

Solvency II Directive

After a lot of negotiation and amendments, the Solvency II Directive has now been approved by the European Commission, European Parliament and European Council and it must be implemented by national governments by 31 October 2012. The FSA are keen to ensure that UK insurers start thinking now about how Solvency II will impact them and have published Discussion Paper 08/4 "Insurance Risk Management: The Path To Solvency II" followed by Feedback Statement 09/1.

Background to Solvency II

Solvency requirements have existed for insurers in the European Union since the 1970s. The Third Insurance Directives acknowledged that solvency regimes should be reviewed. Solvency I, implemented in 2004, only tinkered with the existing regime on the margins. It was intended to be an interim measure whilst a comprehensive review of solvency requirements was carried out.

Solvency II is the result of this much wider review of solvency requirements. It is intended to reflect much more closely an insurer's overall financial position, business profile and risk management strategy. It is also intended to be consistent with concurrent developments in International Financial Reporting Standards and Market-Consistent Embedded Values.

Whilst the Solvency II Directive is the responsibility of the European Commission, most of the drafting and consultation on the Solvency II framework is delegated to the Committee of European Insurers and Occupational Pensions Supervisors (CEIOPS). CEIOPS is composed of high-level representatives from the insurance and pensions supervisory authorities of EU Member States.

The framework of Solvency II

Solvency II is based on a three pillar approach.

Pillar 1: Demonstrating adequate financial resources

Pillar 1 contains the requirements regarding the demonstration of solvency. The focus of much of the work done so far on this Pillar concerns the two capital requirements – the Solvency Capital Requirement (SCR) and



the Minimum Capital Requirement (MCR) – which represent different levels of supervisory intervention and hence are calibrated at different probabilities of solvency. The SCR is a risk-based requirement, calibrated such that the probability of remaining solvent after 1 year is 99.5% and is the main solvency control level. The SCR is required to cover all the quantifiable risks that an insurer or reinsurer faces over 1 year, and to take account of any risk mitigation techniques. The MCR is a lower (i.e. stricter) requirement and its breach is likely to trigger greater regulatory intervention including the withdrawal of authorisation to write new business.

In addition to the SCR and MCR, Pillar 1 makes other significant changes to the construction of an insurer's balance sheet. Technical liabilities must be valued at market value where these are observable. Where relevant market values are not observable, technical liabilities must be calculated as the sum of the best estimate liability and a risk margin reflecting the expected future cost to the insurer of holding sufficient capital to meet its SCR.

On the asset side of the balance sheet, assets must be valued at market value. Capital must be divided into tiers depending upon its availability to absorb insurance business losses. Restrictions are placed on the extent to which capital in the lower tiers can be taken into account when presenting the financial position under Solvency II.

The diagram below illustrates the structure of the balance sheet required by Pillar 1 of Solvency II.

Pillar 2: Systems of governance

The purpose of Pillar 2 is to encourage insurers to have effective systems of corporate governance and risk management in place. A sound risk management framework entails ensuring that there are sufficient management systems, controls and information in place to enable the Board to monitor the level of risk to which the insurer is exposed. The Pillar 2 requirements anticipate that large insurers will have in place a Risk Management Function, an Internal Audit Function and an Actuarial Function.

