



ANALYSES ET SYNTHÈSES

-  Analysis of the 2014 Solvency II preparatory exercise

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Executive summary

The ACPR conducted a new preparatory exercise for Solvency II (SII) in 2014. Participation was extremely high, as the information received and analysed in this study covers 99% of life insurance business and 89% of non-life business in France.

Many insights have been gleaned from the data provided. However, there are a number of particularly salient facts.

Items in the prudential balance sheet, measured according to SII valuation principles, differ to varying degrees from the corresponding items in accounting balance sheets, depending on the undertaking and sector. Investments, for example, are valued on a marked consistent basis. However, the resulting increase in balance sheet size is not matched by an identical increase in own funds, notably because in the life sector, a portion of the unrealised capital gains is integrated in the valuation of liabilities through the profit-sharing mechanism. Technical provisions assessed under SII and defined as the sum of the best estimate and risk margin are thus 19.5% lower on average than book value in the non-life sector but 3.8% higher in the life sector. Average values aside, situations varied – sometimes considerably – from one undertaking to another. Risk margin accounted for 3.9% of SII technical provisions on average but the proportion was very different among life undertakings (1.3%) and non-life undertakings (7.1%). A full 97% of own funds were classified Tier 1, which corresponds to the highest loss-absorbing capacity.

The structure of the solvency capital requirement (SCR) also varied depending on activity. The market risk module accounted for 86% of the SCR of life undertakings and for 80% of the SCR of composite undertakings. Underwriting risk was the largest component of the SCR among non-life undertakings, at 61%. The impact on the SCR from the loss-absorbing capacity of technical provisions (44.3%) and deferred taxes (13.5%) is remarkable, highlighting the need for undertakings to justify the valuation methods that they use.

Subject to the caveat that they were assessed using non-definitive technical specifications as part of a preparatory exercise, SCR coverage ratios had a median value of 256% at end-2013. There were pronounced valuation differences between capital requirement coverage items under Solvency I and II for life undertakings (-42%), composite undertakings (-54%) and non-life undertakings (9%).

Besides Pillar I and Pillar III items, the exercise also provided an opportunity to gather preparatory Own Risk and Solvency Assessment (ORSA) reports from 404 undertakings. For the most part, these reports dealt with the three assessments required under the directive. The main areas for progress include better integration of ORSAs within decision-making processes and better appropriation by governing bodies of ORSAs prepared by outside service providers.

A total of 460 undertakings completed the preparedness questionnaire, with 89% of respondents (21% more than in 2013) saying they had made good progress on their preparations for compliance with Pillar I of the directive. The areas that saw the least progress were the establishment of written policies (27% of undertakings said they were well advanced in 2014, compared with 15% in 2013), oversight of outsourced activities (22% of undertakings were well advanced in 2014, compared with 16% in 2013) and preparation of narrative reports (8% of undertakings were well advanced in 2014, compared with 7% in 2013).

Study carried out by the ACPR

1. Introduction

Adopted by the European Parliament, the new Solvency II (SII) regime will take effect on 1 January 2016. At its conference on 12 December 2013, the General Secretariat of the Autorité de Contrôle Prudentiel et de Résolution (ACPR) presented a timetable for preparing the French market for the changes, consistent with guidelines issued by the European Insurance and Occupational Pensions Authority (EIOPA).

During the transitional period leading up to SII, the ACPR has asked undertakings to conduct preparatory exercises and to liaise with it for that purpose.

The 2014 exercise entailed submitting a variety of quantitative and narrative information to the ACPR, including:

- a set of 15 SII annual Quantitative Reporting Templates (QRTs), based on data to 31 December 2013,
- a methodological memo, as in 2013,
- an ORSA report for individual undertakings and insurance groups,
- a questionnaire on SII preparedness.

The purpose of this report is to summarise the information gleaned from the data provided by undertakings in 2014. The study chiefly analyses the SII annual QRTs and their technical annexes, ORSA reports and questionnaire feedback.

For Pillar I, which concerns quantitative aspects (valuation of assets and liabilities and solvency assessment), undertakings were asked to submit data based on the standard formula exclusively and to refer to the most recent technical specifications available when the exercise was carried out, namely those published by EIOPA on 30 April 2014. Interest rate term structures were those of the stress tests published at the same date. However, since the regulations were still being prepared, undertakings might have used different assumptions and technical specifications, and 16% of participants did in fact use older specifications. Accordingly, care must be taken when comparing the results for different undertakings. In particular risk-free interest rate term structures were not always updated in the case of calculations started prior to 30 April, which could materially affect best estimate values. Also, when analysing the results of this exercise, it is important to keep in mind that undertakings' processes and tools are not yet finalised.

The French market participated extensively in the exercise. In all 460 sets of QRTs were filed, covering 99% of life business and 89% of non-life business. A full 198 returns were in XBRL format and offered better quality overall.

The analysis is divided into three parts. Part 2 concentrates on Pillar I items, i.e. SII balance sheet, own funds and solvency. Part 3 reviews the information obtained from ORSA reports. Part 4 summarises the feedback from the market preparedness questionnaires.

2. Compliance with Pillar I requirements

Undertakings were required to submit a set of QRTs containing the main Pillar I information. These disclosures were supplemented by questionnaires on the specificities of the data, assumptions, tools and processes used by undertakings. This part analyses the aggregate SII balance sheet of undertakings, before looking at own funds and the solvency capital requirement (SCR).

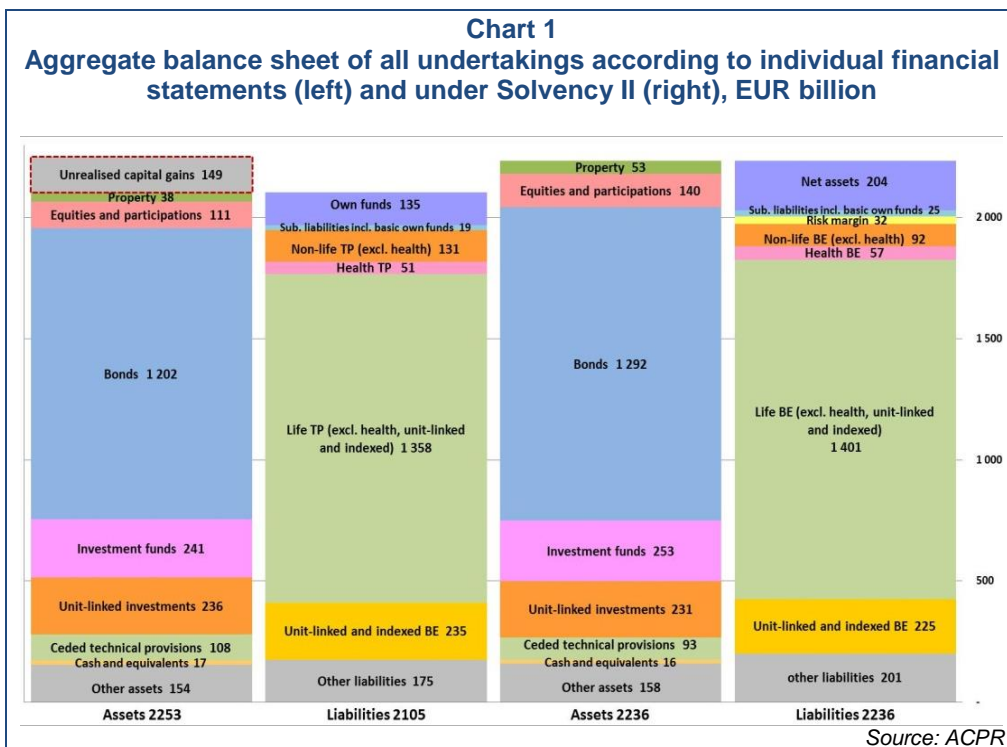
2.1. SII balance sheet

At end-2013, the total assets of all undertakings that took part in the preparatory exercise stood at EUR 2.236 trillion, or slightly less than the total obtained from prudential returns under SI for the same population, which came to EUR 2.253 trillion after recognition of unrealised capital gains and losses. Accordingly, the returns filed covered 96% of the overall market¹.

A balance sheet comparison highlights three major differences between SI and SII: 1) asset valuation, and in particular 2) valuation of deferred taxes, and 3) measurement of own funds.

2.1.1. Asset valuation

Chart 1 shows the respective balance sheet structures under SI (left-hand side) and SII (right-hand side). There are several notable differences on both sides of the balance sheet, chiefly reflecting the use of historical cost accounting under SI and fair value accounting under SII.



On the asset side, the inclusion of unrealised capital gains raises the value of investments recorded in the individual financial statements by EUR 149 billion, or 7.4%, from EUR 1.979 trillion to EUR 2.127 trillion. The value of bonds increased by 7.5% from EUR 1.202 trillion to EUR 1.292 trillion, while that of investment funds rose 5% from EUR 241 billion to EUR 253 billion. Equity holdings climbed

¹ The ACPR's report entitled "The French banking and insurance market in figures" put total assets for the entire market at EUR 2.343 trillion after recognition of unrealised capital gains and losses.

26% from EUR 111 billion to EUR 140 billion, property investments were up 39.5% from EUR 38 billion to EUR 53 billion while other assets were 2.6% higher, at EUR 158 billion compared with EUR 154 billion.

On the liability side, although technical provisions under SII² and SI are close overall at EUR 1.807 trillion and EUR 1.775 trillion respectively, trends differed by sector, with the ratio between SII and SI provisions standing at 103.8% in the life sector and 80.5% in non-life.

Reflecting these developments, SII net assets came to EUR 204 billion for all undertakings, or 9.1% of total assets.

2.1.2. Deferred taxes

In the 2014 preparatory exercise, undertakings that said they did not use IFRS to measure their deferred taxes accounted for 3% of the total assets of the study sample. Instead of using IFRS, these undertakings approximated deferred taxes by multiplying the normal tax rate by the difference between own funds in the annual financial statements and SII own funds. Most of these undertakings are small, and those covered by the Mutual Insurance Code account for a higher proportion than in the overall sample. Undertakings that said they belonged to a tax consolidation group accounted for 85% of the total assets of undertakings that took part in the exercise.

Valuation of deferred taxes

The SII balance sheet is prepared using market or transfer values, whereas tax payments are calculated using accounting data taken from the financial statements whose items are chiefly carried at their historical value. Valuation differences recorded in the balance sheet result in additional taxes or tax deductions for the undertaking to be paid or received later. These are recognised in the SII balance sheet as deferred taxes.

For example, in the case of assets in the form of unrealised capital gains, a future tax flow has to be recognised for the tax that the undertaking will incur when the gain is realised. Conversely, if the transition from the financial statements to the SII balance sheet causes an asset's value to be reduced, this may be mitigated by the assessment of deferred tax assets.

The SII delegated regulation requires deferred taxes to be recognised in the SII balance sheet according to IFRS principles and based on the asset and liability values used in the SII balance sheet. IFRS require checks to ensure that deferred tax assets net of deferred tax liabilities are effectively recoverable. The undertaking must therefore demonstrate that it will be able to generate taxable profits allowing it to book these future tax credits against the tax charge associated with the profits.

When a group uses tax consolidation to calculate its taxes, the measurement of deferred taxes must take account of specific rules relating to the nature of the tax consolidation agreement to establish the SII balance sheet and determine the SCR deferred tax adjustment. Insofar as the tax consolidation mechanism follows rules that are specific to each group and where all group undertakings could be affected in the event of a shock, this is a source of complexity and potential errors.

2.1.3. Own funds

The vast majority of total own funds – 92.4% – are classified as Tier 1. Tier 1 own funds comprise items with the highest loss-absorbing capacity. They also include securities issued before 19 January 2015 under a grandfathering clause. The proportion of Tier 1 own funds is higher among non-life undertakings (96.2%) than among life undertakings (89.2%).

² Defined as the sum of the best estimate and the risk margin.

Basic own funds account for 99.75% of total own funds, with ancillary funds making up 0.25%.

SII own funds

SII own funds comprise:

- Basic own funds, which are equal to the difference between assets and liabilities (less own shares held by the insurance or reinsurance undertaking) plus subordinated liabilities; and
- Ancillary own funds, which are capital items that may be called up to absorb losses.

