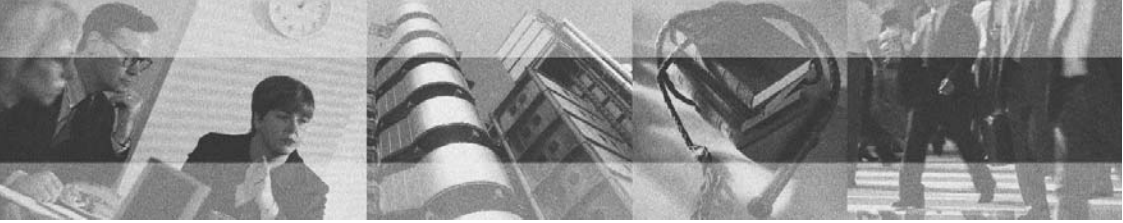

THROUGH THE LENS: WHERE BANKS LEAD INSURERS FOLLOW – BASEL II AND SOLVENCY II

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From 31 October 2012,[1] EU countries should have in place laws that oblige insurance companies to run their businesses by reference to the rules prescribed by Solvency II. The changes that insurers need to make in order to comply necessitate root and branch renovations to the calculation of capital adequacy and companies' risk management and reporting systems. As insurers know well, implementation is expensive and time consuming. Compliance costs hit small insurers particularly hard.

Although financial regulation is sector specific,[2] the architecture for the regulation of insurance and securities companies is based on the framework for the regulation of banks. Solvency I and II are built on the rules and principles developed by the Basel Committee. This Committee designed the global capital framework that prescribes the requirements that govern the operation of internationally active banks. The substance of that framework is applied across financial services.

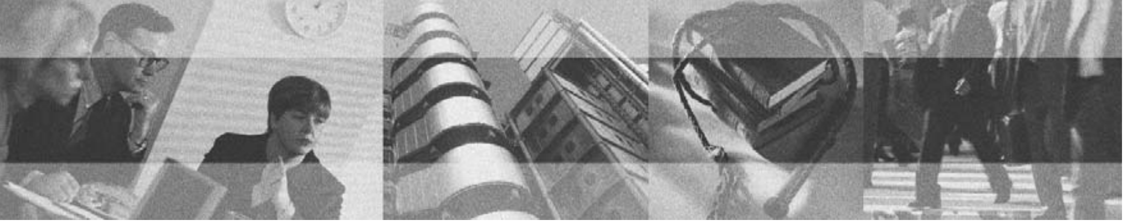
In the context of insurance, for the time being at least,[3] we have an EU wide (rather than global) framework by reference to which insurance companies are regulated and supervised. This framework has a great deal in common with Basel I and once Solvency II is in place, it will look much like an enhanced Basel II. The rationale for the regulation of banking, insurance and securities is broadly the same. The aim is to protect consumers and ensure systemic stability.[4]

Much frantic navel gazing has followed the near collapse of the banking system. Basel II[5] has come into sharp focus. One view is that the capital adequacy and regulatory framework prescribed by the Basel Committee has failed. It was unable to secure the stability of the international financial system. Another view is that the work of the Basel Committee had facilitated systemic stability since it was introduced and the improvements to the Accord (designed to address the increasing convergence of financial markets and the speed and reach of financial transactions) were simply not in place soon enough.[6] To its supporters, the recent crisis has highlighted the urgent need to enhance the nature and expand the scope of financial regulation.[7]

This article looks at the relationship between Basel II and Solvency II and considers the lessons learnt from what generous commentators describe as the recent economic turbulence. It aims to consider whether the march towards homogeneity in the global regulation of financial services is appropriate in the context of insurance and what it means for the industry.

Basel I[8]

Although it has recently gained a momentum of its own, financial supervision has historically developed as a response to crisis. Following the collapse of Bretton Woods in



1970, the G-10 industrialised countries set up a standing committee to address regulatory and supervisory practices in banks. The committee is based in Basel in Switzerland. Although the Basel Committee has no law making power, it is hugely influential. It formulates supervisory standards and guidelines that are implemented into national law across the world.

With the prize of worldwide financial stability its aim, the Basel Committee's chief concerns are threefold: (1) that no internationally active banks should fall through the supervisory gap as a result of operating in a number of countries; (2) that a bank's entire global operations should be subject to supervision; and (3) that there should be consistency in the supervision of internationally active banks. The Committee looks closely at capital adequacy as well as the internal organisation and regulatory supervision of banks.

