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SOLVENCY II—WHAT IT MEANS FOR REINSURERS

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What is Solvency II? Solvency II is a radical overhaul of the European regulatory regime for insurers and reinsurers. Its proponents, as well as U.K. and E.U. industry bodies, believe that it will increase customer protection and international competitiveness across European markets. It will apply to insurers and reinsurers alike and the references in this article to insurers also include reinsurers.

Solvency II will introduce a risk-based approach for the calculation of insurers' regulatory capital, so that the level of capital which each firm is required to hold is tailored to the risks that firm faces.

National regulators will continue to be responsible for prudential supervision in each member state of the European Economic Area. Solvency II intends to create a uniform set of rules which the national regulators will apply.

What Has Been Agreed?

Following sufficient consensus amongst member states on the outline of Solvency II, the European Commission produced the draft Framework Directive in July 2007. The Framework Directive describes some important characteristics of the new regime:

(a) regulation will be about more than a capital buffer; it will also cover risk management;

(b) a firm's solvency requirement will be based on specific risks that firm faces;

(c) the solvency requirement will reflect a firm's insurance liability risk, but will be sensitive to all risks;

(d) there will be three pillars of regulation:

  (i) rules to define liabilities and the admissible capital to cover them;

  (ii) self-assessment by firms of their risks and solvency need followed by a regulatory assessment and (possible) adjustment;

  (iii) disclosure to the market as a means of maintaining discipline; and

(e) the regulation of insurance groups will change.

For now, we do not know what the detail of the regime will look like. However, the regulators have reached agreement on its shape and the insurance industry is broadly happy with it.

Where Will the Detail Be Found?

The European Commission will add much of the detail of Solvency II in technical implementing measures. In drafting this detail, the European Commission consulted with CEIOPS, a committee comprising the national insurance regulators of the member states. CEIOPS has been asking firms to simulate the effect of the proposed legislation on them. The responses are collated and recorded in CEIOPS' Quantitative Impact Studies (QIS). Over 1,000 firms took place in the last QIS in 2007, covering more than 60 percent of the market in most countries.

What Capital Will Insurers Need?

The new capital requirement starts with the "non-zero failure principle." Firms will not be required to hold sufficient capital to eliminate the risk of them ever becoming insolvent. They must hold enough capital to reduce this risk to below the agreed threshold of a one-in-two-hundred chance of failure over a 12-month period.

Capital Requirements

One of the most important features of Solvency II is the level at which insurers will have to maintain capital. This is called the Solvency Capital Requirement (SCR).

By the time a firm breaches its solvency margin under the current EU rules and triggers regulatory intervention, it is likely to be too late for effective remedial steps. Accordingly, a number of EU regulators have imposed stricter standards than the current European minimum, leading to a patchwork of differing solvency requirements across the EEA.
Solvency II intends to set the SCR at a high enough

level that regulators intervene earlier, in time to supervise the firm's recovery.

Two important features of Solvency II contribute to the SCR. The first is that the SCR will be based on the risks actually faced by the firm. The current rules apply mechanical formulae to historic premiums and claims information. Under Solvency II the SCR will be forward looking and will take into account not only insurance risk, but also the particular market risk, credit risk and operational risk that a firm faces.

The second feature is that firms will be able to calculate their SCR using a standard formula or by reference to their own internal risk models. Before a firm is allowed to use its internal risk model, the model will have to be validated by the firm's national regulator.

It is also intended that there will be a trigger for serious regulatory intervention called the Minimum Capital Requirement. The level at which the MCR will be set is under discussion.

What Form Will The Supervisory Review Take?

National regulators will be actively involved in the calculation of a firm's SCR. An insurer will carry out a self-assessment of its capital needs based on a detailed review of its risks. This self-assessment will be known as an Own Risk and Solvency Assessment or ORSA. The national regulator will review the ORSA and notify the insurer whether it thinks the insurer's calculation is adequate, and if it is inadequate will indicate the extent to which the regulator regards it as insufficient.

If the national regulator thinks that an insurer's corporate governance, systems and controls and risk management are inadequate, the regulator will be able to require the insurer to put more capital in place. This process is inherently very subjective. Will regulators adopt and apply a consistent approach to validating ORSAs throughout the European Economic Area?

Group Supervision

Solvency II will introduce a new regime in relation to the supervision of insurance groups. The new rules will shift the focus from imposing additional regulation to one which recognizes the benefits that insurance groups can present.

The current regime seeks to ensure that groups do not make multiple use of the same capital. To that end, each insurer within a group must report the solvency position of the group as a whole and of various sub-groups within it.

Many commentators consider that large groups with diversified risks will be the main beneficiaries under the new regime. The European Commission believes that medium-sized niche insurers will continue to thrive, provided they have sufficiently strong governance and risk management systems.

Solvency II seeks instead to recognize the benefits of diversification and pooling of risk which occur within groups. In particular it will be possible in certain circumstances for parental support declarations to count towards subsidiary SCRs.

When Will These Changes Come Into Effect?

The deadline for full implementation set out in the Framework Directive is Oct. 31, 2012. Whether this can be achieved will depend on the speed of the proposal's passage through the European legislative process and on agreement over the detailed implementing measures.

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Will Insurers Need More or Less Capital?

The SCR is tailored to each firm based on its particular risks, so the effect on firms will vary. The latest QIS (QIS3) contains some interesting findings on this:

(a) for 30 percent of respondents, the SCR results in an increase of more than 50 percent to their surplus available under the current rules.

(b) for 37 percent of respondents, their surplus shrinks by more than 50 percent when the SCR is calculated.

(c) 16 percent of respondents would need to raise additional capital to meet their SCR.

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There will be an additional administrative burden for firms to bear in digesting and adapting to the new requirements. It is likely that smaller firms will find this cost harder to absorb. These factors may well lead to consolidation in the European insurance market.

How Will U.K. Insurers Have To Adapt?

It is tempting to look at the regime proposed by Solvency II and to conclude that the U.K. regime is already largely in line with the new rules. Since the end of 2004 U.K. firms have, after all, submitted individual capital assessments to the FSA.

However, the capital models adopted in the United Kingdom under existing rules may not quite bring firms into line with the requirements of Solvency II. They have been designed for the valuation of assets and liabilities. Under Solvency II they must also cover day-to-day risk management decisions. In addition, under Solvency II a firm must show that its internal model is widely used in the actual running of the firm before it is approved.

An important difference is that the FSA introduced its existing requirements relatively informally and had discretion to give firms time to adapt. It is likely that Solvency II will require its provisions to apply with full effect on implementation.

The Challenges Ahead

The Framework Directive seeks to achieve a common approach, but there are a number of areas which will be left to the judgment of national regulators. Consistency of approach at a national level is an important target but will not be measurable for some time. ✷