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Contents

Introduction	1
Project objectives	2
The Lamfalussy process	3
Main features of the new regime	5
Pillars two and three (collectively referred to as 'pillar five')	13
Third country (re)insurance companies and groups	19
Glossary	21

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Introduction

The prudential regulation of insurance and reinsurance ((re)insurance) companies across the European Economic Area (EEA) is due for radical modernisation from October 2012, including a review of the insurance industry's solvency framework. This follows the adoption in November 2009 of the Solvency II Directive (the Directive) and its publication in the Official Journal.

One of the primary aims of the Directive is to produce a more consistent solvency standard that will protect consumers across all markets. It provides the legal foundation for the new regime and replaces the current regime, Solvency I. This practice note outlines progress on the project to-date and how it may evolve over the next few years.

A glossary of new or difficult terminology is included at the end of this note.

Project objectives

The UK government originally identified the main objectives of the Solvency II project as:

- deepening integration of the market;
- protecting policyholders and beneficiaries;
- improving the competitiveness of the industry in Europe; and
- promoting better regulation.

The Directive identifies protecting policyholders as the main objective of supervision. This has also been the driving force behind many of the amendments that the EU Parliament has made.

More recently, however, there has been a particular focus on the lessons that the financial crisis may teach us. For example, article 28 of the Directive now requires consideration of ‘the potential impact of [supervisors’] decisions on the stability of the financial systems concerned in the EU, in particular in emergency situations’.

The Lamfalussy process

Level one

The Solvency II regime is being adopted under the Lamfalussy process. This is a four-level structure often used for European legislation in the financial services sector.

The text of the level one Directive agreed in April 2009 and adopted in November 2009 in theory contains the regime's main outlines and high-level principles. Agreement on this text was arrived at between the European Commission (the Commission), the Council of the European Union (the European Council) and the EU Parliament.

Level two

Further detailed measures at level two will also be required to supplement the Directive in a number of areas. Some of these will be further directives adopted by the Commission, which member states will need to transpose into their own legislation, as with the level one Directive.

The Commission is keen, however, that at least some implementing measures will be regulations that are directly effective in the law of member states. These may therefore leave less scope for member states to adapt the regime to their own insurance markets. The Commission considers that another advantage of regulations over directives is that they avoid some of the common problems arising in the financial sector when member states are late in implementing directives.

There will be much less scope at level two for disagreement between the Commission, the European Council and the EU Parliament to hold up the legislative process.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) consulted on level two measures in the course of 2009. Most of these consultations have now resulted in final advice to the Commission.

The Commission intends to present its own level two proposals in autumn 2010. It is expected to follow CEIOPS' advice in most respects, but it may not always do so.

Level three

The level two directives and regulations will in turn be supplemented by non-binding standards and guidance that CEIOPS itself will adopt at level three. CEIOPS' consultations usually include sections in normal 'white text' discussing the issues, followed by sections in blue containing the draft advice on level two measures. Some of the white text in the consultation papers is expected to be transformed into level three guidance. CEIOPS began to consult on level three guidance at the beginning of 2010.

Level four

The Commission will review how member states comply with the regime at level four. It will take enforcement action if, for instance, any member states are late in transposing the level one and two directives or transpose them in an unsatisfactory way.

How the Lamfalussy process applies in practice

The Solvency II level one Directive, however, falls well short of realising the Lamfalussy ideal. In a number of areas, including group supervision, it is highly detailed. There is limited scope for revising this material other than by a further level one directive. The text of the level one Directive also reproduces word for word many arguably obsolete provisions from the old Solvency I regime. Again there is limited scope for revising the detail.

In other areas, by contrast, such as own funds (more commonly referred to as regulatory capital in the UK), the level one text is so high-level that the substantive debate is beginning to take place only in the context of the level two rules.

Main features of the new regime

Introduction

Compared with the old regime, the new one is intended to:

- be more consistent with best market practice;
- be better harmonised across Europe, rather than just setting minimum standards; and
- apply modern risk management, actuarial, accounting and governance standards more comprehensively.

The three pillars

As far as possible, the new regime is also more closely aligned with its equivalent regime in the banking sector under the Basel II Accord. This alignment is aimed at reducing the scope for regulatory arbitrage, so the prudential regime is divided into three 'pillars'.

- Pillar one – minimum capital requirements.
- Pillar two – supervisory review (allowing for the pillar one requirements to be adjusted, by means, among other things, of 'capital add-ons' as described in 'Capital add-ons' below) and covering governance requirements.
- Pillar three – public transparency and market discipline through public reporting standards, disclosure and other tools.