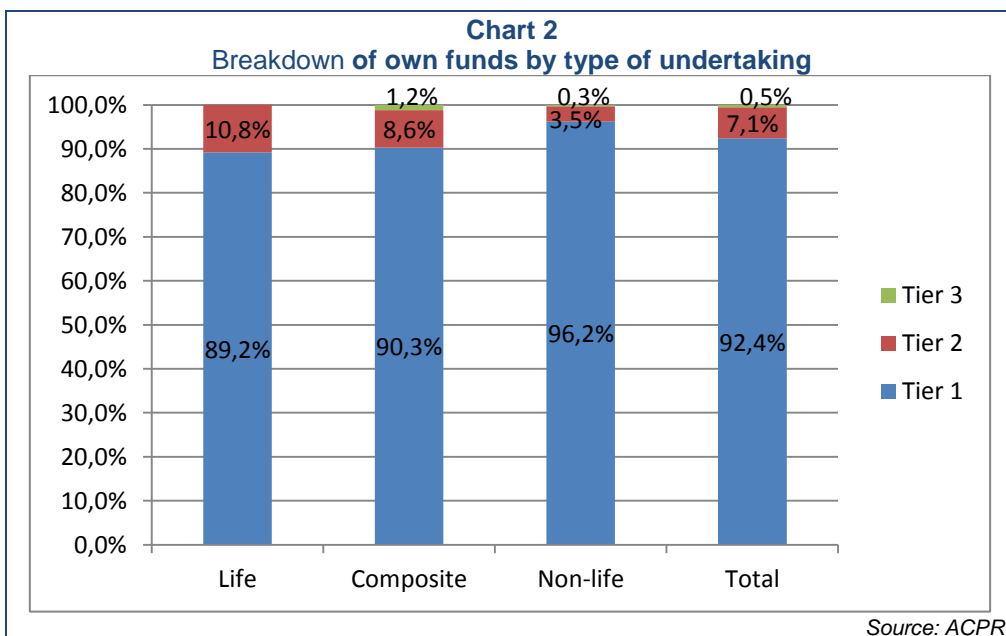
The directive divides basic own funds into three tiers (1, 2 and 3), based on their availability, subordination and permanence.

Furthermore, the guidelines (Level 2 document) set quantitative limits for the amounts of own-fund items eligible to cover the SCR:

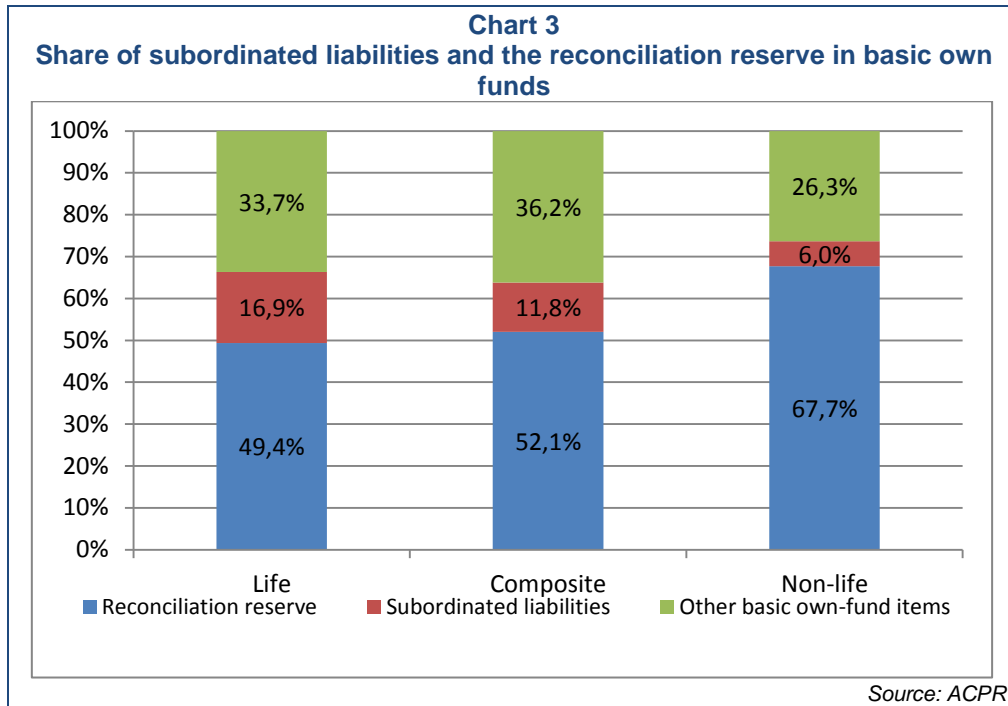
- The eligible amount of Tier 1 items must be at least one-half of the SCR.
- The eligible amount of Tier 3 items must be less than 15% of the SCR.
- The sum of the eligible amounts of Tier 2 and Tier 3 items may not exceed 50% of the SCR.

Limits have also been set for the Minimum Capital Requirement (MCR):

- The eligible amount of Tier 1 items must be at least 80% of the MCR.
- The eligible amount of Tier 2 items may not exceed 20% of the MCR.



The reconciliation reserve corresponds to the difference between SII adjusted net assets and pure capital. It includes the amount corresponding to expected future profits. The reconciliation reserve has a larger share among non-life undertakings (around 68% of basic own funds) than among life and composite undertakings (49% and 52% respectively). These proportions reflect differences between liability values in the individual financial statements and SII balance sheet: if the best estimate (plus risk margin) is lower than SI technical provisions, this generally results in an increase in the reconciliation reserve owing to the valuation of future profits (provided assets are carried as unrealised capital gains). Accordingly, the reconciliation reserve occupies a larger share of own funds among non-life undertakings, whose liabilities are 30% lower under SII compared with SI.



2.2. Best estimate of liabilities and risk margin

The fair value measurement of insurance liabilities is a key issue because of its technical complexity and the choices that it entails.

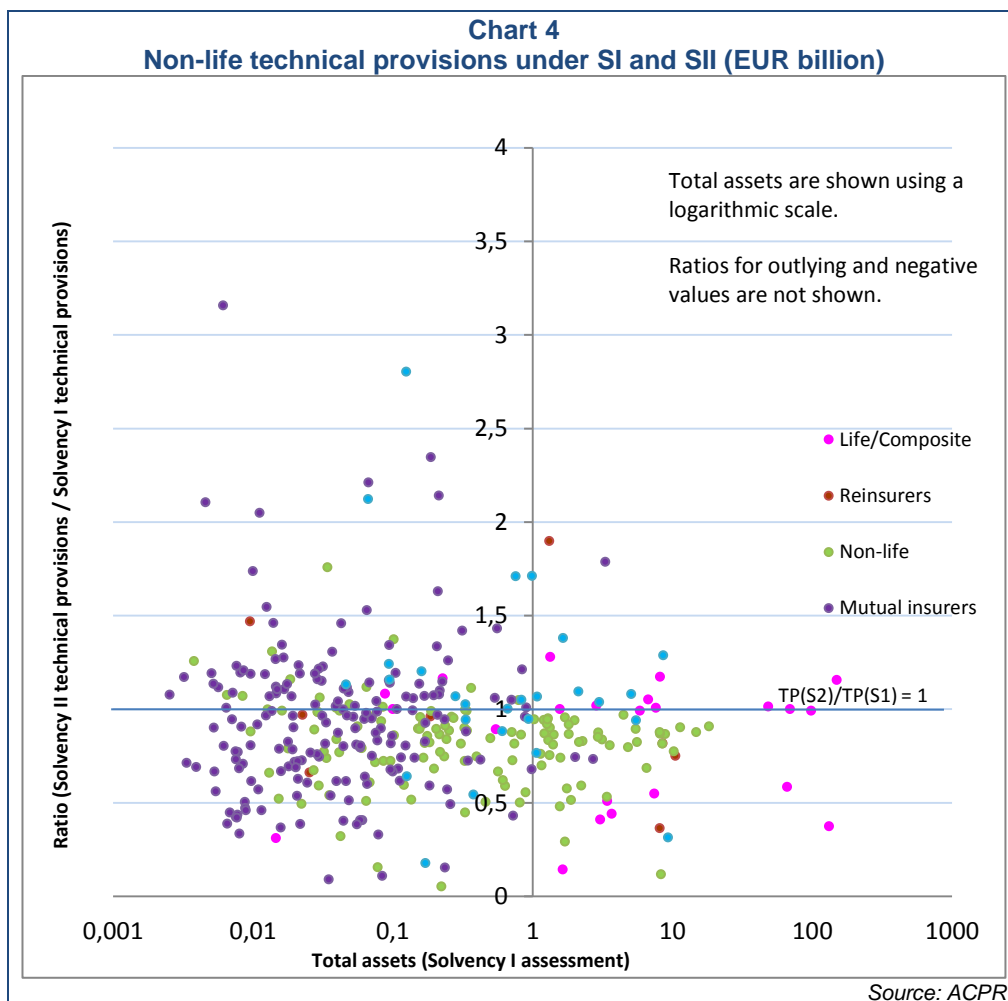
In a change from SI, SII requires the prudent estimate of obligations towards policyholders to be replaced by a best estimate of future cash flows, to which is added a risk margin representing the cost of providing the capital needed to cover the marginal SCR amount associated with holding these obligations. Life SII technical provisions are discounted using the risk-free rate instead of the technical rate set at the beginning of the contract. Moreover, profit-sharing has to be estimated over the entire contract term. In non-life insurance, the equalisation provision is transformed into a reserve.

The preparatory exercise made it possible to demonstrate the impact of this new measurement approach.

2.2.1. Comparison between SII and SI technical provisions

For non-life activities, Chart 4, which analyses the ratio of SII³ to SI technical provisions, reveals substantial differences among the majority of undertakings, ranging between 0.5 and 1.5, even without including outlying values. This reflects a wide variety of situations.

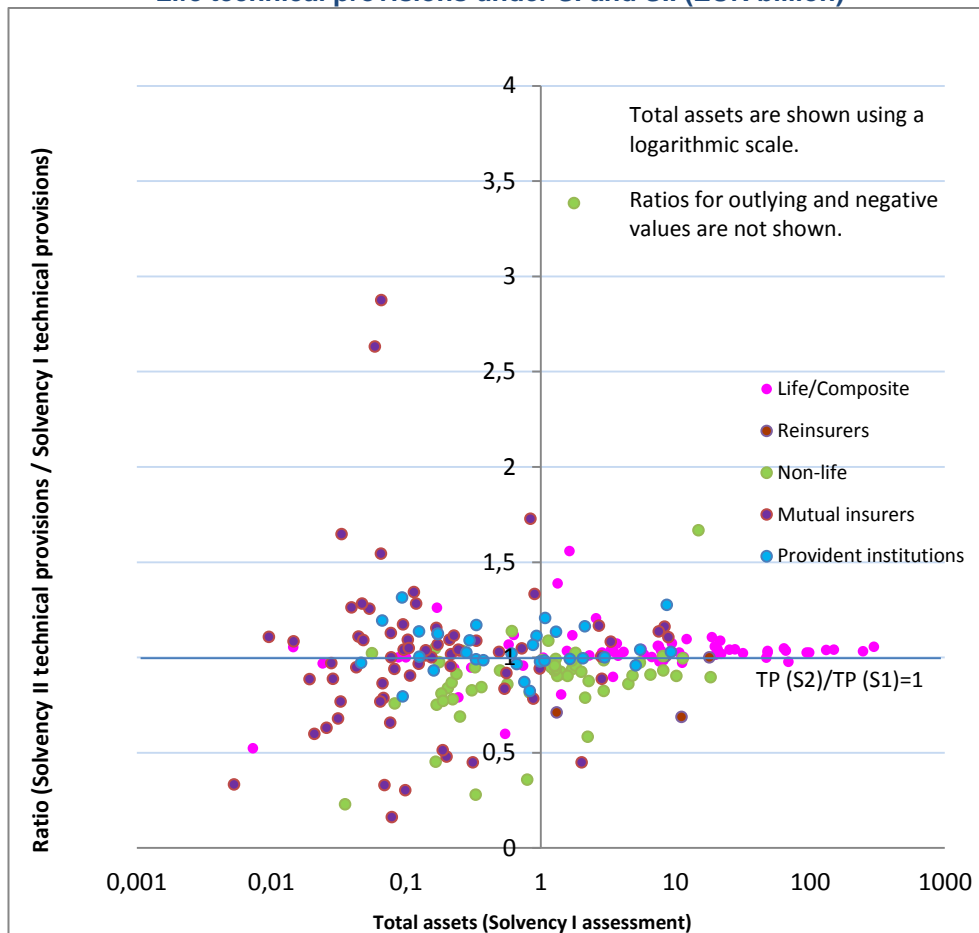
³ Under SII, technical provisions are the sum of best estimates and risk margins for each type of risk. Furthermore, a distinction is drawn between similar to life (STL) health technical provisions and non-STL health technical provisions. Only non-STL health technical provisions are included in total non-life technical provisions under SII.



Overall, non-life provisions are lower under SII than in individual financial statements under SI, with a decline of some EUR 30 billion, i.e. a difference of around 20%. When the focus is narrowed to undertakings subject to the Insurance Code and whose sole business is non-life insurance, total technical provisions fall by just 15.6% between SI and SII. In addition, the decline in non-life technical provisions involves virtually all these undertakings. However, the aggregate results were heavily influenced by a handful of undertakings that made a large contribution to the overall decline.

The situation was more mixed among undertakings subject to the Mutual Insurance Code. On aggregate technical provisions declined slightly, by EUR 0.2 billion, between SI and SII. Large relative decreases were mainly observed among smaller undertakings.

Chart 5
Life technical provisions under SI and SII (EUR billion)



Source: ACPR

For life activities (chart 5), the technical provisions are higher under SII than in individual financial statements under SI, with a difference of around 3,8%⁴. Large relative differences were mainly observed among smaller undertakings.

