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Dear Karel

### **Proportionality principle, supervisory reporting and disclosure requirements in Solvency 2**

We would like to thank you for attending the meeting to discuss proportionality and disclosure requirements on 18 February at ICAEW. We found the meeting very helpful and as agreed during the meeting, ICAEW welcomes the opportunity to provide further comments on these issues.

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### **Introduction**

In line with the conclusions we jointly reached with you at our meeting on 18 February, we have produced some examples which you might wish to consider when drafting implementing measures to the Solvency II Directive. In particular we have drafted these examples to allow you to insert them directly into the Level 2 text to illustrate key points, should you so wish. We believe the judicious use of such examples through the Level 2 text, illustrating points of principle or contention, would enhance greatly the understanding and application of the Directive.

In section 1, the example uses three hypothetical firms to examine how the proportionality principle might apply to risk management. It provides an example of what might be reasonable for supervisors to expect from each broad category of firms. We believe that a fundamental tenet of the proportionality principle is that firms determine for themselves the most appropriate approach to the requirements of the Directive, based on their detailed understanding of their nature, scale and complexity. This approach should then be discussed with, challenged by and ultimately agreed by their supervisor. This is consistent with the spirit of the Level 1 Directive. The Commission will be aware that the CEIOPS interpretation appears to be that the application of the principle of proportionality under the Level 2 advice is a concession, rather than a right. We must however differ from that approach. To this end we

recommend that a specific piece of Level 2 guidance should be produced to articulate what proportionality and materiality are considered to mean and how insurers and supervisors are expected to address the issue. This could be used to explain that proportionality is a right. There could then be in addition examples of proportionality, such as in our example, to be included in different elements of Level 2 guidance as appropriate.

Our example below is not intended as a set of requirements for firms at each level of scale and complexity, but as guidance of how a firm of a particular size might satisfy the requirements. We recognise that further debate is required on this approach, in particular in relation to group undertakings that are considered small and simple. The three categories of firms we have considered are: very small/simple undertaking; small-medium/moderate complexity and large/highly complex.

Section 2 contains the suggestion of a format that we believe could form the basis of a template to meet the Solvency and Financial Condition Report (SFCR) disclosures for a simple small firm. In producing this template our starting presumption is that market discipline is much less effective for small insurance companies than large public interest insurance companies/groups and therefore that the material costs of complex disclosures cannot be shown to be matched by any tangible benefit.

Research tends to show that of the stakeholder groups who are relevant to these smaller insurance firms, policyholders have very limited appetite for, and understanding of, anything other than very simple disclosures. There are limited numbers of other stakeholders for these firms such as insurance intermediaries who will also probably prefer a succinct summary of the solvency position rather than a very detailed document to aid their assessment of the insurer. We do not consider it likely that other stakeholders such as shareholders or rating agencies would make use of extensive solvency disclosures for smaller insurers and any significant general interest from the public or other bodies would be limited.

Supervisors on the other hand will receive very significant disclosures through the Report to Supervisors (RTS), since we would expect the detailed elements within the SFCR proposals from CEIOPS that are reduced within our suggested public disclosure would still be expected to be within the RTS, although hopefully with a little less prescriptiveness and more proportionality. The supervisors will also have access to ask for further information if required. We suggest that the limited external information requirement that exists should be met by a simple, relatively prescribed disclosure.

To aid this process, we have produced two versions of a possible standard disclosure as the basis for discussion. The first version is a minimalist version. This is designed for the situation where the maximum likely information needs of a stakeholder of the firm is a summary of the regulatory requirements that apply and statements from the governing body that confirm the firm has complied with these. We believe this statement could be viewed as representing constructive compliance with the requirements of Art 51 and that this could be accepted where it is believed that more detailed disclosure is not demanded.

The second version applies a similar template within which more detailed disclosures are to be inserted. This deals with all aspects of Art 51 and could result in significantly more detailed disclosure. We believe this is likely to be the minimum standard for larger more complex firms.

Should you be interested in the two examples provided below, we would be very pleased to discuss the detail of these further with you and how the templates might be of use. We remain willing to explore other areas where similar examples would be useful and to provide suggestions for draft text to your team. In doing so, if you are agreeable, it would be helpful to discuss with your team how our examples might best be integrated with the material that you are producing.

## Section 1

### Proportionality – governance example

#### Background and context

The CEIOPS Advice for Level 2 Implementing Measures on Solvency II: System of Governance (former CP 33) was published in October 2009 and sets out detailed advice for the operation of overall governance and specific governance functions (risk, actuarial, internal control, internal audit) and the management of outsourcing.

