

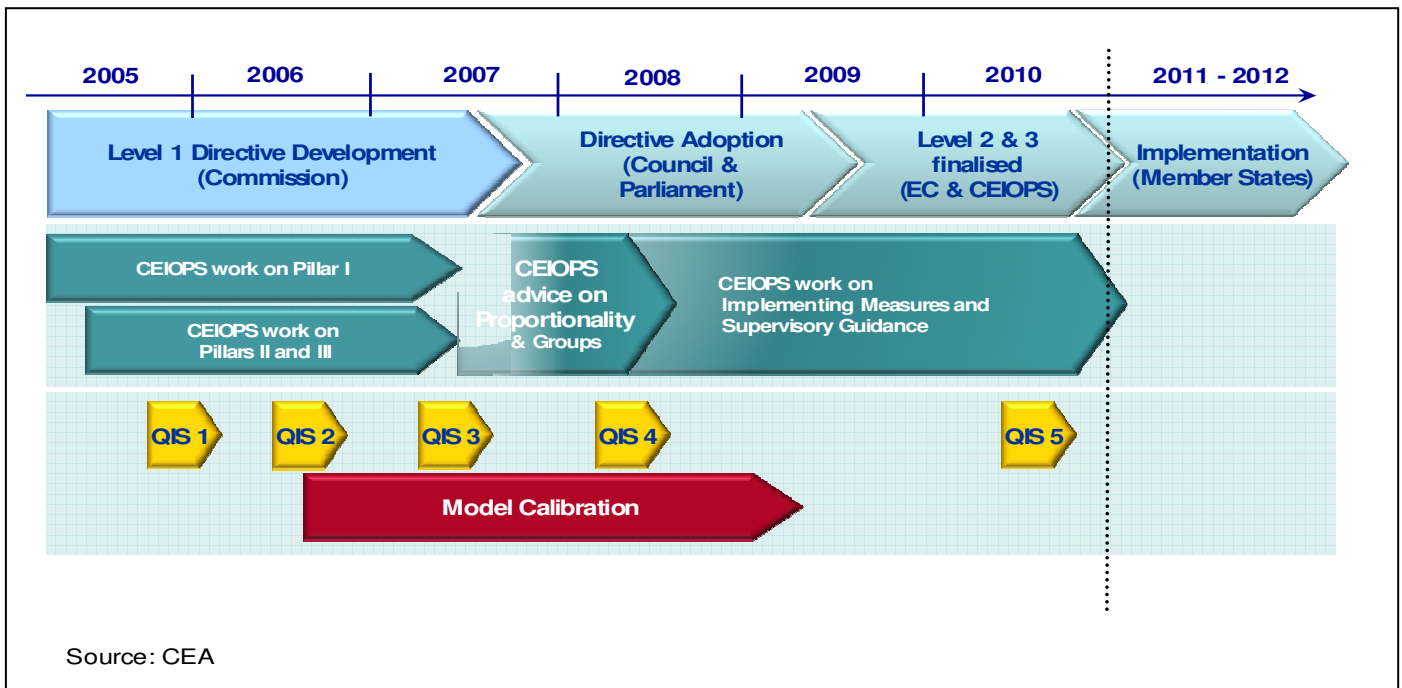
Solvency II Update

May 2009

1. Introduction

Last month the European Parliament approved the proposed text of the framework Directive for the new supervisory regime, 'Solvency II'. This text was formally ratified by the Council of Ministers on the 5th May 2009 with a view to full implementation by 31 October 2012. This marks the end of 'Level 1' (the framework principles) of the Solvency II project which will now progress to 'Level 2', the more detailed Implementing Measures. Level 3 of the process will involve the setting of supervisory standards and Level 4 will be concerned with the monitoring of compliance and enforcement.

Solvency II Timeline



2. Level 2 Implementing Measures

The Level 2 Implementing measures are required to take account of advice from CEIOPS (the Committee of European Insurance and Occupational Pension Scheme Supervisors), whose advice is due by the end of 2009. To this end CEIOPS has recently issued 12 consultation papers on which comments are due from interested parties by June 2009. The Appendix to this briefing note contains a full list of these papers. Each of the consultation papers contains the Directive text to which the paper relates, the CEIOPS' advice itself and also some background explanatory text, outlining their reasoning.

