De Nederlandsche Bank N.V.

Solvency II Implementation

No.: 01B/EN

31 March 2010
De Nederlandsche Bank would like to thank the various market parties for their responses to the Solvency II Implementation consultation document of 29 October 2009. The comments have been incorporated into this document.

Note:
The implementation date of Solvency II will probably be postponed from 31 October 2012 until 1 January 2013. The Solvency II Implementation (consultation) document was written with the date of 31 October 2012 in mind. It should be noted that DNB is of the opinion that both insurer and supervisor will have to be cognizant of SCR from the first day that Solvency II becomes effective in order to be able to meet the stipulations of Section 100 of the Framework Directive. As far as DNB is concerned, the preparation phase in essence does not change, as the delay is only two months.

For further information, please send an e-mail to: Solvency2@dnb.nl
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Chapter 1  The key messages of Solvency II

Introduction

1.1 This document of De Nederlandsche Bank N.V. (‘DNB’) is published in the context of the implementation of the Solvency II Directive\(^1\) (hereafter: Directive) and the amended Dutch legislation to be based thereon. The purpose of this document is to familiarise the industry with the envisioned supervisory approach regarding the implementation of Solvency II in supervision.

1.2 The Directive comprises a fundamental review and recasting of EU Directives relevant to (re)insurers\(^2\). It is to replace the current Solvency I rules with new regulations on capital requirements, valuation principles and risk management. In April and May 2009, the Directive\(^3\) was adopted by, respectively, the European Parliament and the European Council of Ministers\(^4\). The Directive states that by 31 October 2012 the regime must be implemented in all Member States and thereby enter into force for all European insurers. The Directive will apply to insurers having gross premium incomes in excess of EUR 5 million or gross technical provisions in excess of EUR 25 million\(^5\).

1.3 Solvency II intends to introduce a more risk sensitive solvency regime, encouraging adequate risk management by insurers. The key concepts are transparency, harmonisation and risk sensitivity.

1.4 Owing to the emphasis on adequate risk management, Solvency will provide enhanced protection of policyholders. The ample room for national variations offered by the current Solvency I framework has engendered differences in local standards. Solvency II provides more detailed requirements that will make the protection of policyholders more consistent across European countries.


\(^2\) The term ‘insurer’ as used in this document also refers to reinsurers.

\(^3\) The officially approved text of the Directive may also be found at DNB’s website. The sections stated in this document refer to this text.

\(^4\) The final version has been published in the Official Journal of the European Union (PB L 335, 17-12-2009).

\(^5\) Pension funds, benefit in-kind funeral insurers and small insurers (premium income \(\leq\) EUR 5 mln. and technical provisions \(\leq\) EUR 25 mln.) which do not belong to a larger group and offer no liability, credit or surety insurance, nor engage in reinsurance activities will not be subject to Solvency II. Small insurers may nevertheless opt to be included in the Directive’s scope. An insurer expected to outgrow (either of) these thresholds within five years does fall within the scope of Solvency II.
Structure of this document

1.5 This document outlines the main elements of Solvency II. While the Directive is the most important reference, this document does not intend to summarise the Directive. It does attempt to shed light on the most significant changes vis-à-vis the current, Solvency I-based legislation and to communicate what principles DNB will apply with respect to the implementation of Solvency II in the Netherlands. This should serve to admonish and assist the Dutch insurance industry in its preparations for Solvency II.

1.6 The other chapters in this document discuss the following topics: Pillar 1; Use and assessment of internal models; Governance / ORSA (Pillar 2); Reporting requirements (Pillar 3); Group supervision; and Proportionality and small insurers.

1.7 In view of the far-reaching implications of Solvency II for the insurance industry, DNB also presents several proposals regarding adequate preparation for Solvency II. Because Solvency II is not yet in effect, such preparations are not required by law. However, because DNB regards as necessary that adequate preparations are made, and is willing to support the sector in doing so, DNB has included a programme of preparatory activities in this document, in which firms are invited to participate. Each chapter lists preparations DNB considers necessary in a separate section.

1.8 It is invariably the responsibility of individual firms to make adequate preparations. This document intends to communicate transparently to the sector how DNB will assess firms’ preparations. Because Solvency II has not yet entered into effect, DNB will not enforce redress of shortcomings it finds.

1.9 This is an unofficial English translation of the Dutch text. In case of variance, the Dutch text always prevails.

1.10 The consultation period ended on 15 January 2010. The reactions DNB received during this period have been incorporated into this document. The document has now been finalised and DNB will now commence the implementation of Solvency II in accordance with the approach stated in this document.

1.11 Finally, DNB recommends that insurers take due note of the Level 2 consultation papers published by the Committee of European Insurance Supervisors, CEIOPS. These papers contain the advice of CEIOPS to the European Commission on Level 2 implementation measures that will be transposed into Dutch regulations prior to the introduction of Solvency II. In offering advice, CEIOPS takes due account of lessons drawn from the credit crisis. Although these Level 2 implementation measures have not been finalised and are subject to emendation, this will not change the general outlines of Solvency II.

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6 See www.ceiops.eu
7 In the Netherlands, the Ministry of Finance is responsible for the implementation of Solvency II in Dutch legislation.
Key messages regarding the implementation of Solvency II

1.12 This chapter presents the key messages communicated in the context of Solvency II implementation. The principal message is that given the dramatic changes in requirements for insurance supervision which Solvency II will bring vis-à-vis the current requirements under the Wet op het financieel toezicht (Financial Supervision Act) or Wft, DNB advises insurers to continue, or to launch, their preparations for Solvency II with vigour.

1.13 Solvency II introduces a range of responsibilities for the senior management of insurers. They bear ultimate responsibility as regards risk management within their undertaking, and as regards sound preparations for Solvency II.

1.14 DNB suggests that as part of these preparations, each insurer carries out a self-assessment in order to identify shortcomings and that it drafts a realistic implementation plan to achieve compliance with all statutory and regulatory requirements by 31 October 2012. Such a self-assessment and implementation plan will have to include at least the elements set out in this document. In order to promote the performance of a self-assessment and to gain insight into the degree to which the sector prepares itself to Solvency II, in April DNB will issue a questionnaire via e-Line, which can be filled in by insurers. In a letter, insurers will be requested to fill in this questionnaire.

1.15 In implementing Solvency II, DNB will make use of the experience gained during the implementation of Basel II, the Capital Accord providing capital requirements for banks and investment firms. One of the most important lessons to be drawn from this experience is that an early start with preparations provides the best chance of successful implementation.

1.16 A large number of insurers have been engaged for some considerable time in making preparations for Solvency II. This is made necessary by the rapid pace at which European developments evolve. In 2009, the Level 1 Directive was adopted, while the Level 2 advice of CEIOPS has also gone through consultation. Final recommendations were issued in October 2009 (first and second waves) and in January 2010 (third wave). In 2011, CEIOPS is to release the first Level 3 Guidance and in early 2011 the final Level 2 implementing measures will be adopted by the European Commission.8

1.17 DNB concludes that the technical details of Solvency II have not been finalised and are currently being negotiated at the EU level. However, the outlines have been clearly defined and the risk if preparations for the implementation are put off is great. Inaction may mean

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8 For more information see http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm.
that an insurer does not meet official requirements by 2012 and/or that the cost of redressing the shortcomings at short notice will run disproportionately high.

1.18 Because not everything has been finalised, the content of this document is based on the current state of affairs. Moreover, DNB leaves open the possibility that DNB may make changes to its supervisory approach on the basis of progressive insights.

Pillar 1

1.19 Pillar 1 of Solvency II entails major changes from current qualitative and quantitative requirements. Pillar 1 imposes two capital requirements: a Minimum Capital Requirement (MCR), and a more risk-sensitive Solvency Capital Requirement (SCR). The calculation of the SCR, in particular, will bring a major change vis-à-vis the current requirements.

1.20 The institutions that have participated in RiSK have been able to gain a fair perspective on the quantitative requirements made by Solvency II. DNB has urged insurers that have not participated in RiSK directly to fill out the RiSK spreadsheets later after all. This is a necessary step to gain a good perspective on how well the insurer is currently prepared and how much still remains to be done. On this basis, the insurer may make preparations in time to meet all future requirements. DNB offered help on this through meetings where it provided elaborate verbal feedback to insurers on its findings concerning the RiSK outcomes, and also discussed preparations for Solvency II.

1.21 In 2010 the fifth Quantitative Impact Study (QIS5) will be launched within CEIOPS. QIS5 is intended to test, among other things, the quantitative impact of (any changes in) Level 2 parameters. Again, DNB recommends to insurers to use this opportunity to prepare more fully for Solvency II, also because QIS5 will be the last opportunity to influence the framework before it is finally adopted.

1.22 Although it is still uncertain whether any more QIS rounds will follow, DNB expects that in 2011 and 2012, insurers will continue to perform the pillar 1 calculations on, respectively, end-2010 and end-2011 figures.

1.23 Solvency II will also bring changes as regards eligible own funds and the way investments and liabilities are to be valued. Insurers will in the run-up to Solvency II have to check whether their capital structure already complies with the new supervisory regime, with due consideration to current Solvency I requirements. Although some institutions already mark their requirements to market, Solvency II will introduce certain principles that will apply to all insurers.
Use and assessment of internal models

1.24 Solvency II includes the possibility to determine the SCR using an internal model. This is subject to strict quantitative and qualitative conditions. One is that an infrastructure must be created within which data systems are developed and managed. Also, there are specific requirements for insurers’ use of the model in day-to-day operations.

1.25 The model must be assessed in advance by the supervisor. The assessment process is a complex, time-consuming and intensive process. Approval is subject to several criteria. The Directive mentions the following tests: use test, statistical quality standards, calibration standards, validation standards, documentation standards, and profit and loss attribution. In addition, specific requirements apply to the use of a model obtained from a third party and to the internal model governance.

Governance / ORSA (Pillar 2)

1.26 Pillar 2 will bring a number of major changes to insurers in relation to current requirements. For instance, the Directive explicitly mentions several functions in the context of governance which an insurer must have in place. In addition, every firm must perform a so-called Own Risk and Solvency Assessment (ORSA).

1.27 The insurer must implement, among other things, a risk management function and an actuarial function. Some insurers already have such a function in place. They will have to consider to what extent they meet the additional requirements under Solvency II. Those that do not already have these functions in place will need to consider how to implement them. In case of outsourcing, the insurer itself will remain responsible.

1.28 In the context of its risk management system, the insurer must carry out an ORSA. The ORSA includes an assessment of an insurer's overall short-term and long-term solvency needs.

