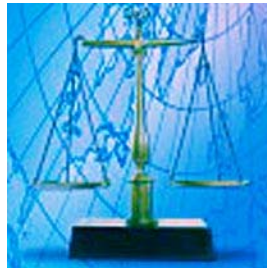




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Solvency II – The Way Ahead

IN-FOCUS



In anticipation of the publication of the draft Solvency II framework directive in Summer 2007, this In-Focus provides an overview of the process towards the new regulatory regime for the insurance industry, which is expected to become effective by 2010. On release of the draft directive, we will prepare and circulate a special guide on its impact.

Introduction

In Spring 2007 the Committee of European Insurance and Occupational Pensions Supervisors (**CEIOPS**) launched its third round of quantitative impact study (**QIS III**) in relation to Solvency II. By way of consultation with the insurance industry, QIS III will look at the potential effects, on both insurance undertakings and groups of undertakings, of CEIOPS' latest proposals for the assessment of technical provisions and for the calculation of a solvency capital requirement (**SCR**) and a minimum capital requirement (**MCR**).

Background

In May 1999 the European Commission published the outline of a Financial Services Action Plan (**FSAP**) which was endorsed by the Lisbon European Council in March 2000. The FSAP is designed to help integrate Europe's financial markets and finally to establish a Single Market across the European Union (**EU**) as a whole. It contains legislative and other measures to tackle three specific objectives: (i) a single wholesale market; (ii) an open and secure retail market; and (iii) state of the art prudential rules and supervision.

Solvency II is an integral part of the FSAP which reviews and amends the existing Insurance Directives. It aims to establish a single insurance market that allows insurers to operate throughout the EU and to establish and provide services freely. This is achieved by a common prudential framework, founded on three generations of life and non-life Directives, harmonising essential rules.

According to the European Commission approximately three quarters of the new Directive will consist of a codification of the 14 existing Insurance Directives. The remaining one quarter reflects the new Solvency II system. The first preparations for the new regime started in late 2002.

What is Solvency II

Solvency II not only harmonises insurance provisions throughout the European Union, but most importantly overhauls the amount of regulatory capital an insurance firm must hold as a cushion against unforeseen events. The current margin requirements were introduced in the early 1970s and were amended by the Solvency I Directives in 2002. Solvency I, however, was widely blamed as being too rigid and simplistic and as such not able to reflect the true risk in a given portfolio of an insurance undertaking. In response to these criticisms, Solvency II now aims to implement margin requirements that better reflect the risks companies face. Furthermore, the new regime offers incentives, in the form of reduced capital requirements for the implementation of appropriate risk management systems and sound internal controls.

As with Basel II for Banking, the regime is based on a three-pillar approach with each pillar governing a different aspect:

- Pillar 1, focuses on the quantitative requirements of the solvency system. It comprises of a Solvency Capital Requirement (**SCR**), which represents the standard target level of capital. The determination of the level is either based on the firm's own risk assessment model or by a standard formula



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provided by the implementing legislation; the Minimum Capital Requirement (**MCR**) sets out the absolute regulatory minimum level of capital needed for an insurer. The MCR will be set at a relatively low level. If the capital falls below the MCR, severe supervisory action, like the suspension of new business will, be triggered automatically. Between SCR and MCR there is a so-called "ladder of intervention". This means that the supervisor will take action which is more severe, the closer the capital moves towards the MCR.

- Pillar 2, focuses on a company's risk management and ensures that the company is adequately capitalised. It encourages companies to develop their own risk management process which incorporates the management of policies, claims provisions and risks. If the available capital falls below the SCR the supervisor is empowered to intervene to prevent the capital from falling below the MCR.
- Pillar 3, addresses market discipline and harmonises disclosure requirements and reporting rules. It requires insurers to demonstrate to the regulator that the analysis supporting the other two pillars is dependable.

The way ahead?

Lamfalussy process

The new regime will be adopted following the Lamfalussy process. To speed up the amendment and implementation of community law, the Economic and Financial Committee (**ECOFIN**) appointed a Committee of Wise Men under the chairmanship of Baron Alexandre Lamfalussy. In February 2001 it announced a new decision-making procedure (Lamfalussy report) for the adoption of EU legislation affecting the securities markets. One year later, ECOFIN extended this process to legislation on banking, insurance and financial conglomerates.