A business line decomposition of technical provisions is more difficult by the fact that the classes of operations provided for in Article A 344-2 of the Insurance Code for SI⁵ do not correspond exactly to the business lines used for SII reporting. Differences in data granularity make it impossible to establish a rule for moving automatically between the two classifications. A partial compilation is however possible for certain classes of non-life insurance operations.

⁴ Like in the case of non-life technical provisions, these provisions include the best estimate, risk margin and technical provisions calculated as a whole. Furthermore, similar to life health technical provisions are also included.

⁵ See also Article A114-5 of the Mutual Insurance Code and Article R931-2-1 of the Social Security Code.

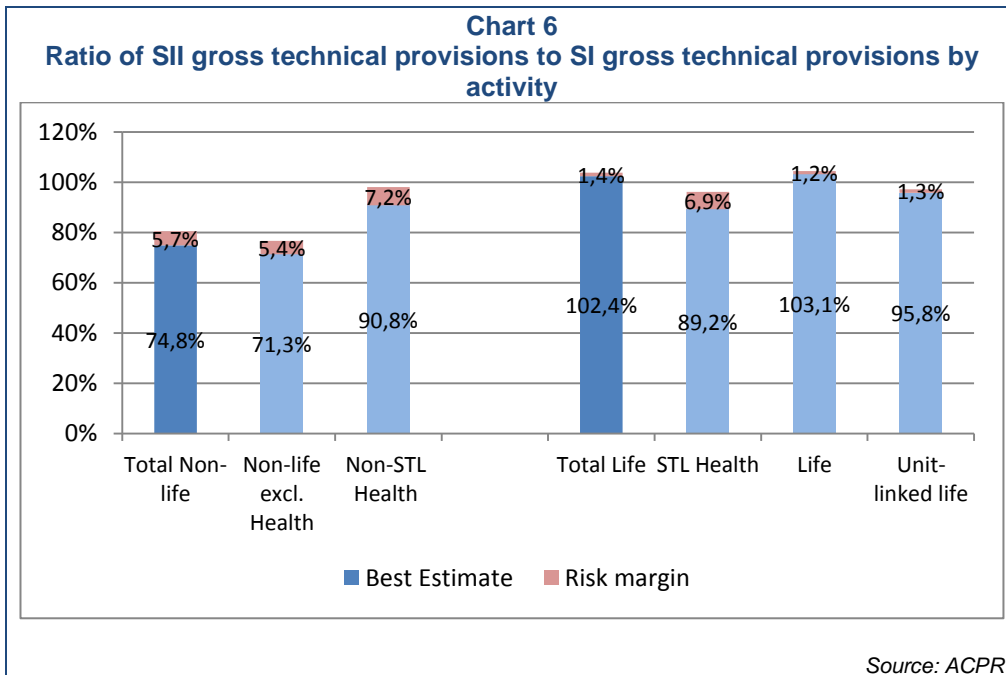
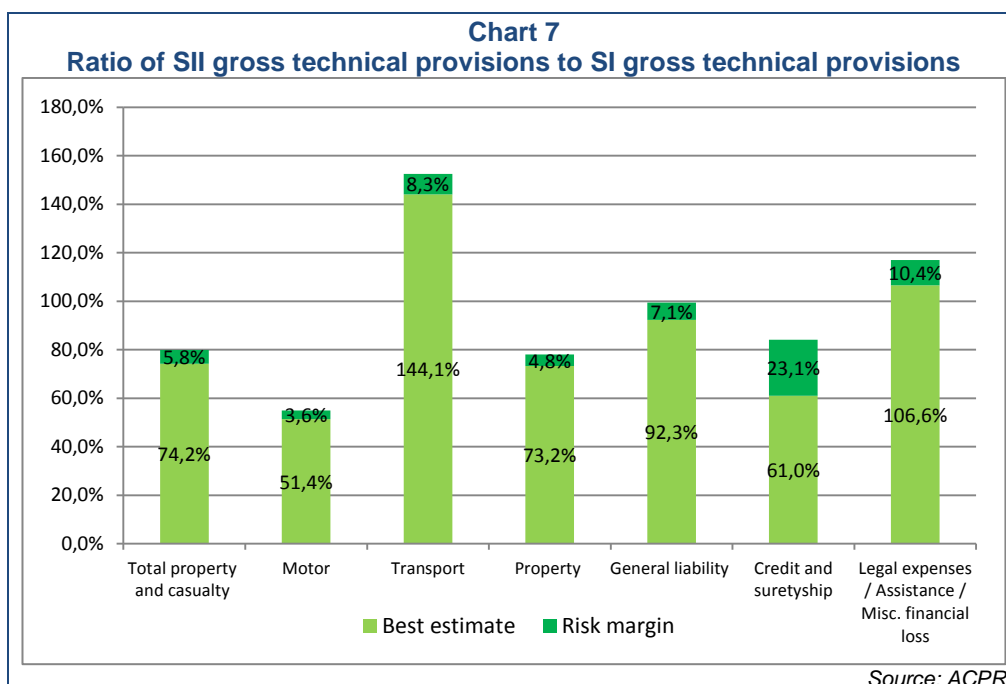


Chart 6 shows the ratio of technical provisions under SII to the amount under SI.

The change in technical provisions varied across categories. Within life insurance, non-unit-linked technical provisions increased by 4.3%, technical provisions for unit-linked life insurance fell by 2.9%, while STL health technical provisions declined by 3.9%.

The decline in non-life technical provisions was primarily driven by non-life excl. health technical provisions, which were 23% lower, while non-STL health technical provisions were down by just 2%.

The proportion of the risk margin reflects the relationship between the SCR (more specifically underwriting risk) and the best estimate of liabilities. The proportion is low in non-unit-linked life (1.2% of the best estimate) and unit-linked life (1.3%) but is higher in non-life excluding health (5.4%), non-STL health (7.2%) and STL health (6.9%).



Among the categories of non-life liabilities for which it is possible to compare the SI and SII statistics, some, such as motor, credit and suretyship, display ratios that are well below the average, while others, including transport, general liability and legal expenses/assistance/financial loss, are much higher, reflecting the pronounced impact of fair value measurement.

2.2.2. Factors explaining best estimates

To support their quantitative returns, undertakings supplied technical annexes in which they explained the procedures used to measure best estimates.

2.2.2.1. Life best estimates

In life insurance, the factors that impact future cash flows are basically future premiums and hence contract boundaries, benefits and, within this, surrender and cost modelling. A stochastic assessment entails defining and establishing probabilities for different states, which are essentially characterised by distinct movements in financial variables (interest rates, asset values, inflation), generally provided by tools called economic scenario generators.

Surrenders due to cyclical conditions

In addition to the structural surrenders that insurers may see in non-unit-linked life insurance savings policies under “normal” economic conditions, undertakings must also consider “cyclical” surrenders, which may occur particularly in very competitive environments as policyholders switch out of insurance policies and into other products, such as insurance, banking or property vehicles.

In general, undertakings model structural surrenders consistent with their internal data. But they point to a lack of sufficiently detailed data to establish cyclical surrender rates, often citing a scarcity (or absence) of atypical surrender rates calculated overall and observed over a more or less long period.

If data are unavailable, undertakings usually refer to a normative model in which parameters are set by applying expert judgement and where cyclical surrenders are considered as a function of the difference between the insurer’s payout rate and the rate expected by policyholders.

When the payout rate is less than the expected rate, cyclical surrenders increase structural surrenders, and reduce them in the opposite case. The average impact of applying a cyclical surrender rate to the best estimate observed for the reporting sample corresponds to a 0.5% increase in the best estimate compared with a

measurement not including cyclical surrenders. For the most part, recognition of cyclical surrenders results in increased payments to policyholders.

Furthermore, one-quarter of life undertakings said they adjusted surrender rates for unit-linked products with cyclical surrender rates in the same way as for non-unit-linked savings products. In 2014, non-application of these rates to unit-linked products would have led to a 0.4% reduction in the best estimate.

Cost modelling

Cost assumptions have a major impact on the measurement of the life best estimate. This impact is mainly linked to the *a priori* distribution of costs between acquisition costs (not projected) and other costs (projected).

The life technical annexes reveal extreme distributions among some undertakings either in favour of acquisition costs or other costs. This type of distribution is hard to justify.

However, some undertakings said in the methodological memo appended to the technical annex that they were conducting studies to refine the distribution of costs and their projection for the purpose of calculating best estimates.

Future premiums

The returns filed by undertakings⁶ point to diverse practices in terms of future premiums, notably as regards recognition of scheduled payments on savings contracts or payments into group retirement contracts.

While no individual savings undertaking projected premiums for discretionary payments, around one-third said that they projected liabilities relative to scheduled payments, while the rest did not project them. For undertakings that did perform projections, scheduled payments were recognised even when the contract did not offer a guaranteed rate of more than 0%.

The proportion of undertakings projecting future liabilities on retirement-related future premiums was higher, at around 50%. In the case of group retirement contracts that may be terminated annually, future premiums should not be projected beyond the valuation horizon.

Economic scenario generators

As regards economic scenario generators, the majority of undertakings used external tools developed by suppliers although a substantial proportion of tools were developed internally.

Where an external provider was entrusted with developing the economic scenario generator, the use of the data by undertakings is an area that requires attention. The data for the 2014 exercise show that a significant portion of undertakings used the standard parameters of these tools directly, without showing whether these were suited to their risk profile. Conversely, 30 undertakings said that they had adjusted the generated scenarios, mainly by introducing an interest rate cap.

The tools developed comprise several sub-models dedicated to specific classes of financial risk (interest rate, real interest rate or inflation, equity, property, foreign exchange, credit and so on). Interest rate, inflation, equity and property risks were most extensively addressed. By contrast, models for sovereign and corporate

⁶ The 2014 life technical annex was more detailed than that of 2013, analysing future premium projections by guarantee (type of contract, or within the same contract, distinction between the savings portion and ancillary guarantees such as Guaranteed Minimum Death Benefit or various rate guarantees). The questionnaire also included the amount of expected profits included in future premiums (EPIFP) measured by the company and hence the own-fund impact of recognising these premiums.

credit risk were rare. Not modelling credit risk causes the volatility of financial products to be underestimated.

Most undertakings performed tests to make sure that the generated scenarios verified the desired properties. These mainly included martingale tests on investments and replicability tests on interest rate option prices.

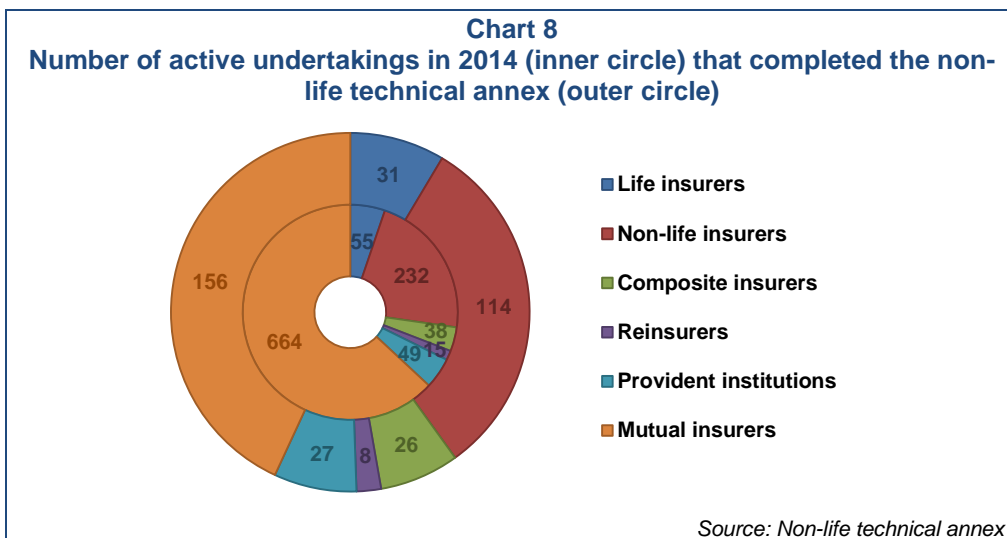
The number of stimulated scenarios has a direct impact on the quality of the assessment. Of the 57 undertakings that provided information about their economic scenario generators, 32 simulated exactly 1,000 scenarios, nine simulated 500 scenarios and 15 simulated more than 1,000 scenarios. A full 44 undertakings used the same variance reduction technique, namely the antithetic scenarios method.