1.29 As part of the Supervisory Review Process (SRP), the supervisor has an instrument at its disposal to ensure that the calculation of the SCR is more accurately aligned with the insurer’s risk profile: the possibility to impose so-called capital add-ons.

Reporting requirements (Pillar 3)

1.30 The third pillar of Solvency II sets out the reporting requirements. The pillar 3 requirements imply major changes vis-à-vis the current Wft requirements. For one thing, there will be two separate reporting streams, one for the general public and one for the supervisor. The
public reporting stream intends to promote transparency and market discipline in the insurance market.

**Group supervision**

1.31 To date, insurance supervision of an insurance group exists as a supplement to solo supervision, performed at the level of the solo undertaking. Under Solvency II, prudential group supervision will be an independent part of insurance supervision performed at the level of the parent company.

1.32 Group supervision also means that the parent is expected to be able to demonstrate that it has a fair view of the risk exposures within the group and manages them. Before taking part in QIS5, an insurance group will have to ascertain how every entity within the group is to be accounted for in calculating the capital requirement.

1.33 Another important change in supervision will be the communication between the supervisors and the several entities in a group. Under Solvency II, the group supervisor will be responsible for group supervision, maintaining contact via the parent, whereas the supervisors of the subsidiary companies are responsible for solo supervision. This set-up places a clear responsibility on the supervisors to ensure their own efficient and close cooperation.

**Proportionality and small insurers**

1.34 Proportionate application of the requirements to insurers with a low risk profile is one of the main principles underlying Solvency II. Insurers with a low risk profile, whose products and investments are less complex, may be eligible for simplified application of Solvency II. This way, the requirements are applied in a manner proportionate to an insurer’s nature, scale and complexity.

1.35 Below a certain threshold, Solvency II will not apply to small insurers (see section 7.6 for the exact scope). DNB is currently investigating, together with the Ministry of Finance, what type of regime should apply to the group of insurers outside the scope of Solvency II. This new regime will adhere as closely to the Solvency II principles as possible, yet applied proportionately. The Ministry of Finance and DNB intend to release the concrete plans for this regime for consultation in the course of 2010.
European time schedule

1.36 The time frame for the development of Solvency II is highly ambitious. It is to be determined by the European Commission, which is itself held to the deadline for entry into force stated in the Directive: 31 October 2012.

1.37 Before that date there will be many further developments at the European level. Important milestones are the adoption of both Level 2 implementing measures under the Directive and the Level 3 Guidance and the implementation both in national legislation and in practice. Furthermore, other tracts are also important, such as QIS5, the determination of third countries’ equivalence and an impact analysis of the administrative burden.

1.38 As indicated above, one of the trickier elements of the preparation for Solvency II, for both supervisors and insurers, is that while it is crucial to make a timely start in implementing the new regime, this may require beginning at a time when legislation and regulations have not been finalised.

1.39 The European agenda provides guideposts on the road to 31 October 2012. The first guidepost is the Directive. This text is final and will provide the basis for Solvency II preparations. Table 1.1 below summarises the milestones marking the progress of international negotiations.

Table 1.1: Summary of Solvency II-related European activities

<table>
<thead>
<tr>
<th>Year</th>
<th>Level 1 Directive</th>
<th>Level 2 Implementing measures</th>
<th>Level 3 guidance</th>
<th>QIS5</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>April/May: adopted by European Parliament and European Council of Ministers</td>
<td>October: final advice 1st and 2nd wave of CEIOPS advice</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>• January: final advice 3rd wave of CEIOPS advice • November: draft Level 2 implementing measures from the European Commission</td>
<td></td>
<td>• August – October: QIS5 for solo companies • August – mid-November: QIS5 for groups</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>• November: Level 2 implementing measures finalised</td>
<td>• first half of 2011: consultation on CEIOPS Level 3 guidance • December: CEIOPS Level 3 guidance finalised</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1.40 From October 2009 until November 2010, DNB is to base its work on the final CEIOPS advice rounds. Subsequently, until November 2011, DNB will base itself on the final Level 2 implementing measures. Ultimately, from November 2011, DNB will be able to take its lead from the final Level 2 implementing measures. A similar approach will be taken as regards the Level 3 guidance.

1.41 This means that where DNB takes its lead from the advice on or draft version of Level 2 implementing measures rather than from the Directive, points of view or implementing measures may change as a result of progressive insights or negotiations. While DNB realises that this may occasionally create confusion, it cannot see how it could postpone the implementation until the texts have been finalised. Naturally, DNB will proceed with great care and continue its intensive consultations with the industry and the Ministry of Finance throughout the process.

Preparations

1.42 DNB will oversee insurers’ preparations through regular assessments which may be either quantitative (QIS) or qualitative (self-assessments / implementation plans), and correct its course where necessary. Every chapter of this document contains a section on ‘Preparations’, summing up the preparative actions DNB regards as necessary.

1.43 DNB will follow up each of its assessments by feedback to individual insurers, given either in writing or in supervisory meetings, and pointing out which elements are deemed or expected to fall short of the requirements as applicable after 31 October 2012. In doing so, DNB will take guidance from the self-assessment compiled by the insurer. This self-assessment will include an analysis of current compliance with the requirements set out in this document and of work that remains to be done. The subsequently drafted implementation plan will list what actions are scheduled and when each will be carried out so the insurer will meet all requirements by the time Solvency II enters into effect. In order to promote the performance of a self assessment and to gain insight into the degree to which the sector prepares itself to Solvency II, in April DNB will issue a questionnaire via e-Line, which can be filled in by insurers. In a letter, insurers will be requested to fill in this questionnaire.

1.44 The schedule below outlines the activities undertaken by DNB and the sector with regard to Solvency II as envisioned by DNB. It is not an exhaustive list. All elements are explained more fully in the appropriate chapters further down.
### Table 1.2: Summary of national-level activities

<table>
<thead>
<tr>
<th>Year</th>
<th>Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>- RiSK (balance date: 31 December 2008)</td>
</tr>
<tr>
<td>2010</td>
<td>- Second quarter 2010: “Self assessment Solvency II”</td>
</tr>
<tr>
<td></td>
<td>- July 2010 – March 2011: Pre-application phase I internal models</td>
</tr>
<tr>
<td></td>
<td>- QIS5 (balance date 31 December 2009)</td>
</tr>
<tr>
<td>2011</td>
<td>- Pillar 1 calculations (based on the standard formula plus, if applicable, an internal model) as at 31 December 2010</td>
</tr>
<tr>
<td></td>
<td>- Pre-application phase II internal models</td>
</tr>
<tr>
<td></td>
<td>- Reporting requirements implementation plan</td>
</tr>
<tr>
<td>2012</td>
<td>- Formal application internal models</td>
</tr>
<tr>
<td></td>
<td>- Pillar 1 calculations (based on the standard formula plus, if applicable, an internal model) as at 31 December 2011.</td>
</tr>
<tr>
<td></td>
<td>- Final rehearsal for ORSA as at 31-12-2011</td>
</tr>
<tr>
<td></td>
<td>- Shadow quarterly report on the second or third quarter of 2012</td>
</tr>
<tr>
<td></td>
<td>- Satisfaction of all requirements: 31-10-2012</td>
</tr>
<tr>
<td>2013</td>
<td>- First formal report under Solvency II due by 31-12-2012⁹</td>
</tr>
</tbody>
</table>

⁹ Assuming the European Commission decides that the report concerning 31-12-2012 must indeed be entirely in compliance with Solvency II.
Chapter 2 Pillar 1

Introduction

2.1 Pillar 1 of Solvency II sets out the quantitative requirements insurers have to meet. These requirements concern both the valuation bases for the market value balance sheet\(^{10}\) on economic value and the calculation of both required and available capital.

2.2 The basic principles underlying Pillar 1 of Solvency II are marking to market and risk sensitivity. The prudential balance sheet is based on market value and provides a realistic estimate possible estimate of the insurer’s solvency position. An explicit capital requirement is made for risks identified in the standard formula.

2.3 Solvency II offers the possibility to determine the SCR by means of either a standard formula or an internal model. This chapter confines itself to the standard formula, while the next discusses the use of an internal model in more detail.

2.4 Table 2.1 presents a bird’s-eye view of some conspicuous differences between Solvency I and Solvency II.

\(^{10}\) Article 75.
### Table 2.1 – The main differences from Solvency I to Solvency II

<table>
<thead>
<tr>
<th>Asset valuation</th>
<th>Solvency I (current framework)</th>
<th>Solvency II Directive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation of technical provisions</td>
<td>IFRS or BW2.9.</td>
<td>Market consistent</td>
</tr>
<tr>
<td>Valuation of other liabilities</td>
<td>IFRS or BW2.9.</td>
<td>Market consistent</td>
</tr>
<tr>
<td>Prudential own funds</td>
<td>Two quality levels (tiers): Tier 2: up to 50% of minimum or actual solvency (whichever is lower). Distinction into on- and off-balance sheet assets (part of Tier 2).</td>
<td>Three quality levels (tiers). Tier 1 at least $\frac{1}{3}$ of Minimum Capital Requirement, Tier 3 up to $\frac{1}{3}$ of Minimum Capital Requirement. Distinction between on- and off-balance sheet assets.</td>
</tr>
<tr>
<td>SCR</td>
<td>Solvency margin. Quantified on the basis of insurance technical variables only. No confidence level specified.</td>
<td>Covers quantifiable insurance, market, counterparty credit and operational risk. The SCR is determined so as to provide sufficient risk coverage for an entire year with 99.5% confidence. SCR may be calculated according to an internal model (see Chapter 3 of this document).</td>
</tr>
<tr>
<td>MCR</td>
<td>Guarantee fund. Equals one-third of the solvency margin.</td>
<td>The MCR capital requirement is determined so as to provide sufficient risk coverage for an entire year with 85% confidence.</td>
</tr>
</tbody>
</table>

Note: ‘BW’ = Burgerlijk Wetboek, the Dutch Civil Code.

### Valuation

2.5 The principle underlying Solvency II is market valuation.\(^\text{12}\) Where market valuation is not possible, as in determining technical provisions, it must be approximated on the basis of models. In the case of provisions, the valuation method is prescribed and consists of a best estimate plus a risk margin.\(^\text{13}\)

2.6 For life insurers, the valuation of technical provisions under Solvency II is similar to the Adequacy Test under the Wft. However, since Solvency II intends to achieve a uniform methodology, there is less freedom in the way provisions can be calculated. The method risk margin calculation, for one, is requisite, while there are no quantitative stipulations regarding the calculation of the adequate uncertainty margin in the Adequacy Test.