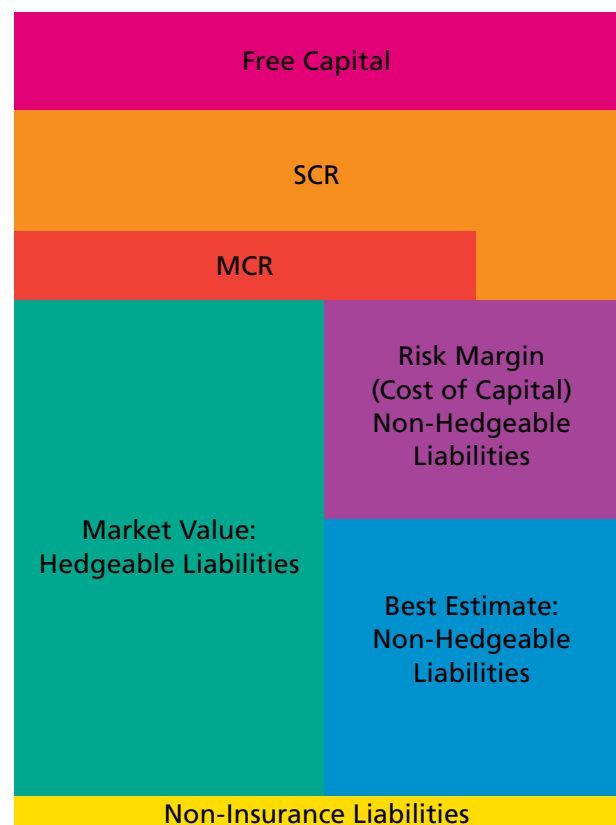
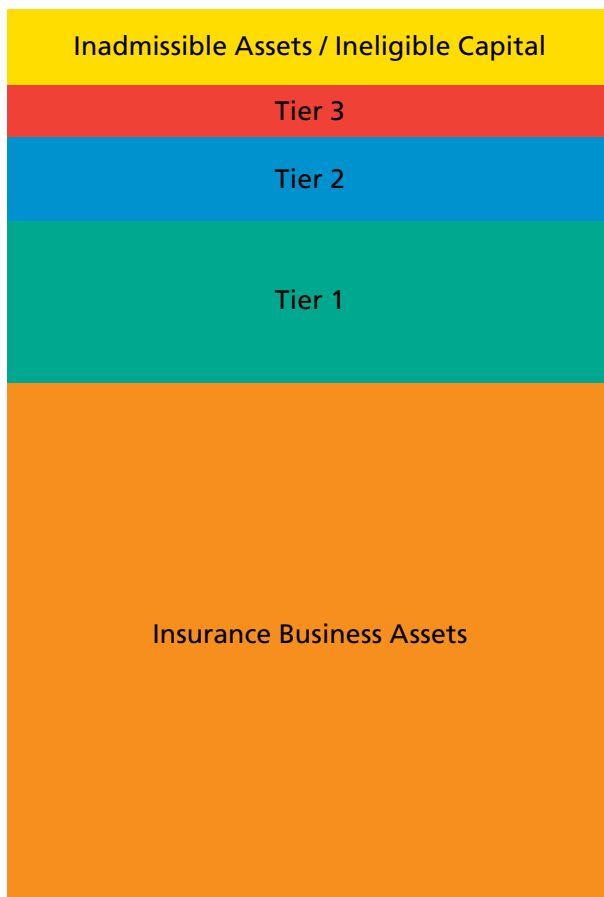
The Solvency II framework recognises that smaller insurers will not have the resources to create separate functions, and permits them to arrive at governance arrangements

that are proportionate to their business. This may include the outsourcing of these required functions, or retaining these functions within the responsibilities of the Board or senior management. Note that for general insurers in the UK, the requirement to have an Actuarial Function is a new development under Solvency II.

A key requirement being discussed under Pillar 2 is the Own Risk and Solvency Assessment (ORSA). As the name suggests, this process will be the insurer's own assessment of the risks inherent in its business and the capital required, giving due regard to their business profile, risk management framework, and quality of management systems, controls and information. The requirements of Pillar 2, and of the ORSA in particular, are intended to open up a dialogue with the regulator about the insurer's risk management framework.

Pillar 3: Reporting requirements

Pillar 3 covers both public and supervisory disclosure requirements. Little detail has been provided about this so far, but it is anticipated that the public disclosure requirements will be more extensive than under Solvency I particularly regarding insurers' risk management frameworks.



What does Solvency II mean for my firm?

Having been wrangling with the issues associated with the production of Individual Capital Assessments and Realistic Balance Sheets since 2005, the UK insurance industry may consider it has embraced the idea that risk management frameworks are a useful tool. For example the ORSA sounds very similar to the requirements of an Individual Capital Assessment, so UK insurers may be tempted to think that they are better prepared than other European insurers to implement the requirements of Solvency II.

However, the FSA have stressed that the standards required under Pillar 1 for Solvency II regarding internal models, risk management frameworks and governance procedures will be much more demanding than those applying to Individual Capital Assessments, and so they are keen that insurers start work on this now. And let's not forget, there are many UK insurers who have not had to produce Realistic Balance Sheets or Individual Capital Assessments. It seems that Solvency II will encompass a large number of UK insurers that have not previously had to worry about such in-depth analyses of their business, many of whom do not have the resources to allocate to such a big project. CEIOPS talk about the concept of proportionality in the implementation of the Solvency II requirements, but it has yet to be seen what form any such proportionality might take!

There is a temptation within the insurance industry to regard Solvency II as purely an actuarial issue. However, the requirements for Solvency II are clear that input and cooperation from many different functions within the insurer are required. Depending on each insurer's governance arrangements, functions that will be heavily involved will be Compliance, Risk Management, and of course the Board of Directors themselves, who will have ultimate responsibility for implementing Solvency II. We perceive that actuaries have at least two roles under Solvency II:

- Performing the quantitative calculations required by Pillar 1 and providing opinions on the insurer's underwriting policy, reinsurance strategy and risk management framework.
- Ensuring the other functions in the firm, most crucially the Board of Directors, are also embracing the concept of Solvency II, giving particular consideration to the requirements placed upon them by Pillar 2.

