



Solvency II

Making it clear

Reporting and disclosure in the Solvency II world

The Solvency II Directive is built around the '3 pillars' of quantitative requirements (Pillar 1), supervisory review (Pillar 2) and disclosure requirements (Pillar 3). In their preparations to date many insurers have focused on Pillars 1 and 2 and, in particular, on likely capital requirements and on necessary enhancements to systems of governance.

However, the qualitative and quantitative disclosure requirements of the Directive are extensive and diverse, and new detail on the requirements has recently been published by CEIOPS (Consultation Paper No.58). PricewaterhouseCoopers has analysed CP58 and this paper explores our views on the contents of the paper and the key issues facing the industry. We expect that producing the necessary information will pose a significant challenge for all insurers, but that it will also represent an opportunity to enhance communication with the market and with regulators. The development of Pillar 3 disclosures is expected to become an increasing area of focus for insurers as they prepare to implement the Directive.

Key messages

CP58 sets out very extensive public and private disclosure requirements

Firms should consider the level of disclosure they will have to provide and the processes, resources and data that will be required to do this. Quarterly reporting will be required for all firms. Equivalent information drawn from other sources must be reproduced in full, so firms can expect a very significant increase in the volume of information they have to produce.

Disclosure will be both qualitative and quantitative

CP58 includes detailed qualitative as well as quantitative disclosure requirements and firms will have to produce qualitative disclosure in new and incremental areas, including systems of governance, risk management and internal control systems, capital management including capital add-ons and, where applicable, internal models.

Reporting at both group and entity level

CP58 covers both groups and solo entities. While there are provisions

(with supervisory agreement) for a single group-wide Solvency and Financial Condition Report (SFCR), this would have to include, as annexes, the solo SFCRs of the parent entity and each subsidiary. Supervisory reporting will occur at the level of each insurer within a group to national supervisors and also at a group level to the group supervisor. CEIOPS will consult separately on group quantitative reporting templates.

Qualitative disclosure must use a predefined structure

CEIOPS has set out a fixed structure for public as well as private qualitative reporting with free-form reporting restricted to an executive summary targeted at policyholders.

Firms should aim to align their regulatory reporting with existing disclosures

Alignment of regulatory reporting obligations with existing disclosures under IFRS or local GAAP, in addition to streamlining of existing regular reporting, should be an important objective for firms seeking to establish an efficient reporting process. Requirements under Solvency II are expected to be reasonably

well aligned with IFRS in a number of areas, although the level of detail required under Solvency II may be greater.

Materiality is a key judgement

The level of regulatory reporting and the application of the principle of proportionality is centred on a judgement of materiality. Firms should consider where this cut-off will lie and how this will affect their level of disclosure.

Reporting will be subject to external audit

While the scope and level of assurance is to be finalised at Level 3, elements of both qualitative and quantitative reporting will be subject to external audit. This is, to some extent, familiar for UK firms where the Insurance Annual Return and certain qualitative information produced in other financial reporting is currently subject to external audit, but will represent a more significant step-change in many other territories.

Greater transparency in the financial services industry has been a topic high on the international agenda in recent months. In the course of the present financial crisis, disclosures have been the subject of market scrutiny and to a great extent found wanting; in particular, qualitative disclosures made by banks under the requirements of Basel II have arguably lacked sufficient clarity and accessibility.

The Solvency II Directive promises full and transparent public and private disclosures under Pillar 3, but has lacked detail to date. However, the publication of Consultation Paper No. 58 (CP58) – Supervisory Reporting and Public Disclosure Requirements, by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) as part of its second wave of advice on the Level 2 implementing measures for Solvency II, fills in many of the gaps around the public and private disclosures that insurance companies will have to provide. Subject to adoption by the European Commission, the proposals stemming from CP58 will provide the substance for the Pillar 3 requirements. CEIOPS has requested comments on

CP58 from stakeholders by 11 September 2009.

CP58 introduces extensive qualitative and quantitative disclosure requirements for insurers, and requires both annual and quarterly reporting. Disclosures will be public in the form of a Solvency and Financial Condition Report (SFCR) and private in the form of a Report to Supervisors (RTS).

