Dillon Eustace

Solvency II Directive
–
Insurance and Reinsurance Sectors
(Life and Non-Life)

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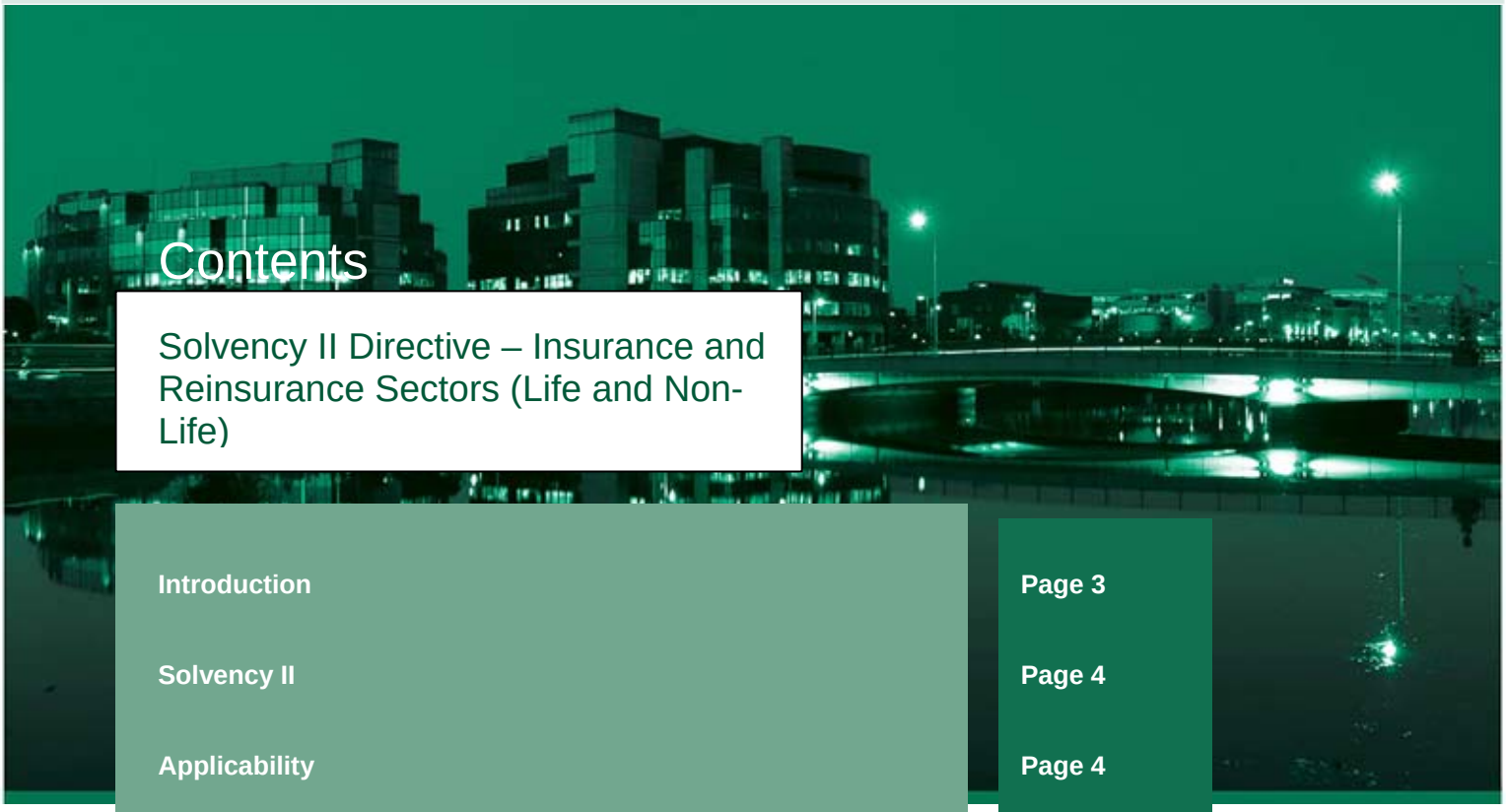

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INTRODUCTION

This memorandum is aimed at providing a high level summary of the Solvency II Framework Directive (2009/138/EC) ("Solvency II" or "Directive"). The Directive was adopted by the European Parliament in April, 2009 and is due to be implemented across Europe on 31 October, 2012 (possible postponement until 1 January, 2013 being considered by the European Commission).

