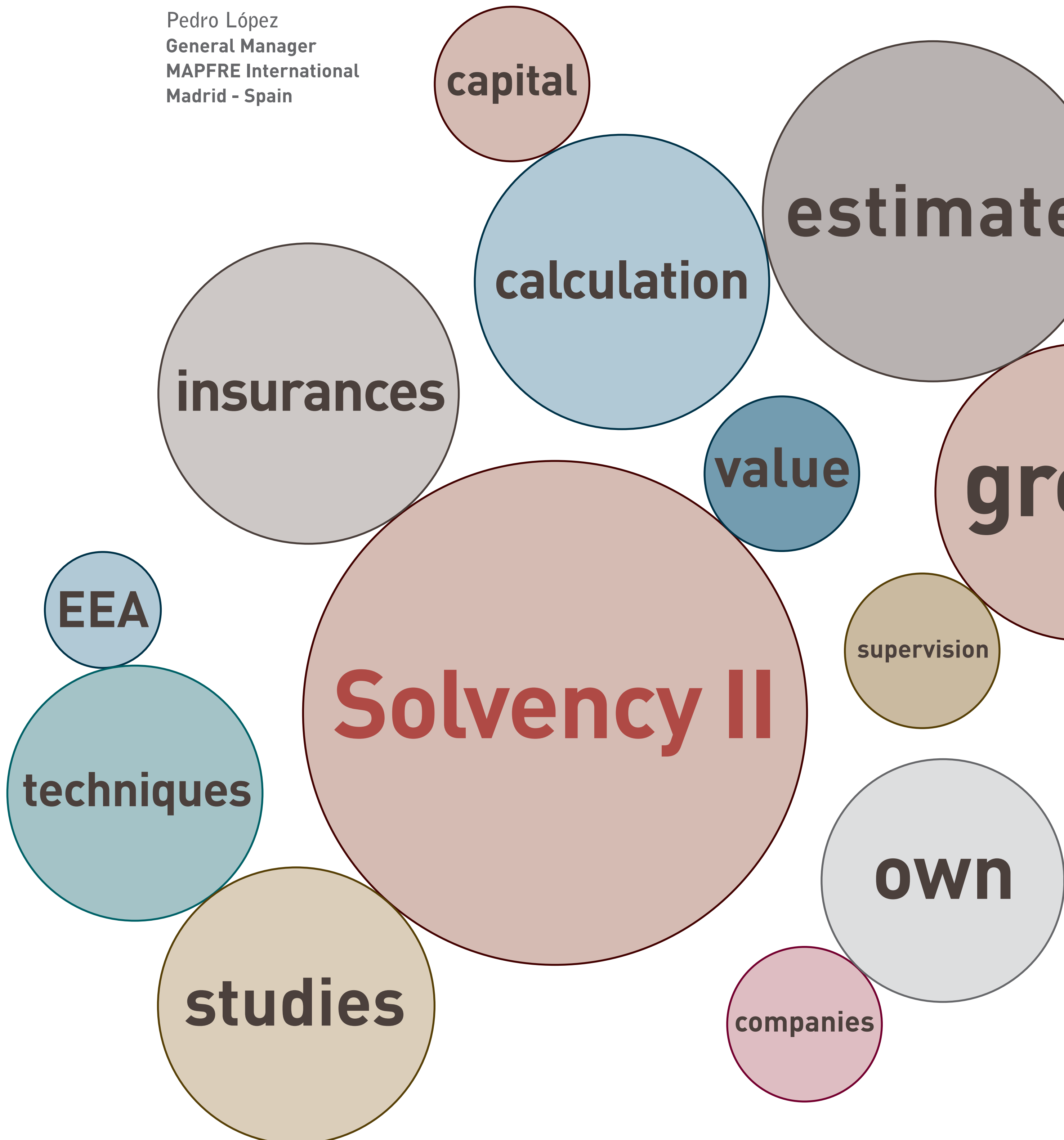

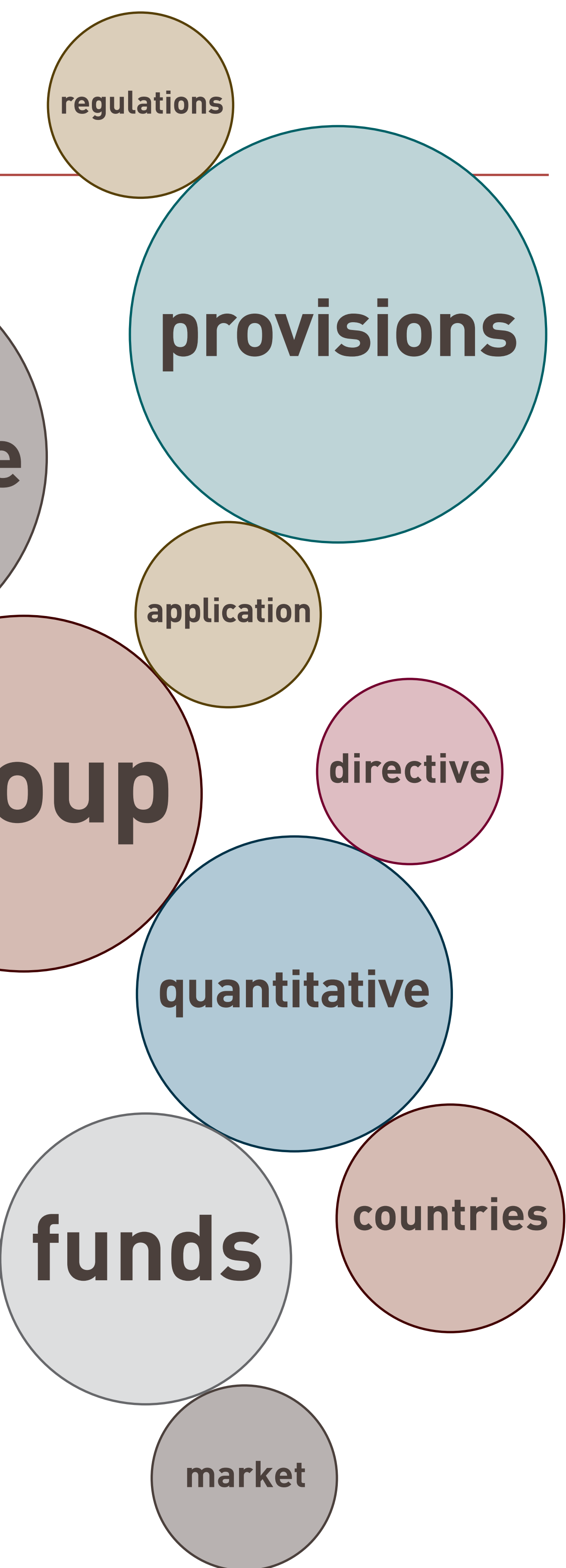

A complex business

Article 2 of Directive 2009/138/EC of the European Parliament and of the Council dated 25 November 2009 "on life insurance, and on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)" stipulates that the Directive's scope of application comprises life and non-life insurance companies established on the territory of a Member State.

Nevertheless, Title III of the Directive regulates its application to companies which form part of a group, even though such companies