



ADDLESHAW GODDARD

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Solvency II



A Step by Step Guide

What is Solvency II

Solvency II is the updating and further harmonisation of EU capital requirements for life and general (re)insurers using a risk based approach to capital requirements that is aligned to the specific risk profile of a firm. It moves away from the current focus on insurance risk (i.e. liabilities) to a "total balance sheet" type regime covering a range of risks including market risk, credit risk and operational risk.

The broad objectives of Solvency II are:

- the further integration of the EU insurance market;
- improving the international competitiveness of EU insurers and reinsurers;
- enhancing the protection of policyholders and beneficiaries; and
- promoting better regulation.

Solvency II - implementation

The Solvency II Directive (the **Directive**) is a framework directive, adopted under the so-called Lamfalussy process, setting out the principles to which the new system will be subject. More detailed implementing measures are currently being prepared by the European Commission (the **Commission**) together with the Committee of European Insurance and Occupational Pensions Supervisors (**CEIOPS**), market participants and Member States. It is envisaged that these measures will be finalised by 2010.

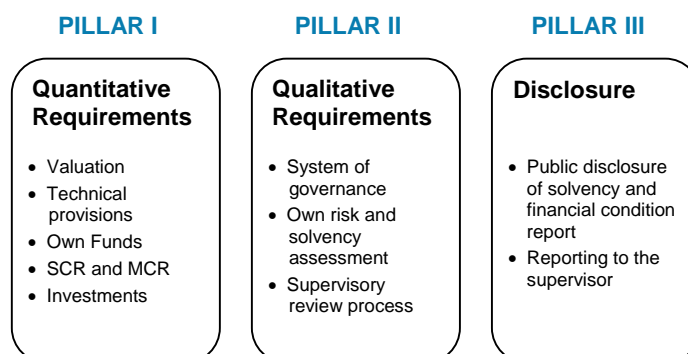
Member States will have to transpose the Directive into national legislation by at the latest 31 October 2012.

Application

Solvency II applies to all general and life (re)insurers established in the European Economic Area (**EEA**), including those in run-off, businesses at Lloyd's and captives. There are a number of exceptions, the most notable of which include small insurance undertakings and those reinsurers that had ceased to conduct new reinsurance business by 10 December 2007. The Directive requires the Commission to ensure implementing measures take account of the principle of proportionality, in particular to very small insurance undertakings and captives in order to reflect the nature and the complexity of the risks inherent to these businesses.

The 3-pillar approach

Solvency II is based on a three pillar approach which is similar to the Basel II Accord for the banking sector.



SOURCE: Addleshaw Goddard



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The concept of the pillars is to ensure sufficient capital adequacy, and that (re)insurers have sufficient foresight to anticipate and deal with potential risks which could have an impact on their capital requirements.

Pillar 1 contains the quantitative requirements. In addition to technical provisions, which cover expected future claims from policyholders, (re)insurers must meet two capital requirements: the Solvency Capital Requirement (**SCR**) and the Minimum Capital Requirement (**MCR**).

Pillar 2 covers qualitative requirements on (re)insurers such as governance systems and internal solvency assessments, as well as supervisory review and intervention processes. This is to enable the business to be much more proactive in dealing with solvency issues.

To enhance market discipline, pillar 3 requires (re)insurers to publicly disclose annual solvency and financial condition reports (transparency). (Re)insurers will also have to disclose a greater amount of information to their supervisors (reporting).

All these requirements apply to solo entities and (re)insurance groups. However, to ensure that the new regime is not too burdensome for small and medium-sized (re)insurers, the principle of proportionality will allow for a range of methods tailored to the nature, size and complexity of the (re)insurer.

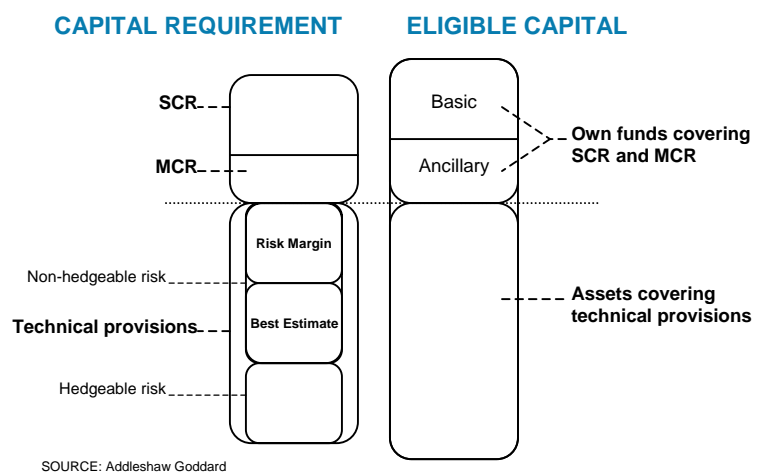
Pillar 1 - Quantitative Requirements

– Valuation of assets and liabilities

Both assets and liabilities should be valued at the amount for which they could be transferred or settled between knowledgeable willing parties in an arm's length transaction. With respect to liabilities, valuation standards do not take into account the firm's own credit standing.