Pillars two and three are often referred to in combination as 'pillar five'.

Harmonisation

The Solvency II regime is intended to achieve a high degree of convergence in regulatory standards across Europe. By contrast, the current Solvency I regime merely applies minimum standards, which have long been regarded as outdated.

Some member states have applied requirements that are 'super-equivalent' to Solvency I standards and anticipate many features of the Solvency II regime. The UK adopted this course at the end of 2004.

Supervisory convergence is identified as an objective in article 71 of the Directive. On the other hand, the Directive standards include some flexibility in their implementation from state to state. It is recognised that the standards should:

- be adapted to each national insurance market;
- enable member states and their insurance supervisors to exercise a wide degree of discretion in the application of some of the standards; and
- recognise the importance of the proportionality principle.

This means, among other matters, that it may be inappropriate to apply the Directive standards in all their rigour to smaller (re)insurers or to some

firms such as captive (re)insurers whose operations create lower market risks. (Re)insurers are referred to hereafter in this practice note as 'firms'.

The Financial Services Authority (FSA) has previously stated its 'reservations about the possibility that [level two] provisions could in some areas emerge as over-prescriptive and maximum harmonising'. It argued in favour of standards being expressed in principles or desired outcomes rather than detailed rules. This view is not shared by all other member states, however. To determine the degree of harmonisation to be achieved by any specific provision in the Directive, the correct approach may be to consider the article in question in conjunction with the recitals that refer to it.

Another development that may limit the FSA's powers arises from proposals made by the Commission following the de Larosière report of February 2009. The Commission proposals lay out a framework to make European financial regulation more effective. One such proposal recommends the creation of three new European Supervisory Authorities to replace the Committee of European Banking Supervisors (CEBS), CEIOPS and the Committee of European Securities Regulators (CESR). They would have the role of 'co-ordinating the application of supervisory standards and guaranteeing strong co-operation between the national supervisors'. A formal proposal to this effect was made by the Commission in September 2009.

Timing issues

The level one Directive and the level two measures are due to be transposed by member states by 31 October 2012. Level two regulations are due to come into force on the same date without needing to be transposed by member states. This may not be ideal for the great majority of firms whose financial years end on 31 December. Firms and national supervisors will need to expend considerable time and effort to ensure that the project is managed effectively and that they are ready on time. It will be particularly important that firms should have adequate time to prepare after publication of final level two implementing measures and level three standards.

In late 2008 the Commission was proposing to extend the Solvency II timeline into 2013, but reverted to 2012 following pressure from the EU Parliament. Paul Sharma of the FSA has said that the 2012 target is 'less likely to be delayed than the London Olympics', although it is possible that the change process may be eased by transitional and grandfathering arrangements.

Pillar one

Under pillar one, firms will be required to:

- make technical provisions (often referred to as 'reserves') against (re)insurance liabilities;
- adhere to a minimum capital requirement (MCR);

- calculate, and generally adhere to, a solvency capital requirement (SCR); and
- maintain eligible own funds, (that is, capital), to cover these requirements.

Technical provisions

The calculation of the technical provisions to be made by firms against their (re)insurance liabilities will be based on their current exit value. This value reflects the amount that an insurer would expect to have to pay today if it transferred its contractual rights and obligations immediately to another organisation.

Technical provisions will be calculated as the sum of a best estimate plus a risk margin. The only exception will be in the case of hedgeable risks that arise from insurance or reinsurance obligations.

With non-hedgeable risks, the risk margin is calculated using the ‘cost of capital’ method, which is the same for all firms. The cost of capital is based on the additional rate, above the relevant risk-free interest rate, that would be:

- incurred by a firm holding an amount of eligible own funds;
- equal to the SCR (see ‘Solvency capital requirement’ below); and
- necessary to support the relevant (re)insurance obligation over the lifetime of that obligation.

In the case of life insurers, technical provisions must take into account ‘all payments to policyholders and beneficiaries, including future discretionary bonuses, which insurance and reinsurance undertakings expect to make, whether or not these payments are contractually guaranteed’. This will bring the rest of Europe into line with the FSA’s prudential rules applying to with-profits business that were adopted at the end of 2004.

CEIOPS has consulted and submitted final advice to the Commission on a variety of issues relating to the calculation of technical provisions.

