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Solvency II – Aligning Risk and Capital Management

Solvency II will introduce economic risk-based solvency requirements for (re)insurance undertakings which will ensure that risk is measured on consistent principles and that capital requirements are aligned with the underlying risks of the undertaking concerned.

The new rules will introduce a two tier capital requirement for (re)insurance undertakings which seek to ensure the financial soundness of undertakings and to protect policyholders.

The rationale behind the introduction of this two tier capital requirement is to provide supervisory authorities with a so called "supervisory ladder of intervention" which will enable regulators to act in a timely, pre-emptive and effective manner to ensure the continued financial soundness of a (re)insurance undertaking.

The "supervisory ladder of intervention" also aims to ensure that any supervisory action undertaken is customised to the specific scenario affecting the undertaking concerned. This marks a fundamental change from the existing regulatory framework in Ireland.

Solvency II - Ireland's Regulatory Framework

The Irish Government is currently in the process of transposing into Irish law the Solvency II Directive (Directive 2009/138/EC) as amended by the Omnibus II Directive (Directive 2014/51/EC) which will become effective across all twenty eight EU Member States from 1 January 2016.

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In Ireland, the Solvency II regime will be given legal effect by secondary legislation in the form of Statutory Instrument. The Solvency II Directive will also be supplemented by more detailed technical Commission Level 2 measures and they in turn will be supplemented by Level 3 guidance for national supervisors developed and adopted by the European Insurance and Occupational Pensions Authority (EIOPA).

A New Prudential Supervisory Approach

Solvency II provides for a risk sensitive supervisory regime which is based on a prospective calculation of an (re)insurance undertaking's Solvency Capital Requirement ("SCR") and Minimum Capital Requirement ("MCR") with the aim of protecting policyholders and ensuring the financial soundness of (re)insurance undertakings.

The SCR of an (re)insurance undertaking should reflect a level of eligible own funds that enables re(insurance) undertakings to absorb significant losses and that gives reasonable assurance to policyholders and beneficiaries that payments will be made as they fall due. The SCR should cover all risks that an undertaking faces and should also take full account of any risk mitigation techniques applied by that undertaking.

The MCR should ensure a minimum level below which the amount of financial resources of an (re)insurance undertaking should not fall. Essentially, the MCR is intended to represent the minimum level of capital below which policyholders and beneficiaries would be exposed to unacceptable risks were the undertaking to continue its operations. The Solvency II framework requires that the MCR be calculated in accordance with a simple formula, which is subject to a defined floor and cap based on the risk-based SCR in order to allow for an escalating ladder of supervisory intervention and that the calculation is based on data which can be audited.

A Supervisory Ladder of Intervention

The Central Bank of Ireland (the "Central Bank") has indicated that it will exercise early and pro-active supervisory interventions where there are breaches in the SCR or the MCR. This approach builds upon the "supervisory ladder of intervention" principle enshrined in Solvency II.

Implications of a Breach of the SCR or MCR

The Central Bank will use the SCR and the MCR as regulatory tools for monitoring the financial stability of an (re)insurance undertaking.

Supervisory authorities will treat the breach of the higher capital requirement threshold of the SCR as an indication that the financial soundness of the undertaking concerned is deteriorating and as such will take appropriate action by entering into formal discussions with the undertaking concerned with a view to putting in place a recovery plan. The supervisory authority will also be obliged to state that, in the case of a breach of the SCR, that does not mean that the (re)insurance undertaking is insolvent. In the event of a breach of the MCR, supervisory authorities have legal powers under the Solvency II framework to impose a very strict recovery plan on an undertaking and, in the event that the plan is not complied with, the (re)insurance undertaking concerned will have its authorisation withdrawn.

Solvency II requires (re)insurance undertakings to have procedures in place to clearly identify deteriorating financial conditions and they are under an obligation to notify the supervisory authority of any deterioration in the financial conditions of the undertaking or any non-compliance with capital requirements.

Capital Add-ons

In exceptional circumstances, supervisory authorities may require an undertaking to hold more capital in the form of a capital add-on. In the event of a capital add-on being imposed on an undertaking, the amount of the capital add-on is added to the (re)insurance undertaking's SCR to calculate the new SCR for that undertaking. Once imposed by a supervisory authority, a capital add-on should be reviewed at least annually by the regulator and if the circumstances that led to the imposition of the capital add-on have been remedied, then the capital add-on should be removed.

The SCR and MCR – Keys to Value Creation

The introduction of the two tier capital requirement and the concept of the "supervisory ladder of intervention" represent effective early-warning mechanisms which will enable supervisory authorities to intervene in a timely and pre-emptive manner to ensure the continued financial soundness of (re)insurance undertakings. The new regime requires (re)insurance undertakings to take account of all relevant risks and this will be reflected in their capital requirements which will ultimately protect policyholders and ensure a viable and stable (re)insurance market.

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