Structural implications of Solvency II

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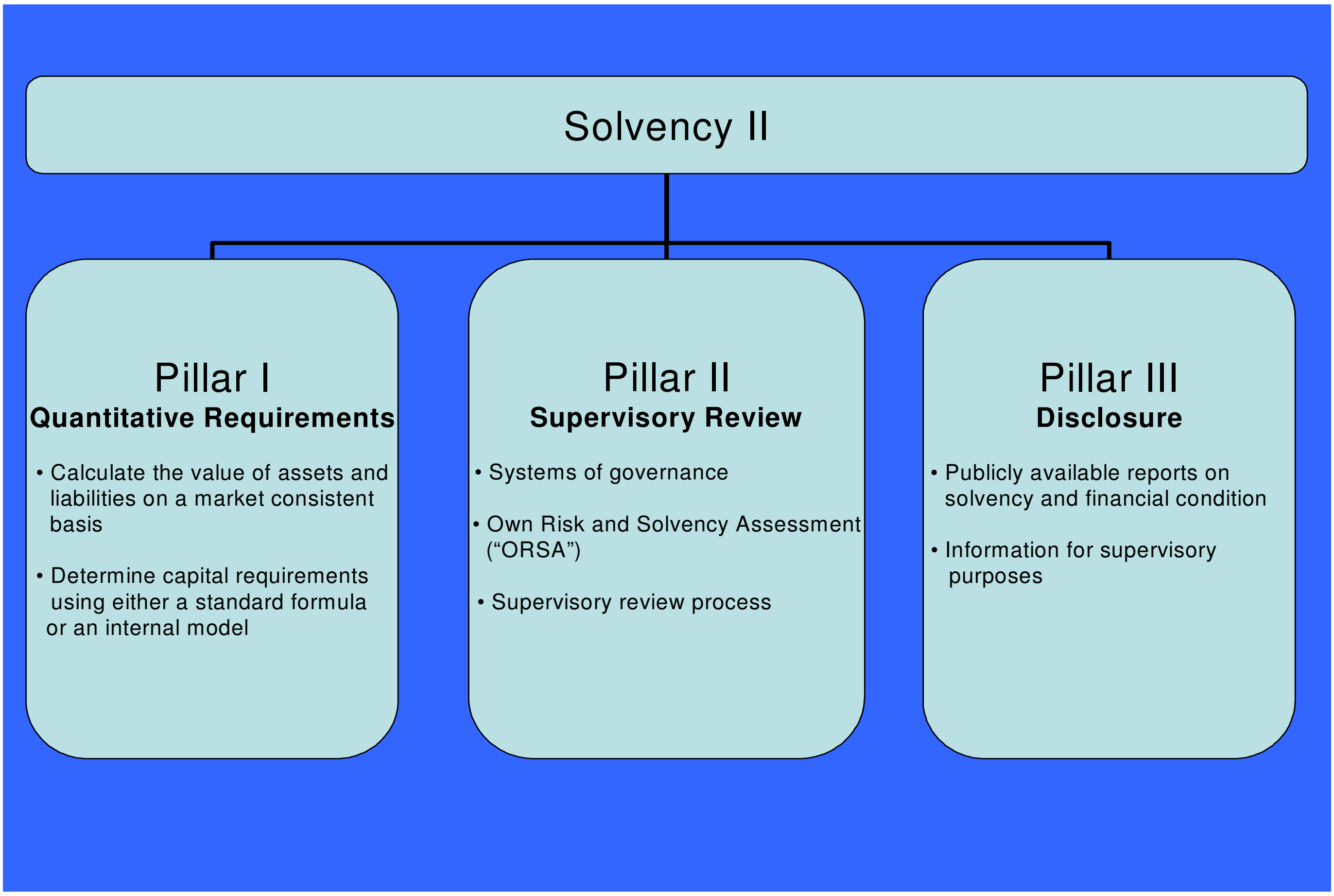
1. Introduction

A major overhaul of the solvency system for insurance companies – a project known as Solvency II – is currently underway at European Union level. This will replace the current one size fits all regime with a risk-based approach to assessing capital adequacy for insurance companies. Risk in this context will be wide ranging and will include insurance, operational, credit and market risk.

