

THE MOMENT OF TRUTH

Solvency II is a fundamental reshaping of the solvency regime for the European insurance and reinsurance industry. It is an economic, risk-based regulatory regime that meets the needs of a modern insurance marketplace, facilitates group supervisory cooperation, enhances insurers' risk management practices and improves capital allocation, so strengthening the sector's ability to resist financial crises.

The European Commission first proposed a text in the summer of 2007. Since then, the relevant European Parliament committee has proposed numerous amendments. Having progressed through the EU legislature under successive Portuguese, Slovenian and French presidencies, expectations are now high that the Czech presidency, which runs till 30 June this year, will be able to get the regime adopted.

But this may not happen as the new presidency has inherited a compromise text which falls short of resolving tensions between member states, conflicts with the Parliament's and Commission's position, and raises concerns for the industry. Agreement on the remaining contentious issues assumes a greater urgency because of Parliamentary elections in June. Parliament will therefore need to take a final vote on the text in first reading this in April. Since appointment of a new Commission is also scheduled for later this year, any further delay could delay the implementation of Solvency II to well beyond 2013.

The financial crisis has highlighted the need for effective, comprehensive cross-border financial services regulation. Last year, the Commission mandated a High-Level Group chaired by Jacques de Larosière to propose recommendations for a new framework. The Group's 31 Recommendations were issued on 21 February; they provide a number of solutions for regulatory, supervisory and global repair action which were endorsed on March 4 by the Commission in its "Communication for the Spring European Council – Driving European Recovery". The Group's key message to the European insurance industry is that, while it needs to draw conclusions from the crisis, Solvency II is already an important step in improving insurance regulation and supervision. The Group calls for rapid adoption of Solvency II.

Solvency II is entering a critical phase, say **Guy Soussan**, **Philip Woolfson** and **Gavin Coull**, as they outline the issues, options and timing for its adoption.

issues, although there still could be some last minute unravelling. These issues include the calculation of capital requirements, the use of surplus funds, the status of small and medium-sized insurers and of captives, and the treatment of third country (non-European Economic Area) insurers, in particular the recognition of their regulatory regimes.

An important feature of the proposal is the introduction of an integrated, coordinated and centralised regime for the supervision of EU insurance groups; they will have to carry out a single, comprehensive analysis of risks which will dictate the single, consolidated capital requirement applicable to the group. A group supervisor, working closely with the supervisors for each local subsidiary (a supervisory system known as a "college of supervisors") then validates the risk analysis.

Group support is a further key aspect. The regime allows a subsidiary in a European group to meet its local solvency capital requirement by relying on a financial commitment made by the parent ("declaration of support") thereby allowing a substantial reduction in the capital that the subsidiary must hold.

Unsurprisingly, European groups and certain large member states in which they have their head offices, are pressing for group support. Critics, mostly smaller members without any head offices, point out that the powers of the group supervisor may conflict with the regulatory powers of the other ("solo") supervisors and will not adequately reflect their legitimate, national concerns. Their primary statutory duty is to protect local policyholders, and they fear that group support would create uncertainty regarding the equality of treatment of policyholders throughout a group in the event of insolvency; concerns have also been expressed as to the legal enforceability of the declaration of support. The group support regime was withdrawn from the compromise text initially proposed by the French Presidency last year.



From top

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THE HOT ISSUES

Group support and the capital charge for equity investments are the two most contentious issues that could derail the legislative process and timetable. A consensus should emerge on other, less problematic



Above left Jacques de Larosière, whose 31 recommendations were issued on 21 February, has called for rapid adoption of Solvency II.

Above Czech Vice-Premier for European Affairs Alexandr Vondra, who received the EU Presidency baton on 7 January. The Czech presidency was able to broker a compromise deal on Solvency II as we went to press at the end of March.

The Commission strongly opposes a solvency regime stripped of its group support provisions and would appear to be supported by the Parliament. The industry has emphasised that, in the absence of acceptable consensus, it would be better to delay adoption to allow for more constructive negotiations. The de Larosière report echoes the views of the Commission and the Parliament but suggests additional safeguards in group supervision for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes.

Current discussions between the three institutions in so-called “trilogues” continue in search of a compromise. Proposals which have been on the table such as a national opt-in/opt-out on group support or even an enhanced cooperation in a college of a supervisors and a mediation role for CEIOPS all fall short of a genuine group support regime.

Solvency II proposes that, when insurers and reinsurers invest in equities (a riskier class of securities than bonds and other debt instruments) the supervisory authorities should apply a higher risk or capital charge when calculating solvency ratios. The capital requirements for equity holdings originally proposed under Solvency II were, and remain, manageable for most European insurers. But French insurers disagree with this view.

Last December’s French presidency compromise text echoed the concerns of its own industry by recognising that (in principle) equities generate, over the long term, superior rates of return, and that their risk assessment, therefore, should better reflect this.

In a rather desperate attempt to secure agreement by the end of last year, the presidency proposed a trade-off: a lower capital charge for equities in exchange for deletion of the group support provisions. The three institutions now seem ready to address the pro-cyclicality of market risk treatment by allowing an adjustment mechanism (so-called

Pillar 1 dampener) and by giving more flexibility to supervisory interventions in the event of a breach of solvency capital requirements over a longer period of time (Pillar 2 dampener).

The Czech presidency, which started on 1 January this year, now has to lead “trilogue” meetings between the Council, Parliament and Commission to reach agreement on the group support and French equity issues.

Despite or perhaps because of the financial crisis, the Commission and the Parliament continue to advocate Solvency II’s modern, risk-based regulatory regime. In their view, the financial crisis has simply demonstrated the urgency of its adoption. Some member states remain opposed, however, to the loss of their authorities’ supervisory responsibilities and fear that, in times of financial distress, group support might not function as intended, leaving local policyholders insufficiently protected and angry with local supervisors. Recent bank rescues show that, faced with a run on deposits, national supervisors adopt national solutions with scant or, at best, belated regard for Europe-wide solutions.

The crisis has also highlighted other sensitive aspects of Solvency II including the treatment of hybrid capital, whether the use of an “internal model” for solvency (allowed by Solvency II as an alternative to a “standard model”), and, again, whether an insurer or reinsurer would honour a guarantee to its subsidiary.

The Commission’s Communication, endorsing the de Larosière recommendation to adopt Solvency II without delay, shows that Solvency II is the right response at least meantime. However, Solvency II will need to be further adapted to address the supervisory repair action now proposed by the Commission, in particular the transformation of CEIOPS into a European Insurance Authority.

Karel Van Hulle (head of the insurance and pensions unit at the Commission’s Internal Market and Services Directorate General) has warned that the delay in agreeing a final text last year has already pushed the implementation date for Solvency II to at least early 2013. However, this date assumes that a compromise is reached in the trialogue discussions and approved, without any unacceptable amendments, during Parliament’s plenary session scheduled for April.

All of the European institutions want to avoid a second reading in Parliament and the consequent delays. In the midst of the financial crisis, it remains to be seen whether the Czech presidency will be able to broker an acceptable compromise. A moment of truth for all.

STOP PRESS: Since preparing this article, the authors report that the proposal has reached ‘political agreement’ in the Council (without group support). This opens the way for formal adoption before the summer.