A Architecture of Solvency II

A.1 The architecture of Solvency II, and the set of rules underpinning it, is built on a 3 pillar framework:

- Pillar I – contains the quantitative requirements;
- Pillar II – contains the qualitative requirements; and
- Pillar III – contains disclosure and reporting requirements.

A.2 There are also specific rules for reinsurance and insurance groups ((re)insurance groups), laid out in Directive 2009/138/EC, and rules for EU based (re)insurance groups with businesses in non-EU jurisdictions, and non-EU based (re)insurance groups with businesses in the EU.

Pillar 1 – Quantitative requirements

A.3 Pillar I covers the quantitative requirements a (re)insurance undertaking is expected to meet.

A.4 Broadly speaking, this covers the amount and quality of capital a (re)insurance undertaking is required to hold after undertaking a market consistent valuation of its assets and liabilities, and determining its requirements for Own Funds.

Assets and liabilities

A.5 A (re)insurance undertaking is required to undertake a market consistent valuation of its assets and liabilities under Solvency II, in order to determine its solvency position. Solvency requirements are based on an economic valuation of the whole balance sheet. As such:

- Assets shall be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction; and
- Liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction.

Technical provisions

A.6 A (re)insurance undertaking is required to establish technical provisions to cover its reinsurance and insurance liabilities (liabilities), corresponding to the current amount a (re)insurance undertaking would have to pay to transfer its liabilities immediately to another (re)insurance undertaking.

A.7 The value of technical provisions is equal to the sum of a (re)insurance undertaking's best estimate of its liabilities, plus a risk margin. The best estimate (of a (re)insurance undertaking's liabilities) corresponds to the probability weighted average of future cashflows, taking account of the time value of money, using a relevant risk-free interest rate term structure.

A.8 The risk margin is calculated to ensure that the value of technical provisions is equivalent to the amount that a (re)insurance undertaking would be expected to require in order to take over and meet another (re)insurance undertaking's obligations.

Own funds

A.9 A (re)insurance undertaking's own funds form the difference between the sum of a market consistent valuation of its assets, less the sum of a market consistent valuation of its liabilities.

A.10 Own funds can comprise of basic own fund items (the excess of assets less liabilities, or subordinated liabilities) and ancillary own fund items (unpaid share capital; letters of credit; or any other legally binding commitments received by (re)insurance undertakings).

A.11 (Re)insurance undertakings are obliged to hold a certain quantity and quality of own funds to act as an asset or capital buffer above the value of their liabilities, and provide cover against significant, adverse events which could affect the values of their assets and liabilities and, therefore, the (re)insurance undertaking's solvency position.

A.12 The *quantity* of own funds that (re)insurance undertakings are required to hold is determined by the Solvency Capital Requirement and Minimum Capital Requirement, which represent two distinct thresholds of capital requirement and two different levels of supervisory intervention.

A.13 The Solvency Capital Requirement and Minimum Capital Requirement must comprise of a certain *quality* of own funds, or capital, too. Basic and ancillary own fund items are classified into three tiers (tier 1, 2 or 3) depending on their permanent availability and subordination.

A.14 Broadly speaking, the highest quality of own fund or capital, Tier 1 capital, substantially possesses the characteristics of being permanently available and subordinated; Tier 2 capital, the next highest quality of capital, substantially possesses the characteristic of subordination; and Tier 3 capital comprises of (any basic and ancillary) own fund items which are not classified as tier 1 or 2.

A.15 Ancillary own fund items cannot be classified as tier 1 capital, but are classified as tier 2 where they substantially possess the characteristics of being permanently available and subordinated.

Solvency Capital Requirement and Minimum Capital Requirement

A.16 Solvency II establishes a dual supervisory intervention mechanism for (re)insurance undertakings through the creation of a Solvency Capital Requirement and a Minimum Capital Requirement. One of the objectives of Solvency II's two-tiered approach for supervisory intervention is to help ensure supervisors are made aware of the difficulties faced by (re)insurance undertakings at an advanced stage i.e. when a (re)insurance undertaking breaches the higher of the two thresholds, the Solvency Capital Requirement.

A.17 This will give the (re)insurance undertaking and the supervisor time and opportunity to take steps to help mitigate the possibility that the (re)insurance undertaking may breach the Minimum Capital Requirement, which is the lower of the two thresholds.

A.18 The dual supervisory mechanism also acts to protect the policyholders of (re)insurance undertakings which are in difficulty, and thus which may be unable to meet their insurance obligations. The Minimum Capital Requirement is a less flexible requirement, which, when breached, gives supervisory authorities the ability to withdraw a (re)insurance undertaking's authorisation.

Calculation of the Solvency Capital Requirement and Minimum Capital Requirement

A.19 The Solvency Capital Requirement covers all the quantifiable risks a (re)insurance undertaking faces (taking into account any risk-mitigation techniques) and determines the amount of capital which (re)insurance undertakings have to hold to back their risks.