The disclosure required in the SFCR and RTS is extensive and concepts of proportionality and materiality will be subject to significant interpretation by firms. Extensive quarterly quantitative reporting will be introduced for all firms, with deadlines of three or four weeks after the quarter end. Annual deadlines will be broadly similar to the current UK reporting timetable of three or four months after year-end, but the significant increase in the breadth and depth of reported information may stretch what is already a pressurised timetable for many firms. We therefore think it important for the industry to comment on how feasible it will be to comply with the requirements in practice, and this is an area in which CEIOPS has particularly invited comment.

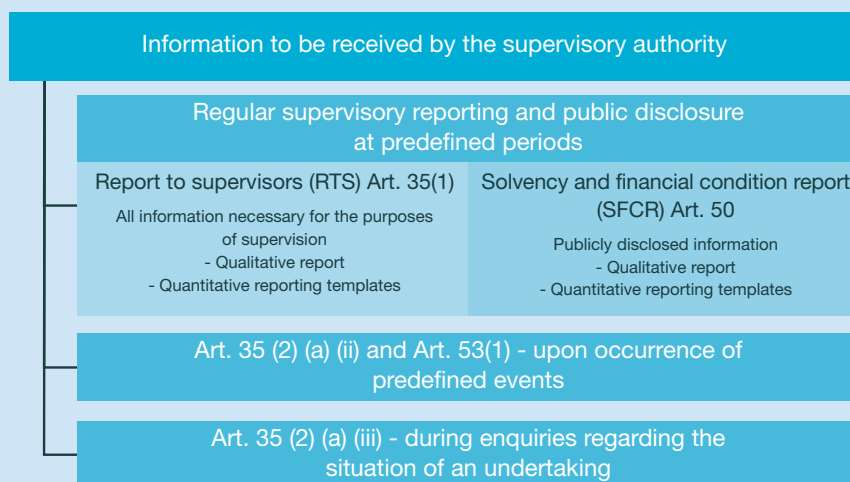
The SFCR and RTS are distinct and self-contained, although there will be significant shared content. In an effective departure from the Directive, cross-referencing to equivalent disclosures in other reporting will be acceptable only where the referenced information is reproduced in full, making each report stand alone. Insurers will therefore be required to produce two separate documents for external reporting, in addition to their Own Risk and Solvency Assessment (ORSA), which must be produced as part of the risk management system.

The qualitative content of the reports will be free-form, but based on a structure and set of requirements defined by CEIOPS. CEIOPS are also currently drafting quantitative reporting templates that are included in draft for comment in CP58, but which will be subject to further development and finalised as part of Level 3 measures – once this has been done, CEIOPS will determine which quantitative templates should be included within the SFCR as public reporting and which will remain private as part of the RTS only.

In addition to the SFCR and RTS, supervisors may require reporting of information either on the occurrence of predefined events or during enquiries regarding the situation of an insurer. The reporting requirements are illustrated in CP58 as set out in Figure 1.

This paper provides an analysis of the contents of CP58 including the key issues that may be faced by the industry. If you would like to discuss any of the contents of this paper in more detail, please speak with your usual contact at PricewaterhouseCoopers or one of the individuals listed at the end of this document.

Figure 1: Reporting requirements detailed in CP58



Source: CEIOPS Consultation Paper No. 58 paragraph 3.23

Understanding the Pillar 3 requirements

The SFCR and RTS provide public and private disclosure under Solvency II. The two documents are distinct but closely linked, and share a common structure. Here we discuss the proposed structure and highlight those important aspects that will have an impact on your business.

Harmonisation

One of CEIOPS' key aims in CP58 is to harmonise reporting between undertakings and territories. CEIOPS tries to achieve this by setting out a clear structure for the qualitative and quantitative information in the SFCR and RTS (see Figure 2), with detailed requirements for what must be disclosed in each section (albeit the format for disclosing the required qualitative information is at the discretion of the undertaking).

The structure of the information required is common to the two documents. However, the RTS will provide an additional level of detail and granularity for private disclosure to the regulator over and above that required for public disclosure in the SFCR. For example, when discussing internal audit, the RTS would include details of audits performed and the findings in addition to the description of how the internal audit function operates and maintains its independence required in the SFCR.