2.7 Solvency II attempts to achieve maximum consistency vis-à-vis international accounting rules, especially the development of IFRS phase 2. However, since Solvency II is a prudential supervision framework, it is bound to deviate in places from the accounting

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\(^{11}\) These limits may still be adjusted in the implementing measures. A concrete CEIOPS proposal to increase the weight of Tier 1 is under consideration.

\(^{12}\) Article 75.

\(^{13}\) Article 77.
rules. For instance, Solvency II, in valuating insurance liabilities, does not take the insurer’s own credit status into account\textsuperscript{14}, contrary to what is customary according to some accounting rules.

2.8 There will be far-reaching changes in key elements of the valuation bases. Therefore insurers must already begin to think about new valuation techniques, data collection and process and system design, so as to arrive at a Solvency II compliant balance sheet. Insurers must invest in acquiring sufficient knowledge about the new system.

**Eligible own funds**

2.9 An insurer must have sufficient own funds available to meet its capital requirements. Eligible own funds are subject to a distinction into three quality classes or tiers, of which Tier 1 has the highest loss-absorbency. Also, a distinction is made between on-balance sheet basic own funds and off-balance sheet ancillary own funds\textsuperscript{15}. Examples of basic own funds are ordinary share capital and subordinated debts. Examples of ancillary own funds are non-budgeted supplementary premiums and letters of credit.

2.10 The SCR may be fulfilled using Tier 1, Tier 2 and Tier 3 capital. The MCR can only be fulfilled using Tier 1 and Tier 2 basic own funds. Solvency II will also impose a maximum on the amount of Tier 2 and Tier 3 own funds that may be used to fulfil the capital requirements\textsuperscript{16}.

2.11 During the run-up to Solvency II, insurers must already verify whether or not their current asset structure satisfies the new supervisory framework, while duly observing Solvency I requirements.

**Capital requirements**

2.12 Solvency II includes two capital requirements referred to as the SCR and the MCR.

2.13 The SCR covers all material and quantifiable risks. These risks are distinguished into market risk, counterparty risk, insurance technical risks (life, non-life and health) and operational risk\textsuperscript{17}. These categories are subdivided into individual risks. The SCR has been determined so as to be sufficient to last out an entire year with 99.5\% certainty\textsuperscript{18}. This means that SCR has been calibrated in such a way that in 99.5\% of cases, the relevant insurer leads a loss equal to or smaller than the SCR (profits are negative losses).

\textsuperscript{14} Article 75.
\textsuperscript{15} Articles 94–96.
\textsuperscript{16} Article 98.
\textsuperscript{17} Article 104.
\textsuperscript{18} Article 101.
2.14 The SCR may be calculated at different levels of complexity. The standard formula is the starting point, but an insurer may also – subject to certain prerequisites – use simplified calculations in respect of immaterial risks. Furthermore, Solvency II offers the possibility to use an internal model approved by the supervisor for all or part of its risks. Finally, the supervisor is empowered to impose a capital add-on (see Chapter 4).

2.15 Calculation of the MCR is simpler than that of the SCR. This capital requirement has been determined to as to be sufficient to last out an entire year with 85% certainty. In addition, the MCR will be within 25% and 45% of the SCR. The nether limit of the MCR is the Absolute Minimum Capital Requirement or AMCR, which is equal to the minimum amount of the guarantee fund.¹⁹

2.16 The Directive does not explicitly mention a requirement to adopt a recovery plan as referred to in section 3:132 Wft. However, the Directive does provide the supervisor with ample powers to impose preventive or corrective measures.²⁰ Furthermore, if an insurer’s solvency position deteriorates, the Directive empowers the supervisor to take all measures necessary to safeguard the interests of policyholders, or the obligations arising out of reinsurance contracts.²¹ Finally, the Directive provides for the power to restrict the free disposal of assets if an insurer fails to comply with the requirements regarding technical provisions.

2.17 If the eligible own funds are insufficient to fulfil the SCR, yet sufficient to fulfil the MCR, the ladder of intervention is mounted. This means the insurer is placed under stricter supervision and must take action to restore its own funds to where it fulfils the SCR. The closer the insurer approaches the MCR threshold, the more stringent supervision will be imposed. See also below under the header ‘Non-compliance with capital requirements’.

2.18 The MCR must be reported at least four times a year to the supervisor.²² The SCR must be reported at least once a year. An insurer is required to monitor the amount of the SCR on an ongoing basis. If there is evidence that the insurer’s risk profile has changed significantly since the last time the SCR was reported, DNB may require the insurer to recalculate its SCR.²³ In its advice to the European Commission,²⁴ CEIOPS notes that the MCR calculation is dependent on the SCR calculation. It is not yet clear whether this implies that the SCR must therefore be calculated four times a year or that simplifications will be applied. In any case, the insurer will have to anticipate a requirement to provide a well-underpinned SCR estimate on a quarterly basis.

2.19 The fulfilment of capital requirements is not the only objective of Solvency II. Adequate risk management means more than just the fulfilment of minimum requirements. It also

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¹⁹ Article 129.
²⁰ Article 34.
²¹ Article 141.
²² Article 129.
²³ Article 102.
regards such things as actual versus desired risk exposures, the long-term continuity of the insurer etc. These things are included in the Second Pillar of Solvency II – see Chapter 4.

Non-compliance with capital requirements

2.20 The moment an insurer has insufficient eligible own funds available to fulfil the SCR, or suspects this situation to arise within the next three months, it must inform DNB without delay and within two months submit a realistic recovery plan.\(^{25}\)

2.21 The moment an insurer finds itself without sufficient eligible own funds to fulfil the MCR, or suspects this situation to arise within the next three months, it must inform DNB without delay.\(^{26}\) Within one month, such an insurer must submit a short-term finance scheme. If DNB is of the opinion that this scheme is inadequate, or if the insurer fails to raise sufficient capital within three months to fulfil the MCR, DNB will have to withdraw its licence(s).\(^{27}\)

Preparations

2.22 Pillar 1 of Solvency II brings far-reaching changes vis-à-vis the current regime. DNB therefore expects insurers to already start preparations for the introduction: investing in knowledge, in processes and in data quality is essential. The self-assessment mentioned in Chapter 1 will include an analysis of the degree in which the Pillar 1 requirements are met.

2.23 The self-assessment looks at the difference between what is available and what will be required. It also provides for a concrete plan, including a timeline, enabling an insurer to bridge the gap. If the insurer wants more than the minimum (as by applying firm-specific data in the SCR calculation for its non-life insurance technical risk),\(^{28}\) the insurer must incorporate such desires in the self-assessment. This self-assessment comprises at least the following subjects:
- level of expertise
- quality and quantity of the required and desired data
- process design, and
- the effect of applying the pillar 1 requirements\(^{29}\) to the solvency position, including an examination of how and to what extent the risk profile and/or eligible own funds need


\(^{25}\) Article 138.

\(^{26}\) Article 139

\(^{27}\) Article 144.

\(^{28}\) Institutions that wish to implement an internal model must perform a self-assessment of their internal models against the applicable requirements as one of the preconditions for participation in the pre-application. See Chapter 3 for more information.

\(^{29}\) Reference frame is the Level 2 advice of CEIOPS on Pillar 1 (www.ceiops.eu).
to be modified between now and the introduction of Solvency II (capital planning analysis).

2.24 In recent years, CEIOPS carried out four quantitative impact studies. The purpose of these studies was twofold. On the one hand, the draft pillar 1 framework itself was assessed, while on the other, the studies enabled participating insurers to prepare for Solvency II. DNB also performed a study at the national level; this RiSK study pursued the explicit purpose of preparing the Dutch insurance sector for Solvency II. DNB regards these studies as highly important aids in the preparation for the new supervisory framework.

2.25 In 2010, the fifth impact study, QIS5, will be carried out. Given the far-reaching changes in the supervisory framework, DNB expects in any case that insurers within the scope of the Directive will participate in QIS5, which will probably concern balance date 31 December 2009. Although it is still uncertain whether more QIS studies will follow, DNB expects the insurers concerned to continue to perform and report the test calculations in 2011 and 2012, with regard to 31 December 2010 and 31 December 2011, respectively. The report on these includes the pillar 1 calculations according to the standard formula and, if applicable, the internal model.

2.26 DNB will not proceed to have participation in QIS5 made mandatory, but it does consider participation by insurers as an absolutely necessary preparation. See also Chapter 5 on the introduction of the Solvency II reporting requirements.

2.27 DNB expects institutions which intend to implement internal models should also perform the calculations mentioned in 2.25 above. After all, it is important such insurers should also implement an infrastructure for the standard model (see Chapter 3).
Chapter 3 Use and assessment of internal models

Introduction

3.1 Solvency II offers the possibility to use an internal risk model to determine the SCR. Use of an internal model is subject to the condition that the insurer has the expertise, data and infrastructure available which are needed to develop and apply such models, on the analogy of the corresponding conditions applying in the banking sector (Basel II).

3.2 The criteria for approval are not purely statistical in nature (i.e. does the model measure the risks with sufficient accuracy?), but also regard the organisational embedment of the model within the insurer’s risk management (i.e. are the results reported regularly; have acceptability limits been set on risks; are decisions about the firm’s risk position taken on the basis of the model results?).  

3.3 The model must be approved in advance by the supervisor. This is a complex, time-consuming and intensive process. In principle, Solvency II permits modelling of all risks included in pillar 1 and will also permit partial models, as well as models for the calculation of the group SCR. The term partial model applies where part of the risks and/or business is modelled while the rest is done according to the standard formula.

3.4 The insurer must have a model change policy in place regarding changes to the model, distinguishing between minor and major changes. Major changes need the prior approval of the supervisor. The model change policy must be submitted for approval together with the application itself.

3.5 The Directive makes the administrative or management body of an insurer explicitly responsible for the application with DNB for approval of the model and subsequent change proposals, and that the internal model operates properly on a continuous basis.

3.6 The Directive also empowers the supervisor, subject to certain conditions, to issue an argued decision to an insurer requiring it to use a (partial) internal model if the risk profile of that insurer deviates significantly from the assumptions underlying the use of the standard formula.

3.7 The Directive mentions eight main subjects about an internal model that must be clearly documented. They are the use of the model in the insurer’s day-to-day operations (use test); the overall statistical model specification; the parameter calibration; the profit and loss

30 Articles 120–127.
31 See also the CEIOPS advice on the integration of partial models with the standard formula (January 2010). This paper also elaborates on the distinction between a ‘full’ and a ‘partial’ internal model.
32 Article 115
33 Articles 116 & 120.
34 Article 119.
Attribution; validation and testing of the model’s ‘goodness of fit’ and predictive power; documentation of the model design and operational details; governance; and the use of outsourced modelling capacity and data.\footnote{www.ceiops.eu/media/files/consultations/consultationpapers/CP56/CEIOPS-CP-56-09-L2-Advice-Tests-and-Standards-for-internal-model-approval.pdf.} Below each of these criteria is discussed in more detail.