2.2.2.2. Non-life best estimates

Scope of respondents to the non-life technical annex

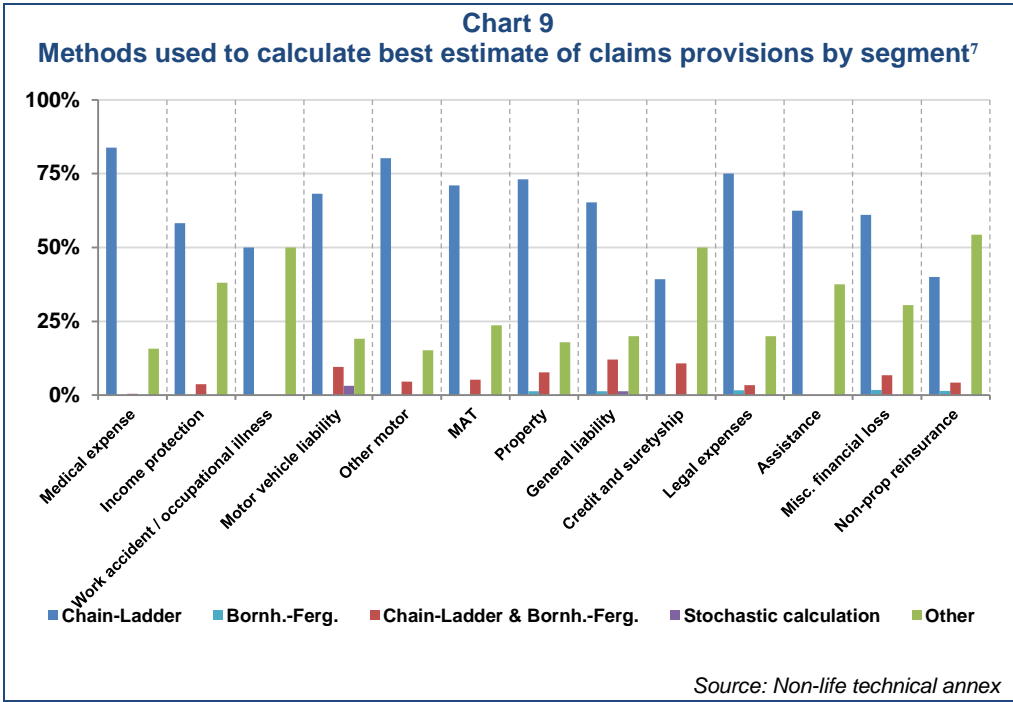
The non-life technical annex seeks to highlight market trends (calculation methods, depth of historical data) and to identify areas of non-uniformity (assignment to Lines of Business, treatment of equalisation provision).

In all, 362 undertakings completed the non-life technical annex. A decomposition by type of undertaking shows that mutual insurance companies governed by the Mutual Insurance Code are under-represented in the sample. Meanwhile, the presence of responses by life and composite insurers reflects the exercise of activities classified as non-life under the new prudential framework (medical expense, income protection).

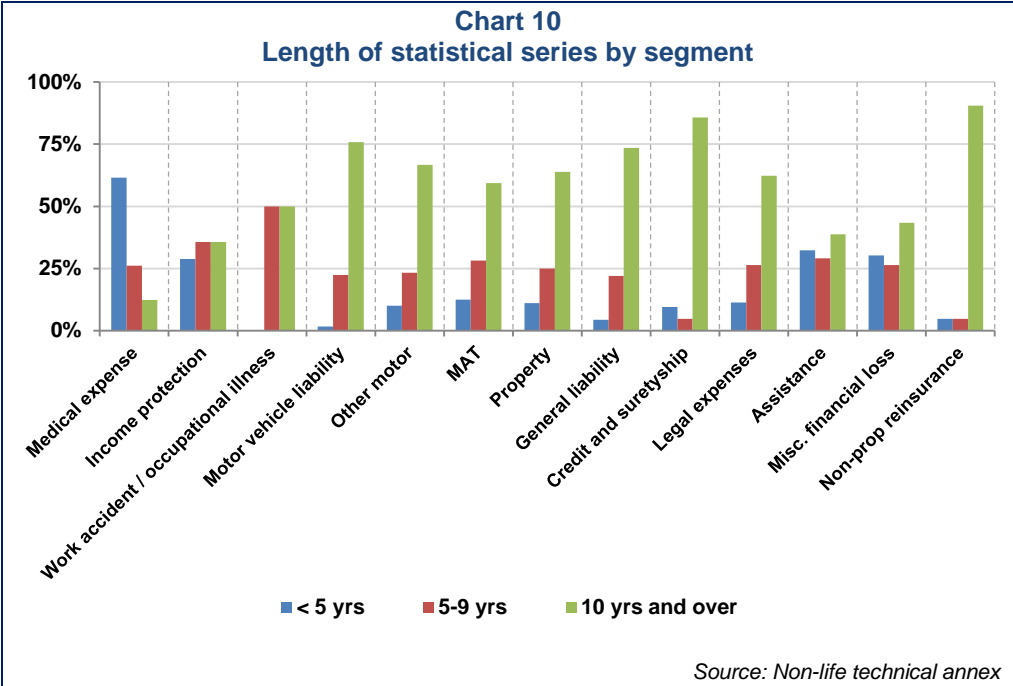


Methodological choices by respondents to the non-life technical annex

The new prudential framework does not challenge the use of conventional non-life calculation methods. Deterministic methods are widely preferred, with chain-ladder the most frequently used technique. Other methods include the case-by-case approach, the claims ratio and combined methods.



Most companies have data going back more than ten years over all segments. Short-tail businesses have the shortest statistical series (medical expense, income protection, assistance and miscellaneous financial loss). The appropriateness, completeness and accuracy of these data still have to be demonstrated by the undertakings, however (cf. SII Article 82).



Points requiring attention in the non-life technical annex

⁷ The Pillar I of the Solvency II directive defines “segments” as including proportional reinsurance obligations which relate to the obligations included in each line of business.

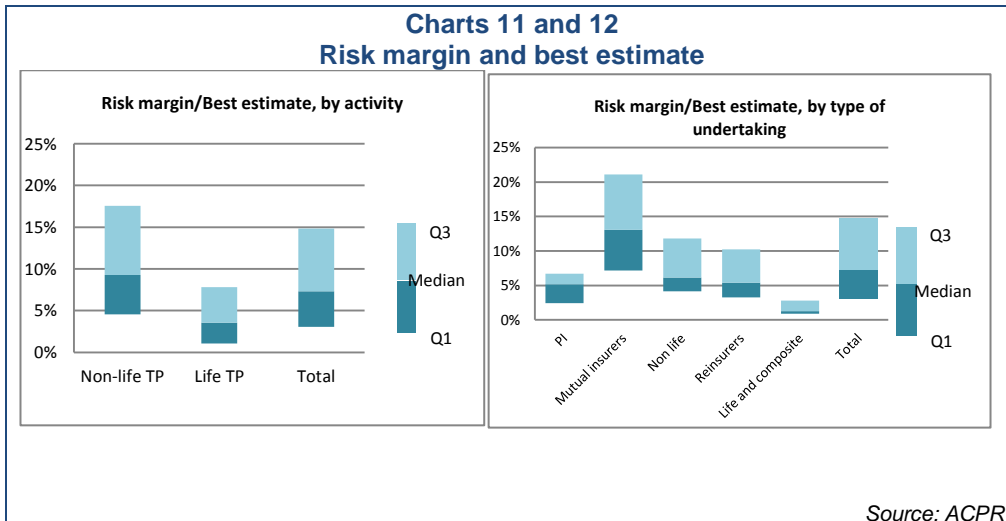
The assessment of premium provisions for non-incurred claims should include low-frequency, high-cost risks. EIOPA Guideline 73 on Technical Provisions⁸ says that high-severity claims have to be included in premium provisions. This estimate must be introduced by undertakings, few of which currently consider catastrophic events when estimating premium provisions (11 undertakings out of the 243 that responded to and were concerned by this question).

Treatment of the contractual equalisation provision requires an in-depth examination of various criteria (transferability, attachment to a specific class). The technical annex revealed a number of practices in this regard, with allocation to claims provisions by 67% of affected undertakings and inclusion in own funds by 19% of affected undertakings.

Irrespective of their treatment under statutory accounting, recent changes to motor insurance regulations have to be integrated in SII. Just 18% of affected undertakings that responded had restated their compensation data to reflect the new scale introduced in 2013. There was more widespread recognition of a future annuity value adjustment in bodily injury liability insurance than in the previous year (57% of affected undertakings that responded). For the time being, the impact is marginal because of the base (insurers bear only the value adjustment for annuities in respect of claims incurred after 31 December 2012), but it can only increase over time.

2.2.3. Risk margin

The risk margin is the discounted value of future SCR amounts multiplied by the cost of capital⁹.



These charts show risk margin/best estimate ratio distributions in “box” form (legend to the right of the chart: the median and first and third quartiles are indicated)

⁸ EIOPA Guideline 73 on the assessment of technical provisions: “Insurance and reinsurance undertakings should ensure that the assessment of the claims cash-flows included in the premium provisions give appropriate consideration to the expected incidence and cost of future claims, including consideration of the likelihood of infrequent, high-severity claims and latent claims”.

⁹ The calculations are detailed in section V.2.1 of the EIOPA technical specifications published on 30/04/2014.

Explanation: the median of the risk margin/best estimate ratio for non-life insurers is 6.1%. Dispersion is shown by the distance between the upper bounds of the first and third quartiles for each category of entity.

Charts 11 and 12 show the distribution by activity and type of undertaking of the risk margin as a percentage of the best estimate of liabilities under SII. The median ratio is 7.5% across all undertakings that submitted data in 2014. Significant differences are seen between risk margins associated with life liabilities (median of 3.5%) and non-life liabilities (median of 9.3%). Furthermore, risk margin rates are less dispersed in the life business (interquartile range of 7%, compared with 13% for non-life). These differences reflect the ratio of the SCR (more specifically underwriting risk) to the best estimate of liabilities, which is lower for life liabilities than for non-life liabilities.

Distributions vary when undertakings are considered according to their legal form. The situation of mutual insurers is particularly noteworthy as they display high dispersion of risk margin ratios relative to all undertakings.

Among undertakings governed by the Insurance Code, life and composite insurers stand out with particularly low risk margin ratios: their median risk margin comes to just 1.3% of the best estimate of liabilities, and this rate is extremely uniform within the population.

Simplification methods

The calculation principle for the risk margin is particularly demanding in that it requires a series of future SCRs to be projected.

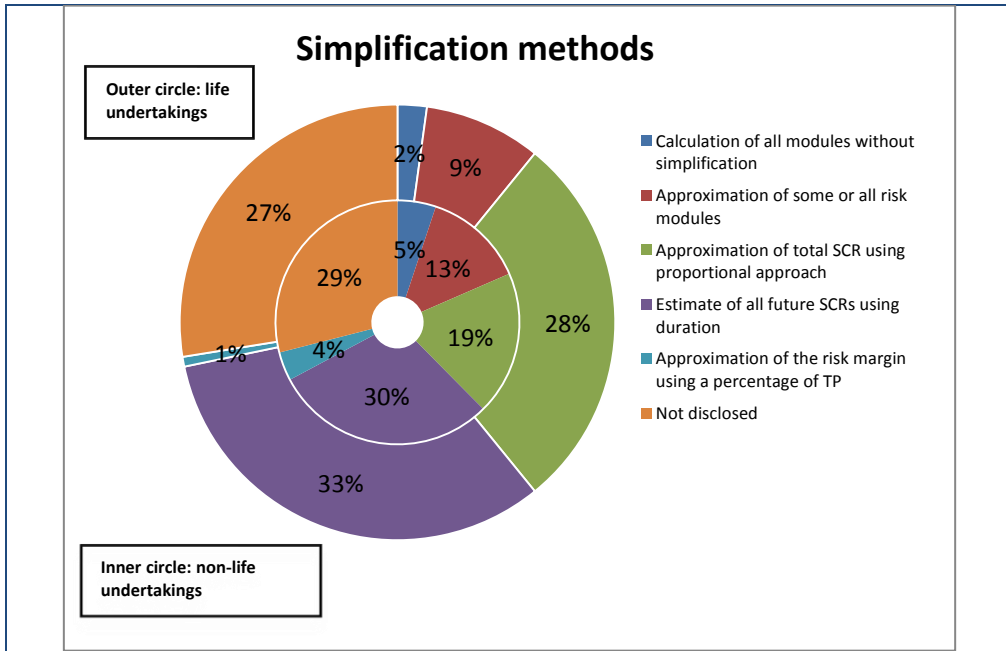
Provision is made for the possibility of using a simplified approach not requiring full modelling of all future SCRs. The various methods considered were as follows¹⁰:

- i. Full calculation of all future SCRs, without simplification
- ii. Approximation of some or all risk modules or sub-modules used to calculate future SCRs
- iii. Approximation of the total SCR for each future year using a proportional approach
- iv. Single estimate of all future SCRs, using a duration-based approximation
- v. Approximation of the risk margin using a percentage of the best estimate of liabilities.

Chart 13

Simplification methods used by life and non-life undertakings

¹⁰ Disclosure of methods used did not form part of Solvency II reporting *stricto sensu* because these methods are not included in the Quantitative Reporting Templates, but was provided separately in the technical annex.