may be established in countries that do not belong to the European Economic Area (EEA). For this reason, application of the new Solvency II regulations is a particularly complex matter (and it is no coincidence that five Quantitative Impact Studies (QIS) have been undertaken in the last five years); it becomes even more complicated when groups are involved. This is why Title III of the Directive devotes more than 90 articles to this subject.

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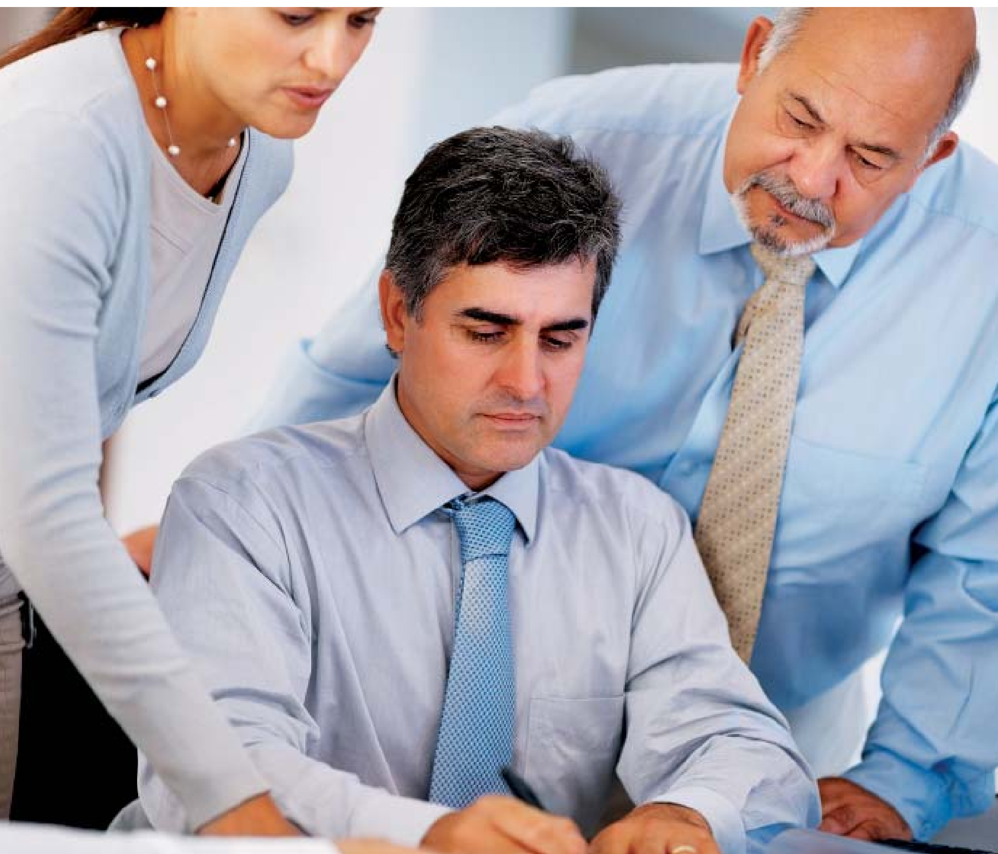
The role of Group Supervisor

