



Solvency II – HM Treasury Discussion Paper

Introduction

HM Treasury (“HMT”) and the Financial Services Authority (“FSA”) jointly issued a [discussion paper](#) on Solvency II at the end of February 2006. The paper analyses the Framework set out by the European Commission (“EC”) in its [July 2005 document](#) and asks for comments on a number of discussion points. Responses should be made to HMT on the discussion paper by 28 April 2006.

Implementation

Development and implementation of Solvency II will follow the four-level Lamfalussy approach (named after Alexandre Lamfalussy, the chairman of an EC committee which recommended this type of approach for the securities market). The aim of this approach is to allow the EC to develop financial services legislation more speedily.

Level	Description
1	Directives (primary legislation) which set out the framework and which are approved by the Council of Ministers and the European Parliament.
2	Measures (secondary legislation) adopted by the EC following consultation with a committee of representatives from finance ministries of Member States. This Level 2 committee is called the European Insurance and Occupational Pensions Committee (“EIOPC”).
3	Measures (such as guidance) to foster supervisory convergence across Member States. These measures are developed by a committee of representatives from the financial regulators of Member States e.g. the UK representative comes from the FSA. This Level 3 committee is called the Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”).
4	Enforcement by the EC to ensure the legislation is effectively and consistently implemented.

As an intermediate step towards Level 1, it is proposed that a single insurance framework directive will be produced which will consolidate the existing directives covering the prudential regulation of life insurance, general insurance, reinsurance, insurance groups, and the winding up and reorganisation of insurance companies. This will make the Solvency II Directive easier to implement to the extent that it covers prudential regulation. Changes to other directives will also be required as part of Solvency II e.g. to the Insurance Accounts Directive.

The current plan is that the Solvency II Directive will be proposed by the EC in mid-2007 with ratification in 2008 and implementation from 2010.

Structure

The structure of Solvency II will broadly follow the three pillar structure adopted in Basel II and the Capital Requirements Directive (“CRD”).

Pillar	Description
1	Minimum capital requirements
2	Supervisory review
3	Market discipline and disclosure

Objectives

The objectives of Solvency II put forward by the EC in its July 2005 paper include:

- To provide supervisors with the appropriate tools and powers to assess overall solvency on a prospective and risk-orientated approach;
- To design the system in such a way that it gives an incentive to supervised institutions to

measure and properly manage their risks;

- The rules should be compatible with the accounting standards being developed by the International Accounting Standards Board (“IASB”). This will ensure convergence of valuation rules, supervisory reporting and public disclosure; and limit the administrative burden on supervised institutions;
- To ensure harmonisation, Member States will not be able to impose additional requirements; and
- To ensure consistency across financial sectors and avoid regulatory arbitrage, the system should as far as possible be consistent with the rules applied in the banking sector (and, thus, with the CRD), so that similar risks should have similar capital requirements.

Key points

Technical provisions

Two approaches are being debated:

- A standard based on a best estimate value of the liabilities plus a quantified prudential risk margin. The current working hypothesis is that the risk margin will be set at the 75th percentile for all lines of business (subject to a minimum of half a standard deviation to ensure sufficient prudence where there is a strongly skewed distribution); and
- A market consistent (fair value) approach to valuing liabilities using a modelling approach for non-hedgeable risks.

The first approach is the one put forward by the EC in its July 2005 document. However, the discussion paper raises a number of issues on this approach including:

- (i) The difficulties in determining the 75th percentile of a liability's distribution;
- (ii) The dangers of using a regulatory valuation approach with a risk margin that does not necessarily reflect the economic cost of the risks and which is likely to lead to large margins in provisions; and
- (iii) The potential that a large prudential margin could lead to an excessive requirement on smaller firms with less diversified portfolios (assuming that risk margins are applied at a portfolio or firm level, rather than at contract level).

The discussion paper favours the second approach reflecting the view of those in the UK, Netherlands and others who desire more fundamental reform with lower margins in provisions. However, some issues are raised with this approach including the method of valuation of non-hedgeable risks and whether liabilities should be assessed on a contract-by-contract, portfolio or firm-wide basis. For non-hedgeable risks, a cost of capital approach is suggested with the possibility of a simplified approach for small companies which is broadly equivalent. The cost of capital would be determined by applying a cost of capital charge to the present value of all future solvency capital requirements.

Whichever approach is adopted, it is proposed that in future the amount of technical provisions will be determined by a method which:

- (i) Uses market consistent discount rates to value future payments (net of expected reinsurance recoveries);
- (ii) No longer prohibits contracts being valued as assets or requires the provision for each contract to be at least equal to its current surrender value (and, instead, makes realistic

assumptions about surrenders and lapses with appropriate stress testing);

- (iii) Places a market consistent value on options and guarantees; and
- (iv) Automatically includes constructive liabilities (such as future bonuses) as well as contractual liabilities.

Solvency Capital Requirement

There will be two capital requirements under Pillar 1: the Solvency Capital Requirement ("SCR") and the Minimum Capital Requirement ("MCR"). The SCR must not be less than the MCR.

