Understanding the prudential balance sheet

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- Solvency Capital Requirement
- Long-term guarantees measures

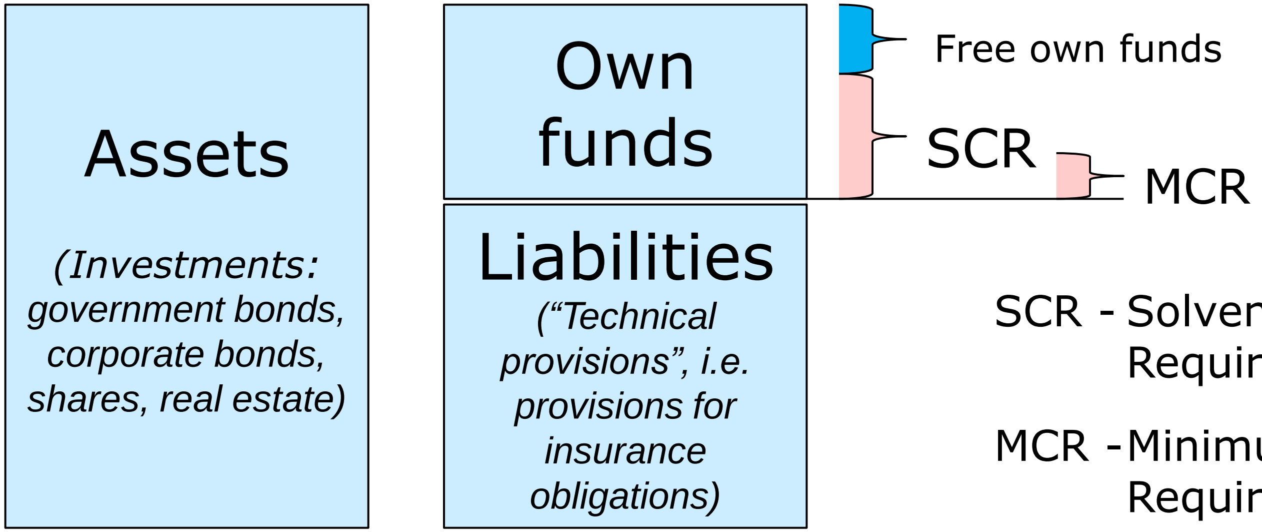
Objective of the prudential balance sheet

Protection of policyholders

Insurers are able to fulfil insurance contracts, also under adverse circumstances

Insurers hold sufficient assets to pay expected insurance benefits and bear unexpected losses

Prudential balance sheet



SCR - Solvency Capital Requirement

MCR - Minimum Capital Requirement

Capital requirements and own funds

SCR

- Risk-based and prospective
- Underwriting risks, Market risks, Credit risks and Operational risks
- Calculated with standard formula specified in the law or internal model developed by the insurer and approved by the supervisor

MCR

- Minimum level of security
- Calculated in simple manner
- Usually between 25% and 45% of the SCR

Own funds

- Insurers need to hold own funds to cover the SCR and the MCR.
- Own funds should absorb losses and be of sufficient quality (permanently availabile, subordinated, sufficient duration).
- Based on market-consistent valuation of assets and liabilities

What if SCR or MCR are breached?

The SCR corresponds to the amount of own funds needed to withstand the worst annual loss expected to occur over the next 200 years …

