



NATIONAL BANK OF SERBIA

**STRATEGY FOR IMPLEMENTATION OF
SOLVENCY II IN SERBIA**

May 2021

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1. Implementation of Solvency II in the European Union

In the past period, insurance activity in the European Union (EU) was regulated by a number of directives within the Solvency I supervisory regime aimed at gradual harmonisation of the rules governing the pursuit of insurance business. While it brought numerous benefits, the Solvency I regime also had some downsides, in particular it failed to: sufficiently incentivize insurance/reinsurance undertakings (hereinafter: undertakings) to adequately manage risks and investments, remove all impediments to timely supervisory intervention, ensure adequate allocation of capital and pay sufficient attention to group supervision.

With a view to improving the Solvency I regime, a new directive – Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (hereinafter: Solvency II) was adopted, to be applied as of 1 January 2016, following a multi-year transitional period allowed for alignment with new regulatory requirements. Solvency II repeals 14 directives (commonly referred to as Solvency I) and provides for a maximum harmonisation regime, thereby ensuring greater convergence within the internal market of insurance services in the EU.

Solvency II is based on three pillars:

- 1) Quantitative requirements,
- 2) Qualitative requirements,
- 3) Transparency.

Quantitative requirements provide for harmonisation of standards for marked-based valuation of assets and liabilities. Technical provisions, representing the undertaking's liability to insured persons, are determined as the sum of a best estimate (probability weighted average of future cash-flows taking account of the time value of money) and a risk margin (risk add-on). Eligible own funds are also established, including capital, classified according to their quality in meeting capital requirements. Solvency II establishes two tiers of capital requirements allowing for timely supervisory intervention: solvency capital requirement (SCR) and minimum capital requirement (MCR). SCR, which may be calculated in accordance with a standard formula or an internal model, is conceptualised so as to cover all quantifiable risks in an undertaking's operation and ensure that an undertaking can withstand during one year a one-in-200-year event (Value-at-Risk measure calibrated to a 99.5% confidence level over a one-year time horizon). MCR is calculated according to a linear formula with the set absolute minimum values (Value-at-Risk measure calibrated to a 85% confidence level over a one-year time horizon). Also, Solvency II introduces a prudent person principle for asset investment, i.e. given that capital requirements take into account market risks, it allows undertakings to freely allocate their investments, as long as the investment is made in the best interest of policy holders and beneficiaries.

Qualitative requirements include fit and proper criteria applicable to all persons who effectively run the undertaking or have other key functions in the undertaking, as well as qualitative requirements relating to the key functions, own risk and solvency assessment (ORSA) and the manner of conducting supervision while respecting the principle of proportionality, i.e. taking into account the nature, scale and complexity of the business of the undertaking concerned, its size and organisational structure, as well as the scale and types of insurance business carried out. Solvency II mandates the setting up of key functions in the undertaking including risk management, system of internal controls, compliance, internal audit and actuarial function, introducing also special conditions regarding outsourcing. Solvency II imposes regular ORSA as part of an undertaking's business strategy, in order to anticipate overall solvency needs, meet the requirements concerning capital adequacy and technical provisions, as well as detect any deviation of an undertaking's risk profile from SCR. Solvency II lays the foundation for convergence of national supervisory practices toward supervision based on assessment of risks to which an undertaking is exposed or may be exposed in its operation, in the form of off- or on-site supervision and imposing of supervisory measures.

Transparency is ensured by supply of relevant information to the supervisor and by the mandated public disclosures. Qualitative and quantitative information is made available to the supervisor through the Regular Supervisory Report (RSR) and quantitative reporting templates (QRT), and it is planned to

harmonise supervisory reporting formats across the financial sector (XBRL taxonomy). Undertakings also disclose the most relevant business information in the Solvency and Financial Condition Report (SFCR).

Special attention is paid to group supervision. Groups are viewed as consolidated entities subject to consolidated supervision. Solvency II establishes the manner of group supervision, the scope of work of group supervisors and relation with other supervisors within the college of supervisors, especially with regard to exchange of data and coordination of activities.