As the Level 1 text of the Directive has been finalised insurance and reinsurance companies should now be focused on the Level 2 implementing measures and working towards fully implementing changes throughout their organisations by 31 October, 2012 (or 1 January, 2013). Insurance and reinsurance companies have a busy schedule ahead of them in 2010 with a number of areas being drafted over the coming months including the draft Impact Assessment Package ("IAP") and the Quantitative Impact Study 5 ("QIS5"). A detailed timeline for the Directive can be found on the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS") website and further details are provided below.

Solvency II is aimed at strengthening the supervision of the insurance and reinsurance sectors by increasing the regulation of their capital requirements. In some respects it is the insurance industry's equivalent to the Capital Requirements Directives (2006/48/EC & 2006/49/EC) which are applicable to credit institutions and investment firms.

Solvency II will replace Solvency I which following a review by the European Commission made limited amendments to the original solvency requirements in 2002. Whilst Solvency I was being implemented it was clear that a more detailed review of capital requirements in the insurance/reinsurance industry was required in order to align an entity's capital requirements more closely with the risk profile of its business. The Solvency II consultation process took place in 2004 and 2005 with the official Solvency II Proposal adopted in July, 2007.

The Directive intends to increase integration and enhance competition of the European insurance and reinsurance market whilst strengthening the protection of both policyholders and beneficiaries.

Insurers and reinsurers will need to be fully aware of all the risks their businesses are exposed to ensuring they effectively manage these risks in a transparent manner.

European Commission President José Manuel Barroso stated:

"By approving the Commission's proposal, the European Parliament has contributed to lasting economic recovery. An integrated and competitive insurance sector, supervised consistently across borders, is essential for every consumer and every business in Europe. Solvency II will help protect policy holders from bad practice. It will help shield our economies against a repeat of the disastrous excessive risk taking by financial institutions, including certain insurance operators, that has contributed to the global crisis. It will be good for insurers and reinsurers themselves, by giving them new opportunities and helping restore confidence."

SOLVENCY II

Following the implementation of Solvency I, many Member States reformed their own solvency requirements which have led to minimum capital requirements inconsistencies throughout Europe. The Directive aims to harmonise these requirements across Member States, promoting competition, transparency and ultimately consumer protection.

Similar to the organisational requirements under the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID"), insurance and reinsurance entities will have to establish a number of functions including internal audit, compliance and risk management under Solvency II.

Solvency II will modernise and simplify group supervision and should benefit all insurance and reinsurance groups. Groups will now have a dedicated group supervisor with power and responsibility to organise the supervision of that group. The group supervisor will set the Solvency Capital Requirement ("SCR") for the group and validate the group's internal model. This should eliminate group supervision being carried out by a large number of supervisory authorities at difference levels which can lead to inefficiency in respect of cost and time for all concerned.

APPLICABILITY

Solvency II will apply to all insurance and reinsurance entities with an annual gross premium income exceeding €5m or gross technical provisions in excess of €25m.

Article 4 of the Directive states:

"Without prejudice to Article 3 and Articles 5 to 10, this Directive shall not apply to an insurance undertaking which fulfils all the following conditions:
(a) the undertaking's annual gross written premium income does not exceed EUR 5 million;
(b) the total of the undertaking's technical provisions, gross of the amounts recoverable from reinsurance contracts and special purpose vehicles, as referred to in Article 76, does not exceed EUR 25 million."

For assistance on the interpretation of any Articles within the Directive, please consult a member of the Insurance Group within the Financial Services Department of Dillon Eustace.

WHAT IS REQUIRED AT A HIGH LEVEL

Under Solvency II, insurers and reinsurers across Europe may need to ensure that they:

- conduct their Own Risk and Solvency Assessment ("ORSA") which will include ongoing compliance with the SCR and technical provisions considering their risk profile;

- formalise their risk management, governance systems and operational control showing prudent management of their business. This will include a requirement to maintain certain internal functions including compliance, risk management, internal audit and actuarial;

- provide publicly available annual reports in respect of their solvency and financial condition.

THREE PILLARS

The Directive follows a three pillar approach similar to that used with Basel II in respect of credit institutions. The three pillars are broken down below.

