



Solvency II and its impact on European Insurers – the new challenges and opportunities

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Background to Solvency II

Solvency II is the updated set of regulatory requirements for insurance firms that operate in the European Union.

The rationale for European Union insurance legislation is to facilitate the development of a Single Market in insurance services in Europe, whilst at the same time securing an adequate level of consumer protection. The third-generation Insurance Directives established an "EU passport" (single license) for insurers based on the concept of minimum harmonisation and mutual recognition. Many Member States have concluded that the current EU minimum requirements are not sufficient and have implemented their own reforms, thus leading to a situation where there is a patchwork of regulatory requirements across the EU. This hampers the functioning of the Single Market.

Solvency II will be based on economic principles for the measurement of assets and liabilities. It will also be risk-based system as risk will be measured on consistent principles and capital requirements directly on this requirement. While Solvency I Directive aimed at revising and updating the current EU Solvency regime, the Solvency II project has a much wider scope.

A solvency capital requirement may have the following purposes:

- To reduce the risk that an insurer would be unable to meet claims;
- To reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully;
- To provide supervisors early warning so that they can intervene promptly if capital falls below the required level; and
- To promote confidence in the financial stability of the insurance sector

Often called "Basel for insurers," Solvency II is somewhat similar to the banking regulations of Basel II. For example, the proposed Solvency II framework has three main areas (pillars):

- **Pillar 1** consists of the quantitative requirements (for example, the amount of capital an insurer should hold).

- **Pillar 2** sets out requirements for the governance and risk management of insurers, as well as for the effective supervision of insurers.

- **Pillar 3** focuses on disclosure and transparency requirements.

Solvency I vs. Solvency II

Since the introduction of the first Solvency framework in the early 1970s, sophisticated risk management systems have been developed. Solvency II introduces a comprehensive framework for risk management for defining required capital levels and to implement procedures to identify, measure, and manage risk levels.

The published timetable for Solvency II

2006

Analysis of QIS1 results

April CEIOPS delivers advice to the Commission on a “standard model” for determining insurers’ capital requirements

May Start of QIS2

July End of QIS2 exercise in companies

October First draft of Solvency II directive

Report on QIS2 Results

December Second draft legislation

2007

February Final draft legislation

July European Commission Solvency II proposal published

Start of discussion by European Parliament

2008 Early Estimated date for incorporation into EU law

TBA Completion of details of new regulations

Adoption into national laws of participating states

2009

Implementation of proposals

2012

New regime begins

Background to Sharon Bowles MEP

Sharon became Liberal Democrat Member of the European Parliament representing South East England in May 2005.

There are lots of committees operating in the EU, the main committee for financial services is the Economics and Monetary affairs committee. Sharon is a substitute member of the Legal affairs committee, and was a member of the committee enquiring into the demise of Equitable Life.

The parliament appoints a rapporteur and shadow rapporteur. Being very experienced at drafting is key to getting things through. In connection with Solvency II, Sharon is rapporteur in the legal affairs committee i.e the lead person in whether the commission has got it right in transposing. In the Economics committee she is shadow rapporteur for the Lib Dems.

How is solvency II progressing

A version came out in the summer of 2007, which is under review. However in recasts you are not supposed to make substantial amendments. Somewhere towards the end of this month the updated version will come along. There will be a months slippage but it has got to be dealt with this year 2008. There has not been huge amounts of discussion in the commission but plenty of “dinner table” discussions. Half are undeclared on where they stand.

The main issues and challenges of Solvency II

The basic proposal outlined above is very simplistic i.e. to replace the tick box approach to capital requirements with a risk based analysis similar to that which banking has done in Basel II. There was a broad based consensus to moving to risk based but some supervisors are not used to this approach. Recent articles that suggested people were going of risk based as a result of Northern Rock have not helped. Undoubtedly Northern Rock is embarrassing for the UK but will probably not affect the legislation.

So what is the internal model that will be used as the basis for supporting the risk approach? The capital will be calculated on the basis of risk – the solvency capital. The minimum capital requirement will be set, below which there will be intervention. One view is that the minimum capital requirement should be calculated separately from the solvency capital requirement. This view believes that it will help judges in courts to understand should any failing result in court cases. Solvency capital is supposed to be the best measure of risk you have done. The issue is will we be able to get it pinned down in order to get political agreement?

The next big issues is control of groups; i.e the idea that you can treat groups as a combined entity. There are host countries and countries where there are operating entities. For example the parent might be asked to send money to improve the capital of an operating subsidiary but it might not come this gives rise to difficulties drafting appropriate legislation. Again who ends up paying if there is a crash One particular EU member thinks all the decisions should be taken at the host supervisor rather than create a pan European supervision.

Comparisons with Banks operations keeps coming up; i.e. would this approach pave the way to what would happen in banking. There is a danger in this thinking in that the two markets are not the same. You just don't get a sudden “run” in insurance.

The final issue is the follow up on the report on Equitable Life, whose lessons mean there are places where we can make a few tweaks. For Example if a regulator is seriously negligent in some countries you can take them to court in others you can not. Thus we need to consider whether there should be a European right to reparation as consumers across Europe do expect to have similar rights.