The Advice recognises the Level 1 text on the principle of proportionality (3.17 – 3.20) but is currently largely silent on how this might apply in practice to the governance of businesses of different nature, scale and complexity. While it is expected that the Level 3 guidance will provide detailed recommendations and guidelines, it is important that the Level 2 process provides firms and supervisors with sufficient information to allow them to interpret principles and advice at an early stage. This is particularly important for small firms with simple businesses, who will wish to understand how proportionality might be applied to their situation.

We have set out below an example on proportionality as it might apply to risk management governance in a firm, in a form that we believe might be appropriate to be inserted directly into the Level 2 text.

#### Example

The example below considers three broad categories of firm to examine, in overview, how the proportionality principle could be applied in practice to risk management governance, and therefore provides an indication of what might be reasonable for supervisors to expect from each broad category of firm after the Solvency II implementation is complete.

**This example is not intended as a set of requirements for firms at each level of scale and complexity, but as a simple illustration. Firms are expected to examine their business and determine the governance and risk management approach most suitable for them based on their own assessment of the nature, scale and complexity of their business.**

Firms will be expected to discuss with their supervisors the approach they have taken, explaining their rationale for such an approach and demonstrating that these have been discussed with and approved by the Board. Supervisors may require additional action, which must be explained, if their assessment of the firm differs from that undertaken by management.

#### Very small/simple undertaking

This is intended to capture those firms that only just exceed the thresholds in Art 4, and whose business operations are simple.

This could be a policy-holder owned mutual providing an income protection product to an affinity group, that has 4,000 members, one office, 8 employees, premium income of €1m and technical provisions of €30m.

#### Small-medium/low complexity

This is intended to capture those firms that, whilst still small compared to many insurance operations within the EEA, are well above the thresholds in Art 4; a very small entity with more complex business would also be considered here.

An example could be a specialist medical insurance provider covering a regional market with 20,000 customers, 6 offices, 1,000 employees, premium income of €300m and technical provisions of €250m.

### **Large/highly complex**

For illustration purposes, this will cover anything not falling within the other two categories.

An example could include a major international insurance group with operations in Europe, Americas, Middle East and Asia. This group has 18 million customers, 23,000 employees and technical provisions of €220bn.

Requirement	Very small/simple	Small-medium/low complexity	Large/highly complex
Board including qualified NEDs	Yes	Yes	Yes
Executive Committee	Possible – need for proper executive oversight	Yes	Yes
Board risk oversight	Responsibility of the Board or the Board Audit & Risk Committee	Responsibility of the Board or a relevant subcommittee such as the Audit & Risk Committee or a separate Board Risk Committee	Responsibility of a Board Risk Committee
Executive risk management	Probably by the Executive Committee	The Executive Committee or its sub-committee, with reports into the Board or applicable Board sub-committee	Executive sub-committee, with reports into the Board or applicable Board sub-committee
Risk management strategy	Yes – a brief document outline the businesses approach. Likely to be exposed only to very specific risks	Yes	Yes – very comprehensive covering all elements of risk and recognising product, geographic and other business issues
Risk management policies	Very limited – brief statements on key risk areas (investment, operational, customer morbidity)	Yes – explicit documentation in support of the relevant risk appetite requirements.	Yes – comprehensive documentation with cascade from overall policy to process. Forming a key part of the Internal Audit review programme.
Chief Risk Officer (CRO)	No – responsibilities likely to reside with Chief Executive	Possible but more likely to be a significant proportion of an executive's role (eg FD, Chief Actuary, COO).	Yes – member of Executive Committee
Risk management function	Yes – but not a full time role – likely to be an element of a member of staff's job description to maintain process, procedures and reporting	Yes – but limited in size – might expect 2-4 staff, with close liaison with actuarial, finance and operational teams.	Yes – major function at Group and subsidiary levels.
Risk management info systems	Very simple – utilising standard software (eg spreadsheets, simple database)	Possible for more sophistication.	Yes – expect to find systems/programmes supporting a wide range of risk exposures.
Reporting processes	Regular (quarterly) reporting based on simple processes (eg	Monthly reporting to any Risk Committee and the Exec	Detailed risk reporting – aggregating up from subsidiaries and sub-

	Word/Excel reports) to Board	Committee with information inputs from across the organisation.	Committees (eg Asset & Liability Committee, Investment Committee). Comprehensive monthly reporting supported by real-time reports for key risk areas (eg credit, equity).
Subsidiary (related undertaking) requirements	Not relevant	Oversight provided on any subsidiaries by the Head Office risk function and Executive.	Substantial resource at subsidiary/divisional level – likely to be divisional CROs

## Section 2

This section includes two examples of a format that could form the basis of a template to meet the disclosure requirements of the SFCR.