CEIOPS stresses that the target audience for the SFCR and RTS is different so rewording of the information in the SFCR is likely to be needed to support the supervisory dialogue in the RTS. Firms may view this as a significant administrative burden, essentially requiring the production of two lengthy documents, particularly given that both documents must be 'stand-alone' as opposed to incorporating information from other published sources by cross-reference.

Qualitative disclosure

The SFCR and RTS will require significant qualitative disclosure of a firm's systems of governance, risk management and internal control systems, capital management including capital add-ons¹ and, where applicable, internal model, as well as financial information on a firm's performance and solvency balance sheet.

Figure 2 - Structure of SFCR and RTS

<p>Executive Summary</p> <p>Business and performance</p> <p>A.1 Business and external environment</p> <p>A.1A Objectives and strategies (RTS only)</p> <p>A.2 Performance from underwriting activities</p> <p>A.3 Performance from investment activities</p> <p>A.4 Operating/other expenses</p> <p>A.5 Any other disclosures</p>	<p>System of governance</p> <p>B.1 General governance arrangements</p> <p>B.2 Fit and proper</p> <p>B.3 Risk management system</p> <p>B.4 ORSA</p> <p>B.5 Internal control</p> <p>B.6 Internal audit function</p> <p>B.7 Actuarial function</p> <p>B.8 Outsourcing</p> <p>B.9 Any other disclosures</p> <p>B.10 Reporting at group level (SFCR only)</p>
<p>Risk management</p> <p>C.1 Underwriting risk</p> <p>C.2 Market risk</p> <p>C.3 Credit risk</p> <p>C.4 Liquidity risk</p> <p>C.5 ALM risk</p> <p>C.6 Operational risk</p> <p>C.7 Other material risks</p> <p>C.8 The nature of material risk exposures</p> <p>C.9 The nature of material risk concentrations</p> <p>C.10 Risk mitigation practices</p> <p>C.11 Risk sensitivities</p> <p>C.12 Any other disclosures</p>	<p>Regulatory balance sheet</p> <p>D.1 Assets</p> <p>D.2 Technical provisions</p> <p>D.3 Other liabilities</p> <p>D.4 Any other disclosures</p>
<p>Capital management</p> <p>E.1 Own funds</p> <p>E.2 Minimum capital requirement and solvency capital requirement</p> <p>E.3 The option set out in Article 305b used for the calculation of its solvency capital requirement</p> <p>E.4 Differences between the standard formula and any internal models used</p> <p>E.5 Non-compliance with the minimum capital requirement and significant non-compliance with the solvency capital requirement</p> <p>E.6 Any other disclosures</p> <p>Additional disclosures for undertakings with an approved internal model</p> <p>Annex – Quantitative reporting templates</p> <p>Source: CEIOPS Consultation Paper No. 58 paragraphs 3.86 and 3.298</p>	

¹ Under Article 50 of the Directive individual supervisors may defer the requirement for firms to disclose publicly the details of any capital add-on for a transitional period of up to 5 years.

Consistency with the information already prepared by insurance companies under IFRS or local GAAP will be a key lobbying point for the industry to ensure efficiency. The CP is fairly well aligned in many areas with the risk-based disclosures currently required under IFRS 7/FRS 29 and firms may be able to reduce the burden on them by producing certain disclosures for their Annual Report and Solvency II reporting on a common basis.

Disclosures of systems of governance, risk management, capital management and the internal control system may represent new/incremental reporting requirements for many insurance companies and production of the required information should be factored into the Solvency II project. An enhanced level of reporting presents an opportunity for firms to send a positive message to the industry and stakeholders, and this message should be considered as part of a communications strategy. Firms that approach Pillar 3 purely as a compliance exercise risk both missing an opportunity and putting out an inconclusive or confusing message to the market compared with their competitors.