In this briefing note we focus on Consultation Paper 33 - Advice on System of Governance - as it is one of the more substantive papers and is of relevance to a number of different areas within an insurance undertaking.

3. Consultation Paper 33- Advice on System of Governance

Consultation paper 33 covers the following areas:

3.1 General Governance Requirements

The Directive requires undertakings to have in place a system of governance which is proportionate to the size and complexity of the undertaking and which will allow for the 'sound and prudent' management of the business. In particular, there is an explicit requirement for written policies, which should be reviewed at least annually, in respect of risk management, internal control, internal audit and, where relevant, outsourcing.

The advice from CEIOPS includes a list of the requirements which the system of governance should meet. These can be summarised as:

- The organisational structure, reporting lines, skills and qualifications, decision making process and record keeping should be appropriate.
- There should be a requirement to establish procedures to identify and manage potential conflicts of interest.
- Contingency and business continuity plans are also required. These should be regularly tested, updated and communicated.

In the explanatory text to its advice, CEIOPS elaborates further on a number of the areas but some of the main points of interest are as follows:

- The remuneration policy should be in line with the company's strategy and risk profile and should avoid potential incentives for unwanted risk taking.
- The internal audit function cannot be combined with other operational duties or functions
- The system of governance should be reviewed on a regular basis with the frequency consistent with the principle of proportionality. Reports on the effectiveness review should be made to the Board at least annually.
- Companies should consider whether a committee structure is appropriate and if so what its mandate and reporting lines should be.
- Consideration should be given to drawing up and implementing a code of conduct for staff.

3.2 Fit and Proper Requirements

All persons who effectively run the undertaking or have other key functions must:

- a. have adequate professional qualifications, knowledge and experience
- b. be of good repute and integrity

The requirements are similar to the existing requirements in Ireland but each insurance undertaking will need to have documented policies and processes for assessing fitness and propriety. CEIOPS expects to develop criteria for assessing policies and processes in Level 3.

3.3 Risk Management Systems

The Board is responsible for ensuring that an effective risk management system is in place which is proportionate to the nature, scale and complexity of the risks inherent in the business. A member of the Board should be designated to oversee the risk management function and CEIOPS state that larger companies and companies with more complex risk profiles, at least, should appoint a Chief Risk Officer.

CEIOPS' advice specifies the minimum requirements for an effective risk management system. These include:

- a clearly defined risk management strategy (which should be approved by the Board)
- adequate written policies to support the implementation of the risk management strategy
- an appropriate Own Risk and Solvency Assessment process.

The Directive states that the risk management system should cover all the risks included in the Solvency Capital Requirement ("SCR") calculation and that it should at least cover the following:

- underwriting and reserving;
- asset liability management;
- investment, in particular derivatives and similar commitments;
- liquidity and concentration risk management;
- operational risk management;
- reinsurance and other risk mitigation techniques.

Written policies are required in respect of each of these risks. The consultation paper sets out CEIOPS' views on what should be covered in the written policies for the asset liability management and investment policies. CEIOPS plans to expand on written policies for the other risks in future Level 3 guidance.

A risk management function must be established and should be structured in such a way as to facilitate the implementation of the risk management system. Where the entity is using an internal model for reserve calculations the risk management function shall also be responsible for the design, implementation, testing and analysis of the performance of the internal model.

3.4 Internal Control

Entities must have in force an internal control system which, at a minimum will, include

- administrative and accounting procedures
- an internal control framework
- reporting arrangements
- compliance function

The compliance function shall ensure compliance with applicable laws and regulations. The intended compliance activities shall be set out in a compliance plan that ensures that all relevant areas of the undertaking are appropriately covered. Any major compliance issues identified must be reported promptly to the Board.

3.5 Internal Audit

Entities must have an internal audit function which is independent of the operational functions which it audits and hence it should operate under the direct control of the Board. This function can be outsourced. Every activity within the organisation falls within its scope. An audit plan, which sets out the audit work to be undertaken in the upcoming business year, should be established using a risk based approach to establish priorities. A written report of the audit findings should be presented to the Board at least annually.

3.6 Actuarial Function

The Directive sets out nine mandatory tasks to be completed by the actuarial function. Whilst the majority of these tasks relate to the traditional actuarial role of the calculation of technical provisions there are also explicit requirements for the actuarial function to contribute to the effective implementation of the risk management system, in particular with respect to risk modelling.