In 1988 the Basel Committee produced the Basel Capital Accord ('Basel I') that laid down a framework for the international convergence of capital measurement and capital standards. Basel I introduced a credit risk measurement framework that prescribed a minimum capital standard of 8%. Internationally active banks subsequently applied the formula they prescribed. The Capital Adequacy Directive implemented it in the EU.[9] In addition, the Committee developed Core Principles for Effective Bank Supervision.[10] These set out the 25 basic principles that, the Committee concluded, must be in place to ensure effective supervision. Like the capital adequacy framework, the formula for the supervision of banks by national supervisors is in place throughout the world. Recent studies by the IMF indicate that overall, there is a relatively high degree of compliance with the core principles relating to the legal and institutional framework for supervision and the authorisation and conduct of business. Compliance with the principles dealing with risk management, consolidated supervision and the abuse of financial services is patchier.[11]

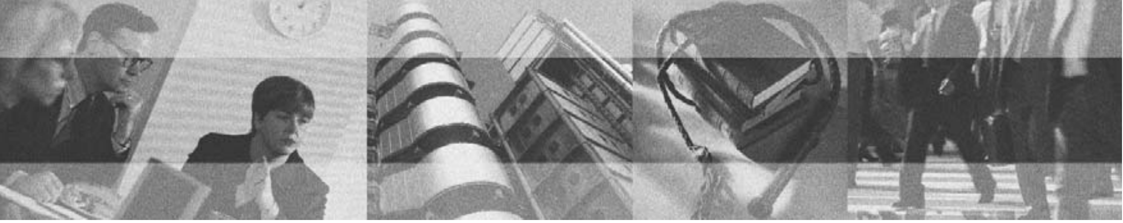
Basel II

As a result of deficiencies in Basel I highlighted by the Asian financial crisis during 1997/1998 and others,[12] as well as a feeling that Basel I was unable to capture and measure increasingly innovative financial products, amendments were made to the Capital Accord. After a long (eight-year) gestation period, the Basel Committee produced Basel II in 2004.[13] Its aim was to strengthen the soundness and stability of the international banking system by introducing a more comprehensive measure of risk and minimum standards for capital adequacy. The revised framework promotes a more comprehensive approach to capital supervision. It encourages banks to identify the risks that they face and improve their ability to manage those risks. The Capital Requirements Directive incorporated Basel II into EU law.[14]

The Financial Crisis – changes to Basel II

The financial crisis largely played out under Basel I. The credit crunch began in the summer of 2007 and was not a test of Basel II. Although it was released in June 2004, Basel II implementation in the EU had not begun until 2007. In the US Basel II has so far only been introduced by a handful of the largest banks that are operating internationally.

Although not a test of Basel II, the financial crisis nevertheless revealed significant



shortcomings in the new framework. Both the 2009 reports of Jacques de Larosière for the EU Commission[15] and Lord Turner for the FSA[16] endorse the view taken by the G-20 that urgent changes to Basel II and financial supervision are necessary. Led by the G-20, there is a move towards designing a new regulatory framework that aims to secure global financial stability. The intention is that this will span across financial systems.[17]

At the request of the G-20 Leaders, the Basel Committee is urgently looking at how to enhance Basel II to provide a more resilient banking system through a more sensitive assessment of risk. In particular it is looking again at how to deal with complex credit products, how to strengthen risk management and provide sound practices for managing liquidity.[18] The Basel Committee is now consulting and intends to produce what it describes as 'a fully calibrated set of standards' by the end of this year, to be phased in by 2012. The conclusions of the Committee will undoubtedly have implications for the insurance industry as the move towards consistent regulation and supervision across financial services gathers pace.

The Regulation of Insurance

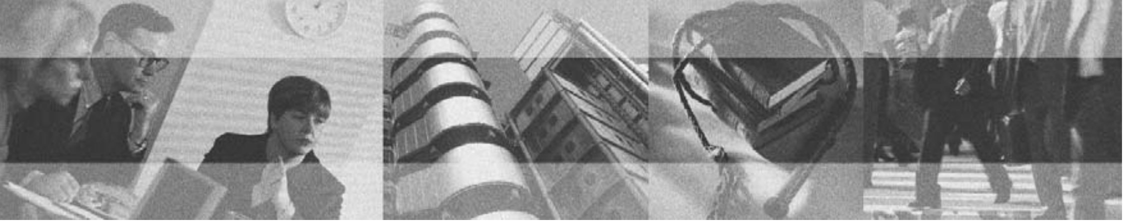
The widely held view is that economic stability cannot be secured by the operation of markets alone. Furthermore that economic stability can only be achieved by appropriate regulation and supervision. It is against this background that the Basel Committee was set up. Increasingly the general consensus grew that other financial services, insurance among them, required regulation and supervision. In the case of insurance this was for the benefit of policyholders and to secure systemic stability. It does also have benefits for internationally active insurers by streamlining regulatory compliance and its cost.