In the course of the legislative process, a late amendment was made to article 132 of the Directive. The effect of this is to prevent member states from requiring assets covering technical provisions relating to insurance risks located in the EEA to be located in the EEA or any particular member state.

The opposite is the case under Solvency I. However, the location of assets covering technical provisions may have a bearing on whether they are prudently invested (see ‘Assets and liabilities’ below).

The liquidity premium issue

One specific issue in the calculation of technical provisions has created problems.

Under existing FSA rules it is permissible for firms to apply a liquidity premium (sometimes referred to as an 'illiquidity premium') in calculating the present value of future cashflows. The underlying principle is explained as follows:

'Where illiquid assets are used to closely match similar illiquid liabilities, as could be the case in an annuities business, it would be appropriate to look at the liquidity premium implicit in the market value of the assets as a proxy for the liquidity premium that should be included in a market consistent valuation of the liabilities.'

The liquidity premium is part of the discount rate applied to the calculation of the liability, so the higher the rate and the higher the liquidity premium included in the rate the lower the value of the liabilities, resulting in turn in lower pillar one regulatory requirements.

CEIOPS advice rejected (it appears by a large majority with the UK in the minority) the use of liquidity premiums in these circumstances, except in relation to 'business in force'. The effect of this proposal, if it is adopted, will be to increase the value of annuity providers' liabilities and possibly to make it more expensive to write annuity business.

Minimum capital requirement

Under Solvency II, the MCR represents a standard 'below which policyholders and beneficiaries are exposed to an unacceptable level of risk'. All firms are required to adhere to it. Non-compliance is likely to lead to immediate, serious consequences. The MCR is a linear function of a set or sub-set of variables net of reinsurance. The variables are:

- technical provisions;
- written premiums;
- capital-at-risk;
- deferred tax; and
- administrative expenses.

The MCR will be calibrated to the value-at-risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 85 per cent (explained in 'Solvency capital requirement') over a one-year period.

It is subject to a 'corridor' requiring that it should be no less than 25 per cent and no more than 45 per cent of the SCR (see 'Solvency capital requirement'). This is because experience with quantitative impact studies (described in 'Own funds' below) showed that for some life insurers the MCR might otherwise end up very close to, or even above, the SCR.

Solvency capital requirement

The SCR will impose a higher level of regulatory capital on firms, although the consequences of an SCR breach will be less severe than those for an MCR breach. This higher level is achieved through:

- the corridor referred to in the section above (see ‘Minimum capital requirement’); and
- the standard formula for the calculation of the SCR, set out in annex IV of the Directive. This applies a confidence level of 99.5 per cent (rather than the 85 per cent applicable to the MCR).

The preamble to the Directive explains the confidence level in non-technical terms. It is ‘the economic capital to be held by insurance and reinsurance undertakings in order to ensure that ruin (net cash outflows exceeding available resources) occurs no more than once in every 200 cases or, alternatively, that those undertakings will still be in a position, with a probability of at least 99.5 per cent, to meet their obligations to policyholders and beneficiaries over the forthcoming 12 months’.

The standard formula for the SCR covers non-life, life and health underwriting risk, market risk, credit risk and operational (including legal) risk. It does not cover risks that arise from strategic decisions, reputational risk or liquidity risk. If these risks are significant, however, they may give rise to a capital add-on or, in the case of liquidity risk, a valuation reserve (see ‘Capital add-ons’ below).

Because market risk is addressed within the SCR, it should no longer be necessary for the FSA to address it separately within the with-profits insurance capital component and (in the case of non-life firms) the asset related capital requirement.

Internal models for calculating the SCR

Firms may use their own internal models for calculating the SCR, as an alternative to using the SCR standard formula, or they may use a combination of the standard formula and internal models. In either event, they must obtain the supervisor’s approval. In the UK this may need to be done through the cumbersome process of a rule waiver under section 148 of the Financial Services and Markets Act 2000 (FSMA). Where internal models are used, the firm may still be required to provide the supervisor with an estimate of the SCR worked out using the standard formula for up to two years after approval of the internal model. Firms will only be allowed to use partial internal models to the extent that they can demonstrate that they have not ‘cherry picked’ particular lines or risks within their business. This may be the case where internal models produce a favourable result on the chosen elements, whilst omitting other lines where the standard formula produces a more favourable result.

The supervisor also has the power to require a firm to use an internal model even if the firm does not wish to do so.