The valuation standards are based upon the current IFRS definition of fair value and will be in line with international accounting developments (IFRS Phase 2 Project).

The calculation of the technical provisions will be based on their current exit level. A distinction is made between a risk that is hedgeable (i.e. a risk that can be effectively neutralised by buying or selling financial instruments) and a risk that cannot be hedged. A hedgeable risk is calculated directly, as a whole, and derived using the values of financial instruments. A non-hedgeable risk is calculated as the sum of a best estimate (i.e. probability-weighted present value of future cash flows) plus a risk margin which ensures that the overall value of the technical provisions is equivalent to the amount (re)insurance firms would be expected to require in order to take over and meet the insurance and reinsurance obligations.





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– Capital requirements

(Re)insurers will be required to hold capital to meet the MCR and the SCR. The MCR is a lower level of capital requirement. If (re)insurers fail to meet this requirement their FSA authorisation could be withdrawn. The MCR is to be calculated quarterly. The SCR should reflect all quantifiable risks that the insurer may face e.g. credit, operational, market, counterparty etc. It is envisaged that if the SCR is breached there would be an increased involvement by the regulator until such time as the solvency issue is rectified.

The level of the SCR is the amount of capital that a firm should have to cover all 1 in 200 year events. The SCR must be calculated annually and recalculated in the event of any material change to the business.

The SCR will, as part of its calculations, need to take into account, amongst other things, the various product lines, classes of business, the operational cost of the business, underwriting, market, economic conditions etc. Diversification should reduce the amount of the SCR by allowing a low capital loading class of business to counter balance a much higher capital loading class of business.

The SCR can be calculated in one of two ways:

- the standard formula – this formula will apply to all (re)insurers and will be used to calculate the types of risk, duration and frequency; or
- the internal model - this is a formula that can be used which is bespoke to the business as an alternative to the standard formula. A partial internal model is also possible which is part standard formula and part internal model. All internal models and part internal models will need to be approved by the relevant firm's regulatory supervisor. For the internal model to receive supervisory approval it will need to be of a sufficient quality and the assumptions used will require verification. The internal model will also take account of, for example, management decisions, benchmarking, and calibration etc.

The standard formula and the internal model will need to be embedded in the business and thoroughly documented. The internal model, if used, should be more efficient than the standard formula due to its bespoke nature. This may give firms using the internal model a competitive advantage over those that do not.

– Capital eligibility

The determination of the eligible amount of capital (own funds) that can be used to cover the MCR and the SCR requirements follows three processes:

Identification of availability of own funds: Own funds are the sum of basic own funds (i.e. on balance sheet items) and of ancillary own funds (i.e. off balance sheet items).

Basic own funds are comprised of the excess of assets over liabilities and subordinated loans. Ancillary own funds consist of items other than basic own funds which can be called upon to absorb losses, for example letters of credit or unpaid share capital. The determination of ancillary own funds is subject to supervisory approval.

Classification of own funds: The various items within the own funds will be classified according to their quality and ability to absorb losses. Thereby account must be taken of: subordination, loss-absorbency, permanence, perpetually and absence of mandatory servicing costs.

Weighting of own funds: As far as the SCR is concerned, at least one third of the total amount of eligible own funds must consist of Tier 1 capital and Tier 3 capital must not exceed one third. As far as the

Classification of own funds

Nature \ Quality	On the balance-sheet (basic own funds)	Off the balance-sheet (basic own funds)
High	Tier 1	Tier 2
Medium	Tier 2	Tier 3
Low	Tier 3	-

SOURCE: European Commission



MCR is concerned, Tier 1 capital must be higher than one half, and Tier 3 capital must not be accounted for. The "Tiers" of capital relate to the level of reliability attached by a regulator to the various forms of capital: Tier 1 being the most reliable capital followed by Tier 2 and then Tier 3.

