Gibraltar
Financial Services
Commission

**Consultation Paper**

# Proposal for the Quality Assurance of the Solvency II capital requirements, own funds and balance sheet

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# 1 Overview

1.1 This consultation paper ("CP") is relevant to firms who are impacted by Solvency II including their service providers such as auditors, insurance managers and those individuals or firms who are likely to use the Solvency and Financial Condition Report ("SFCR").

1.2 Two of the statutory objectives of the Gibraltar Financial Services Commission ("The Commission") are:
The protection of policyholders, no matter where they are located;
The protection of the good reputation of the jurisdiction.
The Commission believes that producing high quality information is central to firms making sound decisions on their capital planning and business strategy. The importance of high quality information is also acknowledged by the European Insurance and Occupational Pensions Authority ("EIOPA") when it stated the following in its newsletter dated 29 June 2015:

*"EIOPA is convinced that only high quality disclosed figures and good public reports can fulfil the goals set out by Solvency II…EIOPA believes that to ensure high quality public disclosure for Solvency II purposes, external audit of that information can certainly be a powerful tool."*

1.3 The Commission has considered a number of options of achieving this goal, with the aim of providing as much value to the management of insurance companies, as well as giving the Commission and other stakeholders the assurance they need.

1.4 We have set out two proposals, which are set out in section 2.7 and 2.8 of this paper, to give users of the SFCR, including the Board, investors, policyholders and the Commission greater confidence in the quality of the disclosure. Investors will need this information to make informed investment decisions, which should contribute to market discipline and the Commission's objectives of securing an appropriate degree of protection for policyholders and the protection of the good reputation of Gibraltar.

1.5 The Commission believes that Proposal 2, set out in section 2.8 of this paper, is the most cost effective. We are keen to hear from stakeholders on improvements to this proposal, and other options that we should consider. In particular, we welcome comments on:

1.5.1 Factors we should include in our implementation of either proposal;
1.5.2 Other options we should consider;
1.5.3 The scope of the review.

1.6 The Commission believes that this approach will capture the detail behind how the financial data underpinning Solvency II is derived, and will therefore be value adding to insurance company Boards to allow them to understand and challenge the significant assumptions in their Solvency II reporting. It will also mean that Boards are able to ensure, through their governance process, that the Solvency II publicly reported information contains consistent appropriate assumptions for the size and complexity of the business which has been externally validated by an independent party. This will help to fulfil their objectives of protecting policyholders' interests.

1.7 We propose requiring external review and validation of the assumptions used to derive own funds, the solvency II balance sheet, the solvency capital requirement ("SCR") and minimum capital requirement ("MCR") calculations, collectively referred to as the relevant elements of Pillar 3 reporting. The reporting templates in scope would be:

| **Template** | **Title** |
|---|---|
| S.02.01 | Balance Sheet |
| S.23.01 | Own Funds |
| S.25.01 | Solvency Capital Requirement |
| S.28.01 | Minimum Capital Requirement |

1.8 The review will be restricted to the insurance undertaking ("solo entity") level. We will not require the review at group level.

1.9 The Commission proposes to require the relevant elements of Pillar 3 reporting to be subject to external review. There are two exemptions:

1.9.1 the SCR would be exempt if calculated using an approved full or partial internal model ("internal model") as our approval process covers this.

1.9.2 Secondly, where a firm is a pure captive insurance company[1] (including captive protected cell companies whose cells are fully collateralised or have cell limitation clauses in place) it would be exempt from the external validation exercise.

Reinsurance captive insurance companies would **not** be exempt from the requirements outlined in this paper.

1.10 This consultation closes on **5 December 2016.** The Commission invites feedback on the proposals set out in this consultation paper. Please address any comments or enquiries to:

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[1] For the purposes of this paper, a pure captive insurance company will be defined as an insurance company that meets the following: is wholly owned and controlled by its insureds; its primary purpose is to insure the risks of its owners, and its insureds benefit from the captive insurer's underwriting profits.

## 2 Solvency II Pillar 3 reporting subject to external assurance

2.1 It is the Commission's view that external independent review and validation can underpin confidence in the quality and accuracy of publicly reported information. This chapter explains the Commission's proposed approach to the external review and validation of the relevant elements of Pillar 3 reporting under Solvency II.

2.2 The Commission's proposals are set out in Sections 2.3 – 2.10. Sections 2.11 – 2.20 provide useful background to the proposals and Sections 2.21 – 2.29 set out the reasons why the Commission has taken this approach.

