NEWSSTAND

Solvency II - An Update

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The Solvency II project has made significant strides towards implementation over the last year. Now that there is some clarity on what the new rules will look like, we review where we are in the process and consider some of the key issues that arise with the new regime.

Progress Check

As many readers are aware, Solvency II is being developed using the Lamfalussy process under which four 'levels' of legislation are created. The current status of each level can be summarised as follows:

- Framework Directive – the text of the Level 1 Framework Directive was adopted in November 2009.
- Implementing measures – the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) (the EEA body tasked with advising the European Commission (EC) on the detail of the Directive, particularly by preparing draft implementing measures) has provided all of its advice to the EC on Level 2 implementing measures. It is expected that this advice will be broadly adopted by the EC during 2011.
- Supervisory standards – CEIOPS will develop the Level 3 standards and guidance, to ensure consistent implementation of the regime. A limited amount of this guidance has been produced to date, with more expected over the next 12 months.
- Evaluation – following the deadline for implemen-tation by EEA Member States, the EC will monitor the transposition of the Solvency II regime across the EEA and take enforcement action where necessary.

CEIOPS will continue its work of calibrating the new requirements through the use of field-testing exercises, known as Quantitative Impact Studies (QIS). Since 2005, CEIOPS has been undertaking QISs to test the financial impact of Solvency II and the suitability of the proposed requirements. Four have been completed to date. A fifth QIS will be completed by November 2010 with results expected to be published in March 2011. Attention will then turn to completing the supervisory standards before the expected implementation date for the new regime of 1 January 2013.

Capital Requirements

The proposed capital requirements have caused concern in the EEA insurance sector. This is largely because, as a result of the recent financial crisis, CEIOPS' more detailed proposals are far more stringent than had been envisaged from the Directive alone.

The Directive sets down a minimum capital requirement (MCR) and a solvency capital requirement (SCR) that must be met by (re)insurance entities operating in the EEA. The MCR is calculated using a formula set out in the Directive and the SCR may be calculated using a standard financial risk model prescribed by the Directive. However, as each firm has its own unique business profile and operates in different markets, the Directive allows for the use of either a stand-alone unique model developed by the firm (known as an 'internal model') or an adaptation of the standard model to calculate the SCR.

The Directive's capital requirements must be met by a firm's eligible own funds. Own funds are separated into two types: basic own funds and ancillary own funds.

Basic own funds comprise the excess of assets over liabilities and subordinated liabilities (eg paid up share capital). Ancillary own funds consist of items other than basic own funds (ie that are not on the balance sheet) and which can be called upon to absorb losses. Ancillary own funds include, for example, unpaid share capital, letters of credit and guarantees or other legally binding commitments. The use of such ancillary own funds as capital is subject to prior supervisory approval.

Following the determination of whether funds are basic or ancillary own funds, the capital is then classified into three tiers depending on a number of factors. In particular, it is worth noting that ancillary own funds, such as letters of credit, cannot constitute the highest tier of capital.

CEIOPS has recommended that, as far as compliance with the SCR is concerned:

- at least 50% of the total amount of eligible own funds must consist of capital in the highest tier; and
- capital in the lowest tier can only constitute a maximum of 15% of the total amount of eligible own funds.

CEIOPS has also stated that, as far as compliance with the MCR is concerned, at least 80% of the total amount of eligible own funds must consist of capital in the highest tier.

The results of the fourth QIS, published in November 2008, showed that whilst the vast majority of undertakings (98.8%) would meet the MCR, 11% of participants would not meet the SCR. Most affected would be captives, of which over 28% would not meet the SCR. However, for the EEA insurance industry as a whole, no additional capital would be needed.

As noted above, a fifth QIS will be completed this year. The technical specifications for QIS5 were released in July 2010. Initial comment on these specifications is favourable - many commentators believe that the capital requirements have softened from QIS4 and that the EC has listened to (re)insurers' concerns. A sixth QIS may also be run by CEIOPS, however, this has not been confirmed.