**Use test**

3.8 It is important that an insurer should be able to demonstrate that the model fulfils a major role in the firm’s governance. For this reason the use test is one of the most important tests before an internal model may be used. The use test evaluates the way the internal model is embedded in the organisation and where, to what end, when and by whom the model is used. The insurer must use the output of the internal model in the ORSA and it is incumbent on senior management to see that the model continues to operate correctly.

3.9 The internal model, therefore, is not just a tool to determine an insurer’s minimum required solvency but also serves other purposes. It should be part of the culture of the undertaking.

3.10 It is not easy to provide an exhaustive list of all the ways a firm may satisfy the use test requirements. Therefore CEIOPS has opted for a set of principles. To begin with there is the following ‘Foundation principle’.

- *The undertaking’s use of the internal model shall be sufficiently material to result in pressure to improve the quality of the internal model.*

3.11 In other words, the undertaking’s use of the internal model shall be sufficiently material to result in pressure to improve the quality of the internal model on an ongoing basis. This foundation principle should provide a healthy incentive to insurers, and the presence of this incentive is viewed as beneficial by supervisors.

3.12 The Foundation principle is followed by another nine principles in the CEIOPS consultation paper:

1. *Senior management, including the administrative or management body, shall be able to demonstrate understanding of the internal model.*
2. *The internal model shall fit the business model.*
3. *The internal model shall cover sufficient risks to make it useful for risk management and decision-making.*
4. *The internal model shall be widely integrated with the risk-management system.*
5. The integration into the risk-management system shall be on a consistent basis for all uses.

6. The internal model shall be used to support and verify decision-making in the undertaking.

7. The SCR shall be calculated at least annually from a full run of the internal model. For requisite quarterly runs, the model does not need to be fully updated, provided there are no major changes. If there are, or the supervisor requests it, a full update will be required.

8. The internal model shall be used to improve the undertaking’s risk-management system.

9. Undertakings should design the internal model in such a way that it facilitates analysis of business decisions.

**Statistical quality standards**

3.13 The undertaking must be able to demonstrate that the methods, assumptions and data used in the model are correct. The output of the internal model must take the form of a probability distribution of a (future) financial item. The probability distribution is responsive to changes in the underlying data. The actuarial and statistical foundation of the probability distribution(s) must be up to date, applicable and robust against outliers, and it must satisfy other professional standards. The distribution must be consistent with the derivation of technical provisions.

3.14 The data underlying the internal model are part of quality control and monitoring. The data must be updated at least annually, with expert judgement being a special type of data. The collection of such data must be documented.

**Calibration standards**

3.15 The insurer must be able to demonstrate that the model offers a degree of protection to policyholders which is at least equivalent to the Solvency II confidence level of 99.5% VaR within a one year horizon. An insurer that applies a different confidence level, risk measure or time horizon must demonstrate equivalence to the one year 99.5% VaR. The supervisor may test the calibration by requiring the insurer to apply the internal model to data and assumptions other than internal data and assumptions.
**Profit and loss attribution**

3.16 The explanation of profit and loss by underwriting class and source must be supported by the internal model. The insurer must be able to reconcile the sources of variance in its financial results with risk types within the internal model, and do so at least annually. Profit and loss attribution also plays a prominent role in the validation of the internal model and the steering of business.

**Validation standards**

3.17 An insurer must be able to demonstrate that the model is surrounded by a well-organised control environment. The validation process entails monitoring the validity of the internal model and its periphery, in particular data, methods, assumptions, expert judgement, documentation, IT/systems, model governance and use. The validation policy itself must also be subjected to assessment. Also, there should be a clear segregation between model design and model validation. The predictive power and operation of an internal model are pointed up in an analysis of prediction errors (back-testing), sensitivity analysis, robustness, stress tests and (extreme) scenarios.

**Documentation standards**

3.18 An insurer must provide for adequate documentation regarding all standards and tests. The test of the documentation of an internal model is, put briefly, whether an independent third party is able to comprehend the model and, in principle, to rebuild it. This especially regards the model specification and considerations underlying the choice of model, data files, expert knowledge – naming names – and algorithms used. Model changes are to be documented as well, and where they lead to major differences from the preceding model version, a difference analysis must be performed. The documentation must be up to date and must also identify deficiencies in the model together with the situations where they emerged. Finally, the documentation must show that all management echelons must be sufficiently conversant with the operation of the internal model.
Governance

3.19 Specific requirements with respect to the governance surrounding the internal model are set out in the CEIOPS advice.\textsuperscript{36} The governance must be adequately integrated into the ‘System of Governance’ (see Chapter 4 on Governance/ORSA).

3.20 The insurer’s senior management is responsible for the quality of the internal model and for the design of the organisation as regards people and responsibilities, required abilities and resources and the maintenance thereof, etc.

3.21 It falls to the insurer’s senior management to approve the application to DNB for approval of the internal model and of subsequent major changes in the model.

3.22 The risk management function and the actuarial function must maintain ongoing mutual consultation in order to keep each other informed and aligned.

External models and data

3.23 External models (software) and data are those that are acquired from external parties for the creation of an internal model. It is up to insurers themselves to test and validate such external models and data in relation to their firm. They must also make clear why they opted for this or that specific external model or dataset. Documentation must show that the insurer controls and comprehends the operation and characteristics of the external models and data. Any continuity risks associated with such external software and data must be inventoried. The use of an external model does not remove the obligation to meet the requirements mentioned earlier.

Preparations

3.24 Depending on the scope of the internal model, implementing an infrastructure for the use of an internal model under Solvency II may take several years and require substantial capacity. The abovementioned requirements also reveal that the necessary (pre)applications and assessments may also be time-consuming and require intensive preparations, on the part of both the insurer and the supervisor.

3.25 For this reason, DNB in 2009 already launched an inventory in order to communicate its plans for early interaction about this issue with individual insurers. Therefore DNB sent out a letter\textsuperscript{37} to all insurers surveying the intentions of institutions as regards the use of a


\textsuperscript{37} Letter of 17 July 2009 met ref. no. TVT/TRO/2009/01427.
(partial) internal Solvency II model, and at the same time announcing a pre-application tract by way of rehearsal for the subsequent application process.

3.26 The pre-application, introduced by CEIOPS\textsuperscript{38} is a ‘dress rehearsal’ for the application process. In addition, CEIOPS has drafted specific pre-application attention areas for groups.\textsuperscript{39}

3.27 Hence a pre-application preceding the introduction of Solvency II is of importance for both the supervisor and the sector as part of the preparations for the actual application. Insurers that intend to file an application for use of an internal model are expected to participate in the pre-application. Of course, participation does not in itself entail approval of the model.

3.28 Non-participation in the pre-application does not automatically preclude approval of a (partial) internal model. However, experience has taught that nearly every assessment process will point up deficiencies. Participation in the pre-application will bring such deficiencies to light at an early stage and thus give the insurer time to resolve them. Added to this, as a result of European developments, the CEIOPS Level 3 Guidance may be declared binding (recommendation by the Larosière Working Group). Hence participation is of importance to both insurers and DNB.

3.29 The pre-application of DNB will take place from July 2010 to March 2011. DNB expects the institutions that wish to participate in the pre-application to make significant prior progress with the implementation of the internal model. For this reason, participation is subject to certain conditions.\textsuperscript{40}

3.30 One condition is the submission of documentation on the progress made towards meeting the requirements for use of an internal model under Solvency II. They are elaborate requirements, and an institution cannot take part in the pre-application unless it is well on the way towards satisfying them. Prior to pre-application, a self-assessment must be submitted to DNB taking the Level 2 advice of CEIOPS on internal models as its reference frame.\textsuperscript{41}

3.31 In addition, it is important that an infrastructure be set up for the determination of the capital requirement by the standard formula, for two reasons. In the first place, of course, an institution has no advance certainty that its internal model will be approved. (For instance, only certain elements of the model may gain approval, in which case the Directive stipulates that at least the other elements must be calculated by the standard formula.) If

\textsuperscript{40} These criteria have been communicated to the sector by letter of 17 July 2009 headed ‘Voorbereiding op Solvency II – Interne modellen’ (Preparations for Solvency II – internal models).
close to the introduction date of Solvency II (partial) approval has not been given, there will in all probability be insufficient time left to set up an infrastructure supporting the standard formula.

3.32 The second reason is that a comparison with the output of the standard formula provides relevant information for the internal model assessment process. The output of the internal model can be compared to those of the prescribed standard formula. The institution thus acquires valuable information on the model’s performance, while the supervisor gains additional information on the solvency development of the institution, which may be compared to that of other, similar institutions. DNB expects insurers to analyse the differences between the internal model and the standard formula, and to deliver the results back to DNB.

3.33 For these reasons, one of the conditions for participation in the pre-application is that the QIS spreadsheets have been completed and a relevant comparison has been made with the internal model. These may be either the RiSK spreadsheets or the QIS4 spreadsheets for balance date 31 December 2008. This way, firms that did not participate in RiSK can still participate in the pre-application.

3.34 Finally, it is DNB’s opinion that a group with international activities and subsidiaries in other European jurisdictions should have to participate only once in the pre-application process. In such cases the process needs to be coordinated at the level of the ‘College of supervisors’ (see Chapter 6 for more information on Colleges). It is at this level that decisions are taken on, for instance, the allocation of duties and (pre-)applications.

3.35 In January 2010, CEIOPS issued a consultation document with further guidance on the pre-application. In March 2010, DNB will issue more detailed instructions on the pre-application, which will be based on CEIOPS’ guidance. Earlier on, DNB will engage insurers that have indicated the intention to use an internal model plus, if applicable, their foreign supervisors, in a dialogue.

**Parallel run**

3.36 After the internal model is approved, the supervisor has power, under the Directive, to require the parallel submission of estimated SCR (calculated using the standard model) for an indefinite number of years. The Directive provides this option because the possibility to determine an insurer’s solvency using internal systems introduces a major change in the way financial supervision is exercised. For the first time, insurers can use their own systems

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43 Article 112(7)
to determine the supervisor’s solvency requirement. It has been mentioned above that comparison between the internal model and the standard formula provides information relevant to the assessment process. This also applies when the model goes live under Solvency II in October 2012.