The Solvency II draft framework Directive was issued in July 2007 and sets a deadline of 31st October 2012 for the implementation of Solvency II. The Directive is intended to outline the basic enduring principles underpinning the new system. It will be further developed by "Implementing Measures" and "Supervisory Standards" which will outline more detailed, technical rules and set out guidelines for national supervisors.

Solvency II is based upon three pillars as shown in the following diagram:



A number of Quantitative Impact Studies ("QIS") have been launched in order to help design the quantitative requirements pillar and draft details of the fourth such study (QIS4) have recently been published.

This Briefing Note is focussed on the second pillar and, in particular, on the structural changes necessary for companies to meet the requirements of Solvency II. CEIOPS has also released an Issues Paper[1] on Risk Management, which gives greater insight in some areas.

2. Systems of Governance

All undertakings will be required to have an effective system of governance which provides for sound and prudent management of the business. This system should include at least an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and the system should be subject to regular internal review.

The draft Directive recognises that the system should be proportionate to the nature, scale and complexity of the operations of the undertaking.

Insurance undertakings will be required to have written policies in relation to risk management, internal control, internal audit and, where relevant, outsourcing. These policies should be reviewed at least annually.

3. Risk Management System

Companies will be required to have in place an effective risk management system comprising strategies, processes and reporting procedures necessary to monitor, manage and report, on a continuous basis, the risks to which they are exposed. The system should be well integrated into the organisational structure and contain contingency plans. It should cover at least the following areas:

- Underwriting and reserving
- Asset-liability management
- Investment, in particular derivatives and similar
- Liquidity and concentration risk
- Reinsurance and other risk mitigation techniques

Insurance undertakings will be required to have a risk management function ("RMF"), structured to facilitate the implementation of the risk management system. This function should be appropriate to the scale, nature and complexity of the operations. The RMF should operate in an objective and independent manner. The CEIOPS Issues Paper mentions that the risk management function is often the responsibility of an independent Chief Risk Officer ("CRO"), although this term is not defined.

If undertakings use internal models then a risk modelling function must be in place and this function should be responsible for developing and documenting all features of the model. This

[1] Risk Management and Other Corporate Issues 17 July 2007

function should also be responsible for the way in which the model is integrated with the risk management system.

4. Own Risk and Solvency Assessment

As part of its Risk Management System every insurance undertaking will have to conduct an Own Risk and Solvency Assessment (“ORSA”). This assessment should include at least the following:

- overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy
- compliance, on a continuous basis, with the capital requirements
- the extent to which the risk profile deviates significantly from the assumptions underlying the calculation of the capital requirements of the company

The ORSA should be an integral part of the business strategy and the undertaking must inform the regulator of the results.

Supervisory Review Process

The regulator will review and evaluate the strategies, processes and reporting procedures which are established by the undertakings. This will comprise an assessment of:

- the qualitative requirements
- the risks which the undertaking faces
- the ability of the undertaking to assess those risks

The regulator will establish the minimum frequency and scope of the reviews, evaluations and assessments having regard to the nature, scale and complexity of the undertaking’s activities. Following the supervisory review the regulator may, in exceptional circumstances, set a capital add-on, i.e. require the company to hold extra capital in addition to that indicated by the company’s calculation of their solvency capital requirements.

5. Other Functions and Systems

Insurance undertakings will also have to establish a number of other functions. The CEIOPS paper clarifies that in small undertakings more than one function may be carried out by one person.

Internal Control

There will be a requirement for an effective internal control system. This should include at least administrative and accounting procedures, an internal control framework, appropriate reporting functions at all levels of the undertaking and a permanent compliance function. CEIOPS note that an efficient control system demands an appropriate segregation of duties and clear reporting lines.