Insurance Groups

Solvency

In addition to supervision at an individual level, Solvency II regulates groups of which authorised entities are a part. A key issue for an (re)insurance group will be to determine the level at which group supervision will be applied. This will usually be at the level of the ultimate parent undertaking of an insurance group, however, Solvency II does introduce the possibility of alternative supervision at sub-group level.

For groups headquartered in the EEA, full group supervision will mean maintaining solvency at group level (ie eligible own funds must be available in the group equal at least to the SCR of the group), preparing an annual group solvency and financial condition report and a group own risk and solvency assessment (broadly equivalent to the "individual capital assessment" required under the FSA's current rules for individual entities), and reporting of risk-concentrations and intra-group transactions. For these purposes, the group may include non-EEA and non-regulated entities, as determined by the relevant group supervisor.

Where a group is headquartered outside the EEA, the extent of the group supervision which will apply will depend on whether group supervision in the jurisdiction in which the group is headquartered is assessed as equivalent to Solvency II. If the local group supervision is equivalent, that regime will apply. If it is concluded that there is no equivalence either at the level of the ultimate parent or below, group supervision may be applied at the level of the ultimate parent company (in the same manner as for groups headquartered in the EEA) or may be applied more flexibly by Member States (for example, the group supervisor could insist that an EEA insurance holding company is established and group supervision applied from this entity downwards).

Supervision

The way in which (re)insurance groups are supervised under Solvency II will change. Most groups operating in the EEA will have a group supervisor. The determination of who takes on this role will depend on the structure of the group and whether the regime in the non-EEA jurisdiction in which the group supervisor is or would otherwise be located is regarded as equivalent to Solvency II. The group supervisor has responsibility for supervising the financial situation of the group and co-ordinating with the other supervisors who have an interest in the group (both within the EEA and outside). Together these supervisors make up the "college of supervisors". The organisation of the college of supervisors is very flexible and will depend on the requirements to supervise that group effectively at any given time. Any arrangement that the college of supervisors makes should be set out in a co-operation or co-ordination arrangement, CEIOPS being on hand to assist the college of supervisors, if required.

Equivalence

Equivalence is a key issue in the context of Solvency II, with those groups headquartered in non-EEA jurisdictions that achieve it gaining significant regulatory advantages in the EEA.

Under various parts of the Directive, the regulation that is applied by non-EEA states can be deemed equivalent to the Solvency II regime. This will be particularly useful for groups headquartered outside the EEA because, as discussed above, the fuller supervisory and solvency regime with regard to the worldwide (re)insurance group under Solvency II will not apply. Instead, reliance will be placed on group supervision in the jurisdiction concerned.

In addition to group solvency and supervision, the EC is also expected to determine the equivalence of non-EEA jurisdictions in respect of reinsurance. If a jurisdiction is deemed equivalent, Member States:

- will be required to treat reinsurance contracts concluded with undertakings having their head office in such a non-EEA jurisdiction in the same manner as reinsurance contracts concluded with an undertaking that is authorised in the EEA;
- cannot require the pledging of assets to cover unearned premiums and outstanding claims provisions; and
- may not require the localisation of assets held within the EEA to cover technical provisions relating to risks situated in the EEA, nor assets representing reinsurance recoverables.

The EC's timetable for the implementation of Solvency II envisages that, by the time the Directive comes into force, it will have made a determination of the equivalence of the most significant non-EEA jurisdictions.

CEIOPS recently published draft advice and proposed that in its first wave of assessments, Bermuda and Switzerland should be considered for equivalence under all relevant areas of the Directive and Japan in respect of reinsurance only. CEIOPS stated that *"advice on possible countries should focus primarily on the risk based nature of the third country regime and the materiality of an equivalence finding to EU insurance and reinsurance undertakings and their policyholders"*. When considering these factors, Bermuda, Switzerland and the US scored highly and were considered of importance to the EU market. Whilst the creation of the Federal Insurance Office in the US may alleviate some of the difficulties in making an assessment of US equivalence, these difficulties (for example, day-to-day supervision of (re)insurers remaining an individual state competence), combined with the resources required to undertake multiple simultaneous assessments, led to CEIOPS proposing not to undertake an equivalence assessment of the US at this stage.