

# A new dawn

**Philip Woolfson, Guy Soussan and Gavin Coull** look at the European regulatory framework developing out of the financial crisis, and how Solvency II fits in

Over the last eighteen months, the world has witnessed a financial and economic crisis which is unparalleled since the Great Depression. This crisis has prompted a myriad of political, economic and policy responses. This article focuses on the EU response and its impact upon the insurance sector, and in particular the question of whether Europe has the appropriate insurance regulatory framework to manage a future crisis.

Last autumn the European Commission appointed The High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière (former managing director of the IMF and Governor of the Bank of France). This group issued its report on 25 February this year. Following a thorough diagnosis of the causes of the crisis, the de Larosière Report sets out 31 recommendations for the creation of a new regulatory agenda with stronger coordinated supervision.

The European Commission responded to the de Larosière Report on 4 March, releasing "Communication for the Spring European Council – Driving European Recovery".

But what does all this activity mean for the insurance sector?

## Diagnosis

The de Larosière Report notes that, although the crisis originated

in the banking sector, it also affects the insurance sector. It strongly endorses immediate adoption of Solvency II, but concludes that in addition, a number of further regulatory initiatives are needed.

The report identifies several well-known shortcomings in achieving a single market in insurance, in particular inconsistent rules, unsuitable implementation of EU directives, divergences in regulation and enforcement leading to regulatory arbitrage.

It recommends more recourse to EU legislation in the form of regulations (directly applicable in EU Member States), and also recommends the adoption of harmonised rules for insurance guarantee schemes.

Finally, the report identifies the lack of an adequate framework for retail investment products (which includes savings-type life insurance products). It calls for improved pre-contractual information, clarification of the responsibility of intermediaries and control over depositaries and custodians.

In addition to these insurance-specific aspects, the de Larosière Report makes a distinction between macro and micro-prudential supervision; in the absence of adequate EU structures to identify macro-prudential risks, macro-supervision has been virtually non-existent.

The first major proposal is to provide the EU with a supervisory framework that detects potential risks early, deals with them effectively before they have an impact, and meets the challenge of complex, international financial markets. The proposed solution is the creation of an *ad hoc* organisation, the European

Systemic Risk Council (ESRC), whose membership would include the chairpersons of the level 3 committees (including the Committee of European Insurance and Occupational Pensions Supervisors – CEIOPS).

The ESRC will decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and provide direction on these issues.

As for micro-supervision, it also calls for a European System of Financial Supervision (ESFS), which would convert the existing level 3 committees into fully-fledged European authorities, namely:

- European Banking Authority
- European Securities Authority
- European Insurance Authority

As part of this conversion process the report believes that these bodies should also be granted additional powers, in particular power to adopt binding supervisory standards and to oversee and coordinate colleges of supervisors.

Although Solvency II already touches on many of the proposed reforms, some additional issues include:

- Ensuring macro-prudential supervision of the insurance industry, i.e. within the ESRC and in conjunction with the ECB and CEIOPS
- Upgrading the quality of supervision by national supervisors
- Granting CEIOPS ultimate decision-making powers in the college of supervisors for cross-border groups and transforming it into a European



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Insurance Authority, with an expanded role, e.g. prudential assessment of pan-EU mergers and acquisitions

### The Commission's response: Solvency II and beyond

In its communication, the Commission seeks to demonstrate that there is an EU response to the crisis and that the Commission has been and remains active; it also ensures that within the G20 the EU continues its leadership role in establishing principles among the G20 participants.

In essence, the communication asks EU leaders to support the de Larosière Report's recommendation for a core set of regulatory standards throughout the EU and to adopt a legislative package of measures going beyond those envisaged under Solvency II for endorsement by the European Council in June 2009 in order that they could be implemented in 2010. The Communication echoes the key principles set out in the report, especially stronger oversight and supervision at the EU level, i.e. the European System of Financial Supervision. It supports the establishment of a macro-prudential, early-warning body to identify and address systemic risks, i.e. the European Systemic Risk Council.

The Commission proposes four general policy objectives for European financial market

regulation flowing from the report:

- Filling gaps where European or national regulation is insufficient or incomplete, e.g. for credit rating agencies
- Ensuring European investors and small and medium-sized companies can be confident about their savings and their rights as investors in financial products, e.g. by strengthening policyholder protection
- Improving risk management in financial firms and aligning pay incentives with sustainable performance, e.g. setting standards for remuneration in the financial services sector
- Ensuring more effective sanctions against market wrongdoing, e.g. to prevent market abuse

In conclusion, it has been said that Solvency II was a regulatory response in search of a crisis. Most industry observers agree that the insurance sector's existing regulatory architecture, together with Solvency II, appear appropriate and prescient. Even with the deletion of the group support regime, Solvency II still contains the blueprint for a modern and robust regulatory system that will respond to financial crises both current and future.

## Solvency II – the final reckoning

Amidst all the soul-searching, the Czech Presidency of the Council has pressed ahead with adoption of the Solvency II Framework Directive.

On 22 April the European Parliament voted to approve the Directive. The legislative procedure ends with the Council's formal vote on the same text. This has been delayed because of the time necessary to finalise the text in all (23) official languages. The Council now expects to adopt the text under the Swedish Presidency (from 1 July). The implementation deadline of October 2012 still applies.

During the debates leading to approval, group support and the treatment of equity risk were the principal contentious issues.

Group support was initially introduced by the Commission as a subset of group supervision, and would have allowed a subsidiary in a European group to hold less than its required solo solvency capital on the basis that it has received a binding declaration of financial support from its parent.

Critics of group support - mostly smaller member states without head offices of European groups - have pointed out that there would be many legal and regulatory obstacles for the smooth operation of the group support regime and enforcement of the group support declaration.

As a result of these objections, the final text removes group support while maintaining group supervision, although it does include a clause providing for future review of group support. As for the treatment of equity risk, the "duration approach" is to be used only after being transposed into member state legislation and for clearly defined life insurance products.

Solvency II is also a critical issue for third country groups maintaining subsidiaries within the EU. Under the new regime, the benefit of group supervision is extended to third country groups to the extent that the third country of their domicile applies prudential and supervisory standards equivalent to EU standards. At stake is the cost of regulatory capital which third country groups might need to hold in comparison to that of EU-based groups, creating a competitive disadvantage. The final text identifies the prudential consequences following a lack of recognition. At the same time, it clarifies, that following recognition of equivalence, the member states will be entitled to rely on group supervision carried out by third country authorities – subject to further cooperation agreements which may be deemed necessary with such countries. Switzerland and Bermuda are in the lead in their efforts to achieve recognition status by 2012.

The compromise text now waiting for final adoption has had a mixed reaction from the insurance sector. The CEA has commented that carving out group support means that Europe has missed the opportunity to introduce a tool that would have met the need for the efficient and effective supervision of multinational groups highlighted in the de Larosière Report.

That said, the omission of group support has not put the industry in a worse position than its current regulatory framework – and the text does expressly provide for future review.