The process is set up of four levels: The first level envisages primary community legislation based on framework principles and defines and determines implementing powers. At Level 2, the European Commission (**Commission**) adopts community legislation in relation to technical details of the principles. In this context, the Commission is being assisted by a committee, in line with a procedure known as "comitology". The committees are forums for discussion, consist of representatives from Member States and are chaired by the Commission. They enable the Commission to establish a dialogue with national administrations before adopting implementing measures. The Commission ensures that measures reflect as far as possible the situation in each of the countries concerned. By differentiating between framework legislation on level one and technical implementing measures on level two, it seeks to improve the quality and efficiency of EU legislation.

Two further levels provide for the cooperation among national regulators to ensure consistent interpretation of the implementing rules (level 3) and for the supervision and enforcement to ensure consistent implementation of EU legislation (level 4).

Lamfalussy process and Solvency II

Applying the Lamfalussy model to Solvency II means that at level 1 the European Insurance and Occupational Pensions Committee (**EIOPC**) will develop the Framework Directive which includes the framework principles and the definition of implementing powers. The Directive will then be adopted by the



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European Parliament and the European Council of Ministers. The HM Treasury represents the UK on EIOPC.

At a later stage (level 2) the Commission, after consulting the EIOPC, will call for advice from the Committee of European Insurance and Occupational Pensions Supervisors (**CEIOPS**) on the drafting of technical implementation measures. For this reason CEIOPS prepares measures in consultation with market participants, end-users and consumers, and submits them to the Commission which finally will adopt these measures. During this stage, the European Parliament is being kept fully informed. It can adopt a Resolution if measures exceed implementing powers. On CEIOPS the UK will be represented by the Financial Services Authority (**FSA**).

At level 3 of the Lamfalussy process, CEIOPS will work on recommendations, guidelines and standards which are not covered by EU legislation. Furthermore, it will compare supervisory practise in the EEA States to enhance their convergence.

After the implementation of the new regulatory regime in the EU Member States, the Commission checks compliance with the EU legislation and may take legal action in case of breach of Community law. (level4)

In addition, the Lamfalussy model provides that the new Directive be accompanied by an impact assessment report, which looks at the quantitative as well as qualitative effects. For this purpose, the Commission Services sent out in July 2004 a first "wave of specific calls for advice" from CEIOPS to assist on those elements by running several studies. These impact studies aim to provide background and argumentation for of the impact of the critical choices made during the preparation of the Framework Directive. In its last wave of specific calls for advise (the "third wave") from April 2005 the Commission Services asked CEIOPS to cover SCR and MCR.

To correspond to the calls for advice, CEIOPS conducted a series of quantitative impact studies (**QIS**) to acquire insight from the insurance industry. The first QIS was launched in November 2005 with focus on the level of prudence in the technical provisions under several hypotheses. CEIOPS conducted QIS II in Summer 2006. In this study CEIOPS analysed the effects of the possible restatement of the value of both assets and liabilities under the Solvency II framework on insurance undertakings, as well as some possible options for setting the capital requirement (MCR and SCR).

Quantitive Impact Study III

With QIS III, Solvency II now enters into a decisive phase. CEIOPS is looking for quantitative information about the possible impact on balance sheets, and addresses the calibration for the calculation of the SCR and MCR. The outcome of this study will be crucial for the determination on how much capital firms need to hold.

In relation to the minimum capital requirement, QIS III will also run a test on the proposed MCR calibration of a 90 percent value at risk target level of confidence over a one year time horizon. Two different formulae will be applied to calculate that calibration: (i) a revised modular formula which may not move in parallel with SCR and (ii) the "compact approach" as suggested by the industry which is based on a percentage of last year's SCR.



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On group issues, QIS III will take a closer look on the extent to which local subsidiaries need to hold the full SCR and on the extent to which surplus capital is transferable between entities to meet overall group capital requirements (with the Group holding a diversified Group SCR at the centre).

The results and the additional data collected by this study will help CEIOPS to develop their advice to the European Commission, in particular, for the calibration of the MCR and SCR.

QIS III, however, will not predetermine the outcome of possible Solvency II rules. Nonetheless, the Commission set out that the results would facilitate to put forward "a justifiably calibrated standard formula". Therefore, QIS III plays a key role for the negotiations of the Solvency II proposal and the development of detailed legislative measures.