Even before the renewed drive towards the convergence of regulatory standards, the regulatory framework for banks and insurance companies had a great deal in common. Much of the framework for the regulation of the insurance industry is based on the work of the Basel Committee for Banks. The Basel Committee encouraged the establishment of the International Association of Insurance Supervisors ('IAIS') in 1994 and the International Organization of Securities Commissions ('IOSCO'). The IAIS describes its roles as (a) contributing to improved supervision of the insurance industry in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders; (b) promoting the development of well-regulated insurance markets; and (c) contributing to global financial stability.

IAIS currently represents insurance regulators and supervisors from 190 countries. It issues global insurance principles, standards and guidance based on a framework that looks very much like those produced by the Basel Committee for banks. It is tempting to say that where banks lead, insurers follow.

Solvency I

After the creation of the European Single market, EU countries ceded regulatory authority for insurance to the EU Commission. First directives were issued to deal with non-life insurance in 1973 and life insurance in 1979.[19] These gave insurers in one EU country a right to undertake insurance business in another member state. Legislation followed that covered all areas of insurance activity: insurance groups, financial conglomerates, insurance



mediation and reinsurance among them. Much of the legislation that has been enacted by the EU aims to achieve a free market within the EU by dismantling tax and regulatory barriers that had historically been in place.

So far as insurance company solvency is concerned, solvency margin requirements were put in place in the 1970s. By the 1990s and the third generation of insurance directives,[20] it was clear the EU solvency rules needed to be revised as the regulatory framework across the EU was very far from the level playing field that was intended. The Müller Commission[21] was set up to look at the regulation of insurance in the EU countries. On its recommendations, Solvency I[22] followed. Based closely on the Basel I framework, it was an effort to enhance the solvency and supervision of insurance companies in the EU and harmonise reserves. It was also a significant step towards a common framework for the regulation of banks and insurance companies in the EU.

Solvency II

Over time shortcomings in the Solvency I framework became apparent. Perhaps central among them is that the framework legislation has not achieved a level playing field for insurers across the EU. As a minimum harmonising regime, regulators in some countries have gold plated the requirements and differences do exist in the approach that countries take when implementing the directives. As a consequence insurers have shopped around and in some cases established their head office where they consider that the regulator has a lighter touch.

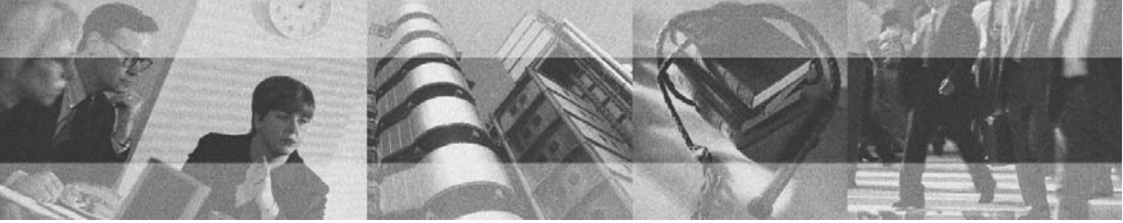
In May 2001, the EU Commission began a fundamental review of insurance regulation, the 'Solvency II' project. Developing alongside Basel II, a revised framework for the regulation of insurance was drafted and adopted by the European Parliament on 22 April 2009. The Council adopted the final text on 10 November 2009.[23] The intention was to build on Solvency I and design a more risk sensitive regulatory regime that would give insurers and supervisors an up to-date picture of risks that they face in order that they could address them in good time. Solvency II will replace the existing insurance directives. The detail is being developed with the Committee of European Insurance and Occupational Pensions Supervisors ('CEIOPS').

At the centre of Solvency II are risk based capital requirements and valuation techniques for insurers. The focus for regulators is an assessment of a company's risk profile and the monitoring of the quality of its risk management and governance systems. The ideas that underpin the present UK framework for the prudential regulation of insurance companies (ICAS) have plenty in common with Solvency II, but the detailed requirements are different.

Basel II and Solvency II

What they have in common and where they differ

Basel II and Solvency II have much in common. Like Basel II, Solvency II follows a three-pillar approach: capital requirements (Pillar 1), qualitative requirements (Pillar 2), and market discipline (Pillar 3).[24] Both are designed to create a prudential framework that affords a wider, more sensitive, assessment of risk that is embedded within the corporate governance



structure. Both are designed to promote market discipline by requiring disclosure and transparency. In the case of Solvency II, the intention is that the risk of an inability to meet claims in full will be reduced and supervisors will have a clearer view of problems and how to address them at an early stage. Both models aim to foster good regulatory relationships and transparency.

