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Solvency II: the review, and what it means for Risk Managers

Background

After political agreement on revisions to the framework was reached in December 2023, the final text of a revised Solvency II is expected to be published in the Official Journal of the European Union by the end of 2024[1].

The European Commission launched its review of Solvency II four years ago, in order to ensure that the regulatory framework governing the insurance sector in the European Union remains robust, responsive, and fit for purpose in a changing financial landscape. One of the key motivations for the review was to enhance the resilience of insurers against financial shocks while also fostering a more competitive and innovative market. The review also aimed to address any unintended consequences of the original directive, such as overly burdensome requirements on smaller and less complex insurers.

Priority area for Risk Managers

Not all of Solvency II directly applies to risk and insurance managers. The focus of this note is therefore on the area of the Solvency II review that will directly impact FERMA Members, especially those running or making use of captive (re)insurance undertakings: proportionality.

Historically speaking, the Solvency II Directive aimed at making the prudential rules governing the (re)insurance business in the EU *more* proportionate. Over time, experience showed that the Principle of Proportionality (PoP) was applied inconsistently and insufficiently.

The main features of Solvency II's PoP may be summarized as follows:

- The rules must be applied according to the nature, scale and complexity of the undertaking.
- Regulatory actions should be commensurate to their final objective.

Key Dates

- **December 2020**: European Insurance and Occupational Pensions Authority's (EIOPA) opinion on the review
- **September 2021**: European Commission's proposed review
- **June 2022**: European Council's view on the European Commission's proposals
- **July 2023**: European Parliament's Committee on Economic and Monetary Affairs (ECON) approved amendments
- **January 2024**: publication of the agreed amendments following negotiations between the European parliament, the

[1] This note therefore relies on the text of the political agreement: https://data.consilium.europa.eu/doc/document/ST-5481-2024-INIT/en/pdf

European Commission and the European Council (i.e. political agreement)

- **23rd April 2024**: agreement formally adopted by the Parliament.
- Implementation date is unknown, with **2026** being a possible target.
- **30 April 2024**: the European Commission requested EIOPA's technical advice on the implementation of the new proportionality framework under Solvency II. The deadline for the advice is 31 January 2025.
- **2nd August 2024**: EIOPA published its Consultation Paper on "*technical advice on the implementation of the new proportionality framework under Solvency II*"
- **25th October 2024**: Deadline for responding to EIOPA Consultation Paper

Principle of Proportionality and Captive (re)insurance companies

Captives are an essential part of a vibrant and competitive EU insurance market. Captives allow their Group to have greater control over risk management strategies and insurance coverage. They also:

- support European enterprises broaden the scope of available insurance coverage
- help to reduce Total Cost of Risk
- consolidate and mutualise group' risks
- assist in leveraging and increasing the negotiation power of a multinational corporation towards the traditional insurance market.

These features of captives are particularly important in a time of an evolving risk landscape, with new risks (such as those related to the transition to Net Zero) emerging at a rapid pace.

Proportionality is therefore crucial for (re)insurance captives, which typically operate on a smaller scale and with less complexity compared to traditional insurers. Applying the same rigorous regulatory standards to captives as to large, diversified insurers could impose excessive administrative burdens and costs, potentially hindering their effectiveness and efficiency.

Solvency II Review and Proportionality: What are the results?

Improving proportionality was one of the primary objectives of the review. Two key features have been implemented to this end:

1. **The introduction of "small and non-complex undertakings" (SNCUs).** FERMA believes this will bring more consistency across EU Member States, and more predictability as the revised text sets out clear criteria any (re)insurance undertaking should meet in order to be classified as a SNCU by their national regulator or national competent authority (NCA). Once classified as SNCU, the undertaking can apply proportionality measures [see below].
2. **Shift in the burden of proof:** NCAs will have to provide explanations and details to insurance undertakings if the NCA wishes to challenge the SNCU classification.

Thresholds and criteria for SNCUs – simplified version

Scale	Annual gross written premiums do not exceed €100 million.
Nature	reinsurance accepted does not exceed 50 % of total annual gross written premiums * cross border activities do not exceed €20 million, or 10 % of total annual gross written premiums ** products are limited to straightforward insurance products, excluding coverage of aircrafts, ships, goods in transit, credit and suretyship
Risk Profile	average combined ratio net of reinsurance is less than 100% over the last three years Absence of complex financial instruments in the investment portfolio Market risk SCR module is less than 20% of total investments

** and ** do not need to be applied by captives*

Are captives considered as SNCUs?