3.37 DNB currently holds that it will not in all cases be necessary to require submission of parallel SCR estimates according to the standard formula for an indefinite period. Often a two-year period will be sufficient to give a fair impression of the relationship between the output of the model and of the standard formula. To keep the burden on the institutions to a minimum, after two years DNB will assess on an individual basis whether it is possible to exempt insurers from the parallel submission requirement.Incidentally, this does not mean that DNB cannot decide to request a parallel calculation for more than two years or for an indefinite period, if need be. This will be done in close consultation with the insurers in question.
Chapter 4 Governance / ORSA (Pillar 2)

Introduction

4.1 Pillar 2 of Solvency II provides the qualitative requirements insurers must meet. These requirements relate to what in Solvency II terms is called the ‘System of Governance’ but is referred to in the Wft as ‘controlled and sound pursuit of business operations’ (beheerste en integere bedrijfsvoering). These requirements concern the organisation and its operational management in general, the fitness and propriety senior management and persons who have other key functions, risk management, internal control & compliance, internal audit, the actuarial function and outsourcing.

4.2 The requirements in the Directive regarding the System of Governance / Controlled and Sound Operational Management (CSOM) are formulated in ‘principle based’ terms and are elaborated, where necessary, in implementing measures. CEIOPS gave its final advice to the European Commission about the latter in October 2009. The advice by CEIOPS, drawn up in consultation with the sector can be found at: http://www.ceiops.eu/media/files/consultations/consultationpapers/CP59/CEIOPS-CP-59-09-L2-Advice-Remuneration-Issues.pdf

4.3 The requirements in the Directive and the prospective implementing measures largely coincide with the Wft and the Besluit prudentiële regels Wft or Bpr (Decree on prudential rules pursuant to the Wft), chapters 2–5. New elements are the requirement for an insurer to implement several specific functions, viz. a risk management function, a compliance function (as part of Internal Control), an internal audit function and an actuarial function. Another novelty is the requirement to perform, as a part of risk management, a so-called ORSA (Own Risk and Solvency Assessment).

4.4 The present document provides an outline of Pillar 2. DNB advises insurers once more to study the Consultation Papers and other documents issued by CEIOPS to which the present document refers.

4.5 Table 4.1 compares Pillar 2 of Solvency II to the Wft and Bpr Wft.


45 The advice by CEIOPS, drawn up in consultation with the sector can be found at: http://www.ceiops.eu/media/files/consultations/consultationpapers/CP59/CEIOPS-CP-59-09-L2-Advice-Remuneration-Issues.pdf
Table 4.1 – Governance: Solvency II vs. Wft

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Functions

4.6 As part of the System of Governance / CSOM, the Directive identifies several functions, referred to as ‘key functions’, which every insurer must implement:
   a. Risk management function
   b. Compliance function
   c. Internal audit function
   d. Actuarial function

4.7 The Recitals to the Directive define a ‘function’ as an ‘administrative capacity’ to undertake particular governance tasks. A function is not by and of itself equated to an organisational department or a person. The insurer is at liberty to choose the most suitable organisational form. Depending on the nature, scale and complexity of the insurer, however, organisational allocation of functions would seem appropriate. In its ‘Advice on the Principle of Proportionality in the Solvency II Framework’,^47 CEIOPS has indicated that where functions are combined, due consideration must be given to the requirement of function segregation, and to the possible incompatibility with operational activities.^48 The Directive stipulates, for instance, that the internal audit function must be independent from operational functions. Where insurers are unwilling or unable to perform certain functions, they may, provided the relevant requirements are fulfilled (see below), outsource such functions.

4.8 The only ‘really new’ mandatory function is the actuarial function. This function need not be allocated to an actuary (i.e. a member of the actuaries’ professional organisation, such as

^46 See, however, the Regeling staten financiële ondernemingen Wft (Regulation on Statements of Financial Undertakings pursuant to the Wft) where it concerns the Staat Organisatie en Risico’s (Organisation and Risk Statement).
^47 www.ceiops.eu/media/docman/public_files/publications/submissionstotheec/AdviceProportionality.pdf
^48 The ‘Advice on the Principle of Proportionality’ notes in this connection that ‘additional measures should be implemented in order to ensure a level of control equivalent to that achieved through a full segregation of duties’.
the Actuarieel Genootschap (Actuarial Association in the Netherlands)). Yet the person(s) performing the actuarial function is/are expected to be competent in actuarial and financial arithmetic. The actuarial function has the responsibility:

a. to coordinate the calculation of technical provisions;
b. to ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;
c. to assess the sufficiency and quality of the data used in the calculation of technical provisions;
d. to compare best estimates against experience;
e. to inform the administrative or management body of the reliability and adequacy of the calculation of technical provisions;
f. to oversee the calculation of technical provisions in the cases set out in Article 82 of the Directive;
g. to express an opinion on the overall underwriting policy;
h. to express an opinion on the adequacy of reinsurance arrangements;
i. to contribute to the effective implementation of the risk management system, internal models and the ORSA.

Risk management system

4.9 Risk management is one of the foundations the Solvency II structure is built on. Risk management – the Directive speaks of the ‘risk management system’ – comprises ‘strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, on an individual and aggregated level, to which [insurers] are or could be exposed.’ The risk management system must be well-integrated in the insurer’s entire organisational and operational structure.

4.10 The importance of risk management is underlined by the recent crisis. As the CEIOPS memorandum entitled Lessons Learned from the crisis (Solvency II and beyond)\(^{49}\) puts it: ‘Solvency II is not just about risk measurement and quantification, rather it is about effective governance and risk management.’

4.11 The risk management system comprises at least the risks included in the calculation of the SCR (standard formula) plus:

a. underwriting and reserving;
b. asset – liability management;
c. investment, in particular derivatives and similar commitments;
d. liquidity and concentration risk management;

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4.12 Implementation by the insurer of the risk management system must include (the creation of) a risk management function. For insurance and reinsurance undertakings using a partial or full internal model, the risk management function covers the following additional tasks:

- to design and implement the internal model;
- to test and independently validate the internal model;
- to document the internal model;
- to inform the administrative or management body about the performance of the internal model, suggesting areas needing improvement;
- to analyse the performance of the internal model and to report thereon.

**Capital add-on**

4.13 As stated in 2.14 above, the SCR is usually determined by application of the standard formula. This formula is designed so as to produce, for a large number of insurers, an output that does not differ significantly from the capital that (theoretically) fits the individual insurer’s specific risk profile. Still, the possibility may not be ruled out that an insurer’s risk profile is significantly misaligned with the standard formula (i.e., its standard-formula SCR comes out significantly above or below the amount of capital that would be (theoretically) appropriate for that insurer’s risk profile).

4.14 The insurer and the supervisor have identical sets of instruments available to reconcile the SCR with the insurer’s risk profile. The insurer may achieve such reconciliation by using so-called insurer-specific parameters in calculating the SCR for its life, non-life and health care modules. The insurer may either choose to do so or be required to do so by the supervisor.\(^{50}\) Another possibility is for the insurer to use a partial or full internal model to calculate the SCR. Here again, the insurer may either choose to do so or be required to do so by the supervisor.\(^{51}\)

4.15 Furthermore, the supervisor has the additional power to impose a so-called capital add-on to achieve a closer fit between the calculation of the SCR and the insurer’s risk profile.\(^{52}\) If a capital add-on is imposed, the SCR plus the capital add-on supersedes the originally calculated SCR. A capital add-on will be imposed only in exceptional circumstances, when other measures and/or instruments available to reconcile the SCR with the insurer’s risk profile have failed or cannot be used.

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\(^{50}\) Article 104(7) and Article 110, respectively.

\(^{51}\) Articles 112 and 119, respectively.

\(^{52}\) Article 37.
4.16 In this context there are two types of capital add-on: a ‘risk profile capital add-on’ and a ‘governance capital add-on’. Within the risk profile capital add-on, there is a further distinction as to whether the insurer uses the standard formula or a (partial or full) internal model to calculate the SCR. The governance capital add-on is not primarily geared to SCR calculation but to significant deviations of an insurer’s governance vis-à-vis the standards set in the Directive.

4.17 Note, once more, that capital add-ons of any type are imposed only in exceptional circumstances – that is, only after other measures have been applied or considered.

4.18 In principle, a capital add-on is a temporary measure. The supervisor will reassess at least once a year whether to continue a measure or whether the originally identified significant difference has meanwhile been sufficiently remedied. However, capital add-ons may also be given a more permanent character, as in the case of a risk profile capital add-on where there is no benefit to the insurer in developing and implementing a full internal model.

4.19 The insurer must specify, in the Solvency and Financial Condition (SFC) report (Pillar 3)\(^{53}\) the calculation of the SCR stating, if applicable, the capital add-on imposed (with concise information on its justification by the supervisor concerned) and explaining briefly the supervisor’s stated reason for imposing it.\(^{54}\)

**ORSA**

4.20 The insurer must, as part of its risk management system, perform a so-called Own Risk and Solvency Assessment (ORSA). The European Commission, in its *Explanatory Memorandum* to the Solvency II Directive proposal,\(^{55}\) states that the ORSA must not be regarded as an internal model and that the outcome of the ORSA does not represent an ‘alternative’ requirement to the SCR or the MCR. The ORSA is, in other words, instrumental in the insurer’s risk management: the ORSA is an integral element of the insurer’s strategy and should be referenced in strategic decision-making. The ORSA must be performed regularly and in any case after every major change in the insurer’s risk profile.

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\(^{53}\) See Chapter 5.

\(^{54}\) Article 51(2), second paragraph.

4.21 The scope of the ORSA must include at least the following:

a. the insurer’s overall solvency needs, taking into account the specific risk profile, the risk tolerance limits and the business strategy, and estimated over a longer time horizon than the one-year horizon applied in calculating the SCR;

b. the compliance with the requirements in the Directive regarding the calculation of the SCR and of the technical provisions;

c. the degree of significance which the risk profile of the undertaking concerned deviates from the assumptions underlying SCR calculation whether by the standard formula or by a partial or full internal model.

4.22 The ORSA is a process which is as important as an actual process as its outcome. In order to provide greater clarity on the ORSA, CEIOPS released an *Issues Paper* on the ORSA in 2008.\(^56\) In it, several key principles on the ORSA are set out, *viz.*:

a. The ORSA should be regularly reviewed and approved by the undertaking's administrative or management body.

b. The ORSA should encompass all material risks that may have an impact on the undertaking's ability to meet its obligations under insurance contracts.

c. The ORSA should be based on adequate measurement and assessment processes and form an integral part of the insurer’s management process and decision making framework.

d. The ORSA should be forward-looking, taking into account the insurer’s business plans and projections.

e. The ORSA process and outcome should be independently assessed (as by the Internal Audit function).