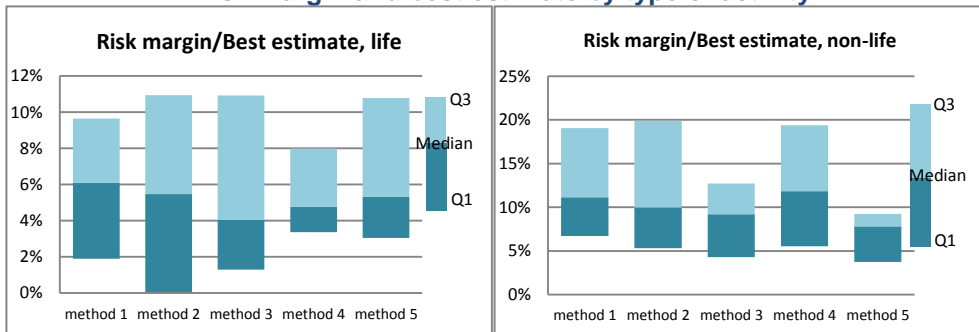


Source: ACPR

Besides a fairly high proportion of missing or unusable data, several salient facts were noted. First, a significant number of undertakings opted for a full calculation this year, whereas none took this option in 2013. Next, methods 3 and 4 (linear and duration-based approaches) were by far the most commonly used.

Simplification methods (cont.)

Chart 14 and 15
Risk margin and best estimate by type of activity



Source: ACPR

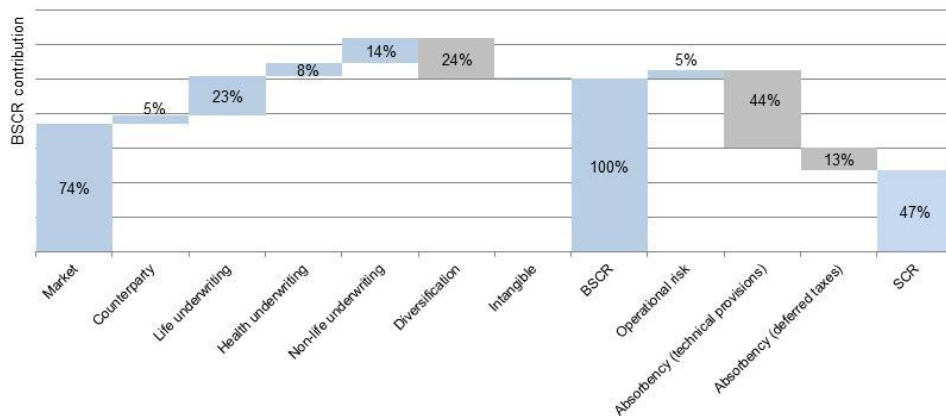
Risk margin/best estimate ratios do not appear to reveal a systematic difference linked to the calculation method used.

2.3. Solvency

The analysis of the solvency capital requirement (SCR) is supplemented by a focus on the loss-absorbing capacities of technical provisions and deferred taxes. This is followed by an analysis of the minimum capital requirement (MCR) and an examination of SCR and MCR coverage ratios.

2.3.1. SCR components

Chart 16
SCR decomposition for all respondent undertakings



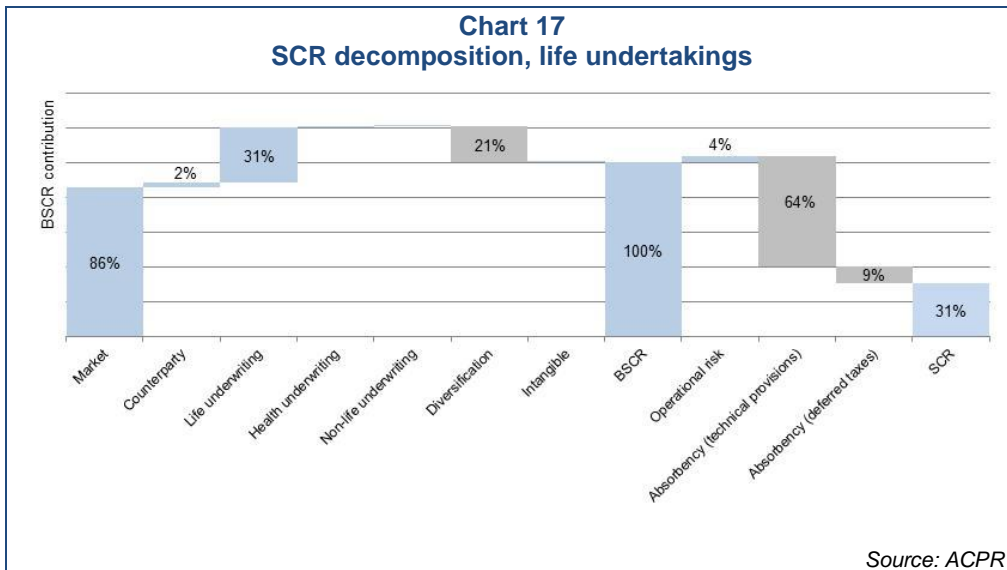
Source: ACPR

Explanation: All items are expressed as a percentage of the basic SCR (BSCR). The BSCR is obtained by adding up the various risk charges and subtracting the diversification effect. Adding the operational risk charge to the BSCR then subtracting the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes gives the final SCR.

The largest risk module for all undertakings is market risk. This reflects the weight of life and composite undertakings in the aggregate balance sheet of insurers (see below).

SCR reduction factors also have a significant impact, including diversification between risk modules (24% of the BSCR) and the loss-adjusting capacities of technical provisions (44% of the BSCR) and deferred taxes (13% of the BSCR).

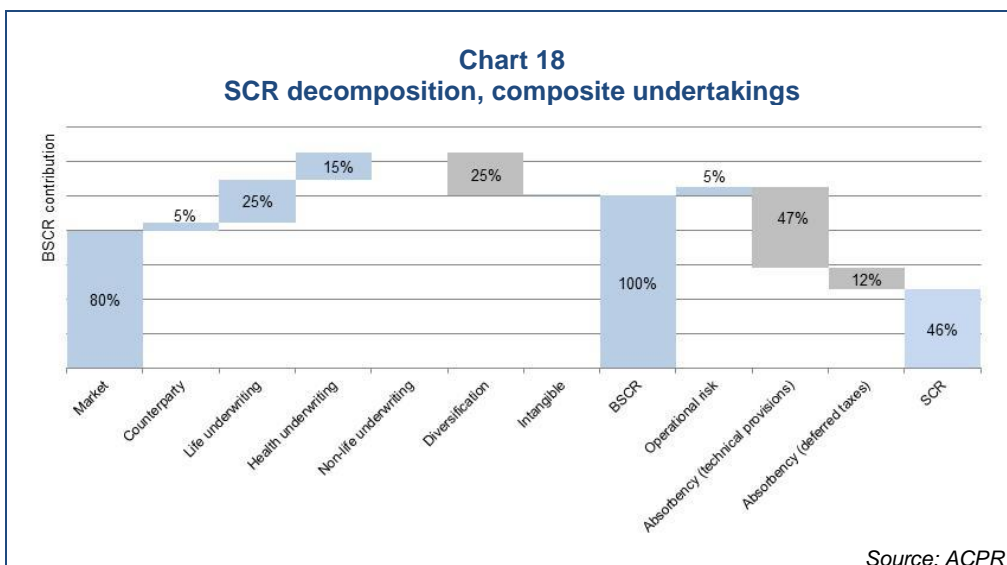
An analysis of the SCR decomposition by type of undertaking provides a clearer picture of the contribution made by different risks to the SCR.

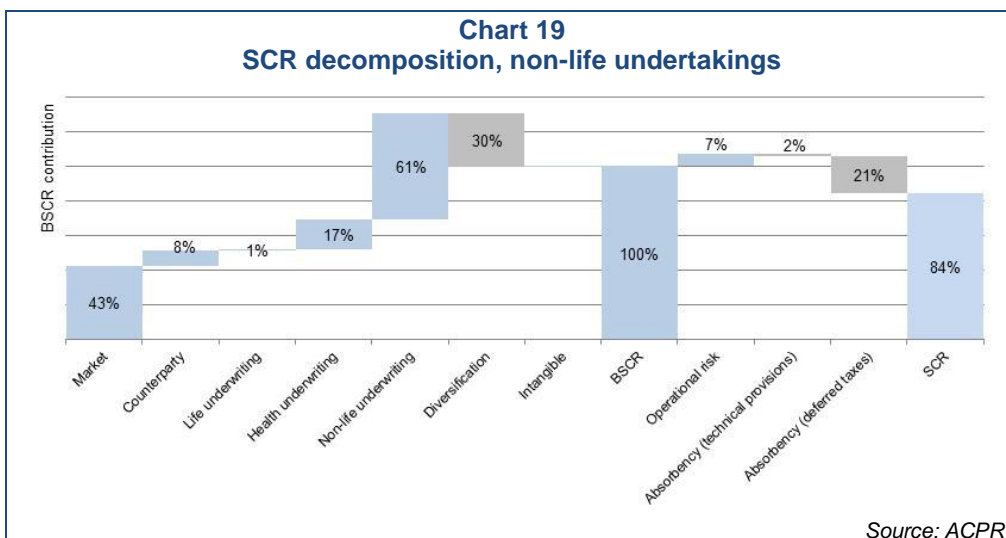


Market risk is the module with the largest weight for life and composite undertakings, owing to contracts with financial guarantees rather than guarantees linked to biometric risks. This is attributable to the amount of assets needed to cover these commitments. However, the absorption of losses by technical provisions considerably reduces the SCR for these undertakings.

Market risk is primarily linked to equity holdings (equity SCR accounts for about 40% of the market SCR of life and composite undertakings) and spread risk on private bonds (around 30% for these two types of undertakings).

Life underwriting risk net of the impact of profit-sharing for life and composite undertakings is dominated by surrender risk (42% for life undertakings and 33% for composite entities) and expense risk (around 20%), far ahead of biometric mortality and longevity risks, each of which accounts for just over 10% of the life underwriting SCR among life and composite undertakings alike.





The SCR decomposition for undertakings classified as property and casualty insurers highlights the predominance of non-life underwriting risk (61% of the BSCR) and health risk (17%). Within non-life underwriting risk, premium and reserve risk accounts for 77% followed by catastrophe risk (around 20% of the module before diversification). The market risk module has a substantial share of the BSCR (43%), although it stands at half the share it occupies for life and composite undertakings. Better risk distribution between modules than in life leads to increased diversification, which amounts to 30% of the BSCR.

2.3.2. Loss absorbency of technical provisions and deferred taxes

The SCR impact of loss absorbency mechanisms is significant on average. It is also extremely uneven, as reflected in the dispersion indicators.

Table 1 below summarises the main absorbency percentages for the two different mechanisms by type of undertaking and for total undertakings as well as the quartile boundaries.

Despite the large number of undertakings for which the loss-absorbing capacity of technical provisions is zero or virtually zero (non-life but also composite undertakings), the BSCR-weighted average rate of absorbency through technical provisions is relatively high, with the relatively larger share of the BSCR of undertakings with high loss-absorbing capacity pulling the average up.

Table 1
Distribution of loss absorbency mechanisms

	Absorbency of technical provisions				Absorbency of deferred taxes			
	Life	Composite	Non-life	Total Undertakings	Life	Composite	Non-life	Total Undertakings
Average	63.6%	47.1%	1.7%	44.3%	9.5%	12.4%	21.1%	13.5%
Q25%	16.0%	0.0%	0.0%	0.0%	12.3%	0.0%	0.0%	0.0%
Q50%	53.4%	0.0%	0.0%	0.0%	33.1%	0.4%	0.0%	7.2%
Q75%	71.2%	4.9%	0.0%	0.0%	50.4%	11.4%	0.5%	19.2%

The total average absorbency rate for all undertakings is 57.8%, comprising 44.3% for loss-absorbency by policyholders through profit-sharing¹¹ and 13.5% for deferred taxes.

Undertakings that said they did not use IFRS to measure the loss-absorbing capacity of deferred taxes accounted for 41% of the sample in terms of total assets.

Many of them used simplification measures, notably including application of an average tax rate. In fact, the vast majority calculated the adjustment for deferred taxes:

- by multiplying the capital requirement by the normal tax rate or an average tax rate,
- and potentially by capping the adjustment at the amount of deferred tax liabilities net of deferred tax assets (rather than merely using deferred tax liabilities recorded on the balance sheet).

The challenge for undertakings is thus to demonstrate that there is not a material difference in assessment between the basic and simplified methods, the key points being the determination of the average tax rate and assumptions for recovery in a stressed environment.

¹¹ Note that absorbency through technical provisions does not apply to non-life entities for which there is no profit-sharing mechanism.

Recap of absorbency mechanisms using technical provisions and deferred taxes

Undertakings can use two adjustment mechanisms to reduce their BSCR and determine their final SCR:

- The loss-absorbing capacity of technical provisions: this is the capacity of the undertaking to transfer a portion of its losses to policyholders through reduced profit-sharing compared with what was expected prior to the shock;
- Loss mitigation through deferred taxes: booking the loss against taxable income will ultimately lead to reduced tax payments in the future compared with what was recorded in the initial balance sheet.

