

Risk-Based Regulation

Solvency II signals change for the Insurance Industry

By Garvan O'Neill, FCA



With the Solvency II Directive running to 312 Articles, it would be reasonable to assume that there is more than enough material in the Directive to implement its specific legislative requirements. However, Solvency II is a Framework Directive and represents just a subset of the total legislation that will be required. At the time of writing, further material is due to be published by the Commission before the end of 2010 and 2011.

Background

In November 2009, the Solvency II Directive, which had been passed by the European Parliament earlier that year, was published. It signalled the introduction of a risk-based regime of regulation for the insurance industry to replace the existing volume-based regime at the end of 2012. Most commentators see the change as positive. The new regime will seek to differentiate between the capital required for entities that carry higher risks – such as property coverage in areas prone to flooding – and capital required for other entities that cover risk but are less prone to significant spikes in claims experience. The Directive, however, does not just examine the insurance risks of an enterprise but rather focuses holistically on all risks impacting the business including market risk, counterparty risk and operational risk as well as less tangible risks such as strategic and reputational risk.

The introduction of a risk-based regime for insurers is consistent with the risk-based system for banks that was introduced in 2006, through the Capital Requirements Directive (CRD) (which mirrors the Basel

requirements) and which will be strengthened by the introduction of the new Basel II and III requirements. A risk-based system which drives capital requirements and which will also drive the level of prudential regulatory intervention is absolutely consistent with the recommendations and expectations that have been developed by the European Union.

A core part of the Solvency II regime – and re-invigorated CRD regime – is the focus on the system of governance and its supporting key functions including Risk Management, Internal Control, Compliance and Internal Audit. The European Parliament and Council are focused on ensuring that from the top of the organisation (the Board of Directors, Supervisory Board), down individuals:

- ▶ are 'fit and proper';
- ▶ have sufficient expertise to understand the complexities of the business;
- ▶ have sufficient financial know-how;
- ▶ have sufficient time to execute their responsibilities; and
- ▶ apply their efforts accordingly.

What are companies doing to address Solvency II now?

At the time of writing, the 5th Quantitative Impact Study (QIS 5) being carried out for the European Commission by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is concluding. This exercise should indicate to companies what their expected capital requirement might be under the Solvency II regime. There is a hope that the participation amongst the estimated 4,300 insurance enterprises across Europe will be very high (greater than 90%); however, this would represent a significant increase over the participation in the QIS 4 exercise which had a participation of only 33%. Participation in a QIS can be a very time consuming exercise in thinly-resourced functions such as the actuarial department of an insurance enterprise. It is hoped that the level of participation by Ireland's 250 or so relevant companies will be high.

Ireland's Financial Regulator has been encouraging insurance companies to carry out gap analyses to determine

where they stand relative to the Solvency II requirements. There is an expectation that, arising from this implementation, plans will be developed. Many organisations that have completed the analysis have identified significant gaps in their risk management frameworks, the transparency of their governance model and the formality of their internal control and compliance functions. Organisations using internal models for their capital calculations face greater challenges but are also likely to have started implementation earlier than their counterparts. For some groups, the Solvency II process has led to an examination of their overall corporate structure where significant capital and infrastructural efficiencies can be achieved in the context of meeting the Solvency II requirements.

Prior to mid-2009, preparation by the Irish insurance industry for this major piece of legislation was quite limited. This changed when the Financial Regulator issued letters requesting updates on the status of each company's Solvency II projects. Now the scale of the impact of Solvency II

is becoming clearer to Boards of Directors and management through the outputs from their gap analyses.

It is worth noting that Ireland's well developed insurance skills infrastructure, strengthened regulatory framework, favourable corporate tax environment (including over 60 double taxation treaties) and well developed history of supporting cross-border insurance operations has encouraged several very large European and Non-EU groups to select Ireland as their domicile and a hub for their European and global operations. This brings direct and indirect employment benefits in highly-skilled areas and serves to enhance the reputation of Ireland as an insurance centre in the international market contributing favourably to the economic wealth of the country.

See also:
http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm#october2010

http://ec.europa.eu/internal_market/insurance/docs/solvency/2010signed_letter.pdf

<https://www.ceiops.eu/home-news/news-details/news/non-life-and-non-sit-health-data-request-to-review-the-calibration/index.html>

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Chartered Status for Internal Auditors

The Institute of Internal Auditors has been awarded Chartered status marking the culmination of a two-year campaign by the Institute of Internal Auditors – UK and Ireland.

The change in status is part of a wider programme of change which has seen the appointment of a new Chief Executive with experience in business and government, and the launch of a new strategy which aims to increase recognition for the profession, which is in the vanguard of the battle to improve risk management in the UK's biggest companies as well as in government.

ISE Investor Relations Service

The Irish Stock Exchange (ISE) has launched a web-based investor relations (IR) service aimed at companies trading on its equity markets. The new service, a collaboration with Thomson Reuters, will give Irish quoted companies sophisticated tools to track and engage with key current and potential shareholders and significantly enhance their normal IR activities.