**Proposals**

2.3 We would welcome comments on the two proposals described in sections 2.7 and 2.8 below.

2.4 The elements that will be considered in scope for the review will be:
- extraction of the source data from the relevant systems, and how it is used in formulating the Solvency II balance sheet and the SCR calculation;
- the underlying assumptions, accounting policies, and the judgements made in the calculation of the Solvency II balance sheet;
- the underlying assumptions, accounting policies, and the judgements made in the calculation of the own funds;
- the underlying assumptions, accounting policies, and the judgements made in the calculation of the minimum capital requirement;
- the underlying assumptions, accounting policies, and the judgements made in the calculation of the solvency capital requirement.

2.5 Under both proposals, the review would encompass the latest quarterly quantitative reporting templates ("QRTs"), annual reporting templates where available, or the Day 1 submission where the insurance company has been granted an exemption from full quarterly reporting.

2.6 The review will be at the solo entity level only and the templates in scope will be:

| Template | Title |
|---|---|
| S.02.01 | Balance Sheet |
| S.23.01 | Own Funds |
| S.25.01 | Solvency Capital Requirement |
| S.28.01 | Minimum Capital Requirement |

2.7 **Proposal 1**

The Commission will request every insurance company, under Section 98 of the Financial Services (Insurance Companies) Act, to have a professional services firm undertake a skilled persons review and produce a 'review and recommend' report across the relevant elements of their Pillar 3 reporting on either the latest quarterly QRTs, annual reporting if available, or Day 1 submissions. The report will be prepared for the Board of Directors of the insurance company and for the Commission. The provider of these services and the detailed scope of the work will be subject to approval by the Commission. The costs for the services received will need to be met by the individual firms.

*Timing of implementation*

These reviews will be requested prior to the end of 2016, and will have to be fully concluded by 31 March 2017 to allow firms enough time to discuss the findings with the commission and incorporate the changes within the year end QRTs and SFCR.

2.8 **Proposal 2**

The Commission will engage the services of a single professional services firm to review the relevant elements of Pillar 3 reporting, across the whole of the insurance market (with the exception of the exempted category firms noted in paragraph 2.27 and 2.28). This would be carried out in conjunction with some of the Commission's permanent staff members (jointly referred to as "the team"). The team will undertake the review of the latest quarterly QRTs, annual reporting if available, or Day 1 submissions and prepare a review and recommend report for each firm within the scope of the review. A market wide benchmarking exercise will also be undertaken, elements of which could be distributed.

During the pre-consultation process, the Commission has discussed these proposals with professional services firms and believes that engaging one firm across the market will reduce costs at each firm level, when compared with the same firm undertaking the review on a firm by firm basis.

In addition, this approach is likely to ensure consistency in the reviews carried out in the market as the approach taken will be determined by one firm in conjunction with the Commission.

There will be other economies of scale to be gained, where for example insurance managers are used and the processes are consistent across all managed insurance companies, this would only need to be reviewed once.

Under this proposal, the Commission will raise a special levy to cover the costs of the external provider. The mechanism adopted to identify the levy on a per firm basis would be based on the complexity of the balance sheet and technical provisions of each firm under review. There will be a significant emphasis on ensuring a mechanism is in place to enable fair distribution of fees, commensurate with the complexity of insurance companies under review.

Furthermore, should proposal 2 be selected, any request for proposal that is issued subsequently, will ask any tendering firm to explicitly address confidentiality and conflicts of interest that may arise from the availability of industry-wide information.

*Timing of implementation*

2.9 It is expected that the requirements for quality assurance would be implemented from January 2017. The information reviewed will be the latest quarterly QRTs, annual reporting, or Day 1 submissions, where firms are exempt from full quarterly reporting. The findings on the assumptions, accounting policies, judgements and data quality, controls and governance would be provided to insurance companies by the end of March 2017 in time for the recommendations to be reflected in the insurance company's the first publicly reported information.

*Policy review*

2.10 The proposals above are considered to provide the minimum level of assurance required by the Commission at this stage. Based on the findings from the initial review, the Commission will evaluate whether any additional assurance will be required. We will consult with the industry should the need for further assurance be identified.

**Background to the Commission's proposal**

2.11 Solvency II came into force on 1 January 2016. Solvency II has three main areas (Pillars). Pillar 1 consists of quantitative requirements (for example, the amount of capital insurers should hold). The requirements for governance, risk management and the effective supervision of insurance companies are set out in Pillar 2. Pillar 3 focuses on reporting requirements at a solo and group level for public disclosure and private reporting to the Commission. The public disclosure is the SFCR.

2.12 The SFCR will consist of quantitative and qualitative information on insurers' business and performance, systems of governance, risk profile, valuation for solvency purposes and capital management. The public disclosure is intended to enhance the quality and comparability of insurers' public disclosure across the European Union.

2.13 The private reporting to the Commission, under Pillar 3 of Solvency II, encompasses the insurers' strategy, projections, expected risks and quantitative reporting templates. In addition the insurer provides privately to the Commission its own risk and solvency assessment ("ORSA") supervisory report, which will provide insight into the future development of the insurer's solvency and financial condition.

