

The FSA's path to Solvency II (or the long and winding road)

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In September 2008, the Financial Services Authority published [discussion paper 08/4 — Insurance Risk Management: The Path to Solvency II](#) and requested feedback from the insurance and reinsurance industry by January 31, 2009. Last month, the FSA released its [feedback statement](#) on DP08/4 ("FS09/1"). This article reports on these two documents and on what the sector should expect in the coming months as the "level 1 text", the Solvency II Framework Directive, moves towards implementation into the national laws of the European Union member states.

The Solvency II provisions highlighted by DP08/4 and FS09/1

In April 2009, the EU institutions reached agreement on the text of the Solvency II Directive. It now awaits final adoption by the Council of Ministers — probably in July — with a view to implementation in all EU member states by October 31, 2012.

From the FSA's perspective set out in DP08/4, Solvency II is a fundamental review of the capital adequacy regime for European insurers and reinsurers, which shares requirements already set in the UK so as to ensure that, based on a risk assessment approach, firms are well-managed with adequate financial resources. Solvency II should also protect policyholders' interests more effectively and make it easier for firms to carry on business across the EU. DP08/4 focuses on the main elements of the Solvency II regime to stimulate and help UK insurers' preparations. It emphasises three important elements on which it invited feedback:

- "Systems of Governance (Pillar 2) and Reporting Requirements (Pillar 3) under Solvency II", which cover the risk management framework and functions, outsourcing, capital add-ons and supervisory reporting.
- "Demonstrating Adequate Financial Resources (Pillar 1)", namely key quantitative requirements, including own funds, technical provisions and the Solvency II capital requirements: the solvency capital requirement and the minimum capital requirement.
- "Use and Approval of Internal Models", namely the standards and tests that those firms which seek approval to calculate their regulatory capital by means of an internal, instead of standard, model are to meet.

Finally, DP08/4 sent an important message to the boards of insurers and reinsurers, namely that Solvency II and its implementation in the UK will bring changes in UK regulatory requirements which firms need to plan for without delay. The FSA emphasises

that boards need to take action on the three elements noted above. Likewise, the FSA recognises that its supervisory role will change and will, therefore, regularly consult the sector to meet its objective, i.e., "... to see UK insurers sustain and accelerate progress in developing risk-management and capital planning processes, to help them move as seamlessly as possible to compliance with Solvency II standards as they develop".

The sector's feedback to the FSA and set out in FS09/1 comprises five main points.

First, the FSA notes amendments are required to DP08/4 in the light of progress towards final adoption in the EU of the level 1 directive and its implementation in 2012. This date means that firms should already have completed a detailed "gap analysis" to identify any shortfalls in compliance with Solvency II. FS09/1 also highlights several final changes in the directive's text, including: the possible adaptation of the own risk and solvency assessment (ORSA) provisions; rules to ensure that, over time and in the light of European policy/legal developments, firms have "the right amount of the right quality capital"; the use and approval of internal models; and the much-debated provisions on group support (now deleted) and equity risk.

Secondly, with regard to Solvency II's systems of governance and reporting requirements, FS09/1 summarises responses to questions on ORSA (as the FSA notes, a "new concept for all insurers across Europe"). It also comments on the consequences of a "breach" of targeted economic capital. Thirdly, FS09/1 reports on responses to questions on how to demonstrate financial resources. Responses have been positive and identified a number of areas where further guidance is sought (covering areas of concern for both the life and non-life sectors).

Fourthly, the use and approval of internal models has prompted the most detailed and wide-ranging responses, for example: whether a board "trusts" an internal model (if not, it would hardly be likely to pass FSA muster); how an internal model is integrated into the risk management, risk appetite and risk register of a business; and whether data can be improved by using shared data. FS09/1 also records that the FSA anticipates: further discussion about the link between risk appetite and credit rating; how the FSA should test the adequacy of internal models; and developing documentation of internal models, which includes ensuring that senior executives know and understand their duties.

Finally, FS09/1 reports on responses to questions on impact assessment, in particular, weighing up the costs of meeting Solvency II requirements against the improved risk management benefits. Firms are positive, have identified benefits and have moved beyond a purely compliance approach.

FS09/1 closes with details of the FSA's next steps, in particular, its thematic reviews, references to consultation papers from the Committee of European Insurance and Occupational Pensions Supervisors and QIS 5. It includes a useful high-level timeline to the 2012 implementation and even beyond.

The broader outlook

In the sections of FS09/1 that are devoted to industry responses, the FSA often refers to "level 2 implementing measures". Now that the level 1 text is final, the European Commission is turning its attention to these measures, with input from CEIOPS and on which CEIOPS is currently consulting stakeholders (e.g., the March "Draft CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: System of Governance" and last month's "Internal Governance, Supervisory Review and Reporting Expert Group Issues Paper on System of Governance — Feedback Statement"). In addition, the FSA's [Business Plan 2009/2010](#) affirms that the FSA will dedicate significant resources to Solvency II over the coming years to ensure that (i) the detailed rules required to implement Solvency II will be practical and reflect the economic, risk-focused approach of the directive; (ii) the FSA and the industry are well prepared to make the transition from the current ICAS requirements to Solvency II; and (iii) the requirements of the directive are applied proportionately. Specifically, partially depending on the progress of the level 2 implementing measures, the FSA plans to publish a further discussion paper in the autumn of 2009.

Reaching agreement on the text of the framework directive was the first step on the Solvency II path — insurers, reinsurers and regulators will now need to put their best feet forward to implement it.

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