During more than a decade-long development of a new insurance regulatory regime for the EU, six quantitative impact studies (QIS) were conducted to analyse the effects of the new regulations, primarily of quantitative requirements, on the EU's insurance sector.

On 16 April 2014, the European Parliament and European Council adopted the Omnibus II Directive amending Solvency II, a new regime effective as of 1 January 2016. Solvency II lays down Level 1 rules regulating insurance business across the EU, which member states transpose into their national legislation.

Under Solvency II, the European Commission is in charge of adopting delegated or implementing acts directly applicable in the EU member states, which ensure full harmonisation of rules governing the insurance business. Technical standards concerning purely technical matters are adopted by the European Commission at the proposal of the European Insurance and Occupational Pensions Authority (EIOPA). These acts and implementing measures represent Level 2 rules regulating insurance business in the EU.

Level 3 rules are EIOPA-adopted guidelines. These guidelines ensure consistent implementation of rules and cooperation between member states. While guidelines are not mandatory, any deviation from them must be duly justified.

At the adoption of Solvency II, the European Commission planned a comprehensive review of Solvency II in 2020 (hereinafter: Solvency II review) based on the prudential experience during the first years of application in order to make sure that the adopted rules at all levels serve their purpose. From 2016 to 2019 specific segments of the framework were reviewed, notably those concerning the treatment of infrastructure investments, securitisation and parts of the SCR calculation according to the standard formula. However, the outbreak of the COVID-19 pandemic postponed the completion of this process. Amendments to Solvency II are now expected to be adopted by end-2021, and to be applied, including possible transitional provisions, from 2022 at the earliest.

2. Insurance sector in the Republic of Serbia

In addition to its primary objective of achieving and maintaining price stability, the National Bank of Serbia (NBS) also contributes to preserving and strengthening the stability of the financial system, as well as to the protection of the rights and interests of financial services consumers. One of the tools the NBS applies in pursuing this objective is acting in its capacity of a regulator and supervisor of the major part of the Republic of Serbia's financial sector, including the insurance industry. The other regulatory authority in the insurance industry is the Ministry of Finance.

After banking, insurance is the second most important segment of the financial sector of the Republic of Serbia. In 2020, total insurance premium per capita equalled EUR 135 and total premiums made up 2.0% of GDP. The Serbian insurance market is dominated by non-life insurance, while life insurance held a 23.8% share in total premium in 2020.

At end-2020 the Serbian insurance market comprised 20 undertakings, 16 insurers and four reinsurers. Of the insurance undertakings, four were exclusive life insurers, six exclusive non-life insurers, while six provided both life and non-life insurance. The breakdown by ownership shows that 15 undertakings were in majority foreign ownership, mostly EU-based. The majority of undertakings in Serbia are subsidiaries belonging to Austrian and Slovenian groups.

Serbia's insurance sector has so far significantly converged to that of the EU, which is particularly evident from the rules on the pursuit of insurance business, entry into the domestic market and operation of the EU-based subsidiaries, transfer of specific knowledge from parent companies, development of new insurance products in the Republic of Serbia, continuous development of life insurance, as well as improvement of the protection of insurance beneficiaries. Further convergence of the Serbian insurance sector to that of the EU will be conditioned by the general economic situation and further improvement of the regulatory framework and insurance practices in the Republic of Serbia.

3. Legal framework in the Republic of Serbia and Solvency II

At the NBS's proposal, on 18 December 2014 the National Assembly of the Republic of Serbia adopted the new Insurance Law, which aligned the domestic legislation with the Solvency I regime, while implementing also some requirements of Solvency II. Namely, considering that Solvency II underwent amendments in 2014 and that implementing acts and measures were not yet adopted at that time, selected requirements from the Directive were transposed into the Insurance Law, particularly qualitative requirements under Pillar 2. The Insurance Law became effective on 27 June 2015, by which time the NBS had adopted 14 supporting decisions¹, and the Serbian Government issued a decree² regulating in detail some of the issues relevant for the pursuit of insurance business. Thus the foundation was laid for the development and improvement of insurance business and protection of insurance service beneficiaries in the Republic of Serbia.