Internal Audit

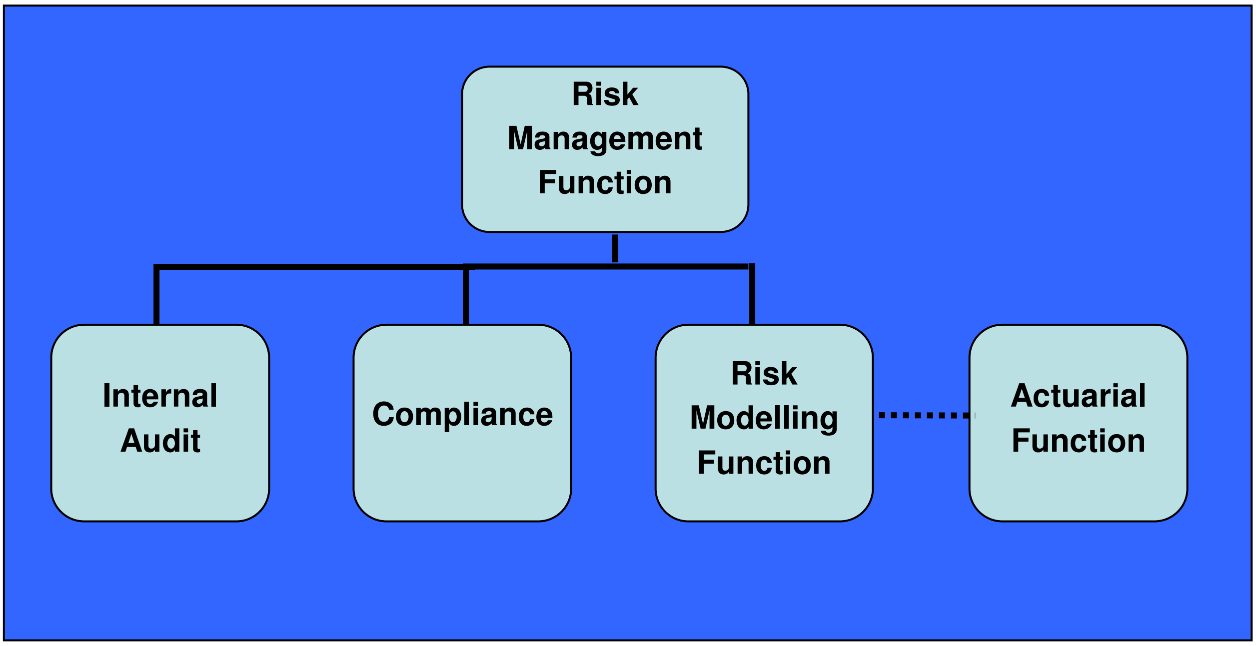
There will also be a requirement to have an effective and permanent internal audit function. This function should be objective and independent from the operational functions.

Actuarial Function

There will be a requirement for undertakings to have an effective actuarial function:

- To coordinate the calculation of the technical provisions
- To ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of the technical provisions
- To assess the sufficiency and quality of the data used in the calculation of technical provisions
- To compare best estimates against experience
- To express an opinion on underwriting policy and the adequacy of reinsurance arrangements
- To contribute to the effective implementation of the risk management system, in particular with respect to the risk modelling

The following diagram outlines the functions that would seem to be required in accordance with the draft Directive and the CEIOPS Issues Paper.



Staffing of these functions will be an issue and was a key problem for banks during the implementation of Basel II. Early recruitment and training would help ease implementation.

The availability of data will also be a key issue. Companies should consider whether they are capturing and retaining sufficient data to allow them to model all risks. In many cases a bank of historical data would be of major advantage when modelling risks such as operational risk.

Systems will also need to be considered, with significant development potentially required in actuarial models, information systems and risk management systems, especially for those companies planning on using internal models.

6. Outsourcing

When critical or important functions are outsourced, the undertaking must remain fully responsible for discharging all of their obligations. Undertakings must notify the regulator prior to the outsourcing of important activities, as well as of any subsequent material developments. The regulator will be permitted to carry out on-site inspections at the premises of the service provider.

7. Group supervision

The draft Directive outlines proposals which would allow a single regulator to take the lead in the supervision of European groups. This could potentially allow groups to capture valuable diversification benefits and also reduce the duplication of modelling across the group. This proposal is controversial and has resulted in considerable debate.

8. Summary

Solvency II will have a major impact on life assurance companies. The risk-based calculation of capital should result in more appropriate levels of capital and a lot of attention to date has focussed on this quantitative element of Solvency II. Solvency II will also impact upon other areas outside of the quantitative pillar and companies should be aware of any structural changes that will be required. Risk management will receive a greater focus and companies should start planning now to ensure that they will have the appropriate structures and systems in place.

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