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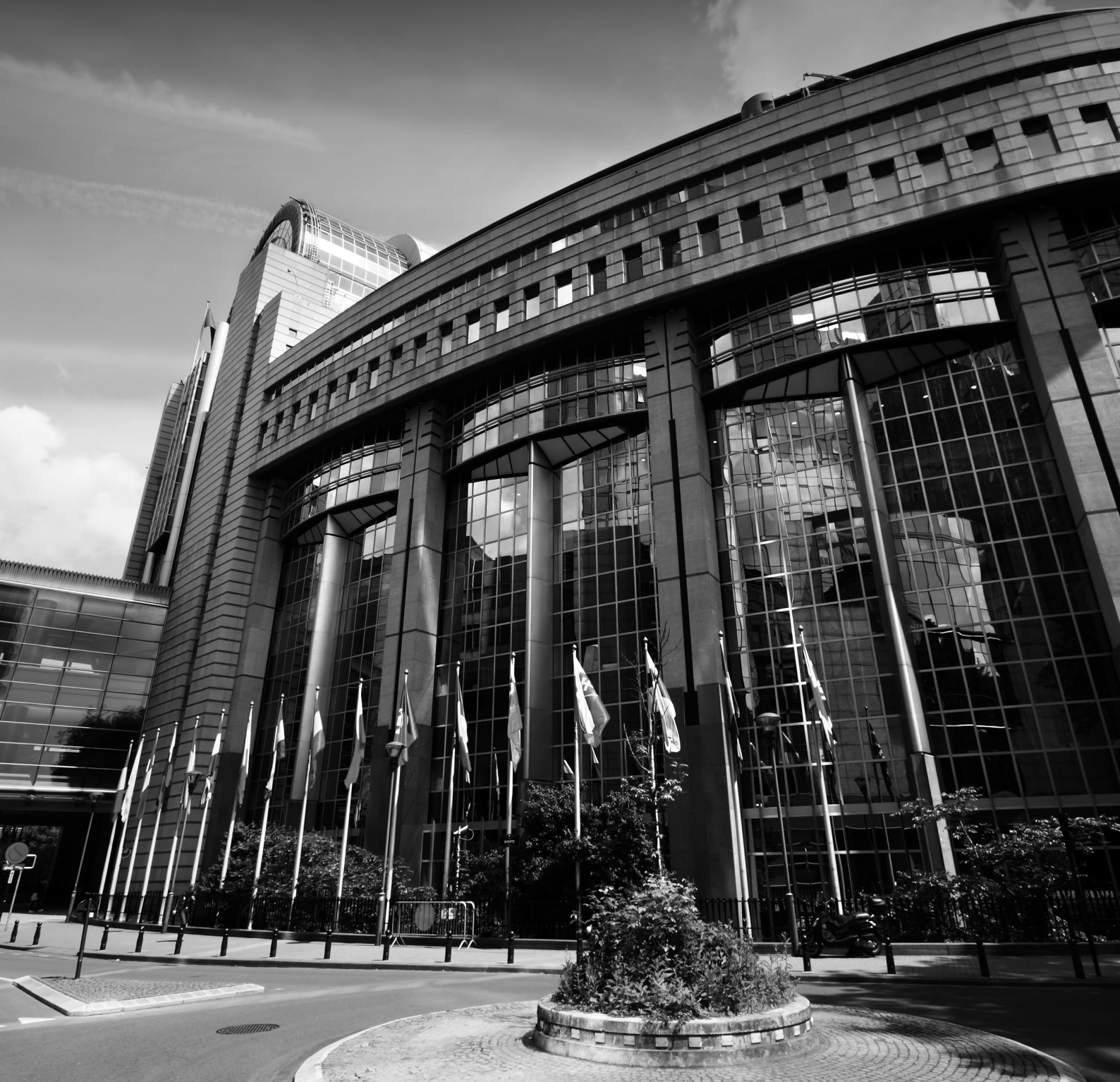
Solvency II

Ten things to know



Solvency II

The following ten things are important features of the new prudential supervisory regime for insurance companies which will take effect in the European Union. The timetable for implementation of the new regime is yet to be decided.