Can I avoid Solvency II?

Though it is expected to encompass a far greater number of insurers than the Solvency I regime, there are still some entities that are excluded from the Solvency II regime including:

- Insurance entities whose annual premium income is less than €5m and whose technical provisions are less than €25m. If either of these limits is exceeded for three consecutive years the entity will then be included in Solvency II with effect from the following year.
- Provident and mutual benefit institutions whose benefits vary according to the resources available, and whose member contributions are determined on a flat rate basis.
- Entities engaged in capital redemption business.

Companies in scope of Solvency II can fall out of scope if their annual premium income and technical provisions stay below the limits for three consecutive years and are expected to remain below those limits for the following five years.

If your insurance entity doesn't meet the exemption criteria, you will be required to comply with Solvency II. Even if your insurance entity's current financial position is such that you can expect to be exempt, you will need to consider how that financial position is likely to change in future as Solvency II applies to initially exempt smaller insurance entities if they do not meet the exemption criteria for three years.

What should I be doing in 2009 and 2010?

Gap analysis

It may seem that 2012 is a long time away, and the current financial turmoil may lead insurers to think that they have more pressing problems to deal with than a regime that is not going to come into effect for a few years yet. However, as pointed out by the FSA, work needs to start right away to ensure that models and governance procedures are brought up to the standard required when Solvency II comes into effect in October 2012.

One of the first tasks for insurers would be to perform a gap analysis of how their current processes fall short of the standard required by Solvency II. Though this task is greatly complicated by the fact that CEIOPS have yet to decide upon the wording of much of the implementation text and guidance that will herald the implementation of Solvency II, the FSA's Discussion Paper and Feedback Statement give some ideas of what insurers can be doing right now.

Internal models

When calculating their SCR, insurers have a choice of using a standard formula to quantify the capital requirements of each SCR component or building an internal model to quantify some or all of the components. The default approach is to use the standard formula to quantify the SCR, and both CEIOPS and the FSA are saying that any internal model that an insurer wishes to use to calculate SCR components will need to meet some very strict criteria.

UK insurers were required to indicate to the FSA by the end of June 2009 whether they intended to have an internal model approved to calculate some or all of their SCR components. It is widely anticipated that only the largest insurers will have the resources to commit to developing an internal model that will be sufficiently robust to meet the standard required. For those insurers who are planning to use an internal model, the FSA has invited them to join a pre-application process that begins in 2010 but has set insurers onerous criteria simply to enter this process.

However, models are not exclusively the domain of the larger insurers. Insurance entities of any size may be required by the FSA to produce internal models if the standard model is considered inappropriate for their business. Also, in order to comply with the requirements of the ORSA, it is likely that more insurers will have to build either a full or partial model rather than rely simply on stress testing, though standards for ORSA models might be less stringent.

Quantitative Impact Studies

CEIOPS has run a series of Quantitative Impact Studies (QIS) intended to assess the impact of Solvency II on insurance industries across the EU. The last of these was QIS4, which ran from April to June 2008. A total of 128 UK insurance entities took part in QIS4, and the total number of participating undertakings across the EU was 1,412. Based on the results of each QIS exercise, CEIOPS identify any problem areas with their current formulation of the requirements, and they develop revised requirements to be tested in the next QIS exercise.

As part of their preparation for Solvency II, the FSA are encouraging any UK insurers who have not yet completed QIS4 to do so as soon as possible. The FSA are keen to ensure that firms complete not only the quantitative assessment of their Solvency II balance sheet, but also answer the qualitative

questions that will help the insurer to identify the process gaps to be filled prior to the implementation of Solvency II in October 2012.

CEIOPS are scheduled to run QIS5 from June to November 2010. It is not yet known whether QIS5 will be mandatory for insurers across all EU Member States, or whether the FSA may separately decide that it should be mandatory for UK insurers.

Further information

The FSA's Discussion Paper DP 08/4 "Insurance Risk Management: The Path to Solvency II" should be read by all board members and senior management. This sets out what the FSA is expecting of UK firms between now and the implementation date of Solvency II.

CEIOPS are in the process of EU-wide consultation on the implementation of Solvency II. The volume of material being released is somewhat intimidating, but Barnett Waddingham can provide you with summaries tailored to your business. We can also compile reading lists and help you understand the potential implications for your business.

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