

Solvency II: a blueprint for avoiding a future financial crisis

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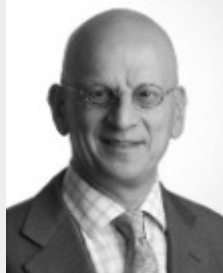


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Solvency II is the economic, risk-based regulatory and solvency regime which proposes to meet the needs of a modern European insurance industry. It will facilitate group supervisory cooperation; enhance risk management practices; improve capital allocation; and, consequently, strengthen the sector's ability to weather financial crises. The European Commission first proposed Solvency II in 2007, well before the onset of the financial crisis. The proposed directive is now at a critical stage. Two contentious issues, group support and the capital charge for equity investments, are currently delaying its timely adoption. The Czech presidency of the European Union is trying to fashion a compromise among member states, the European Parliament and the European Commission. Agreement on the contentious issues has become even more urgent because of parliamentary elections in June and the appointment of a new commission scheduled for later this year. If a compromise is not reached and the proposal is not adopted by May, then Solvency II could be entirely derailed or its implementation delayed well beyond 2013.

The financial crisis has highlighted the need for effective, comprehensive cross-border financial services regulation. Late last year, the commission mandated a high-level group, chaired by Jacques de Larosière, to propose recommendations for a new framework for financial services regulation and supervision. The group's report, which was issued on February 21, contains 31 recommendations which provide a number of solutions for regulatory, supervisory and global repair. The commission endorsed these recommendations on March 4 in its "Communication for the Spring European Council — Driving European Recovery".

The de Larosière Group analysed the complex causes of the financial crisis. It found that although the crisis started in the banking sector, the insurance sector was not immune to problems, as the lack of effective supervision of US-based insurance giant AIG showed.



The group's report highlights the important improvements to insurance regulation, risk assessment and the management of large groups found in Solvency II. It recommends urgent adoption of the directive, including its group support regime. The report also stresses the importance of lessons from the crisis to justify insurance-specific measures for regulatory and supervisory repair. This article examines the regulatory and supervisory repair recommendations that are specific to the insurance industry as set out in the de Larosière Report and the commission's communication.

Regulatory repair

The report's main message is that although additional lessons can be learned from the crisis, Solvency II is already an important step in improving insurance regulation and supervision. The call for rapid adoption of Solvency II, with its group support regime, is complemented by sufficient safeguards for host member states, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes. Beyond Solvency II, the report identifies several shortcomings in achieving a single market in insurance. These include: inconsistent rules; broad regulatory diversity between member states; differences in the enforcement of EU directives; too much regulatory arbitrage; and excessive discretion in implementation, e.g., the [Insurance Mediation Directive](#).

In its current form, Solvency II does not address IGSs. The commission has traditionally avoided legislation in this area but has now announced an IGS proposal for the autumn of 2009.

Finally, the report identifies the lack of an adequate framework for retail investment products, which include life insurance products, and calls for better pre-contractual information, clarification of the liability of intermediaries, and control over depositaries and custodians.

Supervisory repair

The report's proposals for supervisory repair should be considered in the context of existing EU legislation and the proposed Solvency II framework. Solvency II already addresses many of the supervisory reforms that the report and the commission have contemplated, although additional issues will need to be addressed.

Solvency II's proposals for supervisory repair

Micro supervision has historically been the norm in the insurance industry. Supervisory practices have not been adapted to address groups with subsidiaries in the EU. Pending the adoption of Solvency II, cooperation between supervisory authorities has been largely absent, despite the existence of the [Insurance Groups Directive](#). The close cooperation between supervisory authorities, as envisaged in the report and the commission's communication, is already part of Solvency II, where group and solo supervisors will be required to cooperate on the basis of clear rules. A college of supervisors composed of the group and solo supervisors will also need to be set up. They will be bound to share information regarding, for example, the financial situation of the group, solvency and risk concentration, and the governance systems in place. Supervisors will need to consult each other before decisions are made which affect the group structure or before sanctions or financial measures are taken.

Solvency II also contemplates that disagreement between solo and group supervisors, within colleges of supervisors, may arise and, in the absence of a joint decision mechanism, the group supervisor will ultimately decide. Solvency II provides no more than a mediation role for the Committee of European Insurance and Occupational Pensions Supervisors. CEIOPS has been particularly active in the development of Solvency II, providing technical advice to the commission and advising on the forthcoming implementing measures that are required before 2013. The report notes, however, that CEIOPS can only provide non-binding advice since it has no legal powers to make decisions.

The report's proposals for additional supervisory repair

Excessive reliance on micro supervision in the insurance industry has meant that macro-prudential supervision has been lacking. The commission endorses the report's proposal to create a macro-prudential, early-warning body, the European Systemic Risk Council, under the auspices of the European Central Bank, to identify and address systemic risks. The ESRC would work at the macro-level with the ECB and CEIOPS. The presence of a sufficiently large number of international insurance groups in the EU which represent

systemic risks means that they would be subject to closer macro-prudential scrutiny by the ESRC. The report also calls for improved supervision by certain national supervisors in terms of status, degree of independence, appropriate funding and employment policy. In addition, the role of CEIOPS and its secretariat is to be strengthened. CEIOPS would have ultimate decision-making powers in the college of supervisors for cross-border groups. This will be a sensitive issue because it will mean that national supervisors (those in the country where the group parent is domiciled) will relinquish part of their authority.

Perhaps the report's most far-reaching proposal is to transform CEIOPS into a European Insurance Authority, although this transformation falls short of creating a European insurance supervisor. The EIA would perform some of CEIOPS' current responsibilities, such as advising the commission on regulatory issues; defining convergence of supervisory standards; and overseeing colleges. It would, however, also carry out a number of new functions, which include a legally binding mediation role in resolving disputes between national regulators (withdrawal of licence, capital add on, approval of risk internal model) and the prudential assessment of pan-EU mergers and acquisitions. In addition to the provisions in Solvency II, the de Larosière Report has provided ambitious recommendations, many of which the commission will include in its proposals on the future of the EU regulatory and supervisory architecture. The call for stronger oversight at the macro EU level, combined with the maintenance of important roles for national supervisors, will inevitably give rise to intense legislative activity in the coming months.

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