Although they have a great deal in common, there are differences. To some extent, these differences are there because the detail of Solvency II is being written with the benefit of lessons learned from the financial crisis. As the Basel Committee revise Basel II, it is likely that Basel II (or Basel III as it may be) and Solvency II will move closer together. As the frameworks stand, differences include the following:[25]

1. Both Basel II and Solvency II aim to set capital requirements by reference to the risk profile of, respectively, the bank or insurance company.

   The minimum capital requirement under Pillar 1 of Basel II is calculated using the definition of eligible regulatory capital and risk-weighted assets that was first set out in the Basel I capital adequacy framework. In broad terms, regulatory capital is divided into two types tier 1 ('core capital') and tier 2 ('supplementary capital') and each class of asset is given a weight. Very safe assets such as government debt have a zero rating.

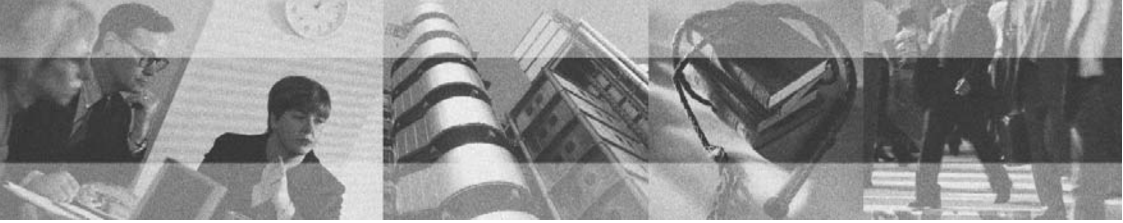
   Pillar 1 of Solvency II sets out the minimum capital required to meet the risks that an insurance company face. The determination of capital requirements has two standards; (1) the solvency capital requirement (SCR), which is intended to represent the target level of capital that the firm; and (2) the lower level, the minimum capital requirement (MCR), that indicates the absolute minimum level of capital below which authorization could be withdrawn (articles 126-129).[26] The MCR/SCR distinction is not part of Basel II. The intention is that SCR will provide an early warning system where an insurer's available capital falls between the SCR and MCR.

2. Basel II requires that a bank maintains regulatory capital that is equal to at least 8% of its risk-weighted assets, based on a measure of its credit risk, market risk and operational risk. The SCR is calibrated to be at a 99.5% level of confidence. This means that the probability of the capital being able to cover unforeseen risks over the net twelve months is at least 99.5%.

3. Pillar 1 of Solvency II sets out the valuation standard for liabilities to policyholders and measures the capital required to meet them. In addition to market risk, credit risk and operational risk, insurers are required to measure all quantifiable risks including underwriting risk and liquidity risk. The standard formula for the calculation of an insurers' capital requirement values individual risks and combines them to calculate the over all SCR (the so called 'bottom-up approach').

4. Solvency II aims for maximum harmonization across the EU. Basel II by comparison is designed to set minimum levels of capital for internationally active banks. National authorities are afforded a discretion to set additional capital requirements above the pillar 1 minimum.

5. Basel II is intended to apply to all banks that are active internationally. Solvency II's



application is limited to EU countries, although similar regulations may well be taken up across many parts of the world including Brazil and China.[27]

6. Solvency II aims to incorporate a measure of risk concentration and diversification.

   Basel II by comparison largely assumes a standard level of diversification across banks (although some diversification is allowed within trading risk and operational risk).

7. Basel II requires a banking group to calculate its capital at group level. Solvency II will require each entity to cover MCR. SCR is calculated at the group-level (see articles 218-231) using either the standard model or an approved internal model.[28] As a result of a last minute change to the Directive, Solvency II excludes the group level support regime. The regime would have allowed part of a subsidiary's SCR to be met by guarantees from a parent. It would also have introduced the concept of a dedicated group supervisor.

8. Unlike Basel II, Solvency II allows a full or partial internal model approach for the calculation of the SCR (articles 110-125).[29] Basel II only allows full internal model use for trading risk and operational risk.