4.23 No mandatory implementing measures for the ORSA have been provided by the European Commission. CEIOPS is to draft Level 3 guidance on this point.

4.24 Finally, the insurer must inform the supervisor of the outcome of every ORSA performed in the context of the provision of information to the supervisor pursuant to Article 35 of the Directive.\(^57\)

**Outsourcing**

4.25 The Direction adheres to the principle that an insurer remains fully responsible for any outsourced tasks and for compliance with provisions in the Directive that may be relevant to


\(^{57}\) Article 45(6).
the outsourced tasks. Outsourcing of so-called critical or important operational functions or activities is permitted unless this would:

a. materially impair the quality of governance system of the insurer;

b. unduly increase the operational risk;

c. impair the ability of the supervisory authorities to monitor the compliance of the insurer with its obligations; and/or

d. undermine continuous and satisfactory service to policyholders.

The insurer must inform DNB in good time of the outsourcing of critical or important operational functions. Also, the insurer must require the party to which functions or activities are outsourced to cooperate with the supervisor and to give the supervisor access to information on the outsourced functions or activities and to its business premises.\(^\text{58}\)

**Preparations**

4.26 This chapter makes it possible to distil several changes facing insurers, in particular the more explicit identification of several functions which every insurer must implement as part of its governance system, and the introduction of the ORSA instrument.

4.27 As regards the functions, the risk management function and the actuarial function stand out in particular. To the extent they have not already done so, insurers will have to start thinking about how to fulfil this requirement. The larger and more complex insurers may be expected to set up a separate department for each of these functions.\(^\text{59}\) Many insures already have similar functions in place and will have to consider to what extent they are in line with Solvency II requirements. Naturally, the internal audit function must be enabled to act independently. Where an insurer decides, whether or not on account of its scale, to outsource a function, it must satisfy the requirements applying to outsourcing. This implies, for one thing, that the insurer remains responsible for the fulfilment of the outsourced function.

4.28 A real innovation is the ORSA instrument. It is designed to make insurers look beyond the SCR, meaning not only an assessment of its own compliance with the SCR, but also a) an assessment of the individual risk profile in both the short and the longer run, including the amount of risk-bearing capital needed to cushion any adverse developments and b) an assessment of the actual availability of that desired amount in both the short and the longer term. As already stated, the ORSA assessment process itself is as important as its outcome.

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\(^{58}\) Article 38(1).

\(^{59}\) Certain functions, such as the risk management and actuarial functions may, of course, be combined within one department.
It cannot be said too often that this instrument, too, will be used proportionately: the ORSA process will prove easier for a small, less complex insurer than for a large, complex insurer.

4.29 The ORSA being new, finding the right shape and substance for this instrument will require efforts from both insurers (and their advisors) and supervisors. Insurers that have already worked with internal economic models have had the time to gain experience. Building on its Issues Paper, mentioned earlier, CEIOPS intends to provide further guidance on the ORSA in future. While insurers can, of course, find their own solutions here, they may also bring in outside expertise.

4.30 Institutions that wish to implement an internal model will have to perform an ORSA as early as 2012 (for 31 December 2011) and submit the outcome to DNB as part of the model approval procedure. However, DNB is of the opinion that the other insurers should also be given a chance to rehearse together with the supervisor before Solvency II takes effect. This is why DNB intends to require ORSAs for 31 December 2011 to be performed and submitted by all insurers as part of the overall dress rehearsal.

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60 See CP 37 ("Procedure for approval of an internal model"), www.ceiops.eu.
Chapter 5 Reporting requirements (Pillar 3)

Introduction

5.1 Under Solvency II, two reporting streams will be required: reports intended for the general public (the Solvency and Financial Condition Report or SFCR) and supervisory reports. The SFCR intends to promote transparency and market discipline in the insurance market. In addition to publicly available information, the supervisor needs to receive information beyond the scope of the SFCR, for one thing because a higher level of detail is required for supervisory purposes, for another because the disclosure of some information is either so competitively sensitive that disclosure cannot be required or subject to secrecy provisions.

5.2 To the extent possible, reporting requirements are to be harmonised on a European scale. Outside this harmonised framework, supervisors will only be permitted to require additional information (on a structural and market-wide basis) if owing to national characteristics it is not included in the European templates. In the Netherlands, such an exception may be made, for instance, for a specifically Dutch product like health insurance.

5.3 Insurers need to prepare themselves for the greater importance attached to transparency under Solvency II compared to Solvency I. Insurers will have to develop a vision with regard to this objective and its realisation. At the same time, insurance groups will be able to benefit from the harmonisation of reporting requirements.

5.4 In 2011 CEIOPS is expected to adopt the final reporting requirements. DNB expects insurers to have a ‘Solvency II reporting implementation plan’ ready by end-2011 specifying, among other things, the processes surrounding reporting, the way these processes will be introduced and the way in which information is to be made available (see also sections 5.23–25 below).

Role of reporting in the supervisory process

5.5 Supervision under Solvency II must be risk-based and prospective. The supervisory process will be a combination of on-site and off-site supervision. These basic principles confer a prominent role on reporting. After all, reporting plays an important role in off-site supervision. Regular reports permit the supervisor to assess a firm’s financial condition and its organisation. Furthermore, they are of importance for the planning of risk-based on-site supervision, since they are instrumental in estimating a firm’s risk exposures and,

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61 Article 29.
consequently, in allocating supervisory capacity: How intense must (on-site) supervision be for each individual insurer and what areas should it concentrate on?

5.6 As already indicated, one important principle underlying Solvency II will be that of proportionality (see Chapter 7 for more information on proportionality). Supervisors assess compliance with the Directive in a proportionate manner; reporting requirements, too, must be proportionate to the nature, scale and complexity of each insurer’s risk exposures. However, this is not expected to result in different reporting frameworks for different types of insurers. The structure underlying the information to be provided is the same for all insurers. Especially as regards qualitative information, however, the supervisor will expect varying levels of detail in the information firms provide.

5.7 Supervision as currently performed by DNB is risk-based, proportionate and prospective. DNB assesses both inherent risks and the measures taken to control them. Supervisory efforts are planned on the basis of the resulting residual (net) risks. This risk-based approach is expected to be further reinforced under the Solvency II regime, including a prominent role for reporting.

5.8 A new role for DNB will be that of supervising compliance with the Directive’s requirements regarding the disclosure of information in the SFCR. DNB expects to take a risk-based approach to supervising the processes underlying the compilation of the SFCR and also on its contents. This should ensure that transparency is viewed by the sector as a serious and important element of Solvency II.

The reporting process

5.9 Although the relevant principles of controlled and sound business operations already include the principles underlying adequate reporting procedures and systems, insurers must realise that the reporting process is going to change.

5.10 The SFCR compilation, approval and disclosure process, in particular, will require insurers’ attention.

5.11 If the financial condition of a firm undergoes such major changes that the information disclosed in the SFCR is no longer sufficiently relevant, the firm should provide an interim update. This would have to be done, for instance, if the firm is out of compliance with the MCR or SCR and is unable to redress this deficiency at short notice. Insurers must develop procedures for such an event.

5.12 Both the SFCR and the supervisory reports must be compiled on at least an annual basis.

62 Articles 51, 53, 54, 55 and 256.
63 Article 54.
5.13 In addition to the annual reports, information must be provided to the supervisor on a quarterly basis. The quarterly reports required by DNB since mid-2009 prepare insurers on a quarterly reporting frequency.

5.14 Apart from the structural reports due every year and every quarter (‘predefined periods’), the supervisor may ask for information in specific events (‘upon occurrence of predefined events’) and on an ad-hoc basis during the supervisory process. This means that DNB may request additional information, as the need arises, from a single insurer, from a group of insurers or from the entire industry. The latter possibility may occur, for instance, in the context of such thematic inquiries as are already performed today.

5.15 For both supervisory reports and the SFCR the insurer needs to have a written and management-approved reporting procedure in place so as to ensure the continuous satisfactory quality of the reported and published information. DNB will assume that both the SFCR and the supervisory reports are subject to approval by senior management.

5.16 Insurers must in addition have adequate systems in place to generate the reports. DNB intends to allocate a major role to the reporting procedure and systems. As is the case with current supervision of firms’ controlled and sound business operations, such a policy will ensure a preventive approach by supervision.

5.17 DNB advocates external certification of at least part of annual reporting so as to optimise the reliability of the reports – similarly to current practice. However, this will entail re-identification of the parts that need to be certified and, for each part, re-determination of the appropriate level of assurance. European-level consultations on this matter are currently taking place.

**Substance of reports**

5.18 Reports should provide a fair picture of insurers’ risk management and should enable the supervisor to take the right decisions. To this end, reports must contain both quantitative and qualitative information.

5.19 The quantitative aspects include the amount and quality of own funds, the MCR and SCR, the technical provisions and other liabilities, the assets and the valuation methods and principles for assets, liabilities and own funds. At least the material differences between the Solvency II balance sheet and the annual accounts require an explanation. And extensive

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64 Article 35.
65 Articles 35 and 55.
66 Article 55 demands this of the SFCR. DNB assumes, however, that analogous procedures are applied to the supervisory reports as well.
information must be provided on risks: exposure, concentration, sensitivity and risk mitigation in the several risk categories.\textsuperscript{67}

5.20 As regards the qualitative elements the system of governance (including risk management and the ORSA)\textsuperscript{68} stands out in particular, plus the way in which this system is able to control the existing risks sufficiently. Information must also be provided on the business and the performance of the undertaking, as well as on the environment in which it operates, so as to enable the supervisor to view the information on risk in its correct context.\textsuperscript{69}

5.21 A large part of the abovementioned information must be provided to both the public and the supervisor. According to current expectations, the exact reporting frameworks, including the extent of the information that is specifically intended for the supervisor and therefore need not be included in the SFCR, are expected to be determined in 2011. Insurers are at liberty to disclose more than the required information in the SFCR.\textsuperscript{70} The new reports will replace the present Wft Statements. The reports are separate from the annual accounts. Under specific conditions (See CP58 with final advice), the annual accounts may be used or referred to in the SFCR.

5.22 The supervisor may give its permission not to disclose certain information included in the SFCR requirements, either because such information is too competitive sensitive to be disclosed, or because disclosure would conflict with secrecy provisions with policyholders or other third parties.\textsuperscript{71} DNB expects these cases to be exceptional.

**Preparations**

5.23 Insurers should be well-prepared and to put their reporting processes in order. This means that the following conditions must be met:

- The compiling and approval process of the reporting system must be documented. This relates in any case to information on source data, processing systems and the division of duties and responsibilities.
- The SFCR disclosure process must be documented. This should extend in any case to the SFCR’s objective and level of ambition, the medium used and the manner in which communication with the press and the public will take place. Attention should be paid to both the annually disclosed report and the disclosure of changed or new information in the course of the year.