Most of the larger firms in the UK are expected to apply to use internal models. The process of ensuring that firms have the approval in place by the date the Directive comes into force has been mapped out by the FSA in its discussion paper *Insurance Risk management – The path to Solvency II* (DP08/4) and its associated feedback statement and by CEIOPS in its consultation paper 37.

The Directive imposes significantly more rigorous requirements for using internal models than are applied under the FSA's current internal capital adequacy assessment process (ICAAP). In any event, the Directive states, firms must demonstrate that 'the internal model is widely used in and plays an important role in...the system of governance...in particular...the risk-management system...[and] the decision-making processes'.

This requirement – referred to as the 'use test' – is a major challenge for senior management and non-executive directors.

Equity risk within the SCR

The treatment of equity risk (a sub-module within market risk) within the SCR was a contentious issue in the negotiations leading to agreement on the level one Directive. A compromise formula is set out in article 106 of the Directive, which allows member states to adjust the equity capital charge by reference to a weighted average of prices over 'an appropriate period of time'. The adjustment must not, however, result in more than a 10 per cent change to the standard equity capital charge. Among other factors, this is aimed at reducing the pressure on firms to sell off equities in a bear market.

There is separate provision in article 304 of the Directive giving member states the option of adjusting the equity capital charge applying to firms that provide pension products. In this event, however, the firm must ring-fence its operations so that only policyholders in its home state are affected.

Non-compliance with the SCR

Where a firm is in breach of the SCR, the supervisor must require the situation to be rectified within six months. This period may be extended by three months. Firms may be compelled to sell off assets to ensure they meet the SCR and this may in turn have significant effects in the financial markets. To avoid this procyclicality, supervisors have special powers 'in the event of an exceptional fall in financial markets' to allow firms to continue operating even when they are not meeting their SCRs. This will not necessarily, however, prevent firms from having to disclose the SCR breach (see pillar two below).

Own funds

Technical provisions, the MCR and the SCR must be covered by eligible own funds (that is, regulatory capital). The Directive divides own funds into three tiers in accordance with their 'loss-absorbing capacity' (ie the extent to which they can continue to be used when the firm is in difficulty). The Directive provides that tier one should represent at least one-third of the total amount of eligible own funds covering the SCR. A majority of CEIOPS

members, however, has proposed that the proportion should be set at 50 per cent, with a minority preferring 60 per cent.

For the first time (except in relation to the Lloyd's market), ancillary or off-balance-sheet capital, such as letters of credit and guarantees, may – with regulatory approval – count towards tiers two and three. Whether that approval will be given is another matter. The FSA does not seem very keen on the use of contingent capital within the insurance sector.

In contrast to other sections of the level one Directive, the requirements relating to own funds are expressed in quite high-level terms. Further detail in relation to the tiering structure was proposed in the specification for the Commission's fourth series of quantitative impact studies (QIS4). In its consultation papers, CEIOPS has raised the question of whether tier one should be confined to paid-up share capital, reserves and the like, or whether it should also include some higher-quality hybrid capital and subordinated debt. Its final advice to the Commission recommended that 'any inclusion of high quality hybrids should be restricted, ie they should account for no more than 20 per cent of tier one'.

The full detail of the own funds regime may not be settled until after the outcome of QIS5 in late 2010, although CEIOPS has commented that, 'the existing provisions regarding insurers' own funds may have helped them maintain relatively stronger capital positions compared to banks'.

A provision within the original draft of article 97 of the Directive allowed the tiers to be sub-divided. This was removed from the agreed version of the level one text, thus preventing the sub-division of tiers. There should, therefore, be no distinction in principle between, for instance, core and non-core tier one capital. The distinction may, however, continue to influence how the rating agencies view a firm.

It is also unclear to what extent existing capital instruments may be grandfathered into the new regime if they are not fully compliant. The Directive is silent on this point and while the most recent CEIOPS consultation paper mentioned the issue, it did not make proposals.

Assets and liabilities

Article 74 of the Directive enables assets and liabilities (other than those covered by technical provisions) to be valued as they might be in an arm's-length transaction between knowledgeable willing parties. This is to be supplemented by level two implementing measures. These will cover, among other matters, the application of accounting standards. CEIOPS has consulted and advised the Commission on valuation issues.

Under Solvency I, direct insurers are required to cover their technical provisions with a limited range of admissible assets that are subject to exposure limits. These rules are abolished under Solvency II. Instead, all firms will be subject to higher-level 'prudent person' requirements in their investment policies, which will include the application of concentration limits.