Regulatory changes as a result of the financial crisis

The increasing convergence of financial regulation across countries and sectors

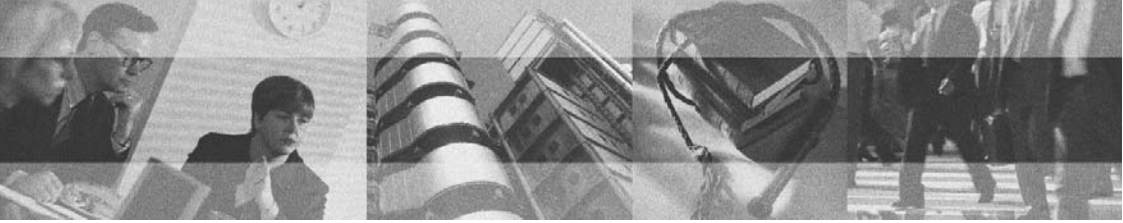
Insurance companies have been less affected by the financial crisis than banks. In large measure this is because they were not strangled by the sudden lack of liquidity. Few insurance companies have needed government support and those that have (AIG is of course the most significant), had exposure as a result of moving away from core insurance business towards a range of financial services products that looked very much like banking activities. In AIG's case, this included credit default swaps and residential mortgage backed securities.

Although the insurance industry survived the financial crisis largely intact, it has been undoubtedly affected by it and the renewed scrutiny of the regulatory and supervisory structure for banks will have very significant spin offs for insurers. The balance of this article looks at three areas of likely reform (1) moves towards the global conversion of regulatory standards; (2) corporate governance; and (3) remuneration.

Convergence of standards and core principles across banking and insurance

All of the recent significant reports that have looked at the global financial crisis conclude that there must be moves toward global standards for the regulation and supervision of financial services.

Although it focuses primarily on banks, the de Larosière report concludes that the risk map should go beyond the banking sector and include other major financial institutions like insurance companies and hedge funds. It recommends that this regulatory consistency across financial services be achieved by coordinating the work of the various international standard setters (among them IAIS and the Basel Committee). It is a sentiment that has the approval of the G-20, all of the international regulatory agencies and the IMF. The Financial Stability Board (the 'FSB') now has oversight of this convergence.



In September 2009, in light of the de Larosière Report, the EU adopted legislative proposals to strengthen the architecture for financial supervision in Europe. The legislation will create a new European Systemic Risk Board (ESRB) designed to detect risks to the financial system as a whole with a critical function to issue early risk warnings to be rapidly acted on. It will also set up a European System of Financial Supervisors (ESFS), composed of national supervisors and three new European Supervisory Authorities for the banking, securities and insurance and occupational pensions sectors.

In January 2010 the Joint Forum of the Basel Committee, the IAIS and the International Organisation of Securities Commissioners ('IOSCO') released a `Review of the Differentiated Nature and Scope of Financial Regulation'.[30] The Report was prepared at the request of the G-20 with the aim of identifying where systemic risks may not be fully captured in the current regulatory framework and identifying what needs to be done to strengthen the regulation of the financial system. Observations and recommendations in the report include the following:

(1) That a sector specific approach to regulation (across banking insurance and securities regulation) increases opportunities for regulatory arbitrage (that is, taking advantage of differences in the way that markets are regulated).

(2) The lack of a uniform global standard for capital adequacy within each sector contributes to regulatory arbitrage, competitive inequalities across jurisdictions and, in some cases, financial system instability. A global standard should be in place.

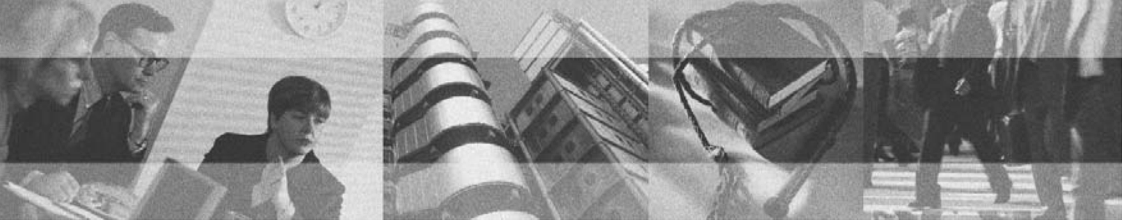
(3) In addition to making core principles more consistent across sectors, the Basel Committee, IOSCO, and IAIS should work together to develop common cross-sectoral standards where appropriate so that similar rules and standards are applied to similar activities, thereby reducing opportunities for regulatory arbitrage and contributing to a more stable financial system.[31]

(4) All financial groups (particularly those providing cross-border services) should be subject to supervision and regulation that captures the full spectrum of their activities and risks. These conclusions are likely to mean further convergence in the regulation of banks and insurance companies.

Corporate Governance

The Cadbury Report[32] provides a good definition of corporate governance when it describes it as 'the system by which businesses are directed and controlled'. The legal and governance requirements that impact on UK companies come from international agencies (such as the Basel Committee and the IAIS), the FSA, the Companies Acts and, in the case of listed companies, the Combined Code.

