Regulatory Reform - Solvency II Bulletin
May 2009

Level One Directive

- On 22 April 2009, after weeks of intensive negotiations between the Parliament, the Council and the Commission, the European Parliament adopted the text of the Solvency II Framework Directive. This text abandoned the concept of "group support" (See *Key Terms Explained*), which was included in earlier drafts and provided that part of the capital requirement for a subsidiary could be met by a guarantee that funds would be transferred from its group if needed.

Other Solvency II- Levels Two and Three

UK- FSA Materials

- In May 2009, FSA published the Feedback Statement 09/1 on its Discussion Paper 08/4 entitled *Insurance Risk Management: The Path to Solvency II.* This followed HMT and FSA joint discussion paper entitled *Enhancing Group Supervision under Solvency II*, which was published in April 2008.

  FS09/1 highlighted the following key points in relation to the newly adopted Framework Directive:

  - **the importance of firms having the right amount and the right quality of capital under Solvency II Level 2 requirements**, in order to achieve consistency with developments in the banking sector and in light of recent market events. FSA states that a low limit for Tier 1 capital would not be consistent with this objective.

  - **the need for convergence in relation to systems of governance and reporting requirements and the Own Risk and Solvency Assessment ("ORSA")**. The Framework Directive includes the possibility that additional Level 2 measures may be adopted to further specify the elements of the ORSA.

  - **the impact on firms of the various options for valuations of assets and liabilities**; notably the two options for valuations of non-insurance liabilities as set out in CEIOPS Consultation paper No 35

  - **the calculation of Minimum Capital Requirement ("MCR")** which under the new Framework Directive must not fall below 25% nor exceed 45% of the firm's Solvency Capital Requirement ("SCR"). This is a change from 20% and 50% respectively under previous draft texts.

  - **the provisions in the Framework Directive concerning lead (group) supervisors and supervisory colleges** which will be developed further under Level 2.

  Click here to view a copy of FSA Feedback Statement 09/1.

CEIOPS Materials

- In October 2008 CEIOPS issued a press release on the current financial crisis in the context of Solvency II indicating that it was reflecting on the "lessons to be learnt" for the proposed regime. In January 2009 CEIOPS also published a 2009 work programme for its Insurance Groups Supervision Committee ("IGSG") covering 19 different workstreams for Solvency II.

- Also in January 2009, IntMod published a "stock taking report" on the use of internal models which helps explain the differences between the UK's ICAS regime and the Solvency II rules on internal models.

- In March 2009 CEIOPS published for consultation its first set of advice on Solvency II Level Two Implementing Measures covering: methods and statistical techniques for calculating the best estimate, segmentation, counterparty default risk, own funds, treatment of future premiums, allowance of financial mitigation techniques, assumptions about future management actions, System of Governance, Transparency and Accountability, Valuation of Assets and "Other Liabilities", SPVs and the procedure to be followed for the approval of an internal model.

Key Terms Explained

The equity dampener- an adjustment mechanism included in the adopted text of the Framework Directive which seeks to address the problem of procyclicality described below. The design and functioning of the mechanism are to be determined at Level 2.

Equity risk- a Member State option included in the Framework Directive. Under this option, Member States may allow insurers to link the calculation of the capital charge for the risk of equity price falls to the duration of the liabilities and the typical holding period of the relevant equities.

Group support- regime set out in an earlier draft of the Framework Directives (Commission proposal 6996/08) whereby the required solvency (the solvency capital requirement or "SCR") for an individual insurer would be met in part by guarantee style commitments from the parent. Although the concept of group support was strongly advocated by UK government, FSA, and ABI and was also proposed by the European Commission, it was abandoned in the adopted Framework Directive following opposition by France and a group of 12 smaller Member States on the grounds that it could make them reliant on regulators in larger nations and that capital may not be transferred to subsidiaries when needed.

Internal model- an individual firm's own model/formula for calculating its regulatory capital and public disclosure requirements. This internal model must be approved by the relevant regulator. Firms not using an internal model must calculate SCR using the standard formula as set out in Solvency II legislation.

Procyclicality- the tendency for insurers' regulatory capital requirements to rise with downswings in the economy and to fall with upswings. The question is whether Solvency II legislation should include counter-cyclical measures to enable insurers to keep assets they are holding to meet their long term liabilities even through a period of market crisis.

QIS- Quantative Impact Studies which are essentially large scale field testing exercises to calibrate the requirements of Solvency II. Four such studies have been undertaken so far and a fifth is scheduled to start in June 2010.

Solvency II- Scheduled Timeline	
Summer 2009	Publication of Level One Directive in the Official Journal
July 2009	A further set of consultation draft advice on Level Two Implementing Levels
October 2009	CEIOPS approves for consultation draft advice on: - valuation of assets - approach to own funds - detailed design of the SCR and MCR - full and partial internal models - governance requirement - supervisory reporting and public disclosure - use of capital add-ons
Autumn 2009	A further set of consultation draft advice on Level Two Implementing Levels
September 2009	FSA Stage 1 Thematic Review will be published
June – November 2010	QIS5 - Possible Testing of Implementing Measures
H1 - H2 2010	European Commission drafts/consults on Level 2 measures
Q3 2010	FSA Stage 2 Thematic Review will be published
H1 2011	Adoption of the Level 2 Implementing Measures
2011	Member States and Industry prepare for implementation
31 October 2012	Solvency II comes into force

Internal Model Approval Provisional FSA Deadlines

June 2009 - Deadline for indication of intent to apply for internal model approval

April to June 2010 - QIS-5 exercise expected to form part of the qualifying criteria to enter the first dry run

July to September 2010 - Commencement of first model dry-run period

October 2011 - Receipt by FSA of first batch of dry-run submissions

April 2012 - Informal feedback on first batch dry-run submissions

FSA has stated that it cannot guarantee to reach a view in time for 31 October 2012 (planned Solvency II implementation date) on any submissions received after April 2012 (i.e. firms dry-running from November 2011)

Click for FSA Update on Solvency II Planned FSA Communications

Key Stakeholders

ABI- Association of British Insurers. The ABI has published two papers – Regulation and Markets for the 21st Century and The Insurance Industry: Rebuilding Confidence in Europe.

CEA- European Insurance and Reinsurance Federation (EU equivalent of the ABI)

CEIOPS- Committee of European Insurance and Occupational Pensions Supervisors which has 19 separate working parties focussing on different aspects of the Solvency II regime

FSA- Financial Services Authority

HMT- HM Treasury

INTMOD- The Internal Models Expert Group, the CEIOPS working party responsible for the development of an effective framework for the review and approval of internal models

Lamfalussy Process

Solvency II will be adopted using the four stage Lamfalussy Process:

- **Level 1 Directive-** contains the broad framework and core political principles as decided by the Parliament and the Council on the basis of a proposal from the European Commission.
- **Level 2 Implementing Measures -** Technical measures are adopted by the Commission with the assistance of a regulatory committee and an advisory committee. These committees help to ensure the provisions are up to date with market developments.
- **Level 3 -** Implementation of Level 1 & 2 in the Member States. National regulators work on coordinating new regulations with other states and the "level 3 committees" such as CEIOPS.
- **Level 4 -** Enforcement of the Solvency II regime.