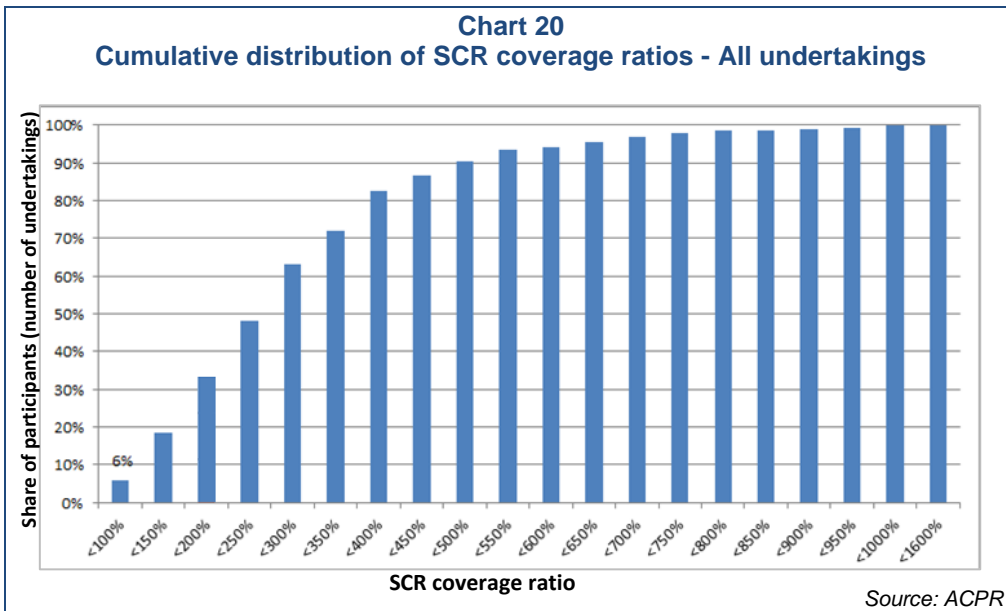
When calculating the SCR, account is taken of the fact that the value of deferred taxes will vary in the event of a shock and absorb a portion of the shock's negative impact on own funds. Accordingly, the loss-absorbing capacity of deferred taxes may lead an undertaking to recognise an ability to pay less tax than it would have if no shock had occurred. The corresponding adjustment may be highly significant, because the average loss-absorbing capacity of deferred taxes is 13.5% of the BSCR for all undertakings.

IFRS are supposed to be used to calculate the loss-absorbing capacity of deferred taxes under SII. In practice, the application procedures are highly complex, owing to the fact that undertakings are expected to determine the impact of the shock on the different items of the SII balance sheet in order to estimate deferred taxes, and to conduct analyses on the recoverability of net deferred tax assets as a function of expected future taxable profits in a stressed environment.

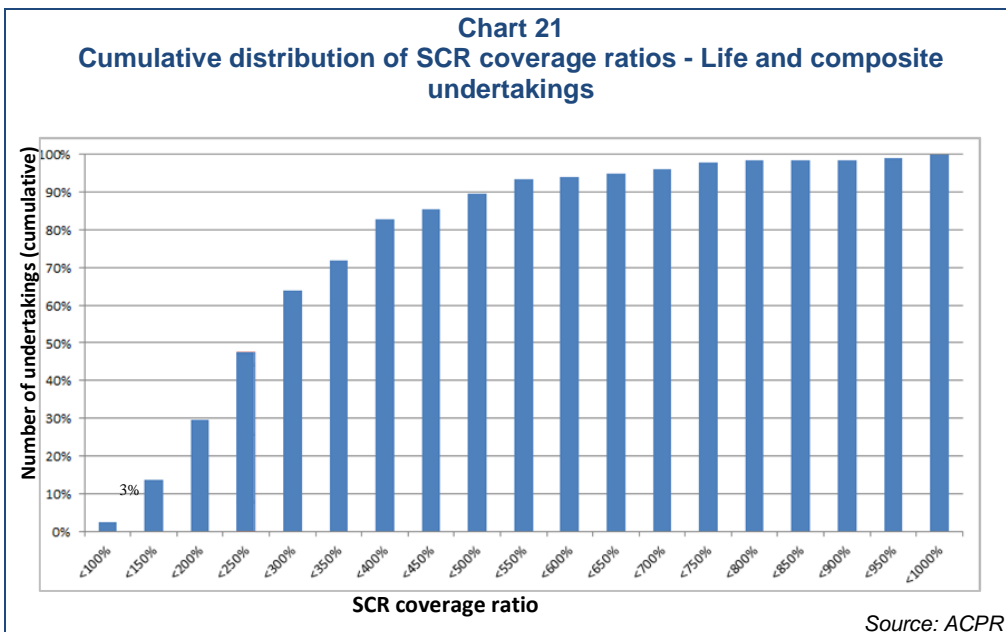
However, supervisory authorities may allow calculations to be performed using methods based on average tax rates, provided undertakings can demonstrate that this approach does not lead to a material error when assessing the adjustment.

2.3.3. SCR coverage ratios

The median coverage ratio is 256%. Just 6% of participants (by number) have a ratio of less than 100%.

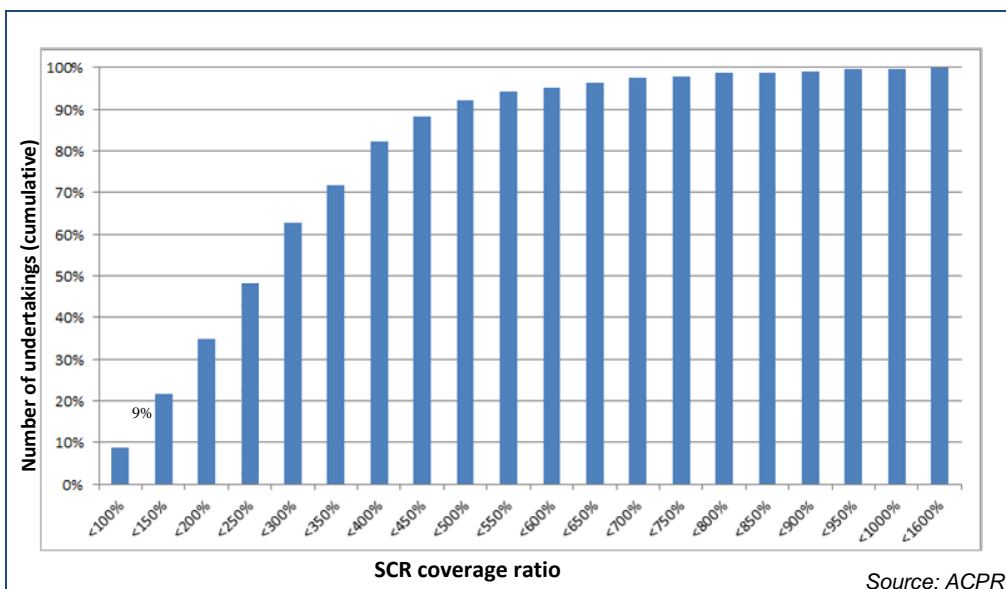


Undertakings with a surplus of more than 100% of the SCR (coverage ratio of more than 200%) account for 67% of the sample.



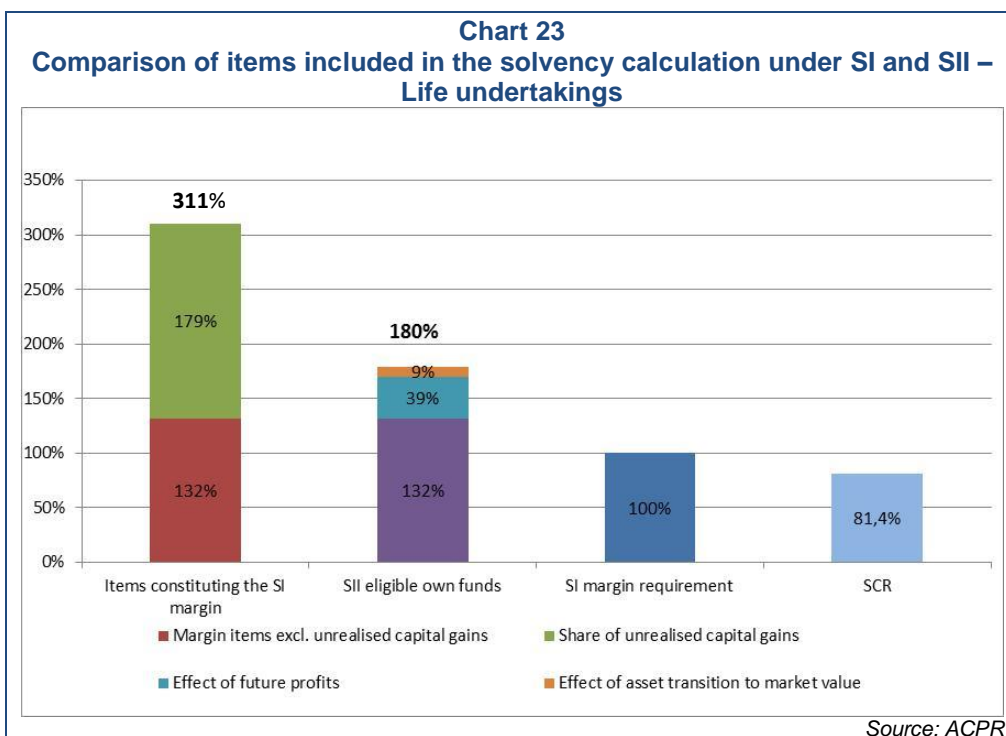
The median coverage ratio for life and composite undertakings is 258% and the average rate is 294%. In all, 3% of undertakings (by number) have a coverage ratio of less than 100%, while 70% have a ratio of more than 200%.





The median coverage rate for the non-life market is 251% and the average rate is 265%. A full 9% of undertakings (by number) have a coverage ratio of less than 100%, while 65% have a ratio of more than 200%.

The change in ratios between SI and SII depends in equal measure on the change in own funds and the margin requirement. The change differs markedly between life and non-life insurance undertakings.

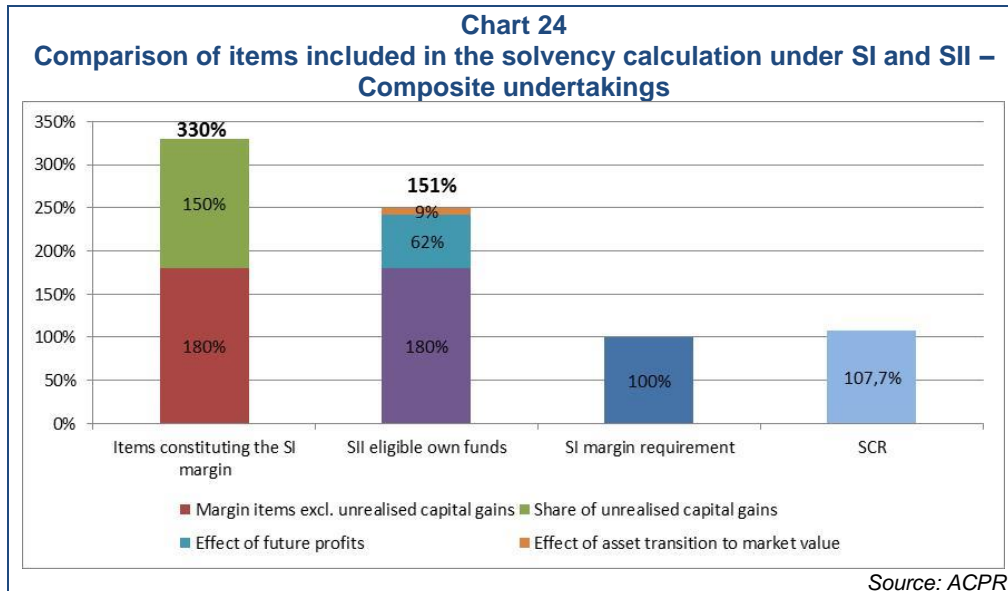


Among life insurance undertakings, SII eligible own funds are 42% less than the items constituting the SI margin.

