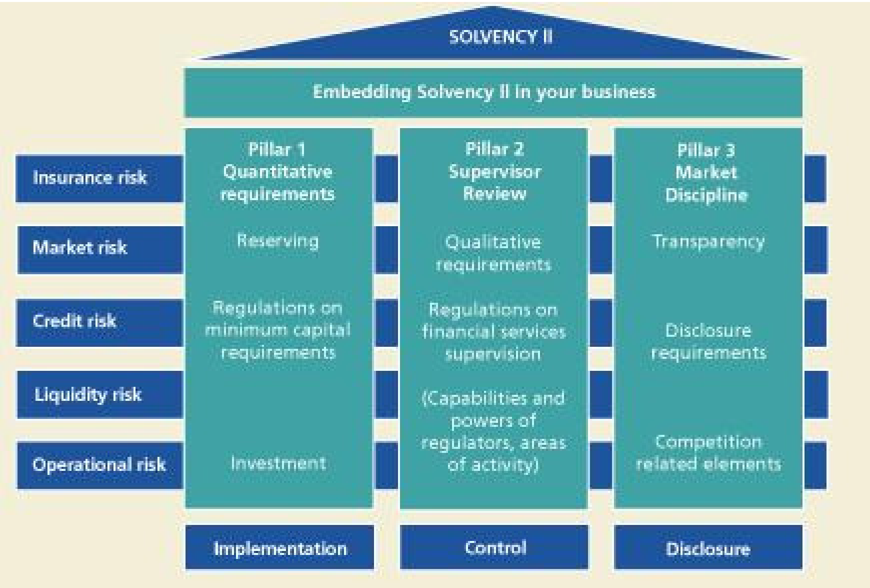
## Solvency II: a real performace enhancer

**Solvency II is not just a regulatory burden: once successfully implemented, it can be a real performance enhancer.**

Solvency II is the most far-reaching change to the framework governing insurance companies in the European Union in over 20 years. It aims to implement solvency requirements that better reflect the risks that companies face and deliver a supervisory system that is consistently implemented across all member states. It is expected to be implemented in 2010 but preparatory work needs to start well in advance.

The Solvency II regime offers incentives, in the form of reduced capital requirements, to implement appropriate risk management systems and sound internal controls. As in Basel II for Banking, the regime has a three-pillar structure with each pillar governing a different aspect of the Solvency II requirements and approach.




## Pillar 1 - Quantitative Requirements

Pillar 1 considers the quantitative requirements of the system, including the calculation of technical provisions, the rules relating to the calculation of the solvency capital requirements and investment management.

**Technical provisions**
For life assurance technical provisions will be calculated on a policy-by-policy basis as the present value of expected future cash flows with an explicit margin for risk. The discounting of cash flows will be carried out using an appropriate term structure of interest rates.

For non-life, premium provisions are likely to be merged, i.e. the unexpired risks provision with the current unearned premium reserve acting as floor. For some lines of business, the equalisation reserves will probably still be permitted but they will be considered as capital for the purpose of meeting the Solvency Capital Requirements (SCR).

**Capital**
Quantitative requirements will depend on the final shape of the rules for Solvency II, but the consultation process foresees two levels of capital requirements. The first level covers the Minimum Capital Requirements (MCR). The second concerns SCR.

The MCR is not necessarily the correct level of capital that companies should hold, but it will act as a safety net. The SCR will be closely aligned to the risks the company faces providing policyholders reasonable assurance that payments will be met as they fall due. The Committee of European Insurance and Occupational Pensions Supervisors' (CEIOPS) working hypothesis is that the SCR will be consistent with a 99.5% confidence level over a one-year timeframe.

When MCR and SCR are assessed against actual available capital, the comparison leads to three potential alternatives:

- If the available capital is more than the SCR, the insurance company is sufficiently capitalised.
- If the available capital lies between the SCR and the MCR, this is an early indicator to the supervisor and the insurance company that action needs to be taken.
- If the available capital is less than the MCR, the insurance company is technically insolvent.

**Investment**
Quantitative limits will apply to address concentration and liquidity risk. Assets covering the MCR and SCR are likely to be subject to the same rules as assets covering the technical provisions. The current Solvency I list will be used as a starting point. Any breach of quantitative limits on investments will be permitted if previously agreed by the regulator.

## Pillar 2 - Supervisor Review

Pillar 2 deals with the qualitative aspects of a company’s internal controls, risk management process and the approach to supervisory review. It encourages insurers to develop and implement a broad and robust internal risk management process that incorporates the management of policies, claims, provisions and risks. Pillar 2 stresses the importance of corporate governance and clearly defined roles and responsibilities for the executive team.

The supervisory approach relies on the two capital levels - Minimum Capital Requirements (MCR) and Solvency Capital Requirements (SCR) - to define the thresholds for supervisor intervention. If the available capital falls below the SCR the supervisory authority can intervene before capital levels fall below the MCR. Pillar 2 will make further allowances for risks that may not previously have been adequately quantified, such as group risk and strategic risk, by adjusting the SCR levels.

Increasingly, the nature of the supervision process will depend upon the risk profile of individual insurers and their approach to meeting Solvency II requirements. For example, if supervisors are dissatisfied with a company's assessment of the risk-based capital they will have the power to impose higher capital requirements.

## Pillar 3 - Market Discipline

Pillar 3 is concerned with enhancing disclosure requirements in order to increase market transparency. It will aim to harmonise reporting but goes beyond the notion of well-defined financial reporting rules and increases market transparency, providing a clear insight into the actual risk and return profile of an insurance company. Companies must interpret the disclosure requirements, develop a strategy for disclosure and educate key stakeholders on the potential impact. The onus is placed on firms to design the information which through public disclosure will be available to regulators, analysts, rating agencies and shareholders alike. Crucially, organisations must also develop the internal processes and systems to produce these reports.

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