Sweden — current solvency regulation and efforts towards Solvency II

Jan 08 2010 Per Johan Eckerberg and Katarina Rykowska

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During the last few years, the Swedish Financial Supervisory Authority has participated in the mounting preparations for the implementation of the EU Solvency II project. To date, the efforts of the SFSA have primarily focused on raising the Swedish insurance industry's awareness and readiness to handle the forthcoming regulatory changes. At the same time, the SFSA has participated in the drafting of the solvency rules at EU level through its participation in the Committee of European Insurance and Occupational Pensions Supervisors. Following the final EU adoption of the Solvency II project, the Swedish implementation thereof will be carried out by the Swedish Ministry of Finance, which will draft the necessary legislative amendments to be presented to the Swedish Parliament. The SFSA will support the ministry with reports pertaining to certain identified issues. The SFSA will also be responsible for drafting the extensive and detailed supervisory regulations that will govern the numerous subsequent issues following from the anticipated new legislation.

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Project group

The SFSA has recently formed a specific project group (the "project group") which is charged with the task of ensuring a proper and thorough implementation of Solvency II into Swedish law through regulations. The project group has stated that it will focus its work on the following seven project areas:

- Capital requirements.
- Capital base.
- Group issues.
- Internal models.
- Supervision.
- Information.

- Reporting.

Reference groups

Furthermore, the SFSA has selected a number of market actors, predominantly from a number of major insurance companies, to form reference groups. The objective for the reference groups is to provide feedback to the project group on proposed new regulations, which will be discussed during the course of their development.

Time schedule

The implementation of Solvency II through new, detailed SFSA regulations is expected to meet the deadline set out in the Solvency II framework directive adopted at the European Parliament's plenary session on April 22, 2009 (the "Framework Directive"). However, the exact timing will largely depend on the progression of the legislative work of the Ministry of Finance.

Key issues

From a Swedish legal perspective, several key issues will need to be examined and resolved before any new legislation can be implemented successfully. At a public hearing on September 22, 2009 with representatives from the Swedish insurance industry, the SFSA declared that the authority had identified the following five key issues areas:

- The requirements for reporting to the SFSA.
- The extent of public disclosure of information.
- The requirements for untaxed reserves in non-life insurance companies (i.e., the "safety reserve") to qualify as Tier one capital.
- The "risk-free" interest rate for discounting long-term liabilities.
- The conditions for using internal models for calculating solvency capital requirements.

In our following updates, we hope to be able to cover the development of these issues.

Surplus funds — the Swedish deal-breaker issue

Prior to formulating the above key issues, the SFSA and the Swedish Insurance Federation had to handle an issue of far greater importance; the "surplus funds". This issue came to the fore at a relatively late stage as a true deal-breaker for the Swedish life insurance industry. It is now generally assumed that this issue has been satisfactorily and permanently resolved. However, considering the magnitude thereof, some explanatory remarks are required.

Background

During the drafting of Article 90 of the Framework Directive, it became apparent that "surplus funds" in Swedish life assurance companies might not qualify as tier one capital. This meant that more than 80 per cent of all risk capital in the Swedish life assurance industry, approximately €55bn, would not qualify as tier one capital (source: the Swedish Insurance Federation) Naturally, this was a clear deal-breaker.

Swedish life insurance business

The problems relating to Swedish surplus funds emanate from the quite unique legal requirements for life insurance business in Sweden. Life insurance companies may be incorporated in any of three different forms: (i) mutual companies; (ii) limited liability companies that are entitled to distribute profits to their shareholders; and (iii) limited liability companies that are operated on a mutual basis. The third category of companies is generally referred to as "hybrid companies" as they are, on the one hand, limited by shares but, on the other, not entitled to distribute any profits to their shareholders.

With some exceptions (e.g., Nordea, Handelsbanken and SPP), all major traditional life insurance companies in Sweden are either mutual companies (e.g., Alecta and Folksam) or hybrid companies (e.g., AMF, Skandia and LF). This means that most Swedish traditional life insurance companies only distribute profits to their policyholders and beneficiaries. These companies hold 95 per cent of the risk capital in the entire Swedish insurance sector (source: the Swedish Insurance Federation).

Technical provisions and assets

Most Swedish traditional life insurance companies offer policies with guaranteed returns on premiums. The policyholders and beneficiaries have an unconditional right to these proceeds. Thus, the guarantees are considered as liabilities for which the company must maintain technical provisions. The technical provisions correspond to the estimated cost for fulfilling the guaranteed undertakings. The fact that mutual and hybrid companies only distribute profits to their policyholders and beneficiaries is reflected in the classification of their assets. Insofar as the market value of the company's assets exceeds what is needed to cover the technical provisions, such excess value is accumulated as surplus funds. The surplus funds are used as any other form of risk capital, e.g., for covering losses. The surplus funds have thus been eligible as tier one capital when calculating the capital base under the Solvency I regulations (including the IORP Directive). The insurance company may also decide to distribute surplus funds as bonuses to policyholders. As soon as such a decision is made, and only then, do these funds become liabilities, i.e., technical provisions.

The draft Framework Directive

Prior to the final wording of the Framework Directive, the draft Article 90 restricted surplus funds eligible as tier one capital to "realised profits". As noted above, this did not apply to the Swedish surplus funds concept. Surplus funds in most Swedish life insurance companies are not realised profits but, rather, equivalent to the market value of the company's assets in excess of its liabilities. As luck would have it for the Swedish life insurance industry, it seems that the SFSA, supported by the Swedish Insurance Federation, was successful in explaining the Swedish predicament to the EU. Considering the nature of the surplus funds as described above, it now appears that these will fall within the scope of surplus funds as defined in Article 90 of the Framework Directive in its final wording. Furthermore, according to Articles 93 and 94, such surplus funds fulfil the criteria of tier one capital.

Further information

Further information relating to the SFSA Solvency II implementation project is available in Swedish on the SFSA web site; www.fi.se.

Further information relating to the Swedish surplus funds issue is available in English on the Swedish Insurance Federation's web site; www.forsakringsforbundet.com, Position paper on the Treatment of Surplus Funds in the Proposed Framework Directive on Solvency II.

Outlook

Provided that the surplus funds issue is satisfactorily settled, we hope to be able to cover the other Swedish key issues noted above in our following updates, as they develop:

- The requirements for reporting to the SFSA.
- The extent of public disclosure of information.
- The requirements for untaxed reserves in non-life insurance companies (i.e., the "safety reserve") to qualify as Tier one capital.
- The "risk-free" interest rate for discounting long term liabilities.
- The conditions for using internal models for calculating solvency capital requirements.

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