Solvency II Update   September 2009

1. Introduction

This note aims to give a general overview of where we have got to so far in the Solvency II process and to highlight the immediate issues for companies which need to be addressed in the short term.

2. A quick recap - the structure of the Solvency II project

The Solvency II framework has three **pillars**:

- Pillar One – a minimum solvency capital requirement for the firm (calculated either via a standard formula, or based on a company specific approved "internal model").
- Pillar Two – the requirement to assess and manage risks within the firm, and to maintain capital sufficient for these risks. This pillar is about how the company is run.
- Pillar Three – the need to disclose publicly key relevant information. For example, the need to publicise annual accounts and information relevant to financial security of the company. This information would include disclosure of breaches of the Solvency Capital Requirement (SCR) and any capital add-ons imposed by the Regulator.

The Solvency II project itself has four **levels**. Activity at the moment is heavily focused on Level 2.

- Level 1 is the Directive itself which is akin to primary legislation. This is now complete.
- Level 2 encompasses the "implementing measures" which are, in effect, supporting regulations. These will define in detail the calculations, methodologies and structures for each of the three pillars.
- Level 3 of the process will involve the setting of supervisory standards (i.e. the role of national regulators, and the process of supervision).
- Level 4 will be concerned with the monitoring of compliance and enforcement.

The European Commission has asked for technical advice on the drafting of the details of the Solvency II rules. They have engaged with CEIOPS[1] to co-ordinate this work. CEIOPS has organised its activities into two main strands – a consultation process on draft implementing measures (see Section 4.A below), and a series of "Quantitative Impact Studies" (QISs) to assess the impact of the proposed measures.

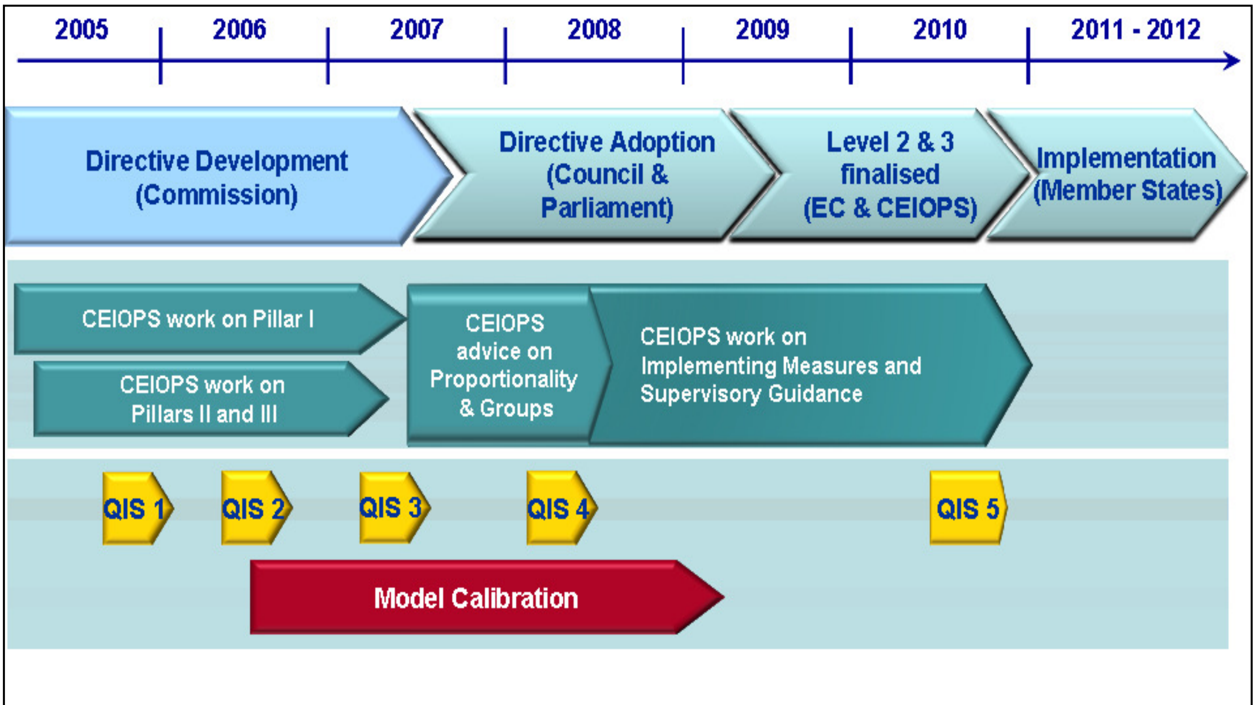
[1] Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

