

The changing shape of Solvency II

Mark Batten from PricewaterhouseCoopers* comments on the latest developments in Solvency II and the implications for restructuring activity across Europe



Solvency II continues to wind its torturous path towards finalisation. The last few months have seen some significant progress towards the ultimate goal of designing and implementing a holistic reform of the prudential regulatory regime for European insurers. However, the implications for insurance business in run-off remain unclear.

After intense negotiations, the European Parliament formally adopted the

Solvency II Framework Directive on 22 April 2009: a decision which was subsequently confirmed by its co-legislator, the European Union's Economic and Financial Affairs Council (EcoFin), on 5 May 2009. The approved text had undergone significant changes as a result of the discussions in recent months, which will have a material impact on the reach and consequences of Solvency II for insurers.

A key change is in respect of the

group support provisions, which, had they remained in place, would have enabled parent companies to potentially reduce the amount of capital required overall for groups. The European Commission's initial proposal in this respect acknowledged that insurance groups operate in such a way as to pool and diversify risks across the various parts of the group. It would have allowed parent companies to provide declarations of group support to meet

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a proportion of the Solvency Capital Requirement of their subsidiaries.

Had this provision made the 'final cut' of the directive, a likely effect would have been a reduction in the power of home member states of the subsidiaries versus that of the parent company. Heightened by the financial crisis, this concern led to the removal of this provision.

While this sacrifice ensured that the directive moved to the next stage of the process, its removal has potential implications for restructuring activity across Europe. Now, in order to realise the full capital benefits possible under the group support provision, organisations may need to transfer business into a single company (and a single member state). They would then need to make use of the European passport to reorganise the group on the basis of a branch structure. The removal of the group support provision could, therefore, provoke an increase in the level of transfer activity and reorganisations of European groups to maximise capital efficiencies.

Whilst clarity is increasing on the key provisions of, and timetable for, the implementation of Solvency II, there is still uncertainty around the treatment of run-off business. In addition to formulating the new prudential regime, the Framework Directive recasts all key pre-existing directives applicable to the insurance industry into the one text. Created at different times, for different businesses and purposes, and based on a 'minimum harmonisation'

approach, each of these directives is subject to its own particular nuances of application and interpretation.

These directives include the Reinsurance Directive which was due to be implemented by member states by 10 December 2007. The criteria for exclusion from the scope of Solvency II in respect of run-off business were broadly understood as business that had been in run-off prior to that date. However, following preliminary discussions with a senior member of the European Commission it would seem that this understanding could require some revision.

Interpreting the text to mean that Solvency II rules would only apply to business entering run-off after that date is unlikely to be the original intention of the directive, and therefore will be an area of debate going forward. Whether run-off business should or should not be excluded from the scope of the directive becomes even

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more questionable given the number of transactions that take place in this market, and complex scenarios that regularly occur where, for example, legacy business is transferred out of a live business into a pre-existing run-off entity falling outside of the scope

of Solvency II.

The adoption of the Solvency II Framework Directive marks an important milestone in achieving the European Commission's goal of a single European insurance market and the modernisation of regulation. The next stage of the process, the development of the Level 2 implementing measures, could be as, if not more, challenging as the first, as highlighted by the FSA's 25 September 2008 Discussion Paper and the recent wave of 12 consultation papers issued by CEIOPS.

The UK is currently experiencing the practical challenges of developing internal models and getting them approved under Solvency II, underlining the need to actively contribute to relevant CEIOPS consultations (in this case CP37). But the same applies across all the papers, another far more substantial wave of which is expected in June.

As Charlie McCreevy, the European internal market commissioner noted: 'We need Solvency II more than ever as a forced response to the present financial crisis.' Owners of run-off businesses are clearly important stakeholders in the process but they need to help clarify that stake. They need to

make their voices heard in the ongoing consultation processes or risk potentially extremely unsatisfactory outcomes. ●

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