The same Solvency I list of admissible assets limits what property or securities unit-linked insurance products may be linked to. Again, this list will no longer apply. Individual member states, however, may apply limitations in relation to products sold to natural persons. Such limitations must be no more restrictive than those that apply to undertakings for collective investment in transferable securities (UCITS). Any such limitations will, in that event, also require technical provisions covering the products in question to be invested in matching assets.

The level one Directive provides that when valuing liabilities, no adjustment can be made to take account of the firm's own credit standing. This is in contrast to proposals under the International Financial Reporting Standards (IFRS) and to what the industry regards as market-consistent practice. The credit standing of a debtor is in principle relevant to the negotiation of a consideration for a transfer of a creditor's rights. The UK lost on this point in the negotiations, although CEIOPS, in its final advice to the Commission, has accepted that the value of the liabilities shall consider own credit standing of the firm at inception, but not subsequently.

Pillars two and three (collectively referred to as 'pillar five')

Governance

The text of the level one Directive contains governance requirements that are considerably more detailed than those applied in Solvency I. In its paper on lessons to be learned from the financial crisis, CEIOPS notes that, 'as in the financial sector at large, governance, risk management and internal controls in the insurance sector need to be strengthened'. This echoes similar points made by the Organisation for Economic Co-operation and Development (OECD).

The governance requirements follow the FSA's emphasis on senior management responsibility. They cover the fitness and properness of personnel, risk management, internal control, outsourcing and the audit and actuarial function. More recently proposals have been made with regard to remuneration with a view to discouraging activities that involve inappropriate risk-taking.

Actuarial function

CEIOPS has consulted and advised the Commission on draft level two measures relating to governance. The actuarial function is the most controversial area here because, in contrast to Solvency I, it will extend to non-life as well as life firms. The actuarial function does not recognise, as the FSA rules currently do, the distinct with-profits actuary function. Will the FSA want to 'gold plate' by maintaining that function, or must it fully align itself with the level two measures?

Fitness and properness

Article 43 of the Directive states that 'where a member state requires of its own nationals proof of good repute...that member state shall accept as sufficient evidence in respect of nationals of other member states the production of an extract from the 'judicial record' or...of an equivalent document issued by a competent judicial or administrative authority in the home member state or the member state from which the foreign national comes...'

This may tie the FSA's hands to some extent in operating its approved persons regime.

Own risk and solvency assessment

Every firm is required to carry out an own risk and solvency assessment (ORSA) covering its 'overall solvency needs [and] taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking'. This is broadly equivalent to the 'individual capital assessment' required under the FSA's current rules. The requirements of the ORSA, however, are much more rigorous.

The outcome of the ORSA will not apply any additional regulatory capital requirement on top of the SCR, although it may lead to a capital add-on (see 'Capital add-ons') that may have that effect. The FSA has commented that,

‘a firm falling below its internal economic capital target would act as an early warning indicator for the supervisor, suggesting that the firm’s solvency position had weakened’.

Reporting and disclosure

The Directive sets out in detail the powers and responsibilities of national supervisors. Much of this material will be familiar to UK firms. By contrast, the effect may be to enlarge the powers of many other European supervisors.

CEIOPS consulted in July 2009 on supervisory reporting (pillar two) and public disclosure (pillar three). CEIOPS’ proposals cover:

- the solvency and financial condition report (SFCR), which is to be published annually; and
- the separate report to supervisors containing further information, including material too sensitive to be published.

The SFCR requires the disclosure of considerably more qualitative and quantitative information about the firm than is required under current FSA prudential rules. By way of example, it will require the firm to give very full information about governance arrangements and ‘the main future trends and factors that are expected to contribute positively or negatively to the development, performance and position of the undertaking (over its business planning time horizon)’. The effects of these changes may be less significant for insurance groups whose holding company is listed and already, therefore, subject to disclosure requirements under the Listing Rules. Public disclosure requirements do not apply to information on internal models (i) that would give competitors a significant undue advantage or (ii) if there are obligations to policyholders or other counterparty relationships that bind an insurance undertaking to secrecy or confidentiality.

Reporting will be required at group as well as at solo level.

Provision is made for firms to report when they breach their MCR or SCR. Although, as noted above, supervisors may extend the period for firms to rectify SCR breaches, the breach will still have to be reported publicly in accordance with the rules.

