# RISK NEWSLETTER

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## SOLVENCY II – WHAT'S IT ALL ABOUT?

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Welcome back to Risk in the Market (RITM). We hope you enjoy the following series on the issues surrounding Solvency II. In this post, we will explore the origins of the new directive and the form it will take. Future instalments will assess the opportunities and inconveniences associated with Solvency II, the challenges that lie ahead and suggest how these challenges can be met.

So, as ever, please feel free to share your comments with us and remember to keep checking RITM regularly for the latest updates.

### THE SOLVENCY II – WHAT'S IT ALL ABOUT?

The countdown has begun. Towards the end of 2013, the new European directive, Solvency II, will come into force.

This new regulatory requirement will affect the insurance industry. Designed to strengthen the sector, Solvency II will provide a safety net for policyholders and support market stability.

Solvency II - What's it all about?

It will ensure the insurance market fully quantifies its risk and allocates sufficient capital to protect its business should difficult conditions (especially market conditions) arise. The requirement to calculate their risks and capital requirements in a controlled and auditable way, suggests that technology will play a central role in delivering future compliance. Therefore, for many companies, this will mean implementing a significant IT programme.

### WHAT WAS WRONG WITH THE OLD REGIME?

The current European solvency regime (Solvency I) is showing its age.

Created in the 1970s, volatile investment markets, increased product complexity and a convergence in financial services, have rendered it out-dated.

With its primary focus on the prudential standards for insurers, not including requirements for risk management and governance within firms, the European Commission felt it necessary to develop Solvency II as a way of providing proper protection for policyholders.

### SOLVENCY II – THE NEW DIRECTIVE ON THE BLOCK

The primary aim of Solvency II is to create an effective single market in insurance services. Its objective is to strengthen policyholder protection by aligning capital requirements more closely with the risk profile of the company to:

> Reduce the risk that an insurer would be unable to meet claims
>
> Reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully
>
> Provide early warning to supervisors so they can intervene quickly if capital falls below the required level
>
> Promote confidence in the financial stability of the insurance sector

By introducing risk-based solvency requirements, Solvency II's more sophisticated approach moves the insurance services industry away from the existing "one-model-fits-all" approach to estimating capital requirements, to more entity-specific requirements.

### THREE PILLAR FRAMEWORK

Solvency II is often referred to as "Basel for insurers" because of its similarity to the banking regulations of Basel II. For example, the proposed framework for Solvency II has three main areas (pillars):

> Pillar 1 – quantitative requirements (e.g. the amount of capital an insurer should hold)
>
> Pillar 2 – requirements for the governance and risk management of insurers, as well as effective supervision of insurers
>
> Pillar 3 – disclosure and transparency requirements

However, unlike Basel, Solvency II demands the valuation coverage of both assets and liabilities. This throws up many challenges.

But before we look at the challenges, we need to consider how Solvency II is viewed by those it will affect. The next post in this series will ask the question – should Solvency II be seen as an opportunity or an inconvenience?

*This post was taken from a white paper written by Michel Duval, serialized for Risk In The Market by Sally Ormond. The full white paper will be made available once the final post in the series is published. Remember to check RITM frequently for the next instalment.*


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