1 Risk-based capital

Solvency II is a risk-based capital regime, similar in concept to Basel II, based on three "pillars". Pillar 1 is a market consistent calculation of insurance liabilities and risk-based calculation of capital. Pillar 2 is a supervisory review process. Pillar 3 imposes reporting and transparency requirements.

2 Jurisdiction

Solvency II will apply to most insurers and reinsurers with their head office in the European Union (EU), including mutuals, and companies in run-off unless their annual premium income is less than €5 million. The directive should however be applied in a way which is proportionate to the nature, scale and complexity of the insurer. Solvency II will replace existing life and non-life directives, the reinsurance directive and various other insurance-related directives (but not the insurance mediation directive).

3 Timing

It is expected that Solvency II will be implemented for insurers on 1st January 2014 with much of the detail contained in directly applicable EU Regulation and guidance from the European Insurance and Occupational Pensions Authority (EIOPA). The original implementation date has been extended due to the time taken to negotiate some of the detail of the regime. The revised 2014 implementation date depends upon a fast-track directive proposed by the adoption of the Commission in May 2012. The regime will include transitional arrangements in a number of areas including the calculation of Solvency Capital Requirements and may include some grandfathering (e.g. of existing capital instruments).

4 Capital calculation

The calculation of insurance liabilities under Solvency II, known as technical provisions, includes a 'best estimate' of liabilities and a risk margin (where the liability is not appropriately hedged). Capital is known as 'Own Funds' and is divided into 3 Tiers (1-3) reflecting permanence and the ability to absorb losses. The risk based 'target' capital requirement, the Solvency Capital Requirement (SCR), will be calculated using either a standard model; a bespoke internal model that has been approved by the insurer's supervisor; or a mixture of both. The standard model will cover underwriting risk, market risk, credit risk and operational risk in a formulaic way. The calculation will be calibrated to seek to ensure a 99.5 per cent confidence level over a 1 year period which is said to equate to a BBB rating. There is also a Minimum Capital requirement (MCR) set at lower threshold (e.g. about 85 per cent confidence level). The MCR should not be less than 25 per cent of the SCR - and represents the minimum amount of capital insurers should hold. There is a 'ladder' of supervisory intervention built into Solvency II. Breach of the MCR is designed, unless remedied quickly, to lead to a loss of the insurer's authorisation. Breach of the SCR results in supervisory intervention designed to restore the SCR level of capital.

5 Assets

The detailed rules requiring investment of assets in a list of specified 'admissible assets' and the counterparty and asset limits contained in the current regime for EU insurers will be replaced by the 'Prudent Person Principle'. This will place responsibility for investment decisions and the need to try to match assets to liabilities on the insurer. The insurer's capital should then reflect its asset position. Some changes will also be made to the UK permitted links rules for unit linked contracts, which will apply in addition to the Prudent Person Principle.

6 Groups

There will also be a group SCR requirement - normally calculated on a consolidated basis. This can reflect diversification benefits but has the downside for EU headed groups of requiring them to calculate the solvency of non-EU subsidiaries on a Solvency II basis. It may, with supervisory approval, be possible to calculate non-EU subsidiaries' solvency positions using local rules - if the relevant jurisdiction is 'equivalent' under Solvency II rules. Non-EU headed groups with EU subsidiaries may also be made subject to Solvency II rules in relation to group SCR calculations if they are based in countries which are not 'equivalent.'

7 Risk mitigation

Solvency II insurers will need to comply with rules relating to risk mitigation techniques and reinsurance. For non-EU based reinsurers, if they are not rated as at least BBB and don't collateralise the reinsurance, they will need to be based in countries which meet the requirement of

'equivalence' for the cedant to be able to take credit for the reinsurance. Bermuda and Switzerland are expected to have been assessed as fully equivalent prior to Solvency II implementation. Japan is expected to have been assessed as equivalent for the purposes of reinsurance only. It is also expected that there will be a period of transitional equivalence for other countries moving towards a Solvency II type solvency model.

8 Governance

Solvency II imposes formal governance requirements, mandating roles such as a risk management function, an independent audit function, an actuarial function and a compliance function. The insurer's processes for risk management should be set out in an Own Risk and Solvency Assessment (ORSA). The ORSA should include a risk-based assessment of the insurer's solvency needs based on its business and its own risk appetite and must be taken into account in running the business. The relevant supervisor will review this as part of the Pillar 2 process. Solvency II also imposes requirements in relation to outsourcing and remuneration.