The purpose of the SCR is to provide appropriate policyholder protection and market stability. The SCR will replace the Required Minimum Margin ("RMM") which applies under the current directives. Where a firm's capital falls below the SCR then additional reporting and a financial recovery plan would be required.

It is proposed that the SCR will be a risk-based capital requirement. The current working hypothesis is that it will be calculated on a going concern basis at a 99.5% confidence level or Value-at-Risk ("VAR") over a one-year time horizon (a 0.5% probability of ruin). The risks to be addressed in calculating the SCR will be based on the International Actuarial Association ("IAA") risk classification and so will include underwriting, credit, market and operational risks.

It is proposed that firms will be able to calculate their SCR in one of two ways by using:

- Either a "standardised approach" based on standard formulae for key risk categories ; or
- An internal model recognised by their regulator.

The possibility of using a combination of these two approaches is also put forward. Unlike the CRD, where the

modelling of different risks is compartmentalised, Solvency II will encourage an integrated approach to internal models so that firms will be able to model risks across risk categories and lines of business.

The EC in its July 2005 document majors on the use of the standardised approach. However, the discussion paper favours the use of internal models although it accepts that the standardised approach can be (more) readily applied in non-life business. The concerns raised about the standardised approach include:

- (i) The approximate nature of the method which is unlikely to deliver accurate risk-based capital requirements where a firm's risk profile differs significantly from the assumptions used in calibrating the standard formulae; and
- (ii) The difficulties of assessing asset-liability matching ("ALM") and the risks of options and guarantees embedded in products, where a standardised approach is adopted.

The discussion paper suggests that an attractive option to overcome deficiencies in the standardised approach would be to allow regulators to impose a higher level of capital under Pillar 2.

The criteria for approval of internal models by regulators might include:

- **Model governance** including a "use test" to ensure that the model is used by the firm's management to run its business and not purely to calculate regulatory capital;
- **Model inputs** including defining categories and quality of data;
- **Model structure** detailing the extent to which relationships between key risk drivers are prescribed; and
- **Model output** which calibrates the output to a level of confidence and time horizon that are consistent with the requirements laid down

(currently proposed to be 99.5th percentile over one year).

The discussion paper warns that the approval criteria must not be too onerous and dissuade firms from obtaining recognition of their internal models. It favours an approach that incentivises firms to use and develop models, including starting with partial models and moving to full models. On the other hand, there are concerns that some firms might use partial models to minimise capital requirements through cherry-picking.

Minimum Capital Requirement

The purpose of the MCR is to set a level of capital below which ultimate supervisory action is required. The MCR will replace the Minimum Guarantee Fund ("MGF") which applies under the current directives.

Four options are being debated:

- A continuation of the Solvency I capital requirements (possibly recalibrated);
- A percentage of the standardised SCR;
- A simplified version of the standardised SCR; and
- A percentage of the technical provisions.

In all cases, the MCR will be subject to an absolute (monetary) floor.

The EC in its July 2005 document made it clear that the MCR should be straightforward to calculate "such as under the present Solvency I Directives". This reflects the requirement in some Member States that legal proceedings are needed before an insurer is closed to new business.

The discussion paper considers that the MCR should provide a buffer which protects against the risk that a firm's financial strength deteriorates during run-off or before transfer to another insurer. It considers that the simplest route would be a percentage of the technical provisions. The use of SCR-based approaches is considered less

straightforward. Retaining the Solvency I capital requirements is considered undesirable as it imports the shortcomings of the current system.

Asset types and limits

Under Solvency II, a market value approach will apply to the valuation of assets and asset risk will be taken into account in determining the SCR. The discussion paper proposes that it is unnecessary to have restrictions on assets except for unit-linked business where the policyholder bears the investment risk. The only possible exception would be to impose some limits to avoid large concentrations of risk.

Other issues

The discussion paper raises other issues including:

- The types of capital eligible to meet the SCR and MCR (including whether to recognise innovative types of capital along the lines of the CRD), with the possibility of stronger reliance on equity for the MCR;
- The flexibility to be allowed to smaller (shareholder-owned and mutual) firms to ensure that regulation is proportionate and does not create unreasonable barriers to entry;
- The appropriate treatment of groups (including cross-border groups) to foster a more integrated single market, avoid distortions in the way such firms approach capital management and to allow for recognition of diversification benefits between entities within a group (and, potentially, to allow for the fungibility of capital across groups); and
- The need to consider carefully the disclosure requirements under Pillar 3 to ensure that disclosures are focussed, relevant and proportionate.

Comment

The views expressed in the discussion paper on the approach to Solvency II are closely aligned with those of the Association of British Insurers ("ABI") and the Chief Risk Officer Forum ("CRO Forum") of the Comité Européen des Assurances ("CEA"). They reflect a desire for fundamental reform which is not held by the authorities in all Member States. Some Member States would prefer a more cautious approach with only modest changes to the regime. They would propose the retention of large margins in technical provisions, continuing restrictions on (non-linked) assets and modest revisions to the Solvency I factors rather than a move to advanced modelling techniques.

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