Capital add-ons

Article 37 of the Directive provides for the supervisor – in exceptional circumstances – to apply a ‘capital add-on’ at solo or group level. It will require the firm concerned to maintain additional capital on top of the SCR. The capital add-on is broadly equivalent to the ‘individual capital guidance’ given by the FSA under its current rules. A capital add-on may be applied if:

- the firm’s risk profile deviates significantly from the assumptions built into the SCR; or
- the firm’s governance arrangements are inadequate.

If a capital add-on is applied, it will ultimately become apparent in the firm's SFCR. During a five-year transitional period, however, member states may elect to require disclosure of only the sum of the SCR and the add-on. Under current FSA rules the firm is not required to disclose the amount of the capital guidance given to it. The UK government has not yet indicated whether the member state option will be exercised to allow this to continue for any part of the five years.

Another point worth noting here is that the FSA currently gives individual capital guidance on a systematic basis. The requirement under Solvency II that a capital add-on should be applied only 'in exceptional circumstances' may tie its hands to some degree, although it may not need to apply add-ons so frequently under Solvency II. This is because the new pillar one requirements will be more demanding and therefore less likely to need supplementing. An additional point is that the meaning of 'exceptional circumstances' has arguably been watered down in recital 27 of the Directive.

CEIOPS has provided advice to the Commission with regard to capital add-ons and possible level two measures.

Special purpose vehicles and securitisations

Solvency II reproduces the provisions in the Reinsurance Directive that relate to insurance special purpose vehicles (ISPVs), often used in the context of securitisations.

The main difference will be that the power to make rules relating to ISPVs will move from member state supervisors to the Commission. This will reduce – to some extent – the scope for member states to compete with each other as the preferred jurisdiction for an ISPV. CEIOPS has consulted and advised the Commission on ISPV level two rules.

To address concern about the risks that arise when firms invest in securitised loans, the Commission will have the power to regulate these investments. In particular, it may impose requirements ensuring that the originator retains a net economic interest of not less than 5 per cent. CEIOPS has advised that it should do so.

However, a recent paper from the influential Chief Risk Officer Forum (CRO Forum) comments, 'Unlike banks, insurers usually keep a significant amount of the risk they securitise: they do not repackage their entire exposure. Unfortunately, the securitisation market as a whole has suffered a complete evaporation of trust. The first step toward reviving it is increased transparency; comprehensive, consistent, easily accessible disclosure, standardised contracts and reporting and stringent rating guidelines'.

Group supervision

The temporary (?) demise of group support

The UK and a number of other larger EU member states had hoped that the Directive would include a new 'group support regime'. This would have provided, in simplified terms, multinational insurance groups with flexibility in maintaining capital within the group. The original intention was that, if the group parent was willing to give a guarantee of group support to members of the group, those members would not then need to maintain solo own funds at a level exceeding their solo MCR. Instead, the benefit of the group support and thus any net benefits of diversification at group level would be 'downstreamed' from the parent.

It was a major feature of the group support regime that the group supervisor should have responsibility for approving capital modelling across the group. The group supervisor is to be appointed in accordance with the procedures provided for in the Directive and would usually be the supervisor in the state where the group had its headquarters.

The effect of a group support regime, however, would have been to shift power from solo supervisors (many of whom are supervisors in the smaller states) to group supervisors (most likely to be supervisors in the larger states in western Europe). When the smaller states objected, various compromises were debated. These included rules requiring group supervisors to work in conjunction with a college of supervisors for each group. A formula was also proposed requiring at least a proportion of the difference between the MCR and the SCR to be maintained within the own funds of each solo firm within a group.

Ultimately, it proved impossible to secure agreement although Recital 141 of the Directive does allow the Commission to propose at a later date a further directive providing for a group support regime.

It seems likely that this proposal will be part of a larger parcel, possibly including a directive for all member states to adopt insurance guarantee schemes. Currently, some member states (including the UK) operate such schemes but many do not. The Commission announced in July 2009 its intention to review the adequacy of existing insurance guarantee schemes across Europe and make appropriate legislative proposals. These are expected very soon.

What is left for group supervision under Solvency II?

Although the group support regime has been temporarily lost, Solvency II will provide some significant advantages for insurance groups compared with Solvency I.

These advantages include the following:

Firms are not required to calculate group capital at any level lower than the ultimate parent at national level. The requirement to maintain group capital adequacy at the level of the ultimate EEA parent will, however, remain

'hard'. The treatment of groups whose ultimate parent is outside the EEA is discussed below.