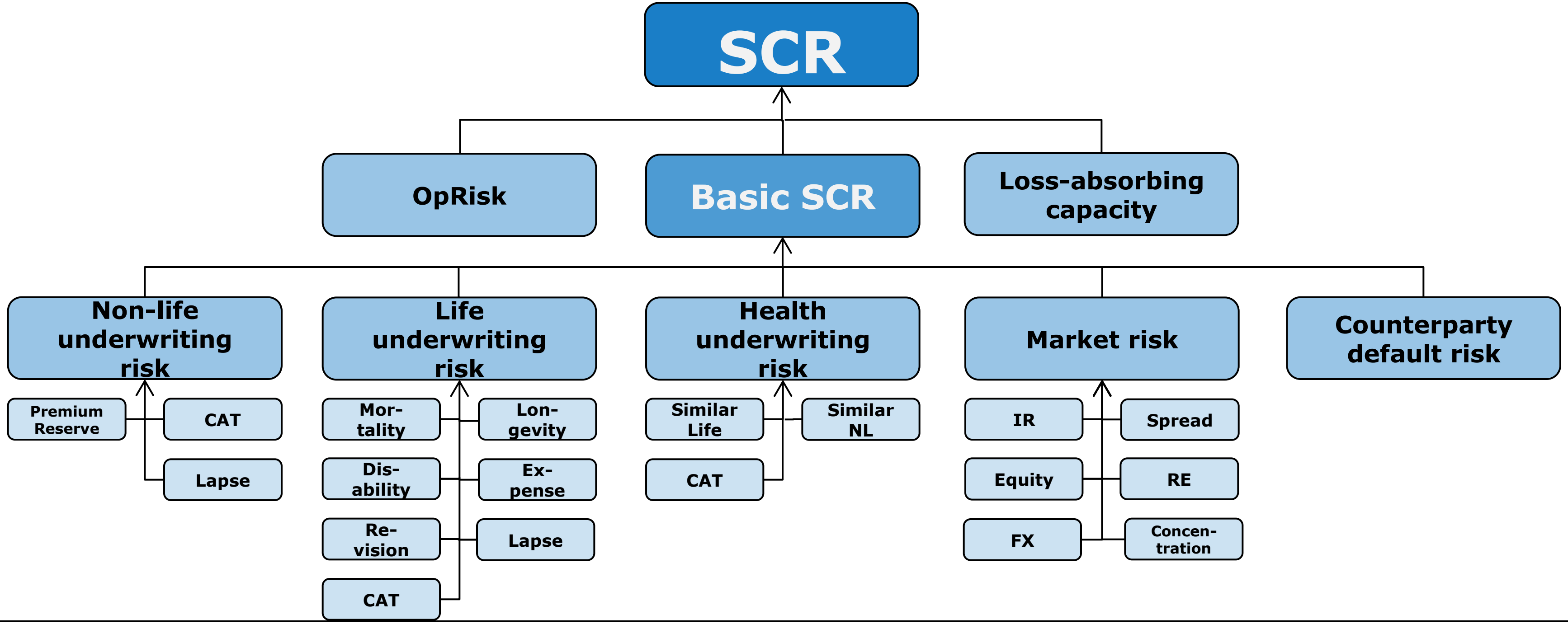
Breach of the SCR → intensified supervision, undertaking required to take measures to meet SCR again within 6 months

The MCR reflects the minimum level of protection of the policyholders and beneficiaries; breaching the MCR would amount to an unacceptable level of risk…

Breach of the MCR → leave the market unless MCR is met again within short period of time

Solvency Capital Requirement

SCR standard formula



Undertaking-specific parameters

Some parameters of the SCR for insurance risk can be replaced by undertaking-specific parameters.

Standardised method

Set out in the law

+

Data

Specific to the undertaking. Approved by the supervisor

=

Undertaking-specific parameter

Undertaking-specific parameters can be introduced on initiative of insurer or supervisor – in the latter case the impact is disclosed.

Solvency Capital Requirement

Internal models

Internal model requirements				
Use test	Statistical quality standards	Calibra-tion standards	Validation standards	Documen-tation standards

- Internal model can be introduced on initiative of insurer or supervisor
- Main differences between internal models and standard formula will be disclosed

Solvency Capital Requirement

Capital add-ons

- Supervisors may impose add-ons to the SCRs of insurers.
- Reasons:
  - Risk profile deviates significantly from the assumptions underlying the **SCR** calculation
  - Risk profile deviates significantly from the assumptions underlying the **long-term guarantees measures**
  - **System of governance** deviates significantly from legal standards
- Disclosure of impact and justification of capital add-ons
- Annual report of EIOPA on capital add-ons

Long-term guarantees measures

Stable extrapolation Volatility adjustment Matching adjustment	Short-term volatility of financial markets is only reflected in the balance sheet to the extent meaningful.
Transitional measures	Smooth transition to Solvency II
Extension of the recovery period	Flexible supervisory action in exceptional adverse situations

Long-term guarantees measures

Discounting technical provisions

- Significant impact on amount of technical provisions

  Example: Value of payment of 100 euros in 30 years:
  - 55 euros with discount rate of 2%
  - 41 euros with discount rate of 3%