Internal models

The disclosure required around an internal model is likely to be particularly extensive for those insurers using them:

‘The level and depth of information to be publicly disclosed shall be based on the principle that a knowledgeable person can get a reasonably good understanding of the design and operational details of the internal model as well as the reliability of the internal model.’²

Article 52 of the Directive allows firms to apply to their supervisor not to disclose information publicly in the SFCR that will give significant undue competitive advantage to competitors (private disclosure to the regulator will, of course, still be required). However, CEIOPS believes that non-disclosure under this Article will be an exceptional event. In practice, where there has been significant internal investment in developing a bespoke internal model, it may prove challenging to develop disclosures that

give the required level and depth of information without putting commercially sensitive information into the public domain.

ORSA

CEIOPS proposes that disclosure of the results of the ORSA be kept private in the RTS, in order to allow firms to conduct a fully transparent ORSA. However, the process undertaken to fulfil the ORSA requirements, including how it is integrated into the management process and decision-making framework of the company, must be publicly disclosed in the SFCR.

Quantitative reporting templates

In addition to the qualitative reporting discussed above, CEIOPS is developing templates for quantitative reporting to supervisors, which will replace all existing quantitative reporting (including the UK FSA Return). To foster harmonisation and comparability between companies and territories, these are being developed as fixed templates to be completed by all firms throughout the EEA. (Although completion of certain elements will not be required for companies that have developed full or partial internal models). The templates are intended to be harmonised across the EEA. Supervisors are permitted to develop supplementary national templates, but only in exceptional circumstances where required by national markets or regulations. CEIOPS intends to provide conditions under which these may be required at Level 3.

The templates are intended to be submitted in full alongside the RTS, and certain of them will be made public as part of the SFCR. CEIOPS intends to develop its views on which templates will be made public as part of Level 3 guidance.

The templates are currently in draft format and are due to be finalised by CEIOPS as part of Level 3 guidance. CEIOPS has particularly requested comment from stakeholders on how difficult or costly the templates may be to complete. In many areas, the draft templates do not represent a significant departure (at least for UK firms) from the information currently collected in the annual FSA Return, although additional

information is required in some areas (for example, additional cash-flow analysis³), and certain important elements are not yet defined which may not align with those currently reported in the UK (for example, the classes of business and product IDs to be reported for life business). For many firms not subject to the UK or a similar local regulatory regime, the templates will represent a very significant increase in the volume and complexity of quantitative information reported, and may require additional reporting systems to be developed.

Proportionality will be a key issue for smaller firms and CEIOPS has not completed its thinking in this area; further guidance is promised at Level 3, although firms may wish to communicate their views to CEIOPS at this stage. It is envisaged that some templates will need to be completed only for material lines of business.

Reconciliation between the Solvency II and accounting balance sheets will be required to enable proper assessment of areas such as distribution of dividends and the quality of the components of equity within the accounting balance sheet. Development of IT architecture, processes and data may be required by some firms to gather the necessary information to complete the templates. CEIOPS is considering the feasibility of developing templates based on management accounting information and has invited firms to contribute templates based on their own management information to aid in developing this avenue.

Firms that approach Pillar 3 purely as a compliance exercise risk both missing an opportunity and putting out an inconclusive or confusing message to the market compared with their competitors.

² CEIOPS Consultation Paper No. 58 paragraph 3.243.

³ Form G4.

Materiality and proportionality

Materiality is a fundamental principle in CP58 and the submission of only material information is one of the key ways that CEIOPS intends to implement the principle of proportionality. CEIOPS proposes to align materiality for the purposes of regulatory reporting with the IAS definition:

'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.'⁴

In this context, CEIOPS proposes that the 'economic decisions of users' should be understood as the 'risk-based decisions to be taken by supervisory authorities when performing the Supervisory Review Process (SRP)'.⁵ This aligns materiality with the expectations of the supervisor and is therefore consistent with the FSA's current Principle 11.⁶

However, since the cut-off for materiality in any situation is a judgement to be taken by individual firms, this principle may result in a higher level of disclosure in earlier years and a significant amount of interaction with supervisors as companies develop their understanding of what is material to their supervisor. The understanding of materiality may also be developed within the context of the college of supervisors.