### Version 1 – Very small/simple undertaking

The template below is appropriate for use by a very small firm where in the opinion of the governing body and with the agreement of the supervisor, a more detailed public disclosure would not be expected by the key stakeholders of the firm.

#### Article 51 Statement for Smallco Insurance Co Ltd

- a. Smallco Insurance is a general insurance company supervised by [regulator] and operating in [market] [and market]. The primary business of the company is the provision of [eg, liability cover to pizza delivery companies]. In the year ending [accounting date] the premium income of Smallco was €XMillion.

The Directors of the company consider that the operating performance of the company is satisfactory and the company continues to satisfy the financial requirements laid down by [the regulator] as a condition of trading as an insurance company [entity].

- b. Insurance companies operating in [market] are subject to a comprehensive set of regulatory requirements which set minimum standards for how a company is organised and governed and in particular how it effectively controls and manages the risks that the business is subject to.

For the period ended [accounting date] Smallco has maintained and operated systems and controls which the Directors believe substantially meet the requirements of the regulations.

- c. The company maintains policies and operates systems for identifying and managing each significant category of risk to which it is exposed.

- d. The assets and liabilities of the company are valued in accordance with regulatory requirements. Assets have been valued at their current market value, taking allowable credit where appropriate of short term deviations in asset values from longer term valuations. The insurance liabilities of the company are stated at the discounted best estimate of their value, taking account of the dates they are expected to fall due and the expected investment income of the company, plus a required risk margin.

- i. The company is required to calculate the amount of capital it should maintain to ensure the financial stability of the company under all reasonably foreseeable

circumstances, using a formula [approved]/ [specified] by the regulator. This requirement is known as the Solvency Capital Requirement (the SCR). All companies are expected to hold capital (known as Own Funds) in excess of the SCR in their normal day to day operations.

The minimum capital requirement (the MCR) is the minimum level of financial resource that the company is required by [the regulator] to hold if it is not to be required to cease trading.

The company maintains own funds in excess of the SCR and MCR. The own funds are of a type and quality that conform to the regulations.

- ii. The SCR<sup>1</sup> for the company for [period] was calculated as [€XX]. The MCR for the company for [period] was calculated as [€XX].

[where relevant – The SCR includes an amount of €Z. This is an adjustment made at the request of [the regulator] to reflect certain risk factors applying to the company which are deemed to be different from the general assumptions made within the standard calculation.]

- iii. The SCR has been calculated using a standard methodology which is prescribed by [the regulator].

[alternatively – a description of the internal model process and how the “underlying assumptions” differ from the standard model]

- iv. The firm complied with the requirement to hold capital in excess of the MCR at all times during the period ending [ref date].

[alternatively, an explanation of any periods of non compliance and how this was remedied]

Signed by [names]  
Date

## Version 2 – Small-medium/low complexity

The template below is appropriate for use by a small firm where in the opinion of the governing body and with the agreement of the supervisor, a more detailed public disclosure would not be expected by the key stakeholders of the firm. However, since the firm is relatively larger and more complex than the one in the first version above, it may need to provide more disclosures than a very small/simple undertaking.

### Article 51 Statement for Smallco Insurance Co Ltd

- a. Smallco Insurance is a general insurance company supervised by [regulator] and operating in [market] [and market]. The primary business of the company is the provision of [eg, liability cover to fast food retailers].

In the year ending [accounting date] the premium income of Smallco was €XMillion. The company's financial statements for the year ending [accounting date] showed a profit after tax of €XMillion and shareholders funds of €XMillion. The performance for the year is set out in the attached extracts from our reporting templates submitted to the [regulator].

<sup>1</sup> This requirement is subject to a 5 year transitional during which member states may opt not to require disclosure.

The Directors of the company consider that the operating performance of the company is satisfactory and the company continues to satisfy the financial requirements laid down by [the regulator] as a condition of trading as an insurance company [entity].

- b. Insurance companies operating in the European Union are subject to a comprehensive set of regulatory requirements which set minimum standards for how a company is organised and governed and in particular how it effectively controls and manages the risks that the business is subject to. [These include ...]

For the period ended [accounting date] Smallco has maintained and operated systems and controls which the Directors believe substantively meet the requirements of the regulations.

- c. The company maintains policies and operates systems for identifying and managing each significant category of risk to which it is exposed.

The company's governance structure comprises .....This structure is considered adequate to address the risks faced by the company because.....