The first chapter of title III (Art. 212) already defines the role of "Group Supervisor" as the person responsible for coordinating and supervising the group of companies, selected from the supervisory authorities of the Member States concerned.

Art. 213 stipulates that insurance companies (regardless of where they are established), whose parent company is an insurance portfolio holding company with its head office in the EEA, are subject to group supervision. This means that if the parent company is domiciled in Spain but has branches in (for example) the Philippines or Brazil, group supervision will apply to both branches and they should comply with the Solvency II regulations.

It is clear that Art. 214 allows the Group Supervisor to exclude a specified company from supervision, but this is only permitted in three cases which are very specific and perfectly understandable:

a. When the company is established in a country where there are legal impediments to obtaining information.



The “Group Supervisor” is the person responsible for coordinating and supervising the group of companies, selected from the supervisory authorities of the Member States concerned

b. When the company represents an insignificant interest as compared to the rest of the companies in the group.

c. When the inclusion of the company proves to be unsuitable or would lead to error in relation to the supervisory objectives.

Solvency II is applicable in all other cases.

Having established that the scope of application is global, it is then necessary to determine its implications as regards the solvency calculation at group level.

For this purpose, Art. 218, clause 3 of the Directive states that:

*“The Member States shall require the participating insurance or reinsurance companies to ensure that **eligible own funds are available** in the group which are **always** at least equal to the group Solvency Capital Requirement”.*

This calculation must be performed at least once per year, but the Directive specifies that if the company’s risk profile alters significantly during the accounting year from the profile at the time of the last calculation, it must undertake a new calculation **without delay**, to be sent to the Group Supervisor.

Solvency calculation at group level

The next question raised by the Directive concerns the method of calculating the solvency capital, and on this matter and as a summary, the Directive states the following:

The solvency capital is calculated on the basis of the consolidated accounts and this capital may be calculated by two methods:

a. Standard formula.

b. Group internal models.

In both cases:

- The valuation methods for the consolidated accounts, which form the basis for calculating the solvency capital, must be identical in all the countries. The valuation of assets and liabilities must be undertaken

at market prices (Art. 75) and in addition, the technical provisions must be valued as the "sum of a best estimate" (*Best Estimate Liabilities*, BEL) plus a risk margin.

- Off-balance-sheet adjustments must be implemented so that assets and liabilities are valued at market prices and in addition, it is necessary to determine whether the technical provisions are the "best estimate"; if not, they must be recalculated, and if they are, the schedule of payments must be obtained and they must be discounted at present value, using a free risk rate.

As may be imagined, these two points have very major implications for large insurance groups, although the International Financial Reporting Standards (IFRS) are already applied in a general manner in many countries, and these standards allow different application options on many points.

For example, real estate may be valued at market price or cost price less depreciations, which would involve the off-balance-sheet adjustments practiced in those countries (such as Spain) where real estate is mostly valued at cost price.

However, the greatest difficulty arises when it comes to valuing the technical provisions, where the valuation approach changes radically; in the past, the technical provisions were valued on the basis of a "prudential criterion", whereas this criterion is now relegated to second place.

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According to the Solvency II calculation regulations (Art. 77), it is the best possible estimate which must be obtained (Best Estimate Liabilities, BEL). The aim here is to calculate a theoretical market value at which the technical provisions can be traded.