3. Where are we now?

In early August, the Financial Regulator issued a letter to companies requesting them to appoint a senior executive with responsibility for Solvency II. In addition, the Regulator asked for details of firms' intentions in relation to the use of internal models. Firms were requested to indicate whether they intend to use an internal model (either initially or eventually), whether this will be a partial or full internal model and whether the model is a Group Internal Model or Solo Internal Model. The deadline for response to the Regulator was August 31st 2009.

The Financial Regulator's letter is a reminder of the further advancement of the consultation process and implementation of the Solvency II Directive. On 22nd April 2009, the European Parliament approved the proposed text of the framework Directive for "Solvency II". This text was endorsed by the Council of Ministers on the 5th May 2009. **The target date for full implementation of Solvency II is October 2012.**

Solvency II Timeline



Source: CEA

4. The next 12 months

We suggest the key areas that you need to consider over the course of the next 12 months are:

A. Monitor the development of the "Level 2" implementing measures

- April 2009: 12 consultation papers were issued by CEIOPS. The deadline has passed for comment on the advice contained in these papers.
- July 2009: A further 25 consultation papers were issued by CEIOPS inviting commentary from interested parties with a deadline for responses of September 11th 2009. A number

of key aspects of Solvency II are covered by these consultation papers such as, for example, the calculation of best estimate technical provisions, advice on the risk free rate to use in calculation of technical provisions and tests and standards for internal model approval.

- November 2009: A final wave of 12 consultation papers will be issued with a likely deadline for feedback for end-December 2009.

It is important to mention at this juncture that worthwhile changes can be brought about by responding to the invitation for commentary during the current consultation phase. For example, the recently published CP39 advises on the expenses that should be used in the cash-flow projections for calculation of the best estimate provision. For a new undertaking, there is welcome advice on the ability to take projected economies of scale into account over the first 5 years of existence. This was a point that was not covered in QIS4 and the change came about in response to lobbying from various parties (including the Irish lobby).

B. Decide your internal model plans

At this stage companies will already have replied to the Regulator indicating their plans (and their Group's plans where applicable) for internal models. The next set of advice from CEIOPS in November 2009 is expected to include consultation on the use of partial internal models (where certain risk factors are modelled using an internal model, and others use the Standard Formula). This is expected to be a very topical issue as companies and Regulators debate one of the more substantial influences on capital needs.

C. Participate in QIS5

The fifth and what is likely to be the final Quantitative Impact Study (QIS) for Solvency II is expected to take place from the end of July 2010. The draft timetable for this exercise is as follows:

- CEIOPS plans to draft the QIS5 technical specification and calibration paper with a view to submitting these to the Council of Ministers for consultation by end-May 2010.
- The Council of Ministers will publish the final QIS5 specification by mid-June 2010.
- CEIOPS plans to publish final spreadsheets for the QIS5 exercise by end-July 2010.
- Solo undertakings must submit results to their National Supervisors by end-October 2010.
- Group undertakings must submit results by mid-November 2010
- CEIOPS plans to publish the results of this exercise by the end-April 2011.

As this may very well be the last QIS exercise, it is important that companies participate in order to find out if the capital requirements calculated under QIS5 are appropriate for their company, and if not, to flag any particular issues. The European Commission is targeting 100% participation in QIS5.

5. Internal Models update

Article 110 of the Solvency II Directive states that companies may calculate the Solvency Capital Requirement (SCR) using a Standard Formula, or alternatively, they may choose to use a company specific partial/full internal model. The importance of considering whether an Internal Model will be used has been highlighted by the recent letter from the Financial Regulator.

At this point, it is important to emphasise that an internal model is not just an internal cash-flow model which is used to calculate the best estimate technical provisions. It is a model that encapsulates the probability distribution forecasts for specific risk factors. These probability distribution forecasts will then be used to generate the “1 in 200 outcome” for that risk factor and the resulting capital required in that scenario will be held as the SCR in respect of that risk factor. A company may decide to use a full internal model (covering all risks) or may use a partial internal model to model a specific risk factor and the Standard Formula to model other risk factors.