The key risks for this company, and the manner in which we mitigate against these, are as follows:

[insert table]

The main concentration of risks to which we are currently exposed and the key sensitivities of these are as follows:

[insert table]

- d. The assets and liabilities of the company are valued in accordance with regulatory requirements. Assets comprise of predominantly [quoted investments], but a full analysis is included in Schedule X<sup>2</sup>. These have been valued at their current market value, taking allowable credit where appropriate of short term deviations in asset values from longer term valuations. The valuation of assets for regulatory purposes is €XMillion which is €XMillion lower than that shown in the company's financial statements. This difference mainly arises from ....

The insurance liabilities of the company comprise of ..... They are stated at the discounted best estimate of their value, taking account of the dates they are expected to fall due and the expected investment income of the company, plus a required risk margin. The valuation of liabilities for regulatory purposes is €XMillion which is €XMillion higher than that shown in the company's financial statements. This difference mainly arises from ...

- e. Smallco maintains capital management policies that the Directors believe are appropriate to the nature, scale and complexity of the business.

- i. The measure of capital resources for regulatory purposes is known as Own Funds. As shown in d above, the regulatory net assets of Smallco are €XMillion, which is €XMillion less than the accounting net assets shown in the financial statements. Further adjustments are required to arrive at Own Funds, for example to ensure that a company is not over leveraged or where there are restrictions on the ability to use the capital. [There are no restrictions on the transferability of capital.]/[An amount of €XMillion, relating to ... , is required to

<sup>2</sup> Relevant extract from quantitative templates



be treated as non-transferable.]

The structure and amount of Smallco's Own Funds, and a comparison to the financial statements capital, is as follows:

[Insert table, unless a simple sentence will suffice]

[There have been no significant changes in Own Funds over the prior year.]/[During the year ended [ref date], the following changes were made to the composition of Own Funds: [insert table].]

- ii. The company is required to calculate the amount of capital it should maintain to ensure the financial stability of the company under all reasonably foreseeable circumstances, using [a standard formula that applies throughout Europe]/[a regulator approved internal model]. This requirement is known as the Solvency Capital Requirement (the SCR). All companies are expected to hold Own Funds in excess of the SCR in their normal day to day operations.

[where relevant – The SCR includes an amount of €Z. This is an additional amount that the regulator has required us to add-on to the SCR that we had determined. This relates to the regulators concerns regarding [certain perceived weaknesses in our governance arrangements, which we are addressing]/[areas where our risk profile I felt to differ significantly from the assumptions underlying the standard formula SCR calculation]/[regulatory concerns regarding the calibration of {risk} within our internal model]. The regulator has justified its decision to require this additional capital add-on as ... .]<sup>3</sup>

In addition, there is a minimum capital requirement (the MCR) that represents the minimum level of financial resources that the regulator will accept. A breach of the MCR would need to be restored quickly if a company is to avoid being told to cease writing new business.

The SCR for the company at [year-end date] was calculated as [€XX]. [where relevant: Final agreement of the SCR is still subject to supervisory assessment.] The MCR for the company at [year-end date] was calculated as [€XX]. The company maintains Own Funds in excess of both the SCR and MCR.

- iii. [There is an option available to life insurers to apply a duration-based assessment to their equity risk to certain classes of business. This reflects the long duration of the related insurance liabilities, for example pension provision. This does not apply to Smallco and accordingly, this basis has not been used.]
- iv. [The SCR has been calculated using a standard methodology which is prescribed by European Directive.]/[The main differences between the assumptions underlying the internal model that has been used to calculate the SCR and those set out under the standard formula approach are as follows: [insert table<sup>4</sup>].]

[The firm complied with the requirement to hold Own Funds in excess of the SCR and MCR at all times during the year ending [ref date]]/[The company complied with the requirement to hold Own Funds in excess of the MCR at all times during the year ending [ref date] and there were no significant breaches of the SCR over that period.]/[The company complied with the requirement to hold Own

<sup>3</sup> This requirement is subject to a 5 year transitional during which member states may opt not to require disclosure.

<sup>4</sup> Suggestion is three columns – IM calibration, SF calibration and rationale

Funds in excess of the MCR at all times during the year ending [ref date]. However, during the period [x] to [y] the company was unable to cover its SCR with Own Funds. This arose due to ... and the company took ... action to resolve the situation and restore SCR coverage. {If able to say this, no subsequent breach of the SCR has occurred since this action was taken.}]/[During the period [x] to [y] the company was unable to cover its SCR with Own Funds. Also for the period [x] to [x] the company was unable to cover its MCR. This arose due to ... and the company took ... action to resolve the situation and restore both MCR and SCR coverage.]

Signed by [names]  
Date

Yours sincerely

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