Regulators have had a key role in addressing corporate governance. It is already an important part of the regulation of insurance companies. The part of the FSA Handbook that deals with senior management arrangements, systems and controls emphasises the basic requirements of good corporate governance and is underpinned by principle 3 that requires firms to establish, maintain, and regularly review, appropriate systems and controls.



In October 2003, and based on the Basel Core Principles for banks, the IAIS adopted revised Insurance Core Principles. Core Principle 9 deals with corporate governance and provides that 'the corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.' Following the financial crisis, the Basel Committee and the IAIS are reviewing and revising their core principles to ensure that they are comprehensive and compatible. The Basel Committee on Banking Supervision, in its consultative paper on corporate governance for banking institutions, stated that because of their crucial role in ensuring systemic stability, minimum standards of corporate governance for banks should be more ambitious than that for non-financial firms.

Both Basel II and Solvency II aim to embed corporate governance in the management of companies. Article 41 of Solvency II contains the general governance requirements. It provides that:

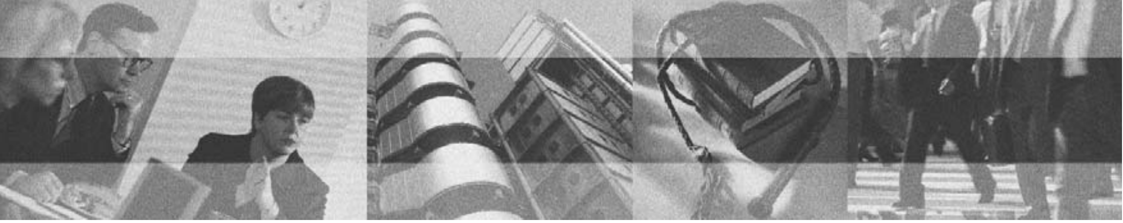
1. Member States shall require all insurance and reinsurance undertakings to have in place an effective system of governance that provides for sound and prudent management of the business. That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. It shall include compliance with the requirements laid down in Articles 42 to 48. The system of governance shall be subject to regular internal review.

2. The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.

3. Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing. They shall ensure that those policies are implemented. Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative or management body and be adapted in view of any significant change in the system or area concerned.

As a result of the financial crisis, an EU corporate governance forum has been set up that is due to release a report on corporate governance in financial institutions within the next few weeks. This initiative has wide reaching implications for the regulation and supervision of insurance companies. The landscape for the regulation of insurance companies is likely to move closer still to that of banks.

The '3L3 Task Force on Internal Governance' (TFIG),[33] is a committee comprising of representatives from the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and CEIOPS. It was created with the aim of exploring ways of promoting greater convergence of regulatory and supervisory practices in the area of internal governance.[34] The three committees have identified corporate governance as one of the six key pieces of cross sector work that is needed in order to address the shortcomings that the economic crisis has revealed in the regulation of financial services.



The 3L3 Task Force aims to (i) identify the consequences of differences between the banks, insurance and securities regulations and establish where those where those differences have a significant practical impact on institutions. The 3L3 Task Force will then make recommendations for Level 3[35] measures to enhance convergence; and (ii) develop cross-sector guidance for institutions operating in different financial sectors in the area of internal governance.

The report makes a number of recommendations for delivering a greater degree of convergence in EU regulatory standards across those three sectors. The main conclusions of the report are that:

(i) *regarding corporate structure and organization* – some of the details that stem from the conflicts of interest for a securities business could be extended to other sectors;

(ii) *risk management systems* – the detailed requirements of policies, processes and procedures for risk management could be further harmonised across all sectors;

(iii) *supervisory review, internal reporting and public disclosure* – there should be a better aligned framework across the three sectors.[36]

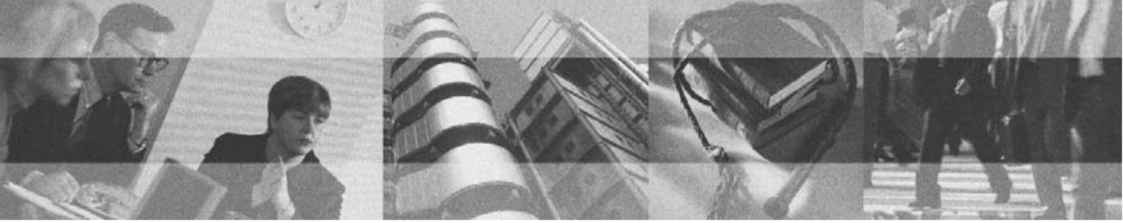
Sir David Walker recently reported to the UK government on the corporate governance of banks and other financial institutions in the UK. The Report concludes that the excessive risk-taking of financial institutions contributed to the financial crisis and makes 39 recommendations as to changes that should be made. Although it is primarily concerned with banks, Walker states that the issues and recommendations are relevant to other (primarily listed) financial institutions, such as life assurance companies.