Those persons carrying out the tasks of the actuarial function are required to have 'sufficient knowledge of actuarial and financial mathematics'. Whilst CEIOPS does not envisage that there would be a requirement to be an 'actuary' as such, nor indeed a requirement to hold a specific university degree, it is clear that the onus is on the undertaking to ensure that the relevant people are sufficiently qualified and hence this might be best demonstrated by means of an actuarial or similar qualification.

The paper is clear on the need for the actuarial function to be sufficiently independent from both the functions it is expressing an opinion on and also management. CEIOPS also comments that full or partial integration of the actuarial function with the risk management function is acceptable.

It should be noted that whilst CEIOPS has issued implementation advice regarding this function, the European Commission is at the same time conducting an impact assessment in respect of the various options considered by CEIOPS in arriving at this advice. The options being considered in the impact assessment relate to the following 3 areas:

1. The technical standards to which the actuarial function will adhere

The consultation paper discusses whether the standards should be those widely acceptable within the industry and profession, whether they should be determined by CEIOPS or whether there should be a set of European standards set by a body of representatives of different stakeholders including CEIOPS.

CEIOPS' advice is for the latter option on the basis that the guidance should be developed at a European level in accordance with the Solvency II regime. They also note that this would not prevent national associations from continuing their existing role but that consistency would need to be maintained.

2. Should Implementing Measures prescribe the scope of the tasks to be carried out by the actuarial function or should the undertaking itself determine these?

CEIOPS favours prescribing minimum tasks so as to ensure there is a certain level of expert technical advice through the actuarial function but that the actuarial function may also be involved in other tasks.

3. Should Implementing Measures determine the structure and content of the annual actuarial reporting to management or should the decision be left to the undertaking?

CEIOPS believes that it is sufficient for the undertaking to determine the contents of this report.

3.7 Outsourcing

The paper is clear that where functions are outsourced it is the responsibility of the undertaking itself to both discharge fully all of its obligations and to ensure that the service provider co-operates with the supervisory authorities. Entities should have in place a process for monitoring the quality of the service provided as it is not sufficient to rely on the service providers' internal controls. Entities should also have a written policy on outsourcing which should consider the impact of outsourcing on the business and the reporting and monitoring arrangements that should be put in place.

When choosing a service provider for any critical or important functions, a company should take all necessary steps to ensure that a specified checklist of conditions is satisfied. Further to this the written agreement with the service provider should include a specified checklist of conditions including right of access to the service provider for the supervisor and the external auditor.

Some additional points of interest are as follows:

- It is possible to outsource to non-EU service providers as well as to EU service providers and different supervisory notification arrangements are not necessary.
- In principle all functions and activities can be outsourced with the exception of core management functions.
- CEIOPS will expand further on what might or might not constitute outsourcing in future Level 3 guidance.
- Companies are required to notify the supervisor prior to outsourcing of critical or important functions or activities and CEIOPS gives an indicative timescale of at least 6 weeks. Although this is a notification process and not an authorisation process, CEIOPS notes that outsourcing must comply with the provisions of the Directive and that the supervisor can object if any "supervisory concerns cannot be dispelled".

4. Conclusion

The Consultation Papers on the Implementing Measures mark another step on the path to Solvency II. The Directive has now been ratified and the advice from CEIOPS on the contents of the Implementing Measures is starting to give greater detail on what will be required in terms of the structure and governance of insurance companies under Solvency II. This briefing note summarises the requirements from one of the twelve consultation papers issued by CEIOPS. It is important to appreciate that Solvency II is not solely a capital calculation exercise - companies should ensure that they are aware of, and start planning for, the additional requirements that will be introduced regarding company structure, governance, documentation and explicit articulation of company policy in numerous areas.

Appendix

Consultation Papers on Implementing Measures

- 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

For further information please contact

Padraic O'Malley on +353 1 6475906 or padraic.omalley@lifestrategies.ie

Ramona Dolan on +353 1 6475504 or ramona.dolan@lifestrategies.ie

or your usual Life Strategies consultant

This Briefing Note is for general information purposes only. Action should not be taken on the basis of the information contained in it without seeking specific advice.