The difference is attributable to unrealised capital gains, which under SI are fully recognised in the items that make up the solvency margin, but which are largely redistributed to policyholders under SII best estimate projections. By contrast, the capital requirement under SII is almost 20% lower than the SI requirement. These results need to be analysed with care and cannot be used to argue that the SCR of life undertakings is systematically lower than the SI margin requirement. The SCR

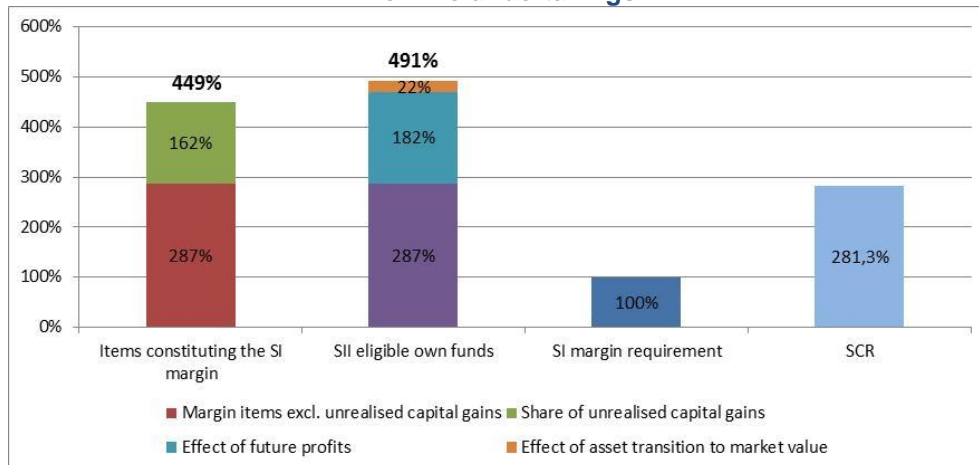
depends primarily on entity-specific factors that are not directly related to those covered by SI, such as the level of investment risk and asset-liability management. It also depends on variable, cyclical factors such as market conditions. Finally, the definitive technical specifications could also have an impact that is different from those used in this exercise.

Overall, the average coverage ratio (weighted by the margin requirement) of life undertakings falls from 311% under SI (including unrealised capital gains) to 220% under SII.



Among composite undertakings, the difference in the amount of own funds when the two solvency regimes are compared is roughly the same as that observed for life undertakings. This reflects the importance of life technical provisions, with this activity overshadowing non-life on the balance sheet and in the SCR calculation. However, the decline in own funds is smaller among composite undertakings. Thus, eligible own funds under SII are 54% lower than the items constituting the SI margin during the same period. Meanwhile, the SCR is 8% higher than the SI minimum margin requirement. The average coverage ratio (weighted by the margin requirement) of composite undertakings declines from 330% under SI (including unrealised capital gains) to 233% under SII. This outcomes reflects both the decrease in eligible own funds and the increased margin requirement.

Chart 25
Comparison of items included in the solvency calculation under SI and SII –
Non-life undertakings



Source: ACPR

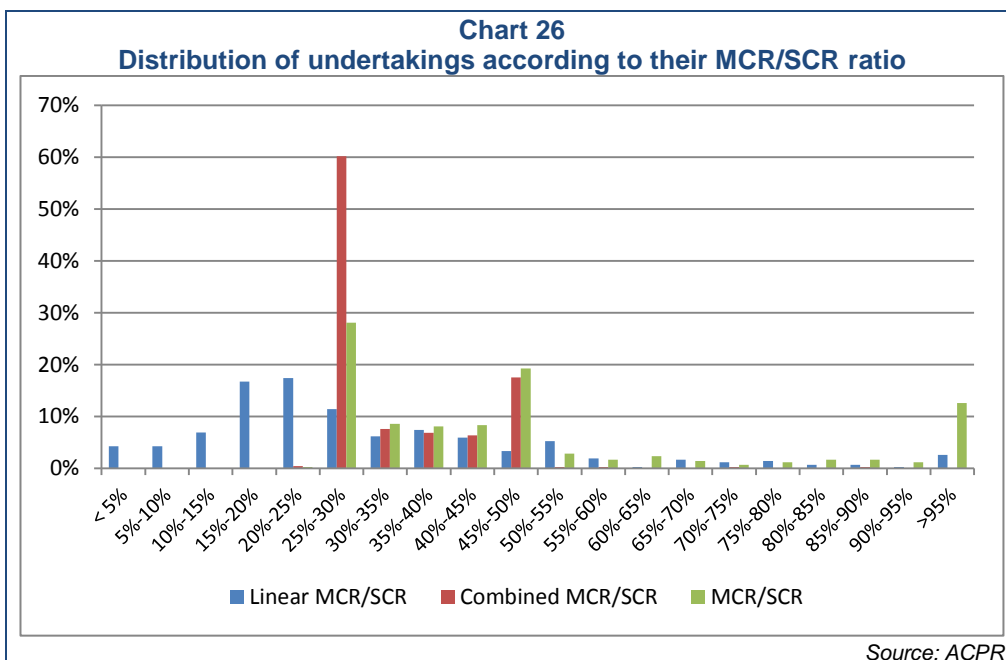
Non-life undertakings, for which there is no profit-sharing mechanism, add all unrealised capital gains to own funds. Accordingly, SII eligible own funds are not affected by the declines recorded among life and composite undertakings in the transition from SI to SII. SII eligible own funds are 9% higher than the items constituting the SI margin during the same period. The SCR is 181% higher than the SI minimum margin requirement. The average coverage ratio (weighted by the margin requirement) is 175% under SII compared with 449% under SI (including unrealised capital gains).

2.3.4. MCR analysis

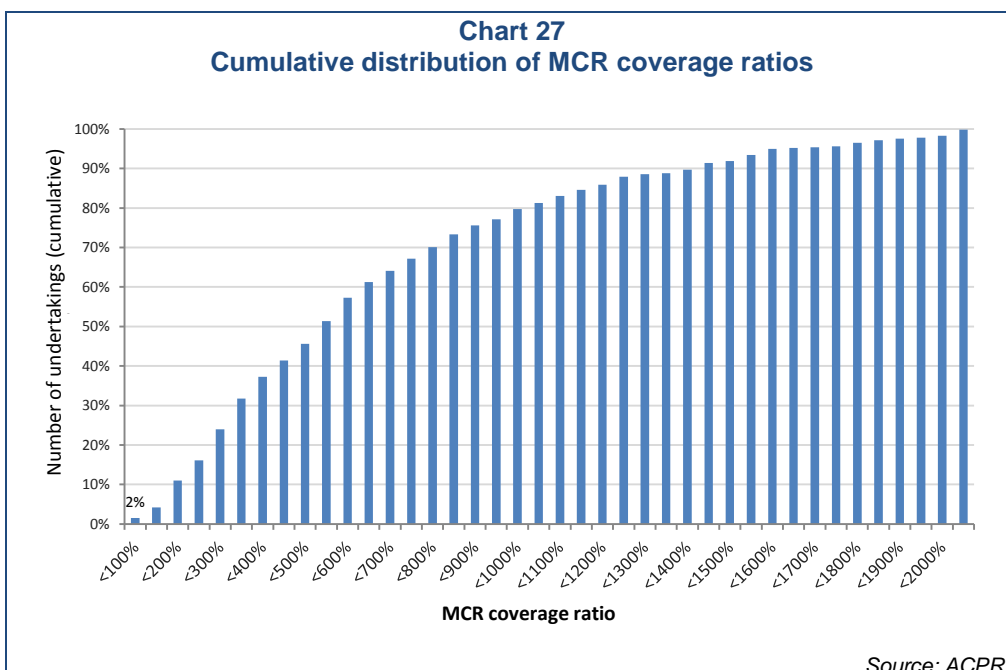
MCR recap

The MCR is the minimum level of capital that the undertaking must hold at all times or suffer immediate intervention that could result in a portfolio transfer. The MCR is calculated quarterly and comprises three stages:

- Application of a simple and verifiable linear function using premiums and technical provisions to obtain the linear MCR.
- Restatement where necessary of the linear MCR so that it is between 25% and 45% of the SCR in order to obtain the combined MCR. The 25%-45% corridor reflects the regulator's wish to allow for a ladder of supervisory intervention between a downside breach of the SCR and a breach of the MCR.
- Where applicable, definition of an absolute floor per type of activity (between €2.2 million and €6.2 million) to ensure a minimal level of prudence.



Because of the minimum threshold, 13% of undertakings have an SCR that is lower than or very close to the MCR. Furthermore, 53% of undertakings are affected by the 25% floor, whereas just 17% are affected by the 45% cap.



The median coverage rate is 540%. Just 2% of participants (by number) have an MCR coverage rate of less than 100%.

3. ORSA preparations

Undertakings were also asked to submit Own Risk and Solvency Assessment (ORSA) reports. An analysis of these reports highlighted room for improvement, notably in terms of appropriation by undertakings.

3.1. A high participation rate

The ACPR wanted the 2014 ORSA exercise to cover the three assessments provided for in the SII Directive, namely overall solvency needs, compliance on a continuous basis with capital requirements and with the requirements regarding technical provisions, and the extent to which the undertaking's risk profile deviates from the assumptions underlying the SCR. It also wanted to extend the scope beyond EIOPA's interim guidelines to include all undertakings subject to the directive. Furthermore, to allow for collective and individual analyses of ORSA reports, the ACPR asked for the preparatory reports to be filed by 6 September, whereas the target regime requires these reports to be filed with the supervisor following their approval by the board of directors and at least once a year. Also, for the first time in 2014, the ACPR asked for group filings in addition to individual filings.

For these reasons, the French market exercise was more demanding than those conducted in other European markets.

Given this situation, the number of responses received was highly satisfactory, with feedback provided by 22 groups, 382 undertakings (205 non-life, 7 reinsurers, 170 life and composite) as well as one branch from a non-EU country ¹².

The life coverage ratio was 70% by market share and 68% by number of undertakings¹³. The non-life coverage ratio was 86% by market share and 64% by number of undertakings. These proportions are well above what was required by the EIOPA preparatory guidelines, which called for a participation rate of 50% of undertakings by market share.

3.2. Quality of reports received: mixed results

3.2.1. Coverage of the requirements set by the directive

The reports dealt, at least formally, with the three assessments provided for by the directive, i.e. overall solvency needs (92% of cases), compliance on a continuous basis with capital requirements and with the requirements regarding technical provisions (82% of cases for the SCR, 31% of cases for the MCR and 12% of cases for risks linked to the calculation of technical provisions), and the extent to which the undertaking's risk profile deviates from the assumptions underlying the SCR (72% of cases, although quantitative information was supplied in just 20% of cases).

A significant proportion of reports included a description of the main risks to which undertakings are subject. This information was supplemented by forward-looking simulations.

¹² A further three reports were not taken into account because they covered companies that are going to be removed due to mergers or other reasons before 2016 while two other reports covered several companies without being single ORSAs.

¹³ The small difference between coverage by number and market share is linked to the fact that very large participants preferred to send one group report rather than file solo reports.

In many cases, the reports would benefit from being supplemented by information or studies concerning technical provisions, reinsurance and investments. Group ORSAs overlooked the risks linked to group structures, such as possible contagion in the event of an entity's failure, risks linked to non-insurance undertakings, and transferability of own funds. Some groups that produced individual and group reports used the same structure in terms of areas covered. A comparison with solvency reports submitted by the same undertakings highlighted a loss of information in ORSA reports in many cases.

However, some good practices were noted:

- integration of an action plan in relation to described risks;
- use of existing tools (risk mapping, top risk assessment, risk and performance indicators);
- integration of strategic deliberations and specific studies (risk linked to the new market-wide agreement on health coverage, liquidity strain, image risk, risks linked to changes in the parent group);
- use of the ORSA to improve risk management systems (calibration of risk limits and budgets, adjustment to ALM strategy, identification of internal reporting needs, definition of economic capital);
- use of the ORSA to review organisational arrangements (organisation of committees, review of task delegations);
- use of the ORSA to challenge the strategic plan (plan's resilience in stress scenarios, revision of assumptions).

3.2.2. Outsourcing preparation of reports

A substantial proportion of reports for this exercise were prepared, co-prepared or reviewed by an outside actuary or consultant. In some cases this was a transitional arrangement ahead of the definitive deployment of an ORSA process within the undertaking. Use of an external consultant is not disallowed under the directive and may make a real contribution in terms of the quality of reports. But it should be remembered that the ORSA process is an important or critical task and that, in general, the governing bodies should steer and take ownership of the process and the report. In particular, ORSAs drafted by third parties often do not include a strategic dimension even though this is essential.

3.2.3. Using the ORSA and its results to inform decision-making processes

Few undertakings said that they use the information in their ORSA report to take strategic or operational management decisions, as reflected in the lack of concrete recommendations and measures, which were seen in merely 29% of cases. This suggests that ORSAs tend to be viewed mainly as reports to be filed with the ACPR. The format of the exercise and the exceptional constraints listed earlier may have played a role in this. But ORSAs seem to have been left mainly in the hands of technical staff. Ultimately, it would be desirable for this report to be taken on at the level of the governing bodies and especially the board of directors. Moreover, in the reports filed, assessments highlighting permanent compliance with capital requirements are often based on insufficiently justified and sometimes overly optimistic assumptions that are inconsistent with historical data.

4. Results of the 2014 preparedness questionnaire

In 2014, 460 undertakings filed SII QRTs out of 598 that were contacted. These accounted for over 99% of the life market and 89% of the non-life market¹⁴. However, just 388 undertakings submitted a qualitative questionnaire, some of which covered several undertakings from the same group.