Pillar 1 - Quantitative Capital Requirements
Pillar 1 covers technical provisions, SCR and Minimum Capital Requirement ("MCR"). SCR is the key solvency control level and a risk based requirement. SCR will cover all the quantifiable risks an entity faces and can be calculated by risk mitigation techniques and the European Standard Formula or by an entity's internal model. The MCR is a lower requirement. It should be noted that a breach to MCR may result in termination of an entity's regulatory authorisation.

Pillar 2 - Qualitative Supervisory Review Process
Pillar 2 covers corporate governance, principles for internal control and risk management, ORSA and capital add-ons. The ORSA is an entity's own assessment of its capital needs by considering its specific risk profile and strategy.

Pillar 3 - Disclosures
This pillar covers the enhancement of market discipline through public disclosures, an annual published financial condition and solvency report and the provision of additional information to regulatory supervisors.

LAMFALUSSY FOUR LEVEL PROCESS

The Directive follows the Lamfalussy four level process which is designed to speed up the legislative process and is summarised below.

Level 1 - Framework Principles
Level 1 involves developing a European legislative instrument that sets out essential framework principles, including implementing powers for detailed measures at Level 2

Level 2 - Implementing Measures
Level 2 develops greater detailed implementing measures (prepared by the European Commission following advice from the CEIOPS). These greater measures are required in order to put the Level 1 framework legislation into operation.

Level 3 - Guidance

The CEIOPS works on joint interpretation recommendations, consistent guidelines and common standards. Additionally, CEIOPS undertakes peer reviews and compares regulatory practice to ensure consistent implementation and application.

Level 4 - Enforcement

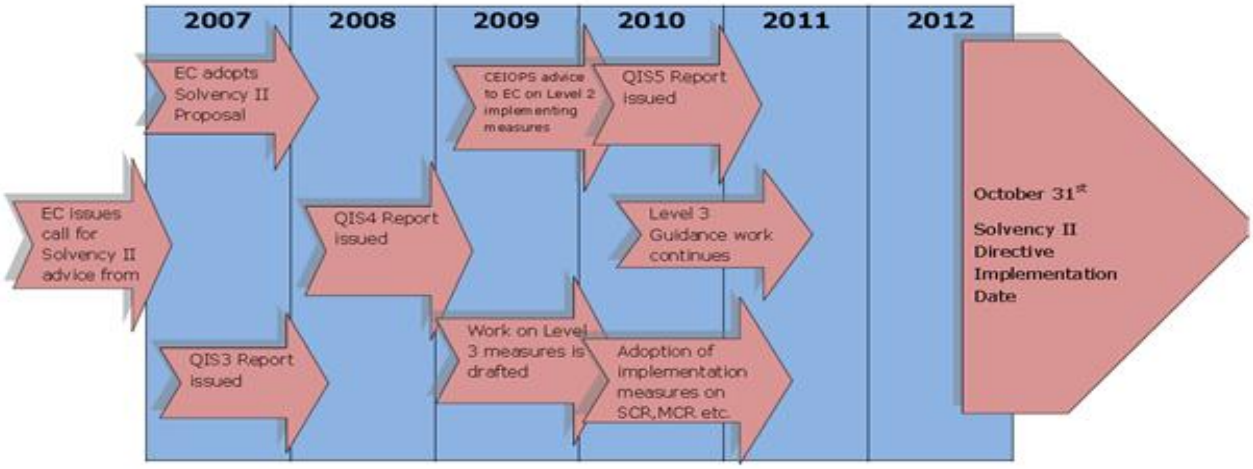
Level 4 is the enforcement of all European measures which is led by the European Commission and includes enhanced cooperation between Member States, supervisory authorities and the private sector.

IMPLEMENTATION TIMELINE

The timeline for implementation of Solvency II has been set by the CEIOPS and can be accessed by visiting the following link:

http://www.ceiops.eu/media/files/requestsforadvice/EC-June-09-CfA/Annex-1.pdf

The Financial Regulator has kindly prepared a simplified version of the CEIOPS timeline which is set out below for convenience.



CONCLUSION

It is advisable that all entities falling within the ambit of Solvency II should, if not already doing so, engage in consultation with industry bodies and supervisory authorities to ensure they have a say in how the Directive is implemented across Europe. The experience of Basel II shows that early preparation and consultation greatly assisted the banking sector in the implementation of the new requirements to their own business models. Insurance and reinsurance companies should view Solvency II not as a compliance burden but rather a huge opportunity to build a more effective way of running their businesses. It is widely acknowledged that entities who embrace Solvency II early on will have a competitive advantage over those that do not.

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