In relation to MCR, QIS II revealed that under certain circumstances the proposed calculation approach was actually higher than the SCR. The Association of British Insurers (**ABI**) therefore asked its members to participate in the study, in order to address those circumstances and to prevent that firms will be required to hold capital unnecessarily.

ABI also pointed to the low UK participation rate with only 2 small and 6 medium-sized firms out of a total of 40 taking part in QIS II. To avoid that Solvency II outcomes are determined by the results from the numerous firms participating in other countries, ABI asked its members to strongly participate in the study.

QIS3 will run from April to 29 of June, this year. In October/November 2007 a summary report with the results of QIS III will be presented to the Commission. After a consultation process from November 2007 until 2008, CEIOPS will give its final advice on MCR and SCR in Spring 2008.

Although QIS III is the last of a series of impact studies, further impact studies might become necessary in the future. CEIOPS envisages at least two more QIS in 2008.

Additional information, including spreadsheets and the QIS III questionnaire can be accessed through CEIOPS' website at: <http://www.ceiops.org/content/view/118/124/>

Recent developments

Within the four level model set out by the Lamfalussy report we are currently at the end of the first stage. The Solvency II Framework Directive is being prepared by the Commission services in cooperation with Finance Ministries, CEIOPS and other stakeholders. A first draft codifying the existing 14 Insurance Directive has been presented to EIOPC for consultation.

The final draft of the Solvency II Directive is expected for 10 July 2007. The process will then enter into the political decision making with the European Parliament and the European Council of Ministers. After the approval of the Solvency II Directive, which is estimated for Spring 2009, CEIOPS will be asked to advise on draft implementing rules.

The EU Member States will have time until end 2010 to implement the new framework into their national laws.



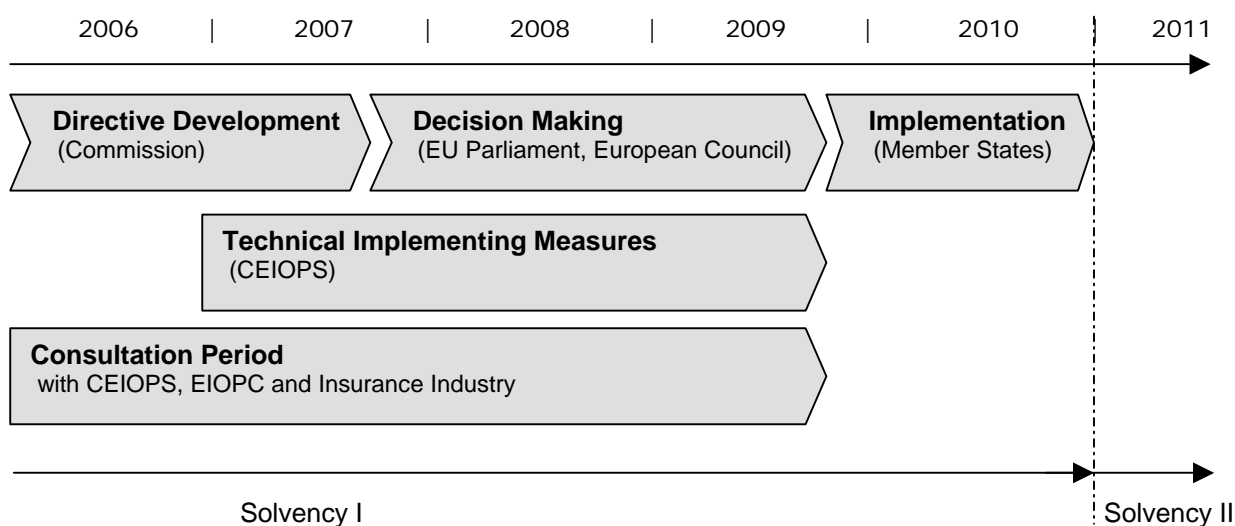
Summary

Solvency II is still at an early stage, however, with QIS III, the project enters into a crucial phase. The outcome of this study will determine how much money an insurance firm must hold as a cushion against potential risk.

This year the new framework Directive will be passed to the European Council and the European Parliament for adoption. The EEA Member States will then have time until the end of 2010 to implement Solvency II into their national laws.

Timeline

The following chart outlines the implementation process of the Solvency II regime:



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If you have any questions regarding this document please do not hesitate to contact Ivor Edwards on 020 7544 5488 or on 07738 697344.