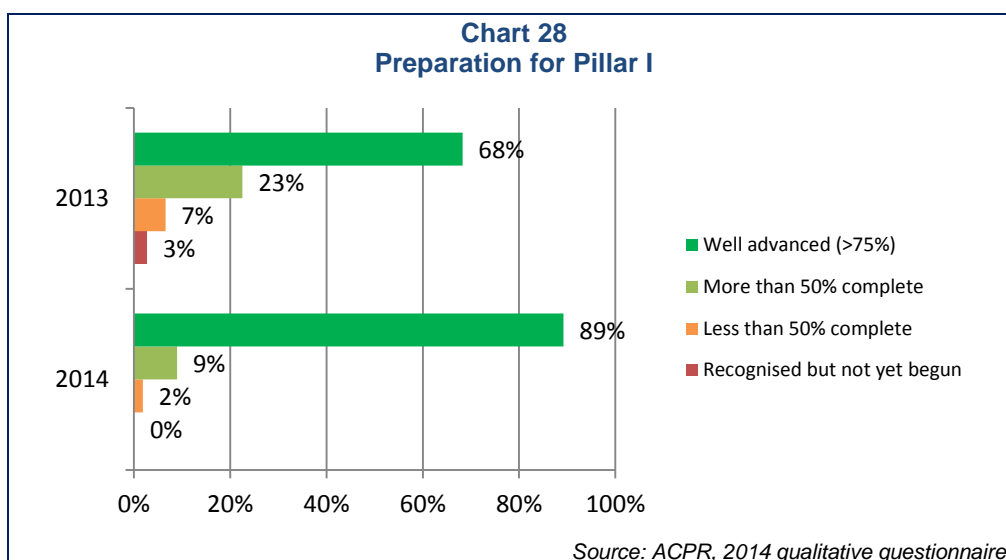
The percentages shown in this study correspond to the number of participants, without weighting for market share. Only individual undertakings are counted.

4.1.1. What SII will change for undertakings

As in previous years, undertakings are looking ahead to two main changes in the lead-up to application of SII: the structure of investments (92% of respondents are holding discussions on the issue) and internal organisation (50% of respondents are considering changes). Also as in previous years, 22% of undertakings are planning changes to products and 20% are anticipating restructuring within the group, and for individual undertakings mergers. Just 9% of participants are planning to step up their use of non-proportional reinsurance.

4.1.2. Preparation for Pillar I

Of the three pillars, Pillar I, which deals with quantitative aspects, is the most advanced. Many undertakings began their projects by starting with this aspect. In 2014, 89% of participants said they had completed more than three-quarters of their work on Pillar I.



Similarly, progress was noted in terms of establishing an audit trail as part of the process of producing the SII balance sheet, with 75% of undertakings indicating that they had made a start in 2014, compared with 67% in 2013. Further, 90% of participants said that they had done work on connecting SII balance sheet items to the French chart of accounts, up from 77% in 2013.

¹⁴ Life market shares are calculated from gross technical provisions, while non-life market shares are based on gross earned premiums.

4.1.3. Preparation for Pillar II

Respondents said that they had made headway in their Pillar II preparations: some areas are well advanced, such as the appointment of managers for key functions. The picture is more mixed in other areas, such as ORSAs, written policies and outsourcing.

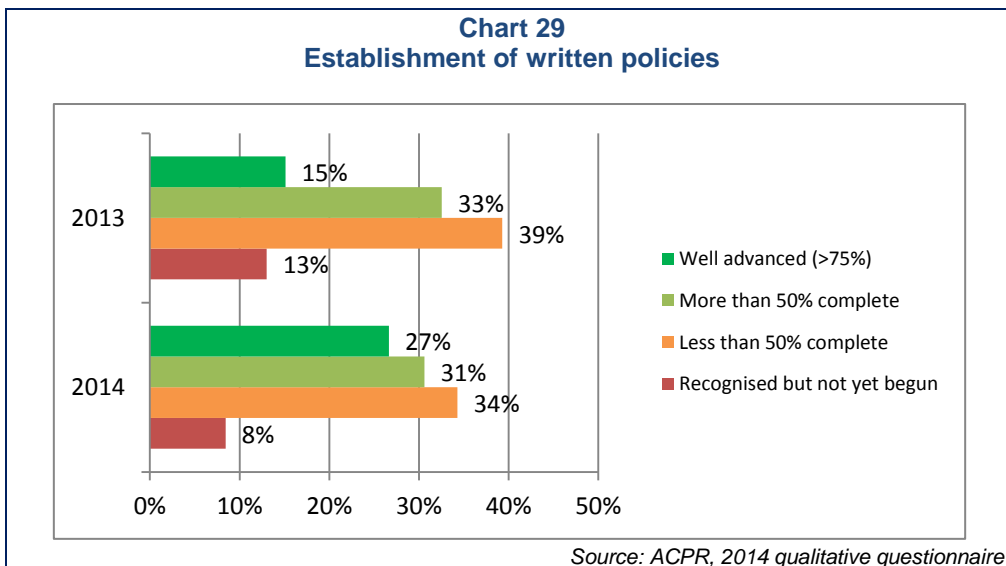
4.1.3.1. Appointment of managers for key functions

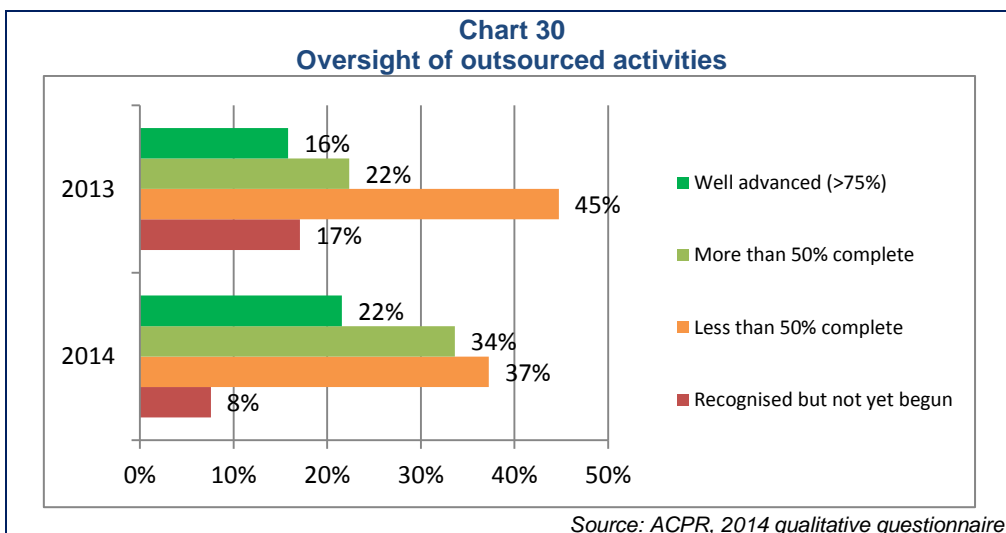
Participants said that they had made good overall progress in governance-related aspects. In almost 90% of cases, managers for key functions were identified. Most participants (approximately 75%) already have dedicated actuarial, risk management and compliance units. Internal audit is more often outsourced, with 43% of undertakings saying that they do not currently have an internal audit unit and just half of those respondents indicating that they were considering setting up such a unit.

A sizeable proportion of undertakings (28%) have not yet started to consider the question of access by managers in key functions to the information that they need. It is thus possible that some undertakings have identified the managers for key functions but have not yet taken the measure of the associated needs.

4.1.3.2. Areas where less progress has been made

Oversight of outsourced activities, which represents a significant change under SII, does not appear to be given sufficient consideration, even though the introduction of SII requirements may lead to changes in outsourcing contracts and delegation agreements, which need to be anticipated. Similarly, little progress has been made on establishing written policies.





4.1.3.3. ORSA: a work area that got underway in earnest in 2014

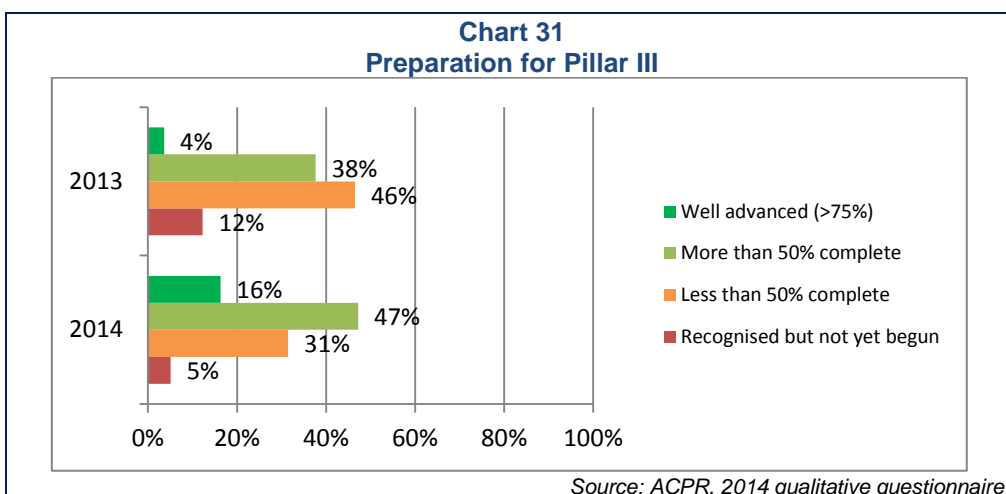
Work on OSRAs got underway in earnest in 2014, with the ACPR organising a market-wide exercise in accordance with European guidelines. Virtually all participants have now made a start on these projects. However, the proportion of undertakings that said they were well advanced remains much lower compared with the Pillar I results.

The work done by entities to check the suitability of the standard formula for their risk profiles illustrates this progress: 73% of participants said that they had performed this assessment, compared with 50% in 2013. However, only 63% of undertakings that did carry out an assessment documented it, up from 30% in 2013.

4.1.4. Reporting and data quality

4.1.4.1. Broad but uneven progress depending on the subject

Overall, progress continued on Pillar III. However, 5% of undertakings still said that they had not made a start, while 31% said that their project was less than 50% complete. Yet Pillar III measures take a long time to implement.



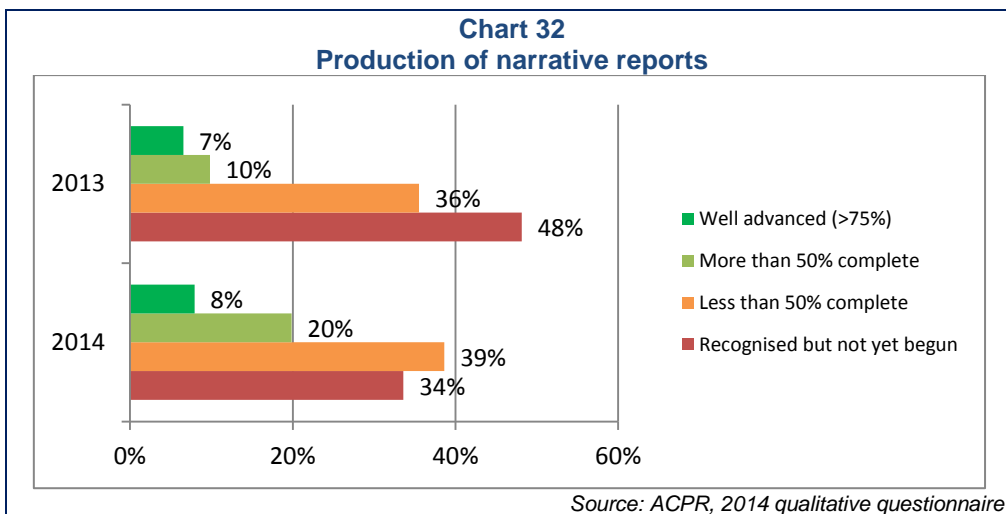
Note also that around one-third of participants said they were planning to prepare their SII balance sheets based on manual restatements. This could make it harder to comply with traceability and data quality requirements.

4.1.4.2. Little headway on data quality

The formal establishment of a data quality policy seems to be an issue that is not widely taken into account in the French market's preparations. In all, 45% of participants said that they still lacked a data governance system, compared with 48% in 2013. Similarly, 68% of undertakings do not have a formal data quality policy.

4.1.4.3. Low levels of preparation for narrative reports

The SII Directive requires narrative reports to be submitted to the supervisory authority. The French market does not appear to have advanced much in this area, with over one-third of participants saying that they had not made a start.



5. Conclusion

The SII preparatory exercise was characterised by a high level of participation, reflecting a serious effort by undertakings to ready themselves for the future regulatory framework. Furthermore, some 200 undertakings successfully used the target XBRL format for automated filings.

The data were used to draw up initial analyses on undertakings' levels of preparation and their methods, thus revealing areas in which progress can be made.

Data quality can be improved by enhancing consistency checks within and between quantitative reporting templates. Progress in this regard will notably be made by filing returns in XBRL format, which already includes many checks of this type. Tighter governance of the processes used to generate QRTs is also crucial to achieving better data quality. At the same time, the production of QRTs need to be standardised to a greater degree by incorporating processes for reviewing assumptions and methods and for checking and analysing results.

In addition, this analysis underscores the need for undertakings to do more to explain the methods and assumptions used in their calculations.

These efforts will be pursued in 2015, which will include a new exercise that also covers group data, the first quarterly data and the first narrative reports.

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