9 Reporting

Pillar 3 requirements under Solvency II will be a mixture of EU mandated requirements and FSA requirements. They will include a private Regular Supervisory Report (or "Report to Supervisors") to be provided on a regular basis appropriate to the nature and size of the insurer. There will also be a public annual report called the Solvency and Financial Condition Report (SFCR) which will include both narrative and numbers (in a specified format). It is expected that the calculation of technical provisions in the UK will be subject to an audit requirement.

10 Supervision

The role of the insurance supervisor is very important and the success or otherwise of Solvency II will, to a large extent, be dependent on its implementation by insurance supervisors in a consistent manner. Part of the process, the Level 3 guidance to be given by EIOPA, is expected to try to cover the detailed areas where there could be a divergence of practice. The directive also contains provisions relating to establishment and operation of the college of supervisors. It is intended that in group situations the relevant supervisors, led by the group supervisor, will co-operate and act in a co-ordinated manner.

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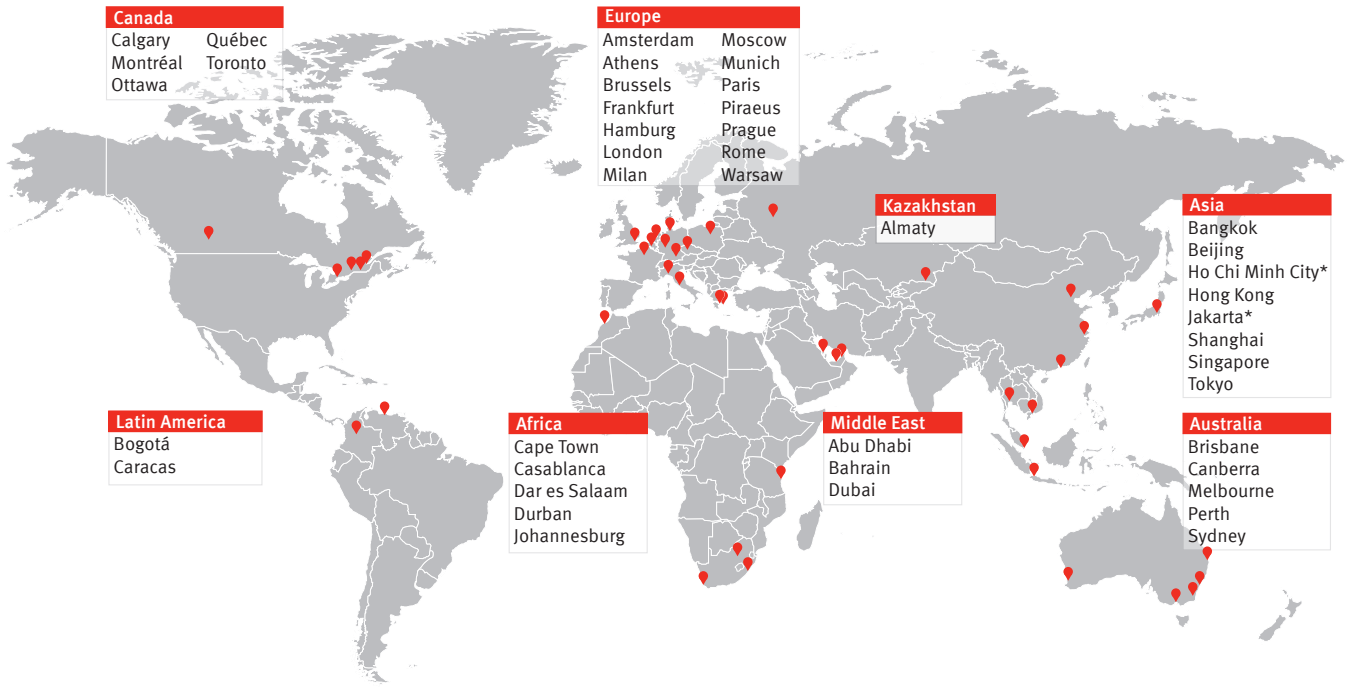

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