The Insurance Law and the supporting secondary legislation regulate the establishment of an undertaking and the start-up of insurance business, i.e. issuance of a license to carry on insurance/reinsurance activities in accordance with Solvency II. They further prescribe the conditions for carrying on insurance business including, among other, fit and proper requirements for prospective qualified holders and members of management, as well as requirements for an efficient governance system. They lay down the rules for valuation of an undertaking's assets and liabilities, primarily technical provisions for coverage of all liabilities under the insurance contract and requirements regarding capital adequacy. Liberalisation of insurance sector, in terms of freedom to establish branches and freedom to provide insurance services is also envisaged, as of the date of Serbia's EU accession. The legislation implements Solvency II requirements in terms of an undertaking's obligation to supply adequate information to the prospective policyholder, prior to contract conclusion and during contract term, while prescribing the minimum content of such information. Supervision of a group of undertakings, which did not exist previously, was also introduced. Reorganisation and liquidation of undertakings are largely harmonised with the rules applied in the EU (the Law on Bankruptcy and Liquidation of Banks and Insurance Companies adopted by the National Assembly of the Republic of Serbia on 3 February 2015).

The Decision on the System of Governance in an Insurance/Reinsurance Undertaking defines, for the first time in the Republic of Serbia, qualitative requirements of Solvency II pertaining to key functions (risk management, system of internal controls, actuarial function and internal audit), ORSA (in 2015 undertakings conducted for the first time their own assessment of risks and solvency) and outsourcing. The Decision on the Contents of the Opinion of the Certified Actuary prescribed the obligation to issue opinion on technical provisions, premium and reinsurance in line with Solvency II requirements, i.e. the contents of the opinion of a certified actuary.

The Decision on the Conditions and Manner of Supervision of Operations of Insurance/Reinsurance Undertakings and Other Supervised Entities in the Insurance Business specifies requirements for setting up risk-based supervision in line with the EIOPA guidelines on the supervisory process.

The Decision on Implementing Provisions of the Insurance Law relating to the Issuance of License to Carry on Insurance/Reinsurance Activities and Specific Approvals of the National Bank of Serbia regulates in detail fit and proper requirements for persons who are to manage/supervise an undertaking and acquirers of a qualifying holding in an undertaking, in accordance with Solvency II and EIOPA

¹ The Decision on Implementing Provisions of the Insurance Law relating to the Issuance of License to Carry on Insurance/Reinsurance Activities and Specific Approvals of the National Bank of Serbia, Decision on Capital Adequacy of Insurance/Reinsurance Undertakings, Decision on the Conditions and Manner of Supervision of Operations of Insurance/Reinsurance Undertakings and Other Supervised Entities in the Insurance Business, Decision on the System of Governance in an Insurance/Reinsurance Undertaking, Decision on Reporting by Insurance/Reinsurance Undertakings, Decision on Technical Provisions, Decision on Investment of Insurance Funds, Decision on Actuary Certification and Further Professional Education, Decision on the Contents of the Opinion of the Certified Actuary, Decision on the Content of Report on the Audit of Financial Statements of an Insurance/Reinsurance Undertaking, Decision on Implementing Provisions of the Insurance Law Relating to Insurance Brokerage and Agency Activities, Decision on Insurance Broker and Agent Certification and Further Professional Education, Decision on the Content and Manner of Keeping Data Registers of Insurance/Reinsurance Undertakings and Other Subjects of Supervision in Insurance and Decision on the Manner of Protecting the Rights and Interests of Insurance Service Consumers.

² The Decree on Risks That May be Insured/Reinsured with a Foreign Insurance/Reinsurance Undertaking.

guidelines, while the fit and proper requirements for actuaries are aligned with Solvency II criteria via the Decision on Actuary Certification and Further Professional Education.