The calibration of the model(s), the probability distribution forecast and the calculation methodology and assumptions are among some of the key areas highlighted in one of the recently published CEIOPS Consultation Papers (CP56) on Tests and Standards for Internal Models.

In addition, it is important to highlight that a proposed partial/full internal model will need to go through a rigorous approval process. One of the areas which will be examined in applying for approval is the “Use Test”. This test is based on the foundation principle that “the use of the model should be sufficiently material to result in pressure to improve the quality”. The “Use Test” also emphasises nine principles on which the use of the model will be based. For example, senior management will need to demonstrate an understanding of the model and the model will need to be integrated with the risk management system of the company. It is clear that demonstration of compliance with these principles will be challenging to say the least.

6. Conclusion

- Work on the Level 2 Implementing Measures is now advancing to the later stages, and there are clear actions falling out of this process. Companies need to start thinking about the impact on their balance sheets and how they will go about calculating that impact.
- With the Financial Regulator highlighting the need to appoint a senior executive with responsibility for Solvency II in each company, the focus on the risk management and governance requirements of Pillar 2 is clear. Again, this highlights that Solvency II is not solely a capital calculation exercise.
- Companies will need to consider next year’s QIS5 exercise when planning the year end 2009 reporting workload – preparation now will make participation much easier. Remember that 100% participation in QIS5 is being sought.
- The Financial Regulator has recently shone the spotlight on whether companies intend to use a full/partial internal model or Standard Formula for calculating the SCR requirement under Solvency 2. Choosing the full/partial internal model approach over the Standard Formula approach involves substantially more preparation and time. The process of developing, testing and gaining regulatory approval for such a model will be extremely involved and work will have to begin now for those companies that have chosen to take this route.

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Appendix
CEIOPS Consultation Papers on Implementing Measures

April 2009

26 Advice on Technical Provisions – Methods and statistical techniques for calculating the best estimate
27 Advice on Technical Provisions - Segmentation
28 Advice on SCR Standard Formula – Counterparty default risk
29 Advice on Own Funds – Criteria for supervisory approval of ancillary own funds
30 Advice on Technical Provisions – Treatment of Future Premiums
31 Advice on SCR Standard Formula – Allowance for financial mitigation techniques
32 Advice on Technical Provisions – Assumptions about future management actions
33 Advice on System of Governance
34 Advice on Transparency and Accountability
35 Advice on Valuation of Assets and “other Liabilities”
36 Advice on Special Purpose Vehicles
37 Advice on the Procedure to be followed for the approval of an Internal Model

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37 Addendum (CP37) Advice on the Procedure to be followed for the approval of a Group Internal Model
39 Advice on Technical Provisions – Best Estimate
40 Advice on Technical Provisions – Risk Free Rate
41 Advice on Technical Provisions – Calculation as a whole
42 Advice on Technical Provisions – Risk Margin
43 Advice on Technical Provisions – Standards for Data Quality
44 Advice on Technical Provisions – Counterparty Default Adjustment
45 Advice on Technical Provisions – Simplifications
46 Advice on Own Funds – Classification and Eligibility
47 Advice on Standard Formula – Market Risk
48 Advice on Standard Formula – Non Life Underwriting Risk
49 Advice on Standard Formula – Life Underwriting Risk
50 Advice on Standard Formula – Health Underwriting Risk
51 Advice on Standard Formula – Counterparty Default Risk
52 Advice on Standard Formula – Reinsurance Mitigation
53 Advice on Standard Formula – Operational Risk
54 Advice on Standard Formula – Loss absorbing capacity of Technical Provisions
55 Advice on MCR – Calculation of the MCR
56 Advice on Tests and Standards for Internal Model Approval
57 Advice on Capital Add-Ons
58 Advice on Supervisory Reporting and Public Disclosure Requirements
59 Advice on Remuneration Issues
60 Advice on the Assessment of Group Solvency
61 Advice on Supervision of Risk Concentration and Intra-Group Transactions
62 Advice on Cooperation and College of Supervisors