2.14 Both public and private reporting will contain some key judgements and assumptions. Differences in these can lead to significant variation in the way items in the Solvency II balance sheet are treated and the calculation of the SCR and reduce the comparability between insurance companies.

2.15 If errors or incorrect treatments are noted in the capital or balance sheet assumptions that in turn result in a change in an insurance undertaking's margin over their capital requirement, it could result in significant reputational damage for the insurance company and more widely for Gibraltar as a jurisdiction.

2.16 The Commission believes that an independent review and analysis of an insurance undertaking's assumptions and accounting policies under Solvency II, and the governance around reporting, will serve to provide Board's with comfort on the firm's assumptions and accounting treatment. It could also provide information on how the firm is positioned compared with the rest of the market and whether it is in line with the requirements of the Solvency II Directive. In addition, it will be a tool to assist the Board's understanding of the detail behind the Solvency II reported numbers and how changes in the key assumptions impact the company's regulatory capital position.

2.17 As we are currently within the transitional period of Solvency II, any issues identified through a review of the assumptions can be corrected before the end of the transitional period. This may reduce the extent of regulatory intervention for any firm that falls below their SCR.

2.18 Under Solvency 1, the Annual Insurance Return and Parent Undertaking Solvency Margin calculation were subject to external audit by the statutory auditor which ranged from reasonable assurance on the Annual Insurance Returns to limited procedures on the Parent Undertaking Solvency Margin Calculation.

2.19 Although there is no requirement under Solvency II for external audit or validation of the public or private disclosure under Pillar 3, EIOPA 'believes that to ensure high quality public disclosure for Solvency II purposes, external audit of that information can … be a powerful tool. In order to make best use of external audit in the context of the SFCR, EIOPA is of the view that at individual and group level, the main elements of the SFCR (balance sheet, own funds and capital requirements) of all insurance and reinsurance undertakings could fall within the scope of an external audit.'

2.20 The proposed 'review and recommend' approach will provide the detail behind the Solvency II reporting templates as it looks at the process, assumptions and judgements adopted to arrive at the final report. As a result of the approach taken, which largely involves the review of previously reported data, we expect there to be less demand on the time of Director's when year end financial statements and returns are being prepared.

**The Commission's approach to its proposal**

2.21 The Commission believes that undertaking a 'review and recommend' exercise on the relevant elements of the Pillar 3 reporting demonstrates good reporting governance as it will assist the Board of an insurance undertaking to understand the detail behind the capital, balance sheet and own funds calculations, and therefore provide them with more information. Investors and other stakeholders have historically relied on insurers' published regulatory returns for undertaking analysis across the insurance sector and this is likely to continue. There are two main reasons for this.

2.22 Firstly, much of the information in the SFCR is not available in other forms to external stakeholders. For example, the calculation of technical provisions in the Solvency II balance sheet may be substantially different from that in the externally audited IFRS or Generally Accepted Accounting Practice ("GAAP") financial statements.

2.23 Secondly, one of the main elements investors analyse is the insurers' solvency and financial condition. It is expected that the SFCR will, therefore, continue to be used by investors and others for a number of years. It is therefore imperative that the accounting policies, assumptions and judgements are correctly applied.

2.24 The process of review and recommend will also provide a view of the consistency of assumptions and methodology across the market and assist in the identification of outliers.

*Elements of Solvency II not in scope for review*

2.25 The Commission does not propose external review and validation of Solvency II disclosure in the following scenarios:

*Where information is subject to private reporting*

2.26 Where the regulators are the primary external users of reporting e.g. the ORSA, the Commission's view is that its needs can generally be served through ongoing supervision and other more risk-focused tools which are more cost effective in these circumstances. When external assurance is needed, it can be obtained through the use of skilled persons under Section 98 of the Financial Services (Insurance Companies) Act.

*Where the firm is a pure captive insurance company*

2.27 Where a firm is a pure captive insurance company (including captive protected cell companies whose cells are fully collateralised or have cell limitation clauses in place) it would be exempt from the external validation exercise. Reinsurance captive insurance companies would **not** be exempt from the requirements outlined in this paper.

*Where information is required by Solvency II or the Commission and is subject to alternative verification*

2.28 Under Solvency II an insurer will have to obtain approval from the Commission to use an internal model. The quality assurance of an insurers' internal model would duplicate work already required to be carried out through an insurer's internal validation and the Commission's independent supervisory review process.

2.29 In addition, the Commission's approach to supervision of an internal model firm under Solvency II will ensure that the Commission has sufficient, reliable information to enable it to fulfil its regulatory functions. The Commission can assess whether the internal model continues to be appropriate through its individual supervision of the firm, the use of sector analytics, periodic reviews of key areas of the model and the review and approval of internal model changes.