For insurance companies, the Walker Review recommendations will need to be implemented in conjunction with the Governance requirements (Articles 41 to 50 and the approved CP 33) under Solvency II.

Remuneration

Under the umbrella of corporate governance, the recent reports into the financial crisis emphasize the role of remuneration. Two dimensions to this problem are identified:[37] one is the often excessive level of remuneration in the financial sector; the other one is the structure of this remuneration, notably the fact that they induce too high risk-taking and encourage short-termism to the detriment of long-term performance. In its bulletin following their meeting in Pittsburgh in 2009, the G-20 restated what it described as the commonly held view that 'excessive compensation in the financial sector has both reflected and encouraged excessive risk taking. Reforming compensation policies and practices is an essential part of our effort to increase financial stability.'

In addition to a review of the operation of the 3 pillars and a commitment to improve and bring about convergence of accounting standards and governance, the Financial Stability Board announced in September 2009 a need for reform of financial compensation practices across what it describes as 'significant financial institutions'.[38] The FSB considers compensation at significant financial institutions to be one factor that contributed to the global financial crisis. The FSB requires both the Basel Committee for Banking and the IAIS



to undertake all necessary measures to support the implementation of the standards that they outline. In broad terms these standards require that a compensation committee be established in each significant company to ensure that compensation rates are appropriate and aligned to long term value creation. The FSB are due to complete a review of the implementation of these principles in March 2010.

EU member states have agreed that the new standards should be reflected in the changes to the Capital Requirements Directive. In the spirit of consistency across financial services, the IAIS is developing revised supervisory standards on remuneration based on the FSB Principles.

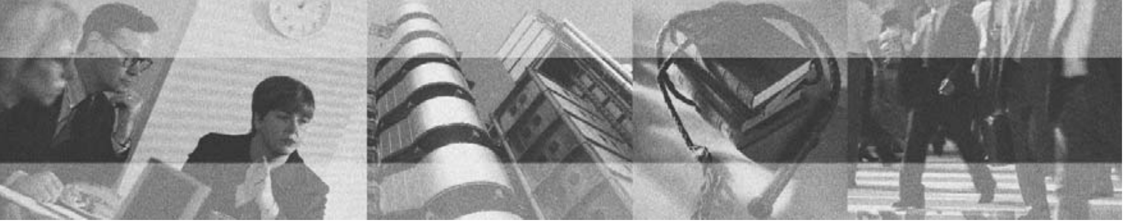
During August 2009, the FSA released Policy Statement 09/15 'Reforming Remuneration Practices in Financial Services'. This states at principle 1 that 'an overall remuneration policy that is in line with the undertaking's business and risk strategy, risk profile, objectives, values, risk management practices, and long-term entity-wide interests and performance should be adopted.'

The FSA's recently introduced regime in relation to remuneration does not yet apply to insurers and the Solvency II Directive does not specifically mention remuneration. Nevertheless, CEIOPS has said in CP 59 that it believes that 'the high-level principles of remuneration policies developed by the Committee of European Banking Supervisors are also generally applicable to the insurance sector'. In addition, CEIOPS draft Advice for Level 2, implementing measures on the system of governance, contains remuneration issues that should also be considered in the establishment of a system of governance. The sentiment, in substance, is that the fixed component of remuneration should be sufficiently high enough to allow a fully flexible bonus policy and payment of the major part of the bonus should contain a deferred component which reflects the 'nature and time horizon of the business'.

Concluding thoughts

The convergence of the regulations that apply across financial services has gathered pace as a result of the recent financial crisis. A risk is that the call for increasing consistency across the financial sectors[39] really means that the G-20 envisages that insurance companies will be subject to the same regulatory requirements as banks. There are clear challenges presented by financial groups and financial conglomerates but are the same rules really needed across the sectors? There is an obvious danger that we are missing the differences between banks and insurance companies and loading insurers with compliance costs that are to the detriment of consumers rather than their benefit.

Inaccurate risk assessment could arise if financial regulations are re-drafted entirely through a lens coloured by financial crisis. At the risk of re-stating the obvious, all financial sectors are not the same. Insurers are not banks. They have very different business models. Life and non-life insurance are different businesses and not all insurance businesses are of the size of AIG. Tempting though it is to draft financial regulations where one size fits all across industries and countries, it is not sensible.



Endnotes

[1] Unless the implementation date is moved.