Pillar 2 - Qualitative Requirements

– *System of Governance*

To ensure the protection of the capital adequacy on a current and on-going basis, a (re)insurer will be required to have in place an effective system of governance which should, as a minimum, include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities. The governance system should include compliance, requirements on risk management, own risk and solvency assessment, internal control, internal audit, actuarial function and outsourcing. It must be evidenced in writing and reviewed annually. The system of governance should be proportionate to the nature, scale and complexity of the operations.

– *Own risk and solvency assessment (ORSA)*

As part of its risk management system a (re)insurer must conduct its own risk and solvency assessment. This will be an assessment of the firm's solvency needs with a view to its specific risk profile, approved risk tolerance limits and business strategy. Included in this will be proper processes, up to date information, correct calibration as to how this forms part of business strategy, risk appetite and management actions. The ORSA will need to take into account the overall solvency requirements and the SCR of the (re)insurer on an ongoing basis whilst also taking into account economic conditions, the legal environment, market, technological changes etc.

As such, the role of the ORSA is twofold: It is an internal assessment process and a supervisory tool of the regulator to assess the current and ongoing solvency of the (re)insurer. To achieve this, the ORSA should be a formalisation of best practice in the business bringing about consistent management and regulatory reporting by way of informed business decisions and strategy.

The ORSA should be undertaken on a yearly basis or on a more regular basis if there is a material change to the business which puts its solvency at risk. Following the outcome of the ORSA, a regulatory supervisor may deem the proposed SCR to be inadequate and impose a capital add-on.

– *Supervisory review process (SRP)*

In addition to the ORSA, there is also the supervisory review process whereby firms will be subject to a risk-based review and evaluation of compliance of the firm. The regulatory supervisors will determine the frequency and exact scope of each review. The regulatory supervisors will need to be able to identify financial or compliance deterioration in the firm, both currently and potentially. Following the SRP, regulatory supervisors who are not satisfied with the proposed SCR may require a capital add-on.

Pillar 3 - Disclosure

– *Information to be provided for supervisory purposes*

(Re)insurers will be required to submit to their regulatory supervisors information which is necessary for the purposes of supervision. Solvency II introduces a number of key principles allowing implementing measures to ensure convergence in the Member States as necessary. In any case the information must include at least the information necessary for the regulatory supervisor to:

- assess the firm's governance systems, the business they are carrying on, the valuation principles they apply for solvency purposes, the risk faced and the risk management systems, their capital structure, needs and management; and



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- make any appropriate decisions.

- *Information to be provided for supervisory purposes*

(Re)insurers will have to publish an annual report on the solvency and financial condition (**SFC**), which will be available for public review. This should also include details of the capital management i.e. SCR/MCR and models used, basis and methods of calculation, risk exposure and consideration together with litigation and overall performance and guidance procedures. An exception will be possible in the case of capital-add ons for a transitional period. Firms will be allowed to avoid making public confidential information. This is a potentially contentious area for (re)insurers, especially in relation to confidentiality and anti-competitiveness.

Groups of (re)insurers

On group supervision, Solvency II contains a number of significant improvements. (Re)insurance groups, for example, will have a dedicated group supervisor that will enable better monitoring of the group as a whole. However, the notion of "group support" originally proposed by the Commission has been abandoned. Group support would have allowed groups to take advantage of group diversifications by recognising that, for a group, less risk capital is necessary than the sum of risk regulatory capital requirements across the local entities. A newly inserted review clause specifically mentioning this regime enables the Commission to make an assessment in 2015 of the benefit of enhancing group supervision and capital management within a group of insurance or reinsurance undertakings. It is expected that by then a more favourable economic environment will permit further reforms on cross-border co-operation between home and host supervisors.

Commercial implications

The implications in the UK for (re)insurers are, we believe, unlikely to be significant, at least in respect of the amount of additional capital likely to be required to meet the SCR. Additional regulatory requirements are likely to result in further corporate governance and systems and controls being needed, together with the work required in respect of the ORSA and the SRP. The greatest impact of Solvency II will be felt in the rest of Europe, particularly in those member states that have not, as yet, instituted any risk based capital requirements. The anticipated cost in the rest of Europe is likely to be much higher.

The Process Going Forward

Solvency II is a framework Directive and there is a substantial amount of implementation required both at EU and UK level. The FSA has started to consult on implementation. It is fundamental that as many people get involved in the implementation process as possible. The implications of Solvency II, although potentially not as significant for the UK compared to most of the rest of Europe, is still material.

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