Solvency II

APRIL 2013

Solvency II will completely restructure the EU insurance solvency regulation system, bringing all insurers and reinsurers doing business in the EU together under a single set of rules. Work on the project began in 2001. In July 2007 the European Commission, the EU?s executive branch, released the draft Solvency II framework directive, the equivalent of a bill in the U.S. Congress, and sent it to the EU?s two legislative bodies, the Parliament, which consists of elected members, and the Council, a group of ministers representing each of the EU?s member states. The European Parliament approved the directive at the end of April 2009. Implementation, originally proposed for the end of 2012, has been pushed forward to at least 2016. The implementation of Solvency II will eliminate what some see as a patchwork of regulatory systems that has developed over time as those dissatisfied with the Solvency I minimum requirements strengthened solvency regulation with their own reforms.

Solvency II has three pillars, which together are expected to strengthen policyholder protection.

Pillar I includes capital requirements based on an evaluation of the company?s entire operation, risks to its assets as well as the risks it has assumed as an insurer. If capital falls below a certain level, as in the U.S., regulators can take action. A company?s loss reserves are to be assessed at current market value. Most countries now, including the U.S., value reserves at the ultimate amount expected to be paid to the claimant at some time in the future.

Pillar II concerns corporate governance and risk management and how regulators are to supervise insurers under the new system. It is designed to encourage companies to integrate consideration of risk into decision making throughout the entire operation.

As part of this process, companies will be required to conduct their Own Risk and Solvency Assessment (ORSA) and give the results to the regulator. This will force insurers ?to devote significant resources to the identification, measurement and proactive management of risk? and to think about any future developments that might affect their financial situation. Solvency II also creates a supervisory review process intended to shift regulators? attention from monitoring compliance with legal requirements to a focus on how the insurer is managing risk.

Pillar III focuses on expanded public disclosure and is intended to streamline the regulation of insurance groups (holding companies) and allow them to more efficiently manage their capital. Under the plan, a single group regulator will coordinate the regulation of the parent and its subsidiaries, generally the regulator of the member state in which the parent is domiciled. Individual national regulators will oversee individual members of the group in their state.

Solvency II Equivalence for Non-European Insurers: Solvency II specifies that for insurers outside the EU to be treated in the same way as those in the European market, the home regulatory system must be deemed equivalent to Solvency II. In September 2012 a committee composed of EU and U.S. representatives issued a report comparing the U.S. and EU regulatory systems in seven areas, including solvency, group supervision and reinsurance. At hearings on the report, the Property Casualty Insurers Association of America (PCI) argued that based on the report, equivalence should be granted. But European representatives said that equivalence should not be granted as long as the U.S. requires collateral to be posted in reinsurance transactions with non-U.S. insurers, see report on Reinsurance [1], and the Bermuda representative was opposed to granting the U.S. any special route to equivalency not available to other countries.

Industry observers note that one of the key differences between the two systems is that Solvency II has a more prescriptive approach than the U.S. system. The EU has set up strict rules for capital adequacy that may require a higher level of capitalization than in the U.S. in an effort to protect the interests of all stakeholders, whereas the U.S. relies more on the free-market and competition to discipline insurers and on state guaranty funds to protect policyholders and claimants in the event that the company has insufficient funds to pay claims and has to be liquidated, see also report on Insolvencies/Guaranty Funds [2]. According to Conning Research & Consulting, ?the European and the U.S. approaches represent competing views of regulation: one, a hands-on approach involved heavily in establishing best practices and creating rules and implementing disclosure requirements; the other, a freer market approach in which government just takes care of outliers and lets the discipline of the market police the participants.? Solvency II represents the former, the U.S. the latter, see U.S. Solvency Regulation [3].

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