



insurance

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briefing

December 2007

Summary

Solvency II aims to introduce a risk-based capital assessment and supervisory regime for European insurers and reinsurers. In this briefing we examine the key proposals in the Directive and outline the process of implementation.

understanding Solvency II

The European Commission has launched the revision of EU insurance law designed to improve consumer protection, modernise supervision, deepen market integration and increase the international competitiveness of European insurers and reinsurers. Under Solvency II insurers will be required to take account of all types of risk to which they are exposed and to manage those risks more effectively.

The aim of the new Solvency II regime is to ensure that insurance undertakings are financially sound and can withstand adverse events in order to protect policyholders and the stability of the financial market as a whole. The Commission recognises that the current solvency system is over 30 years old and that financial markets have developed significantly since then, leading to a large discrepancy between the reality of the insurance business today and its regulation.

The reforms have been driven forward as a consequence of the European Commission concluding that there are widespread divergences in the implementation of the existing insurance directives across the EU and ensuring that the insurance sector has a comparable regulatory and prudential regime to that of the banking and securities sectors in the EU. Under the current regime “regulatory arbitrage” exists therefore distorting the fully integrated European insurance market that had been envisaged under the Financial Services Action Plan.

Solvency II follows the reforms made to prudential standards in the banking sector under the Basel II Accord which was implemented into the EU by the Capital Requirements Directive (the CRD). In the UK the Financial Services Authority (FSA) has implemented the prudential standards in the CRD in the General Prudential Sourcebook. The same risk-based approach has also been applied to the Prudential Sourcebook for Insurers. The FSA’s prudential sourcebooks apply a modernised approach to risk management and it is largely expected that much of the potential impact of the Solvency II regime has been mitigated by the early introduction of these modernised risk management methods. However, the implementation of Solvency II by some Member States will require considerable changes both to existing regulations and to the way in which insurers and reinsurers conduct their operations.

Solvency rules stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed. The rules also lay down the principles that should guide insurers' overall risk management so that they can anticipate any adverse events and handle such situations more effectively.

The new solvency requirements have been designed to ensure that insurers have sufficient capital to withstand adverse events, both in terms of insurance risk (as under the previous regime), and now also in terms of economic, market and operational risk.

The consultative framework for Solvency II

Solvency II will be adopted in accordance with the "Lamfalussy" process. The Lamfalussy process takes a four-stage approach to the introduction of financial services regulation. In the first stage a framework directive is proposed (after a full consultation process) by the Commission and adopted using the "co-decision" procedure whereby the European Parliament and the Council agree on the directive. At stage two technical implementing measures are introduced. Much of the detail is added at this stage. The third stage involves work on recommended guidance and non-binding standards which are not included in the legislation. Finally, the fourth stage of the process requires the Commission to monitor compliance by Member States.

The first stage of the above process has now begun with the publication of the framework directive proposal.

Lamfalussy process and Solvency II

At level 1 the "Framework Directive" will be developed by the European Commission and the European Insurance and Occupational Pensions Committee (EIOPC).

At level 2 the Commission will call for advice from the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) on the drafting of technical implementation measures.

At level 3 CEIOPS will develop recommendations, guidelines and standards which are not covered by EU legislation.

At level 4, after implementation, the Commission monitors compliance with the EU legislation. It is possible for the Commission to take legal action in case of breach of Community law.

How is the Solvency II Directive structured?

Solvency II will be based on a “three pillar” framework. The pillar system originates from the approach taken in the implementation across the EU of the Capital Requirements Directive, which followed the international Basel II Accord for banks and investment firms.

Pillar 1 – minimum capital requirements

Under the first pillar insurers are required to maintain reserves against liabilities (technical provisions). A consistent market-based system is applied for assessing liabilities as well as ensuring a greater matching of assets to liabilities. Insurers and reinsurers must adhere to a Minimum Capital Requirement (MCR), which is the fundamental level of solvency required of any insurer. This has been set at an absolute floor of €1,000,000 for non-life undertakings and reinsurance undertakings and €2,000,000 for life insurance undertakings (Article 126). The calculation measures for the MCR have yet to be decided.

The capital that the insurer has to hold as a buffer in addition to its liabilities will be based on the insurers’ own risk-profile and should be subject to a confidence level in the range of 80 to 90 per cent over a one-year period. The MCR must be calculated “at least quarterly” and the results reported to the supervisory authorities.

The Solvency Capital Requirement (SCR) represents the target level of solvency which an insurer or reinsurer needs to maintain. It is a fully risk-based calculation which can be made either through a standard formula (given in the directive under Chapter VI, section 4) or by using internal models (or a combination of both). Basically the SCR is the amount of capital needed to leave a less than 1 in 200 chance of capital being inadequate over the forthcoming year.

The proposed Directive insists that insurers and reinsurers invest their assets in accordance with the “prudent person” principle and should be “invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole” (Article 129).

The Directive also introduces the concept of tiered capital which now exists in the banking sector (Chapter VI, section 3). The directive outlines three tiers of eligible capital.

Pillar 2 – supervision of risk

Insurers will be required to submit their own assessment of their risk and solvency capital adequacy. In addition they must submit details of their internal systems and controls. The internal risk and capital review process is subject to a regulatory supervision process akin to that introduced by the FSA in the “ICA” regime.

Should it be seen to be necessary, supervisors may add a “capital add-on”. It might be that the supervisor will request that further capital be injected into the SCR following the review process, although this should only occur when the supervisory authority concludes that the risk-profile of the insurer “deviates significantly” from the assumptions underlying the SCR.

Pillar 3 – public disclosure

The third pillar harmonises disclosure requirements. Insurers are required to report publicly on their financial condition, providing information on capital.

Solvency II		
Quantitative requirements	Risk management and supervision	Supervisory reporting and disclosure
<ul style="list-style-type: none"> • Minimum capital requirements <ul style="list-style-type: none"> – MCR – SCR (Standard model) • Eligible capital • Technical provisions • Asset valuation 	<ul style="list-style-type: none"> • Risk management • Internal controls • Corporate governance • Stress testing 	<ul style="list-style-type: none"> • Accounting standards • Regulatory reporting • Ratings agency review
Pillar 1	Pillar 2	Pillar 3

Group supervision

The current Insurance Groups Directive does not provide for a “group or lead supervisor”. Under Solvency II, groups will have a dedicated “group supervisor” with powers and responsibilities to organise the supervision of that group. This “group supervisor”, in co-operation with the other supervisors, will set the SCR for the group and its subsidiaries; it will validate the internal models and it will act as the central point for the effective supervision of the group.

The Solvency II regime introduces only a limited number of derogations to the provisions on “solo” supervision, leaving to local supervisors most of their tools and powers. In particular, local supervisors will keep full responsibility for the supervision of two essential elements at solo level (ie, technical provisions and MCR).

What happens next?

The reforms are in the early stages. The proposed framework directive will be passed on to the European Parliament and European Council for adoption (after any recommended amendments have been made). At the same time the consultation concerning the technical details of the implementing measures will continue. The deadline for implementation across the EU is 2012.

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Contacts

For further information, please contact:



David Whear
Partner
Norton Rose LLP
Tel +44 (0)20 7444 3361
david.whear@nortonrose.com



Noleen John
Legal consultant
Norton Rose LLP
Tel +44 (0)20 7444 3197
noleen.john@nortonrose.com

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