\textsuperscript{67} Article 51.
\textsuperscript{68} See Chapter 4.
\textsuperscript{69} Article 51.
\textsuperscript{70} Article 54.
\textsuperscript{71} Article 53.
- DNB is of the opinion that the above procedures, as part of a ‘Solvency II reporting implementation plan’, including an introduction schedule, should be finalised by end-2011

5.24 Compared to the current supervisory reports, the reporting framework is going to change. Although the topics to be reported on correspond by and large to the content of current reports, their elaboration and level of detail will be different. This is inherent in the differences between the Solvency II and I regimes, which entail changes in the information supervisors need to receive. Insurers have already had a chance to prepare themselves to some extent through the CEIOPS QIS studies and DNB’s RiSK study. One change is the larger amount of qualitative information to be submitted.

- Insurers need to examine whether all information is available and if not to make a plan to address this. DNB is of the opinion that this examination must be finished before end-2011 and that any system changes needed should be started. The examination and the plan count as part of the ‘Solvency II reporting implementation plan’ every insurer is expected to compile. DNB is aware that the date on which the final reporting frameworks are determined may coincide with the deadline for submission of the implementation plan. However, because the Level 3 advice is to be consulted earlier on, it may serve as the basis for the implementation plan.

- DNB recommends that in the course of 2012, administrative processes are set up in such a way that a first quarterly report in Solvency II format may be submitted on the second or third quarter of that year. By providing such a 'shadow report' (according to the so-termed quarterly quantitative reporting templates), insurers may prepare themselves for the first mandatory Solvency II report on the fourth quarter (reporting date 31 December 2012) and give themselves time to address any shortcomings.

- In the course of 2012 the administrative process must be set up in such a way that the first annual report with reporting date 31 December 2012 may be submitted in Solvency II format, and also the corresponding public disclosure report (SFCR). Insurers should be able to show that they can deliver the right information in the right formats.

- The submission dates are currently the subject of European deliberations; they are expected to amount to three or four months for the annual reports and three or four weeks for the quarterly reports.

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72 The annual reports are expected to be made mandatory as of reporting date 31 December 2012. By then, Solvency will be in effect and most of the data may probably be submitted, in particular balance sheet and solvency data. Where data from processes that last throughout 2012 (such as non-life statistics) this may be different. This is/will be discussed on an international level.
5.25 Insurers must also prepare for the public disclosure of large amounts of information. They need to develop a policy regarding the level of detail of the disclosures, possible competitive sensitivity or secrecy issues and the extent to which extra information is to be volunteered. In practice this will entail (as part of the Solvency II reporting Implementation Plan):

- developing an information disclosure policy including objective and level of ambition;
- identifying possible competitive sensitiveness and secrecy obligations and deciding on an approach.
Chapter 6  Group supervision

Introduction

6.1 Title III of the Directive sets out the requirements concerning the supervision of insurance groups. These are to replace and, especially, supplement parts of the current Chapter 3.6 of the Wft. In general, supervision on home groups is equal to supervision on cross-border groups. Exemptions are formed by cooperation in Colleges and the equivalence determination of third countries. These two elements only play a role in cross-border operating groups.

6.2 To date, supervision of insurance groups has been an addendum to solo supervision, performed at the level of the solo undertaking. Under Solvency II, prudential group supervision will become an independent part of insurance supervision, performed at the level of the parent company.

6.3 Group supervision will be aligned with the supervision of individual insurers. In fact the group is treated as if it were a solo insurer, unless the group structure demands a different or supplementary treatment.

6.4 The parent of an insurance group is expected to know what entities fall within the scope of the group, to implement and coordinate governance and risk management procedures, to meet the disclosure/reporting requirements and to calculate a capital requirement and own funds at the group level.

6.5 A major change in comparison to current supervision under the IGD is the communication between the supervisors and the entities within a cross-border operating group. In future, the group supervisor will act as the point of contact for group supervision and therefore keep in touch with the parent undertaking. Any questions about a subsidiary that arise at the group level are put to the group or to the solo supervisor by the group supervisor. The subsidiaries’ supervisors are responsible for solo supervision.

6.6 Group supervision under Solvency II is principle-based. This means that the parent is expected to be able to demonstrate that it is well-informed about and in control of the risks present within the group. For this purpose Solvency II offers a framework consisting of several pillars and aspects. Ultimately, however, the sum total of capital requirement, governance and disclosure will determine for the prudential supervisor whether a parent’s performance is satisfactory.

6.7 DNB regards as important that parent undertakings that will be subject to group supervision prepare for the new supervisory regime under Solvency II and the specific responsibilities incumbent on a parent.
6.8 Below an outline is presented of the several aspects of group supervision under Solvency II in line with the Directive.

Scope

6.9 DNB is of the opinion that the parent undertaking should be able, if asked to, to produce an overview of the individual SCR’s of the entities in the group.\textsuperscript{73}

6.10 The Directive states that group-level provisions apply equally to all (re)insurance entities within a group — that is, all undertakings in which the parent (re)insurer has a stake, including (re)insurance entities in third countries. In this context, any undertaking that exercises a dominant influence on another undertaking is regarded, for supervisory purposes, as a parent, while any undertaking under the dominant influence of a parent is regarded as a subsidiary.\textsuperscript{74}

6.11 A (mixed) insurance holding company having its head office in the EEA above a parent undertaking must be included in the scope of group supervision. In calculating the capital requirement such a holding must be treated as if it were the parent.\textsuperscript{75} The powers of the group supervisor include taking enforcement measures against the insurance holding and its directors in the event of non-compliance with provisions concerning group supervision or if the solvency is threatened, or if intragroup transactions or concentration risk threaten the financial position of the insurers within the group.

6.12 Mutual guarantee companies and mutual insurance companies are included in the definition of a group qualifying for prudential supervision.

6.13 Under certain conditions, the group supervisor has the power, in consultation with the other involved supervisors, not to include elements of the group in group supervision. Elements of a group established in a non-EEA country may, for instance, be excluded from group supervision if legal impediments prevent the exchange of information needed for the exercise of supervision. In addition, elements that are negligible parts of a group, or whose inclusion in group supervision would be inappropriate or misleading may, in consultation with the other involved supervisors, be excluded from the scope of group supervision.

6.14 The Directive provides for subconsolidation. Where subconsolidation is applied, all provisions relating to group supervision will apply, mutatis mutandis, to the subconsolidated entity. For the moment, DNB can in any case imagine that where an insurance group has a parent in a non-EEA country that exercises non-equivalent supervision, subconsolidation of the European part of the group will be considered.\textsuperscript{76}

\textsuperscript{73} Article 246.
\textsuperscript{74} Articles 213(1), 235 and 258.
\textsuperscript{75} Article 216.
Group capital requirement (Group-level SCR)

6.15 Insurance groups are expected to calculate the group SCR on the basis of a consolidated approach. This calculation must be undertaken at least once a year at the level of the parent undertaking. The consolidated calculation may take diversification effects into account. The group-level SCR may be calculated using either the standard formula or an internal model.\(^{76}\)

6.16 After calculating the capital requirement, the group is expected to analyse whether any group-specific risks, not included in the standard formula, should be taken into account in calculating the group-level capital requirement.\(^{77}\)

6.17 If, after calculating the group SCR, the risk profile of the group deviates significantly from the group SCR, DNB will ask the group to develop an internal model. In anticipation of the development of such a model, or if it should be impossible to develop such a model, DNB may impose a capital add-on.\(^{78}\)

6.18 In the event that the risk profile of a group that uses an internal model to calculate the group SCR deviates significantly from the calculated group SCR, DNB may ask the group to improve its internal model or to apply the standard formula. In anticipation of the development of such a model, DNB may impose a capital add-on.

6.19 If there is a (mixed-activity) insurance holding company above the parent undertaking, the calculation of the group SCR should take place at the level of the holding company. The rules applying to the parent undertaking will in this case apply to the holding as if it were a parent undertaking. This should result in more accurate calculation of the risks within the insurance group.\(^{79}\)

6.20 Only where the group supervisor, in consultation with the other supervisors, concludes that consolidated calculation of the capital requirement for (part of) an insurance group would be inappropriate, an alternative method to calculate the group’s capital requirement may be chosen: the deduction and aggregation method. Under this method, diversification within the solo undertakings is recognised, while diversification between the different entities in the group is not. A combination of both methods is permitted.

6.21 For banks within an insurance group, CEIOPS has decided to recommend that the bank’s sectoral capital requirement should be added to the group SCR. This brings the supervision of insurance groups into alignment with the supervision of financial conglomerates.

\(^{76}\) Articles 216 and 217.

\(^{77}\) Article 101.

\(^{78}\) Article 232.

\(^{79}\) Article 226.
6.22 CEIOPS in its advice on group solvency (formerly CP60) has indicated how other non-insurance undertakings may be taken on board in consolidated solvency calculation. This matter has to be further elaborated in the Level 2 implementing measures.

Eligible own funds

6.23 The assessment of eligible own funds at group level follows the methodology at solo level.

6.24 To prevent double counting of assets within the group, and to ensure that eligible own funds are in fact available to the group, the group supervisor, in addition to the requirements that will apply at the solo level, will also assess the availability and transferability of own funds.\textsuperscript{80}

6.25 The group must ensure that the amount of own funds available to the group at least equals the group SCR at all times.

6.26 This matter will be elaborated further in implementing measures and tested in the context of QIS5.

Third countries

6.27 The Directive permits consolidation of an insurance group with head offices in a third country. However, the supervisor will attach certain preconditions to this permission. First thing, information from the third country must be both available and reliable, and confidentiality must be ensured.\textsuperscript{81} If these conditions are not met, a group having its head office in a third country cannot be included in the consolidation, nor will diversification be recognised at group level. Such undertakings can be included in the calculation of the group SCR though partial application of the deduction and aggregation method.

6.28 The local regulatory requirements in third countries may only be used when calculating the group SCR of an insurer having its head office in the EEA if that third country regime has been found equivalent and if, moreover, the deduction and aggregation method is applied.

6.29 DNB is of the opinion that recognition of diversification depends on whether the preconditions are met and not on a decision on equivalence. However, where a regime has been found as equivalent, it will be easier to demonstrate that the preconditions are met.

6.30 Equivalence is established, in principle, by the Commission on the basis of criteria that will be set at Level 2. Where the Commission has not decided, the supervisors will have to make

\textsuperscript{80} Article 222(3).
\textsuperscript{81} Article 229.
their own assessment. DNB would like to see that a decision by supervisors is taken at CEIOPS level, so as to safeguard a level playing field at the European level.