CEIOPS considers that the application of the requirements of CP58 will naturally be consistent with the principle of proportionality since the level of detail firms will be required to provide will be commensurate with the nature, scale and complexity of the risks inherent in their business, and because firms will not be required to fulfil disclosure requirements that are not applicable to them. The judgement of materiality will be key in assessing how proportionality should be applied. In particular, since most

Figure 3 – Frequency and timing of reporting

Report	Frequency	Submission date
SFCR	Annually	Three or four months from financial year-end
RTS	Dependent on intensity of SRP	Three or four months from financial year-end, in full or material changes only
Quantitative reporting templates	All templates annually	Annual submission deadline: three or four months from financial year-end
	Some templates quarterly	Quarterly submission deadline: three or four weeks from quarter end

Source: PricewaterhouseCoopers

elements of the prescribed formats of the SFCR or RTS are likely to be applicable to all firms to some extent, judgement will be needed in determining the level of detail that will be proportionate to disclose under each heading.

Group reporting and disclosure

Article 260 of the Directive provides for insurance groups to submit a single group SFCR. CP58 expands on the requirements for the group SFCR, setting out two parts to the report, a SFCR prepared at the level of the group, and annexes that provide solo SFCRs for each entity, in addition to minimum requirements in respect of the language(s) in which the report must be prepared. As a result, the preparation of public reporting at a group level (which arguably would meet the needs of many users) would not appear to reduce the burden of preparing equivalent information at the level of each entity.

Where firms that are part of groups prepare a solo SFCR, information is required throughout the SFCR setting out matters that arise as a result of being part of a group, under each heading, for example material group specific risks.

There is no provision in CP58 to produce a single group RTS in place of entity level RTSs, although some specific information relating to the group is required, for example group strategy and the role of each subsidiary.

Groups will be required to submit quantitative reporting templates as well as qualitative reporting. CEIOPS does not provide draft templates in CP58, but indicates that these will be provided as part of a later consultation.

Submission timings and format

The proposed timings of submission are summarised in Figure 3. The SFCR is an annual document, as are the full set of quantitative reporting templates that must be submitted alongside the qualitative RTS and SFCR. The timing of the qualitative RTS is a function of the intensity of the SRP and is therefore specific to individual firms, although a full RTS will need to be submitted in year one.⁷

In years where a full RTS is not required by the supervisor, firms will be required to inform their supervisor only of material changes that have occurred to their business over the reporting period, or state that no such changes have occurred. CEIOPS proposes a maximum period of five years between submissions of full qualitative RTSs.

In addition to annual submission of the full set of quantitative templates, CEIOPS also proposes quarterly submission of templates relating to 'core financial and solvency information'.⁸ These are provisionally expected to be those covering the MCR, SCR, liabilities including technical provisions, premiums and claims, and data on assets including investments and own funds. This can be expected to cover a large amount of the draft quantitative reporting templates and will therefore represent a significant increase in reporting requirements for firms both in the UK and in continental Europe.

⁴ CEIOPS Consultation Paper No. 58 paragraph 3.46.

⁵ CEIOPS Consultation Paper No. 58 paragraph 3.47.

⁶ FSA Handbook PRIN 2.1.1 Principle 11 (available at <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>).

⁷ CEIOPS has requested guidance from the European Commission on whether this will be the financial year end following 31 October 2012.

⁸ CEIOPS Consultation Paper No. 58 paragraph 3.500.

CEIOPS has not finalised its thinking on the submission deadline for the SFCR, RTS and quantitative reporting templates. The deadline for the annual reports will be set at Level 3, at three or four months after the year-end. A three-month deadline would align with current timescales for preparation and audit of regulatory reports for UK firms, although to the extent the required information differs from and is more extensive than current reporting requirements, this may prove challenging, particularly in the first year of submission. Submission of quarterly templates will be set at either three or four weeks after month end, requiring firms to produce the relevant information in a very short time frame.

All reports will need to be approved internally before submission to the supervisor and there will be some requirement for external audit (see below). The SFCR must be publicly available, and CEIOPS therefore proposes that those firms that are able to, make the report available on their own or their trade association's website. All firms are required to provide a printed copy within five days of application to their registered office. The SFCR must be available for at least five years post-completion.