The consolidated SCR for a group will take into account the global diversification of risks that exist across all the insurance entities in that group, so that the group's risk exposures may be properly reflected. With the loss of the group support regime, however, there will be no scope for downstreaming the diversification effects to solo firms within the group, each of which will be required to maintain its solo SCR. The sum of the solo SCRs may exceed the consolidated SCR. Moreover, the financial crisis has shown that the benefits of diversification have to some extent been overestimated, which may need to be corrected within QIS5.

Provision is made for the consolidated group SCR to be calculated by reference to an internal model (although this will not necessarily prevent the supervisor for a solo member of the group from applying a capital add-on to that firm).

The default method for calculating group capital will be the accounting consolidation method. The UK is currently the main EEA member state still using the alternative deduction aggregation method. It will, therefore, move over to accounting consolidation when Solvency II comes into force.

Special provision is made for the determination of the SCR for groups with centralised risk management. CEIOPS has consulted and advised the Commission on this issue. Groups with centralised risk management may, where they meet the Directive requirements and obtain the appropriate approvals, concentrate certain governance functions within the state where they are group supervised.

Although in some cases the sum of the capital requirements at solo level may be more onerous than the requirements at group level, the opposite may also be the case. Capital within a group member (as opposed to within the ultimate holding company) counts towards group capital only if it is fully 'fungible' (ie when it can effectively be made available to cover the group SCR of the group holding company). The advice from CEIOPS on group solvency states that 'further work may be useful in order to identify fungibility limits at level three in order to ensure a consistent implementation of Solvency II'.

The position of the group supervisor is given greater recognition under Solvency II than Solvency I. The group supervisor is required, however, in arriving at important decisions, to act in conjunction with the college of supervisors and CEIOPS. CEIOPS will acquire further powers in this respect if and when it is transformed into a 'European Supervisory Authority' in accordance with the Commission's recent proposals (see 'Harmonisation').

The college of supervisors will represent not only national supervisors for each group member within the EEA, but also supervisors for jurisdictions where the group operates through 'significant' branches rather than

subsidiaries and related firms, and supervisors for relevant non-EEA jurisdictions. What is significant for this purpose is yet to be defined.

There are detailed procedures covering the resolution of disputes between member state supervisors. These are perhaps more detailed than is desirable. In any event, there is very limited scope for revising them without a further level one Directive. Experience to-date suggests that there is considerable trial and error involved in designing a workable group supervision regime.

Third country (re)insurance companies and groups

Provision is made under the Directive for the determination of the equivalence of non-EEA insurance jurisdictions for a number of purposes.

Firstly, some (re)insurance companies authorised in the EEA are members of insurance groups where the ultimate holding company is based outside the EEA. Under Solvency I, as interpreted by the FSA, such companies are required to report on the capital adequacy of the group of which they are a member, without necessarily being required to ensure that the capital position of the group in question is positive rather than negative.

Under Solvency II, by contrast, (re)insurance companies will be subject to a fuller supervisory regime with regard to their worldwide insurance group. An exception will be made where the jurisdiction in which the headquarters of the group is based is determined to have a regime equivalent to that applying in the EEA. In that event, reliance will be placed on group supervision in the jurisdiction concerned (subject to the operation of arrangements for the exchange of information).

The Commission's timetable for the implementation of Solvency II envisages that, by the time the Directive comes into force in October 2012, it will have made a determination with regard to the equivalence of the most significant non-EEA jurisdictions. In that event, its determination will be binding on member states.

Secondly, the Commission is expected to determine the equivalence of non-EEA jurisdictions for other specific solo supervisory purposes. These include articles 134, 172 and 173 of the Directive. In the case of a positive determination in that context member states:

- will be required to treat reinsurance contracts concluded with undertakings having their head office in the third country whose regime has been deemed equivalent, in the same manner as reinsurance contracts concluded with an undertaking that is authorised in the EEA;
- cannot require pledging of assets to cover unearned premiums and outstanding claims provisions; and
- must not require the localisation within the community of assets held by non-EEA (re)insurers to cover the technical provisions covering risks situated in the community, nor assets representing reinsurance recoverables.

Thirdly, it will be noted from the section on group supervision above that under Solvency II, accounting consolidation is the default method for determining group capital adequacy. In certain cases, however, the alternative deduction aggregation method may be required to apply. Where an EEA firm holds a participation in a non-EEA firm and the deduction aggregation method is applied, the non-EEA firm may be taken into account

within the group by reference to its local rules (as opposed to the Solvency II rules) if the jurisdiction in question has been determined to be equivalent.