Certain elements of quantitative requirements under Pillar 1 of Solvency II, such as data quality, segmentation, comparison against experience and adequacy of technical provisions are prescribed by the Decision on Technical Provisions.

4. Main objectives and stages of implementation of Solvency II in Serbia

Adoption of a set of regulations governing insurance business in the Republic of Serbia in late 2014 and the first half of 2015 created the preconditions for the convergence of the Serbian insurance sector toward the developed insurance sector of the EU. In the preparatory stage for Solvency II implementation in 2014 and 2015, certain provisions of Solvency II were transposed into provisions of the Insurance Law and the supporting secondary legislation, which led to a significant compliance with qualitative requirements of Solvency II.

The ensuing implementation stages will take into account the level of compliance achieved so far, the current level of development of the insurance sector in the Republic of Serbia and the analysis of the impact of Solvency II implementation on the domestic insurance market.

4.1 Stage I – Compliance analysis

The first stage of implementation, completed in 2017, included an analysis of compliance of the national insurance legislation with Solvency II.

In particular, it was analysed how the Serbian insurance sector would be affected by Article 4 of the Solvency II Directive, which envisages the exemption of very small insurers. It was concluded that all domestic undertakings should be obliged to apply the Directive from the start of its implementation.

The results of the analysis showed that the Insurance Law should to be amended in order to achieve full compliance with Solvency II.

4.2 Stage II – Impact assessment

The second stage, which began in 2018, includes the assessment of the impact of Solvency II implementation on the Serbian insurance sector, conducted primarily through quantitative studies about the impact of Solvency II Pillar 1 requirements on capital adequacy and technical provisions of individual undertakings and the insurance sector as a whole. Quantitative impact studies test the impact of full or partial application of Solvency II requirements in order to assess the level of the undertakings' preparedness and capacity to implement them. They are therefore expected to be carried out continuously until Solvency II requirements are implemented in full, all with a view to ensuring development and long-term financial stability of the insurance industry in Serbia.

4.3 Stage III – Harmonisation of the regulatory framework

The third stage will be implemented in accordance with the results of the detailed compliance analysis and the conducted quantitative impact studies. The timeframe for this stage will be synchronised with the course of the negotiations on Serbia's accession to the European Union.

This stage will also include adjustment of the regulatory framework through the Insurance Law, which will transpose the Solvency II framework in the Republic of Serbia, in the part relating to the pursuit of insurance/reinsurance business and supervision of insurance/reinsurance undertakings and groups of undertakings. Also, the Law on Bankruptcy and Liquidation of Banks and Insurance Undertakings is planned to be amended in the part relating to reorganisation and liquidation/bankruptcy of insurance/reinsurance undertakings in the Republic of Serbia, with a view to transposing Solvency II.

The final result of this stage will be drafts and proposals of regulations which will ensure full compliance with Solvency II requirements, in line with the timeframes and manner envisaged by the National Programme for Adoption of the Acquis.

5. Transparency and cooperation in the process of implementation of Solvency II

The Strategy for Implementation of Solvency II in Serbia and any amendments thereof will be published on the NBS website and made available to all interested parties.

Taking into account the importance and complexity of the Solvency II implementation process, the NBS will review the Strategy annually and amend it as needed, responding to new circumstances and challenges, particularly in the light of Serbia's EU accession process and recommendations issued by the European Commission.

The organisational unit within the NBS responsible for Solvency II implementation and the coordination processes is the Insurance Department, which will be supported in its work by other organisational units. The Department will report to the NBS Executive Board on the implementation of Solvency II at least once a year.

In the process of implementation of Solvency II the NBS will cooperate with all interested parties, particularly the Ministry of Finance, Deposit Insurance Agency, Association of Serbian Insurers, Serbian Association of Actuaries, etc.

The wider public will also have the opportunity to be involved in the Solvency II implementation process, bearing in mind that draft regulations will be subject to a public debate and that important information about the implementation of Solvency II in the Republic of Serbia will be made available on the NBS website.