**Governance**

6.31 Solo-level governance provisions apply *mutatis mutandis* at the group level.\(^{82}\)

6.32 DNB therefore expects the four governance functions (i.e. the risk management, compliance, internal audit and actuarial function) to be adequately implemented at the group level. One important element in this is the presence of written procedures ensuring that the same functions are rolled out over all entities the group and the implementation of these procedures are monitored at group level (top-down). Also, DNB expects to see that the separate entities of the group are able to give input on the way group governance is constituted (bottom-up).

6.33 The *Supervisory Review Process* or SRP is an important element in group supervision under Solvency II. Here, too, solo provisions apply *mutatis mutandis* at group level. Additionally, the group SRP should provide an insight into the way the group handles group-specific risks.

6.34 As part of the SRP, the group is expected to draft and submit a group ORSA. In addition to the solo requirements concerning the ORSA, a group calculating the group SCR based on the consolidation method, must add a note to the group-level ORSA explaining the difference between the consolidated SCR and the sum of all group members’ SCRs.

6.35 An insurance group may draw up a single ORSA for the entire group, provided that the information for each individual entity of the group can be identified in the document. Such an ORSA must be submitted to the group supervisor.\(^{83}\)

6.36 If the SRP leads to the conclusion that the group-level risk profile deviates significantly from that underlying the group-level capital requirement, the supervisor may ask the group to develop an internal model. In anticipation of the development of such a model, DNB may impose a capital add-on.

**Reporting**

6.37 The reporting requirements as explained in Chapter 5 also apply at the group level. In addition, groups will be asked to disclose supplementary information.

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\(^{82}\) Article 246.

\(^{83}\) Article 246.
6.38 The reporting requirements at the solo level will list elements that must be added to reports if the insurer belongs to a group. For one thing, significant risk concentration will have to be reported to the group supervisor on an annual basis. The same applies to intra-group transactions.\textsuperscript{84}

6.39 As regards the SFCR, the group may decide (subject to the supervisor’s permission) to prepare a single for the entire SFCR.\textsuperscript{85} This report must contain both the group-level information and the solo-level information for insurers included in the group.

6.40 An insurance group will have to inform the group supervisor in such a way that the information and data show clearly which parts of the consolidated capital requirement and of eligible own funds may be attributed to group entities in third countries and to sectors other than the insurance sector.

**Cooperation among supervisors**\textsuperscript{86}

6.41 The Directive creates a framework for cooperation between supervisors. Better cooperation should contribute to adequate supervision of the group as a whole and to simplification of the communication between supervisors and insurers.

6.42 In principle, the group supervisor communicates only with the group, while each solo supervisor communicates only with its ‘own’ subsidiary.

6.43 All supervisors of an insurance group are expected to form, for each insurance group under their supervision, a ‘College of Supervisors’ (‘the College’). This requirement expands on the current Coordination Committees (CoCos) that have been created for every insurance group in the EU on the basis of the Helsinki protocol. DNB assumes that as Solvency II comes into effect, the CoCos will be transformed into Colleges of Supervisors; DNB intends to do so with the CoCos it chairs.

6.44 All supervisors of the authorised insurance entities and significant branches in a group are a member of the College. In addition, for those groups for which DNB is the group supervisor, DNB intends to invite the supervisors of non-insurance financial undertakings in the group, such as banks.

6.45 In the case of larger insurance groups, inviting the parties mentioned in the preceding section may result in a large gathering. For the sake of efficiency DNB envisions a structure with a general college in which all supervisors concerned can participate and one or more core colleges in which only the relevant supervisors, depending on the topic, will participate.

\textsuperscript{84} Articles 244, 245.
\textsuperscript{85} Article 256.
\textsuperscript{86} Articles 247, 248.
On the basis of criteria set out in the Directive, the College is to appoint a group supervisor. The group supervisor chairs the College and is responsible for the internal organisation of the College and for the effective exchange of information within the College. Thus the group supervisor ensures the comprehensive insight in the financial condition, solvency, level of compliance, governance and risk management at group level.

The College does not have decision making powers. It can only exchange information and see to the preparation of decisions. The final say lays with either the group supervisor or (in some cases) the solo supervisor. The idea is that consensus should be reached within the College before decisions are taken. Where this is not possible, the Directive provides for mediation by CEIOPS in certain cases. However, as a mediator, CEIOPS can only offer non-binding advice.

The group supervisor has decisive powers regarding, among other things, the exclusion of parts of the group from the scope of supervision, the choice of capital requirement calculation method, and the assessment of a group internal model.

The solo supervisor has decisive powers regarding the imposition of a capital add-on on a subsidiary within the group.

For the groups for which it acts as group supervisor DNB will draft a College agreement providing for the modus operandi, the decision-making process, information sharing, confidentiality and crisis management. DNB aims to implement such College agreements within the CoCos for which it is the lead supervisor as early as in 2010, since both the preapplication and the (pre)validation of internal models will take place in (sub-committees of) these CoCos.

Furthermore, DNB will actively participate in the Colleges for insurance groups where it is represented as the supervisor of a subsidiary or significant branch office.

Preparations

In anticipation of the implementation of Solvency II, DNB expects insurance groups to participate in QIS5 and to calculate their group-level capital requirement in that context.

DNB expects the insurance groups for which it acts as the group supervisor to be able i) to state, prior to their participation in QIS5, what entities are part of the group and which entities should be included in the scope of group supervision and ii) to explain the calculation of the group capital requirement.

The Commission will shortly issue a proposal to give binding status to advice of CEIOPS in its role as mediator. This will have implications for the decision making process within the College.

Articles 214, 220 and 231.
Chapter 7  Proportionality and small insurers

Introduction

7.1 The proportionality principle is one of the main principles underlying the Directive. According to it, insurers with a low risk profile need not satisfy the requirements imposed by the Directive with the same level of accuracy and detail as insurers that have a high risk profile. The regulations must be applied in a manner proportionate to the nature, scale and complexity of the risks run by the insurer.\(^{89}\)

7.2 The proportionality principle applies explicitly to nearly all parts of Solvency II: regular reporting\(^{90}\), regular reviews and assessments\(^{91}\), the system of governance\(^{92}\), the ORSA\(^{93}\), the calculation of technical provisions\(^{94}\) and use of the standard formula\(^{95}\). Furthermore, the principle also applies implicitly, since not every insurer is exposed to every type of risk and since not all parts of Solvency II are mandatory, such as the use of an internal model. Large and complex insurers, for instance, will be required to report on a greater variety of risks, because they are exposed to more risks. Also, insurers of this type are more likely to use an internal model.

7.3 In an Advice to the European Commission, CEIOPS explains how proportionality may be given substance in practice.\(^{96}\) In this Advice, CEIOPS emphasises the following points.

a. Proportionality does not mean the introduction of automatic and systematic simplifications for certain undertakings. The principle will be applied where compliance with all of Solvency II would be disproportionate to the nature, scale and complexity of undertakings’ business. The individual risk profile should be the primary guide. CEIOPS underlines that the scale of the insurer is not the sole determining factor in applying proportionality: after all, there are small and complex insurers as well as large and simple insurers.

b. Proportionality applies to all Pillars and all provisions of Solvency II.

c. Proportionality works two ways. It justifies simpler and less burdensome ways of meeting requirements for low risk-profile portfolios, but also increases the likelihood that undertakings in fulfilling requirements will need to apply more sophisticated methods and techniques, for instance a (partial) internal model.

\(^{89}\) Article 29(3).
\(^{90}\) Article 35(4).
\(^{91}\) Article 36(6).
\(^{92}\) Article 41(2).
\(^{93}\) Article 45(2).
\(^{94}\) Article 86, subparagraph h.
\(^{95}\) Article 109.
The Advice proceeds to elaborate possible ways to implement proportionality for all the different sections of the Directive.

7.4 In January 2010, CEIOPS published recommendations as regards possible simplifications in the calculation of the SCR, simplification of the calculation of technical provisions, simplification of the SCR for captives and simplification of calculations with the standard formula.\textsuperscript{97}

7.5 In addition, CEIOPS will offer guidance to insurers and supervisors on the simplification of the Solvency II framework. If, for instance, an insurer does not have the dataset available that is required to calculate the technical provisions, it may temporarily suffice by using alternative data and proxies, until such time as its own data are such that they can be used to calculate the provisions in compliance with Solvency II.

**Insurers outside the scope of the Directive**

7.6 Articles 4 and 10 of the Directive state which life and non-life insurers fall outside the scope of Solvency II.\textsuperscript{98} They are:
- All benefit-in-kind funeral insurers\textsuperscript{99} and
- Small insurers (with premium income up to EUR 5 mln and technical provisions up to EUR 25 mln) that do not belong to a larger group and which do not insure against liability, credit or suretyship risks or carry on reinsurance activities.\textsuperscript{100} However, the scope of Solvency II does extend to any insurer whose expected growth will cause it to exceed the above-mentioned levels within the next five years.

7.7 For insurers within the scope of Solvency II, the Solvency I regime will end with the introduction of Solvency II. It is for individual Member States to choose an appropriate regime for insurers that fall outside the scope of Solvency II. With a view to policyholder protection, DNB nevertheless recommends that this category of insurers be subjected to proportional supervision.

7.8 The review of the insurance statements in 2007 meant an important first step towards more risk-based insurance supervision in anticipation of Solvency II. For the category of insurers not covered by Solvency II, the Ministry of Finance and DNB are currently exploring, in consultation with the sector, to explore the applicability of Solvency II including ways to uphold the proportionality principle. Like the majority regime, this ‘Solvency II proportionate’ regime should become effective as of late 2012. Solvency II proportionate will bring a further improvement on the current insurance statements and will conform to

\textsuperscript{97} See: http://www.ceiops.eu/content/view/706/329/
\textsuperscript{98} The Directive does not limit the scope for reinsurers, except with respect to government-guaranteed reinsurers
\textsuperscript{99} Article 10.
\textsuperscript{100} Article 4.
the Solvency II principles: risk-based, marking-to-market, transparency and proportionality. The proportionality principle will ensure that the insurers concerned will not have to observe all provisions of Solvency II in full, depending on the individual insurer’s risk profile.

**Preparations**

7.9 Intentions are to release a proposed new regime for insurers outside the scope of Solvency II to the sector for consultation in the course of 2010. DNB recommends that these insurers should also study the Solvency II Directive carefully, since they will undoubtedly face many of its provisions – albeit perhaps in simplified form.