CEIOPS has recently consulted on the matters to be taken into account in determining the equivalence of non EEA jurisdictions for each of the above purposes.

Glossary

Capital add-on

A requirement by a national supervisor addressed to a (re)insurance company requiring it to maintain further capital in addition to pillar one requirements. The equivalent concept under the UK Solvency I regime is ‘individual capital guidance’.

Captive (re)insurer

A (re)insurance company established by a parent firm for the purpose of insuring the exposures of the parent or its affiliates.

College of supervisors

The committee of national supervisors for any insurance group, including supervisors for significant branches.

Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

The level three committee, based in Frankfurt, advising the Commission on – among other things – the Solvency II Directive.

Fungible capital

An element of own funds can fully absorb any kind of losses within the group, regardless of the undertaking within which those own funds are held or where the commitments arise (in compliance with the local prudential and legal rules). Fungible own funds in this sense are not dedicated to a certain purpose.

Group supervision

The supervision of regulated firms by reference to their membership of a group. In the case of (re)insurance companies, this is usually an insurance group, although it may also be a financial conglomerate. The group’s activities may be confined to Europe or may extend to third countries.

Group supervisor

The leading supervisor for an international group, usually the national supervisor for the jurisdiction where the group has its headquarters.

Lamfalussy process

The four-level European legislative process applying within the financial services sector (see definitions of levels one, two, three and four below).

Level one

The first level of the Lamfalussy process, consisting of a level one Directive theoretically setting out the high-level principles of a proposed new regulatory regime (such as the Directive). The level one Directive is adopted through the ‘co-decision procedure’ involving the Commission, the European Council and the EU Parliament.

Level two

The second level of the Lamfalussy process, consisting of level two directives and/or regulations adopted by the Commission and containing more detailed implementing provisions supplementing the level one rules.

Level three

The third level of the Lamfalussy process, consisting of non-binding guidance and standards adopted by the level three committees with a view to achieving regulatory convergence across Europe.

Level three committees

The European organisations advising the Commission on financial services legislation. A misleading expression because these organisations also advise on levels one and two. The level three committees are CESR, CEBS and CEIOPS.

Level four

Level four of the Lamfalussy process. Within level four the Commission reviews member state implementation of the regime and takes enforcement action if necessary.

Minimum capital requirement (MCR)

The lower of the two capital requirements under the Solvency II regime. The amount of the MCR is linked to the amount of the solvency capital requirement (SCR). A breach of the MCR is likely to lead to serious consequences for the firm concerned. The MCR is also a capital requirement under Solvency I but is subject to an entirely different formula in that context.

Own funds

The expression used within Solvency II to refer to the capital required to cover technical provisions, the MCR and/or the SCR. 'Regulatory capital' is a synonym more often used in the UK.

Own risk and solvency assessment (ORSA)

The requirement that firms should calculate their own capital requirements. The equivalent concept under the FSA rules is the individual capital assessment or ICA.

Pillar one (or I)

Pillar one applies prudential requirements, including quantitative capital adequacy requirements.

Pillar two (or II)

Pillar two provides for national supervisors to review the application of pillar one standards and supplement them (for example, with capital additions). It also applies governance standards.

Pillar three (or III)

Pillar three provides for public disclosure of performance by regulated firms and the market discipline that arises from that disclosure.

Pillar five (or V)

Expression often used to refer to the combination of pillars two and three.

Regulatory capital

See definition of 'own funds' above.

Solvency I

The current European regulatory framework for the prudential supervision of (re)insurance companies.

Solvency II

The new European regulatory framework for the prudential supervision of (re)insurance companies, due to come into force on 31 October 2012.

Solvency and financial condition report (SFCR)

The report required to be published annually by (re)insurance companies under Solvency II. Under Solvency I within the UK the equivalent document is the 'regulatory return', although the scope and content of the two reports are very different.

Solvency capital requirement (SCR)

The higher and more risk-sensitive of the two capital requirements under the Solvency II regime. It may be calculated according to a formula provided for in the level one Directive or (with regulatory approval) using internal models.

Technical provisions

The provision that a (re)insurance company is required to make against its (re)insurance liabilities. Technical provisions are sometimes referred to as 'reserves'. This can be misleading because reserves may also refer to the reserves that supplement share capital.

Transferable capital

Refers to the ability to transfer assets and/or liabilities representing the capital to another entity within the group. Transferability leads to an increase or decrease of own funds in a solo entity without increasing or decreasing the group own funds. The time and the costs of the transfer have to be taken into account.

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