"…the best estimate shall correspond to the probability-weighted average of future cash-flows, taking account of the time value of money (expected present value of future cash-flows), by using the relevant risk-free interest rate term structure" (Art. 77. 2).

One direct consequence of this new approach is that the provision for unearned premiums ceases to be a premium accrual account and is converted into an estimate of future liabilities relating to policies and contracts in force on the calculation date (future premiums less claims and liquidation expenses, administration and acquisition costs, all calculated on the basis of our best estimate).

The technical specifications drawn up for completing the Quantitative Impact Studies (QIS) stipulate in great detail when the technical provisions may be considered as BEL; prior studies are necessary in all the companies and all the countries to determine whether the said conditions are met, and the relevant studies must be certified by the technical/actuarial departments of the companies in question.

Finally, it is no less important to note that technical provisions must be calculated at their present value; this implies that they must be discounted with the use of an interest rate curve. The European Commission definitely wants EIOPA (the European Insurance and Occupational Pensions Authority) to provide rate curves for use with the main currencies

Interest rate curves will be difficult to obtain in countries where financial bond markets and interest rate swap transactions are not sufficiently developed

(including EUR, USD and the various currencies of European countries which do not use the euro), but the Authority is unlikely to provide interest rate curves for all currencies. This will present difficulties when it comes to producing these curves in order to conform to the criteria stated in the last QIS5. These criteria are so rigorous and complex that -to put it simply- it is virtually impossible to comply with them in countries where financial bond markets and interest rate swap transactions are not sufficiently developed.

Given that the regulator is aware of the major practical consequences of the aspects described above, we understand that the Directive (Art. 227) allows the solvency capital of the branch established outside the EEA to be the solvency capital calculated according to local criteria. For this purpose, the third country must have an equivalent solvency regime; the equivalence of this regime must be assessed by the Group Supervisor for definitive approval, in consultation with all the supervisory authorities and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). This point may make it very much easier to apply Solvency II in groups with branches in countries with advanced solvency legislation, since it would merely be necessary to aggregate the solvency capital calculated on the basis of the local regulations, with no need to carry out the complex process of off-balance-sheet adjustments and recalculation of technical provisions as described above.

Quantitative Impact Studies (QIS)

As already mentioned, the calculation of solvency capital may be carried out according to standard or internal models. For the calculation of a standard formula at European level, a series of studies known as *"Quantitative Impact Studies"* (QIS) has been developed. Five such studies have been undertaken to date.

These studies cover:

- Calculation of the economic capital based on all the company's risks (underwriting, CAT (catastrophe), operational, financial, counterpart, etc.)
- Comparison with adjusted own funds available for the company.

Since this article does not aim to explain these questionnaires, we shall not embark on such a description except as regards groups and the most important aspects relating to them.

The instructions for completing the QISs are detailed in what is known as "technical specifications". The technical specifications for QIS5 include a section (6) concerning the completion of QIS5 for groups. The point dealing with the group's own funds and their availability is particularly important.

This means that it is not sufficient to determine the solvency capital for the group; it is also necessary to decide whether the amounts of solvency capital calculated in each of the countries are transferrable. A simple example will clarify this concept:

Country	Solvency capital	Available capital	Excess/ shortfall
Spain	1,000	1,100	100
USA	1,500	1,450	-50
Total group	2,500	2,550	50

As can be seen, the group will not have any solvency problems, but if the excess generated in Spain is a consequence of the statutory reserve, it can only be used to compensate losses; therefore, it cannot be used theoretically to compensate for a putative solvency capital shortfall in the USA.

The criteria which groups must follow in order to determine the availability of own funds are as follows:

- National regulations applicable to specified portions of own funds (statutory reserves) stipulate, as a binding requirement, that they are used solely to absorb certain losses.
- Prohibition on transfer of assets in which separate components of own funds may be represented.
- There is slowness in the administrative procedures to authorize the availability of own funds. Specifically, it is stipulated that those own funds whose availability is subject to authorization which takes more than nine months to obtain shall not be considered as transferrable and (therefore) available for the calculation of the group's capital.

Conclusion

The application of Solvency II in large insurance groups will have very major implications which cannot be resolved unless the mechanisms and tools to allow calculation of the solvency capital for the whole group are placed sufficiently ahead of time. The availability of centralized information will save a great deal of effort and will provide a better guarantee of accuracy and homogeneity for the calculations. Entities which do not belong to the European Economic Area will have to comply with the requirements of Solvency II, which in turn means that these companies will need to rely on tools and teams that can ensure the availability of all this information.

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