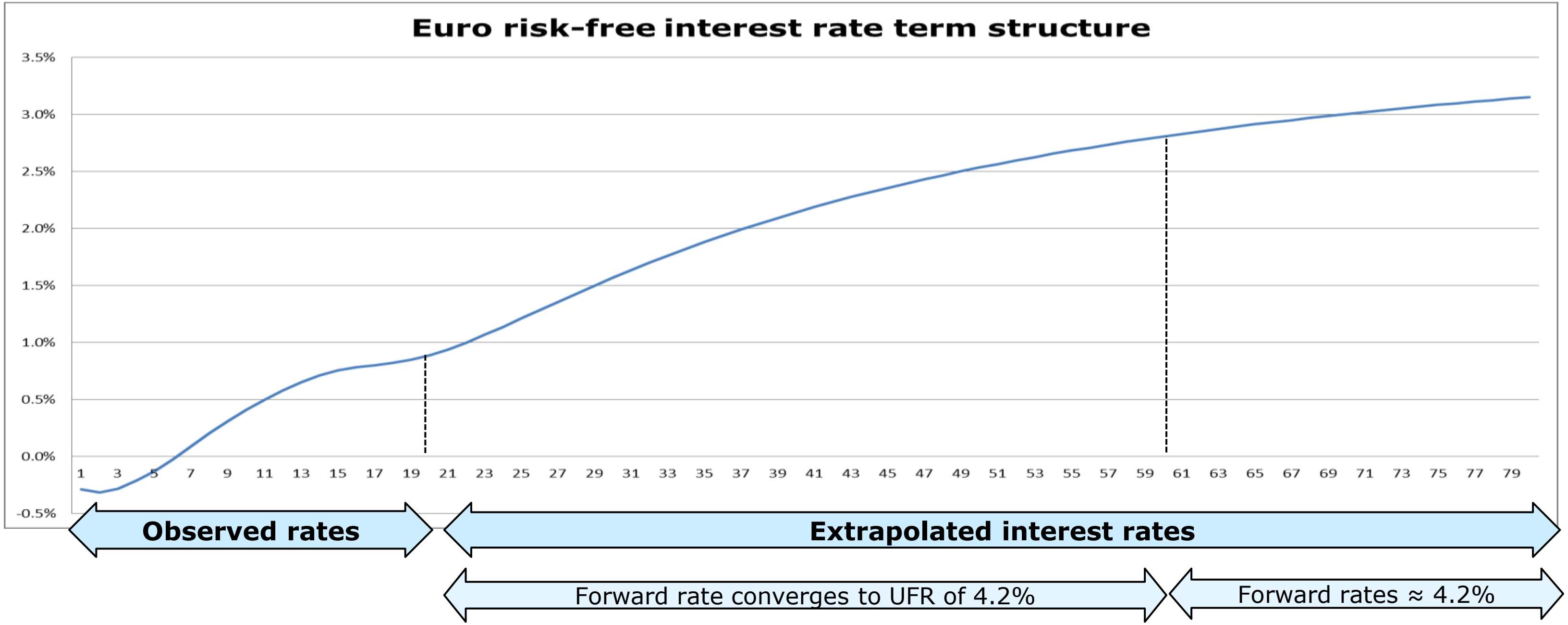
- Discounting with risk-free interest rates: current swap rates or government bond rates adjusted for credit risk

- Risk-free interest rates and information on adjustments are set out in the law and updated regularly.

- EIOPA publishes risk-free interest rates on a monthly basis for information.

Long-term guarantees measures

Stable extrapolation

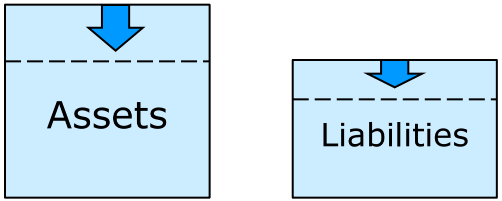


Long-term guarantees measures

Volatility adjustment (VA)

- Partly shields the insurer's own funds from short-term volatility of bond spreads.
- Adjustment to the discount rates for technical provisions depending on the spreads in the bond market

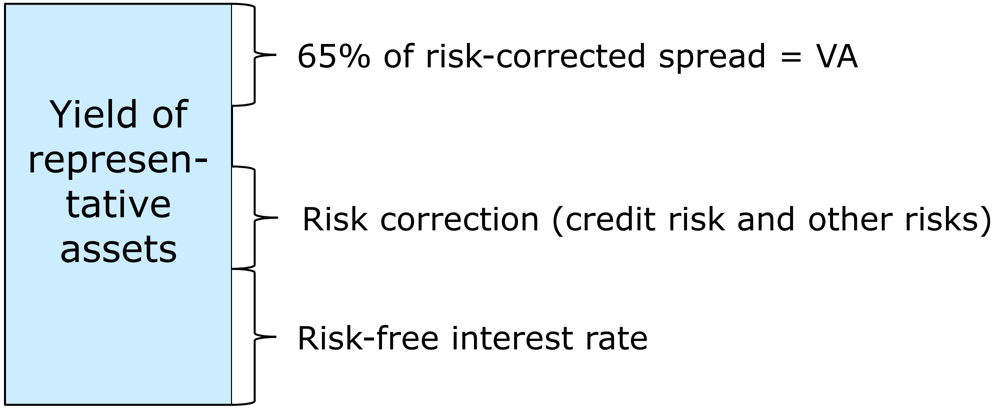
Impact of spread widening on the balance sheet with VA



- Liquidity planning required. In some Member States supervisory approval of VA required.
- Insurers will disclose also financial position without VA.