The majority of Captives domiciled in EU Member States should meet the SNCU criteria and as such benefit from more proportionality.

Thresholds and criteria for being classified as SNCU are listed in Article 29a, which is summarized in the table at the top of this page, which presents the criteria applicable to non-life activities for ease of reading[2]. It is important to note that the criteria relating to cross-border and reinsurance do not need to be met by captives.

In addition, there is a derogation available to captives. The text goes on to allow that captives can also be classified as SNCU even if they do not comply with the above criteria, provided they comply with <u>both</u> of the following criteria:

1. all insured persons and beneficiaries are any of the following:
   a. legal entities of the group of which the captive insurance undertaking or captive reinsurance undertaking is part,
   b. natural persons eligible to be covered under that group's insurance policies, provided that the business covering those natural persons remains below 5% of technical provisions;
2. the insurance obligations and the insurance contracts underlying the reinsurance obligations of the captive insurance undertaking or captive reinsurance undertaking do not consist of any compulsory third-party liability insurance.

Captives complying with the conditions have to notify the supervisory authority of such compliance with a view to be classified as small and non-complex undertaking.

Such notification shall include all of the following:

1. evidence of the compliance with all criteria;
2. a declaration that the captive does not plan any strategic change that could lead to non-compliance with any of the criteria within the next three years;
3. identification of the proportionality measures the captive expects to implement.

The supervisory authority may then oppose the classification as SNCU within two months of receipt of the complete notification.

[2] Other criteria apply to life, and combination of life & non-life activities, which can be consulted in the text found here: https://data.consilium.europa.eu/doc/document/ST-5481-2024-INIT/en/pdf

New features for SNCUs

Captive companies classified as SNCU should benefit from proportionality measures on reporting, disclosure, governance, revision of written policies, calculation of technical provisions, the ORSA and the liquidity risk management plan. Although it will not be a complete revolution, some relief may be expected for captives.

Key proportionality measures that captives qualified as SNCUs could apply are as follows:

Reporting	Regular supervisory report (RSR): if authorised by the NCA, the SNCU may submit the RSR every five years, instead of every three.
	Solvency and financial condition report (SFCR): subject to disclosing a full SFCR every three years, SNCUs may disclose only the quantitative data in the section aimed at other market professionals. In addition, the balance sheet disclosed as part of SFCR should not be subject to external audit [*see note ****].
	Own risk and solvency assessment (ORSA): SNCUs will be permitted to complete the ORSA every two years, instead of annually.
Governance	Key functions: captives may benefit from some flexibility in their general governance requirements. The people responsible for the key functions of risk management, actuarial and compliance may also perform any other key function (other than Internal Audit) or be a member of the Board.
	Liquidity risk management: SNCUs will not be obliged to formulate a liquidity risk management plan.
	Review of written policies: SNCUs should be allowed to review their written policies in relation to risk management, internal control, internal audit, remuneration and outsourcing every five years, instead of at least annually.

*** *On SFCR*

Article 51 paragraphs 3 and 4 set additional requirements for captives – specifically – looking to apply a less onerous set of reporting requirements as concerns the SFCR. Of particular note then is that, for (re)insurance captives hoping to report the SFCR with the part only designated to market professionals (i.e. not to policyholders and beneficiaries), they have to evidence four extra conditions, namely:

- All insured persons and beneficiaries are legal entities of the group, and that the business covering natural personas remains below 5% of technical provisions
- No compulsory third-party liability insurance
- Loans in place with parent or any group company including cashpools do not exceed 20% of total assets held by the undertaking
- Maximum loss can be deterministically assessed without using stochastic methods

What will be avoided?

Climate change scenarios

There is a new requirement in Solvency II for (re)insurance undertakings to assess any material exposure to climate change risks, and if so define two long-term climate change scenarios (one with an overall temperature increase below 2 degrees Celsius, and one above 2 degrees).

Captives will not be required to specify climate change scenarios or to assess their impact on the business. This is a relief if we think about how complex and burdensome this could be, and would have significant complexity for captives

Macroeconomic modelling

The ORSA is also now required to include some analysis of the macroeconomic situation and possible macroeconomic and financial markets' developments, as well as of macroprudential concerns, which will have to be considered when defining the investment strategy

SNCUs will not be required to provide such consideration and analysis.

The Federation of European Risk Management Associations brings together 23 risk management associations in 22 European countries, representing over 5600 risk managers active in a wide range of organisations. FERMA provides the means of co-ordinating risk management and optimising the impact of these associations outside their national boundaries on a European level.

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