A.20 The calibrations for each specific risk are designed so that the (re)insurance undertakings hold 'economic capital to ensure that ruin occurs no more often than once in every 200 cases or, alternatively, that those undertakings will still be in a position, with a probability of at least 99.5% to meet their obligations to policyholders and beneficiaries over the following 12 months'. For the purposes of this document, the level to which a (re)insurance undertaking's risks are calibrated to under Solvency II will be referred to as the 'Value-at-Risk of the basic own funds to a confidence level of 99.5% over a one-year period'.

A.21 The precise quantity of the Solvency Capital Requirement and of the Minimum Capital Requirement will vary depending on the underlying structure, business and risks of the (re)insurance undertaking.

A.22 The various risks that firms may have to consider when deriving their Solvency Capital Requirement can be observed from the diagram of the risk modules of the Solvency Capital Requirement below.

A.23 Firms will also have to consider the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes.

Supervisory approval and action

A.24 Supervisory authorities, amongst other responsibilities, will be required to review and evaluate (re)insurance undertakings' compliance with the rules for estimating technical provisions, capital requirements, and the quality and quantity of own funds as set out in Directive 2009/138/EC.

A.25 As part of this, supervisory authorities will be required to assess the assumptions underlying (re)insurance undertakings' Solvency Capital Requirement, calculated using the standard formula or a full or partial internal model. If a supervisory authority deems that there is a significant deviation in a (re)insurance undertaking's Solvency Capital Requirement from the assumptions within Directive 2009/138/EC, the supervisory authority may, in specific circumstances, set a capital add-on to require the (re)insurance undertaking to increase their Solvency Capital Requirement to correspond to the Value-at-Risk of the basic own funds to a confidence level of 99.5% over a one-year period.

Breach of Solvency Capital Requirement and Minimum Capital Requirement

A.26 A breach of the Solvency Capital Requirement or Minimum Capital Requirement occurs when a (re)insurance undertaking's eligible basic own funds decreases to an amount below the relevant threshold.

A.27 If a (re)insurance undertaking breaches their Solvency Capital Requirement, it is obliged to inform the supervisory authority and to restore the level of eligible own funds covering the Solvency Capital Requirement, or reduce its risk profile to ensure compliance with the Solvency Capital Requirement, within a period of six months. The supervisory authority has discretion to extend the six month period by three months if appropriate. In the event of an exceptional fall in financial markets, the period can be extended further.

A.28 The Minimum Capital Requirement is a lower requirement and its breach could trigger the ultimate supervisory intervention: the withdrawal of authorisation. When the amount of a (re)insurance undertaking's eligible basic own funds fall below the Minimum Capital Requirement, the supervisory authority is able to withdraw authorisation if the (re)insurance undertaking is unable to re-establish the amount of eligible basic own funds at the level of the Minimum Capital Requirement within three months from the observation of non-compliance

with the Minimum Capital Requirement, or if the finance scheme designed to restore eligible basic own funds to the level of the Minimum Capital Requirement is manifestly inadequate.

A.29 Withdrawal of authorisation may have the effect of prohibiting the (re)insurance undertaking's pursuit of, and agreement of, new insurance or reinsurance business, and could lead to the winding-up of the undertaking.

Pillar II – Qualitative requirements

A.30 Pillar II covers the qualitative or governance requirements the administrative, management or supervisory body of a (re)insurance undertaking is expected to meet to ensure compliance with Directive 2009/138/EC. This includes, but is not limited to, requirements around:

- Written policies in relation to risk management, internal control and internal audit;
- Ensuring the continuity and regularity in the performance of a (re)insurance undertaking's activities; and
- The evaluation of emerging risks.

A.31 As part of its risk management system, every (re)insurance undertaking shall conduct its own risk and solvency assessment (ORSA), which must consider the risk profile of the business compliance with capital requirements, and any deviations from the assumptions underlying the Solvency Capital Requirement. The ORSA is expected to form an integral part of a (re)insurance undertaking's business strategy and the results of the assessment will have to be reported to the relevant supervisory authority.

A.32 Supervisory authorities will be required to assess the effective governance of (re)insurance undertakings, and can take steps to ensure a (re)insurance undertaking's system of governance is appropriate and effective, including, for instance, applying a capital add-on.

Pillar III – Disclosure and reporting requirements

A.33 Pillar III concerns disclosure and reporting requirements, which are designed to ensure that supervisory authorities have all the information they need for the purposes of supervision.

A.34 Disclosure of information enables supervisory authorities to assess (re)insurance undertakings':

- Systems of governance;
- Businesses they are pursuing;
- Valuation principles for solvency purposes;
- Risks faced and risk management systems; and
- Their capital structures, needs and management.

A.35 Furthermore, (re)insurance undertakings will be required to publicly disclose certain information, to help facilitate a transparent EU reinsurance and insurance market.