

# Solvency II

A new solvency framework is being developed for the insurance market.

There is a great deal of press speculation at present about the potential impact of Solvency II, the next generation of capital regulation being developed by the European Commission. Lessons learned from recent insurance company failures have increased the need for scrutiny by the industry and its regulators. The aim of Solvency II is not to increase overall levels of capital, but to ensure a high standard of risk assessment and capital allocation.

The industry has voiced strong support for a Solvency II framework that:

- enables institutions to absorb significant unforeseen losses and increases the confidence of policyholders;
- gives the supervised institutions an incentive to measure and control their risk properly;
- helps a better managed and more competitive insurance industry to perform its key function of accepting and spreading risk more effectively than previously; and
- encourages a single European market for financial services.

## Impact of the reforms

Major reforms will include the introduction of capital charges for investment risk and new rules on setting reserves. The changes should lead to greater transparency and give insurers a better understanding of reserving risk.

The new regime will also require companies to establish systems and controls for risk management. Companies that instigate such high standards will be rewarded by a lowering of capital requirements. This in turn should encourage companies to invest in assets that are appropriate to the underlying risk involved.

There has been concern that the changes could affect investment patterns, resulting in significant movements between asset classes and depressing markets. Careful preparation for the implementation of the framework is therefore required. An important part of this preparation is to raise awareness of the insurance market well in advance of the start date of the new regime.

## The future

Solvency II is not expected to be implemented across Europe until 2010. However, it should act as a catalyst for insurers to rethink how they hold capital to meet liabilities and to review business models dealing with live and discontinued business.

Solvency II is also likely to lead to the corporate restructuring of certain insurers, especially those operating in multiple jurisdictions. They will need to review how and where they manage their liabilities and assets. Many companies may consider running off or selling capital-intensive part of their business.

All this can only be good news for the insurance industry. After all, a lower risk of company failure will lead to greater confidence in the industry and financial stability.

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