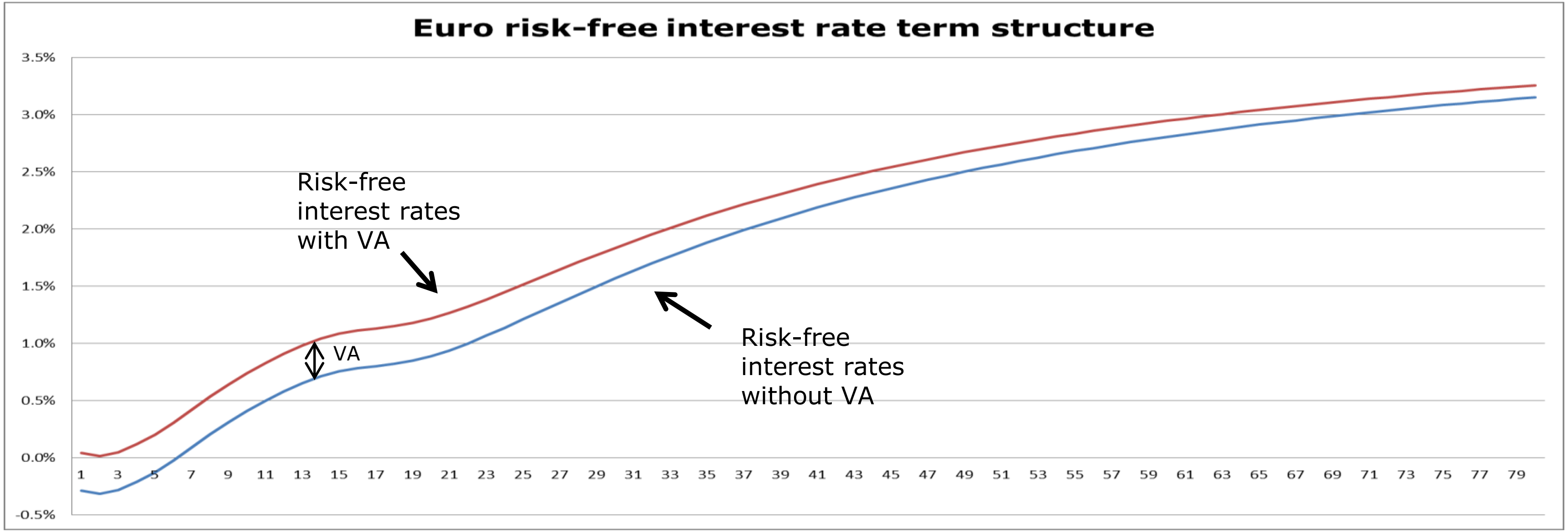
Volatility adjustment (VA)

VA = 65% of the risk-corrected spread of a representative portfolio of assets



Long-term guarantees measures

Volatility adjustment (VA)



Long-term guarantees measures

Matching adjustment (MA)

- Shields the insurer's own funds from short-term volatility of bond spreads
- MA = risk-corrected spread of the insurer's assets
- Requirements:
  - Supervisory approval
  - Cash-flow matching between assets and liabilities
  - Predictable cash-flows
  - Separation of assets and liabilities subject to the MA.
- Insurers will disclose description of the matching adjustment, description of assets and liabilities and also the financial position without MA.

Long-term guarantees measures

Transitional measures

- Two transitional measures – insurers can apply Solvency I valuation approach to:
  - discount rates
  - amount of technical provisions
- Transitionals apply only to contracts concluded before 2016.
- Phase-in of Solvency II valuation approach over 16 years
- Phase-in plan if SCR not met without transitionals: realistic plan how to meet SCR at end of transitional period
- Transitional will be withdrawn if phase-in plan becomes unrealistic.
- Insurers will disclose also financial position without transitional.

Long-term guarantees measures

Extension of the recovery period

- Breach of the SCR: usually insurers are required to recover within 6 months.
- EIOPA declares exceptional adverse situation where significant share of insurers are affected by:
  - unforeseen, sharp and steep fall in financial markets,
  - persistent low interest rate environment, or
  - high-impact catastrophic event.
- Consequence: National supervisors can extend recovery period for affected insurers by up to 7 years.
- Progress report to supervisor every 3 months – without significant progress withdrawal of extension.