External audit

CEIOPS has not finalised its views on what elements of reporting should be subject to external audit, but indicates that some, but not all, of the reported information will be audited. This and the level of assurance to be obtained will be developed as part of Level 3 guidance, raising potential for some variance in audit requirements across member states, and CEIOPS requests input from stakeholders to assist it in developing its conclusions.

However, CEIOPS does include tentative conclusions in CP58 on which elements of reporting may be subject to an external audit, summarised in Figure 4. The proposed external audit requirement covers a large part of the quantitative reporting templates in addition to some qualitative information, and, in broad terms, is not dissimilar in scope to current UK audit requirements, although the level of assurance and form of opinion required, and therefore the level and extent of the audit, remains to be determined. For insurers in other territories, the proposed audit requirement may represent a significant change in regulatory approach.

Figure 4 – CEIOPS' draft conclusions on external audit requirements

Element of reporting	Quantitative reporting	Qualitative reporting
Own funds disclosure		
Accounting reconciliation to regulatory own funds		✓
Details on non-compliance with MCR and significant non-compliance with SCR		✓
Own funds	✓	
Structure, amount and quality of own funds		✓
Assets, liabilities and capital requirements		
Balance sheet	✓	
Basis for measurement and other information on other liabilities		✓
Basis, methods and assumptions used for measurement of technical provisions		✓
Basis, methods and assumptions used for valuation of assets		✓
Expected maturities of assets and liabilities		✓
Life – changes in own funds	✓	
Life technical provisions	✓	
Life technical provisions roll forward analysis		✓
MCR	✓	
Non-life technical provisions	✓	
Non-life technical provisions roll forward analysis		✓
SCR – Standard formula	✓	
Summary investments by class	✓	
Income, expenses, gains and losses		
Basis and assumptions for revenue and expense recognition		✓
Life premiums and technical provision movements	✓	
Life revenue analysis	✓	
Non-life development information	✓	
Non-life technical account per class	✓	
Profit distribution for with-profit funds	✓	
Profit and loss account	✓	
Valuation basis life (quantitative assumptions)	✓	
Valuation basis non-life (quantitative assumptions)	✓	

Source: CEIOPS Consultation Paper No. 58 paragraph 3.517

The reporting elements which may be subject to audit do not include details in respect of internal models. The area of outputs derived from internal models is one where more discussions will be held with the relevant professional bodies to discuss the feasibility of audit and agree an appropriate level of comfort that could be provided.

The judgement of materiality will be key in assessing how proportionality should be applied.

Information following predefined events and supervisory enquiries

In addition to regular regulatory reporting, CP58 provides powers to supervisors to request information from companies either on the occurrence of predefined events, or during supervisory enquiries. This information must be submitted to the supervisor as soon as possible after the event or request, and supervisors may require firms to submit additional regular information over a period of months or years.

No exhaustive guidance on what events constitute 'predefined events' is provided in CP58, since the range of possible events is unlimited, but events are more generally defined as:

'...events that might affect the main objective of supervision namely the protection of policyholders and beneficiaries.'⁹

This may include, for example, changes in business strategy or internal reorganisation.

Information may be required during supervisory enquiries at any point, and does not have to be requested as part of a formal assessment. The supervisor may also request information on contracts entered into by firms with intermediaries or third parties, including written or accepted (re)insurance contracts and financial arrangements, and may request information from external experts who have carried out work with a firm, for example reports provided by accountants or actuaries. In these cases, the request will be made first to the firm rather than the expert.

Next steps

CP58 introduces a considerably extended regulatory reporting framework with a vastly increased breadth and depth of information to be placed in the public domain. While some elements, particularly in respect of entity level quantitative reporting, may be familiar from current UK reporting requirements, others such as many of the areas of qualitative reporting and some of the group level quantitative requirements may pose a significant challenge. Insurers can expect to have to invest significant effort in complying with the new regime, in particular in early years.

Given the impact of Pillar 3 under Solvency II, understanding and responding to CP58 should be high on the agenda of all Solvency II project teams.

If you would like to discuss any of the areas covered in this paper as well as the implications for yourself and your firm, please contact:



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⁹ CEIOPS Consultation Paper No. 58 paragraph 3.519