[2] BCBS, IOSCO, IAIS have developed core principles for financial supervision in their sectors.

[3] The Joint Forum, in its report of January 2010, has called for global uniform frameworks across financial sectors. See the BIS website.

[4] 2006 BCBS Core Principles, 2008 IOSCO Core Principles and 2003 IAIS Core Principles.

[5] Basel II was implemented in the UK by the (Capital Requirements Directive).

[6] See page15 of de Larosière Report.

[7] G-20 in its report Enhancing Sound Regulation and Strengthening Transparency.

[8] The Basle Capital Accord.

[9] Directive 93/6 as amended by 98/31.

[10] September 1997. The Core Principles were revised in 2007.

[11] 'IMF Implementation of the Basel Core Principles for Effective Banking Supervision. Experience with Assessments and implications for future work'. 2 September 2008.

[12] Including the crisis in Russia in 1999 and the bursting of the dot com bubble in 2000.

[13] Basel II: International Convergence of Capital Markets and Capital Standard: A Revised Framework November 2005.

[14] Directive 2006/49.

[15] The High-Level Group on Financial Supervision in the EU Report February 2009.

[16] The Turner Review. A Regulatory Response to the Global Banking Crisis. March 2009.

[17] ' Towards a Global Financial Stability Framework', Herve Hannoun, Bank of International Settlements, 27 February 2010.

[18] The Basel Committee on Banking Supervision (BCBS) met in October 2009. It is developing a revised definition of capital to be assessed in a quantitative impact study this year. It also aims to improve the evaluation of counterparty risk, in particular with regard to OTC derivatives exposures. In July 2009 it produced revised rules in respect of trading book risks and securitization exposures. In addition BCBS are developing a mechanism for reducing the procyclicality of Basel II.

[19] Directives 73/239, 73/240, 79/267.

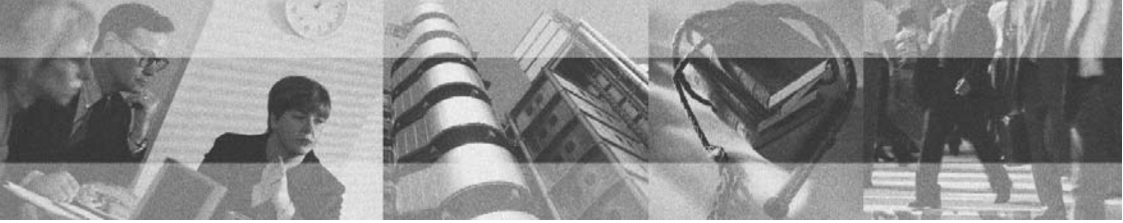
[20] Directives 92/49 and 92/96.

[21] Helmuth Müller et al. (1997) 'Solvency of Insurance Undertakings'.

[22] For non-life insurers it is set out in Directive 2002/13/EC. For life insurers it was set out in Directive 2002/12/EC, which was replaced by Directive 2002/83/EC.

[23] Directive of the European Parliament and of the Council on the Taking up and Pursuit of the Business of Insurance and Reinsurance (Solvency II) 2007/0143.

[24] EC, 2007b.



[25] See the CEA Note of 1 March 2005, 'Why Care Should be taken when using Basel II as a starting point for Solvency II'.

[26] EC, 2007a.

[27] The Swiss Solvency test (that has much in common with Solvency II) is in place in Switzerland.

[28] According to Recital 66 of the level 1 text of Solvency II,[28] it is necessary to determine which insurance undertakings fall within the scope of supervision at group level.

[29] Basel II permits a full internal model approach to be used for trading risk and operational risk only.

[30] A Review of the Differentiated Nature and Scope of Financial Regulation. Key Issues and Recommendations January 2010'. Produced by The Joint Forum comprising of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the IAIS.

[31] Page 12 of the Report op cit.

[32] Report of the UK Committee on the Financial Aspects of Corporate Governance page 11.

[33] See the Report dated October 2009.

[34] 3L3 Task Force on Internal Governance (TFIG) Cross-sectoral stock-take and analysis of internal governance requirements.

[35] Following the Lamfalussy approach, at level 3 supervisory committees facilitate the convergence of regulatory outcomes.

[36] At pages 4 and 5 of the Report.

[37] See page 30 of the de Larosière Report.

[38] 'FSB Principles for Sound Compensation Practices', 25 September 2009. The FSB is the successor to the FSF. It was established in April 2009. The Governor of the Bank of Italy chairs it. Its secretariat is located in Basel and it is hosted by the Bank for International Settlements.

[39] See page 33 and the recommendations in the Joint Forum January 2010 report that the core principles should be developed to make them more consistent across sectors.