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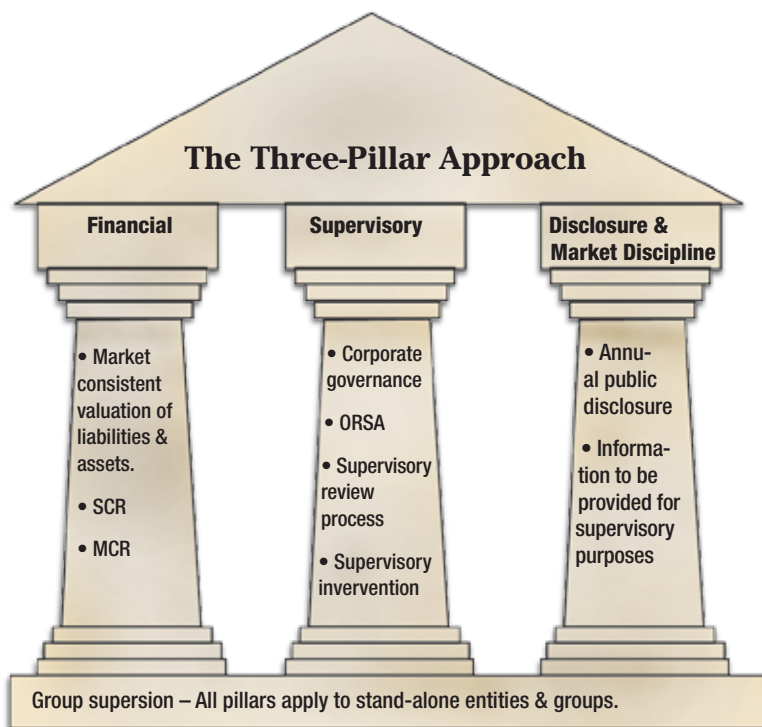
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## Solvency II and its Impact On A.M. Best Ratings

Solvency II is the new principles-based regulation that will apply to all insurance operations domiciled in the European Union from 2012. It is expected to revolutionise the way companies are regulated in the EU, providing for a complete break from previous regulation for most European countries. The current Solvency I provides for a crude measure of regulatory capital requirements based on the premiums and reserves of an insurance company.

Regulation under Solvency II will depend on three pillars, not only covering the capital requirements for insurers but also setting the framework for supervision and stipulating the levels of disclosure. There is currently significant debate on the levels of required capital, probably because the insurance industry is undergoing a series of Quantitative Impact Studies (QIS) to calibrate the “standard formula,” i.e. the basic model, to be used for quantifying the capital requirements.

The implementation of Solvency II will improve the understanding of risks undertaken by European insurers. However, its implications also are likely to be felt outside the EU, not least because of the operation of third-country subsidiaries in the EU and, conversely, subsidiaries of EU groups in third countries. These then are two of the main reasons for a series of papers by A.M. Best, the first of which is this, examining the implications of Solvency II for Best’s ratings.



This methodology is available at  
[www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology)



The implementation of Solvency II is likely to accentuate the differences in the treatment of companies based outside the EU, being either the parents of EU subsidiaries or subsidiaries of EU groups. The differences in capital requirements are likely to be focused on the diversification benefit provided for by Solvency II and the allowance for use of internal capital models. This is not likely to result in changes in Best's credit ratings, as A.M. Best will continue to provide for diversification benefits in its analysis based on consistent formulae throughout the world.

In line with current practice, A.M. Best will continue to investigate cases where Solvency II highlights significant differences between its analysis and the regulatory view of the risks assumed or the impact of specific risks. In the analysis of a company's risk-adjusted capitalisation, A.M. Best will continue utilising its proprietary Best's Capital Adequacy Ratio (BCAR) for the foreseeable future. The allowance for use of internal capital models for the definition of regulatory capital requirements is viewed as a positive development. Indeed, this point transcends several regulatory regimes, as companies outside of the EU for years have used internally developed capital models for their capital allocation and management. A.M. Best will be evaluating the use of companies' own internal capital models in its analysis under certain criteria, which will be specified in a separate criteria report.

Further, the introduction of Own Risk and Solvency Assessment requirements and the establishment of requirements for the System of Governance mean that capital management will not be seen as a regulatory obligation but as part of a greater enterprise risk management ethos. This can only be good for the industry but is likely to result in increased pressure on resources of smaller companies and regulators. The pressure on industry and regulatory resources is likely to be the main downside from the disclosure requirements as well (stipulated in Pillar III). While they are likely to result in increased transparency of the industry, they also are likely to fall short of bridging the gap between International Financial Reporting Standards (IFRS) and Solvency II disclosures and balance sheets.

However, not all is positive news concerning Solvency II. Some of the instruments available to count as capital under the provisions of Pillar II may afford less policyholder protection than originally assumed, especially in stress scenarios. Use of Tier II and III instruments, up to the maximum level prescribed by Solvency II, will result in over-leveraging, especially for higher rating levels. A.M. Best will continue applying maximum limits different from Solvency II and in line with the rating level of an insurer.

The valuation of assets and liabilities at market values will increase the volatility

## A.M. Best Company Methodology

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of regulatory balance sheets. Probably the greatest impact to companies' ratings is to come from the definition of liabilities under Pillar II. The discounting of reserves is in line with a principles-based regime, but the great majority of the industry is far from being able to manage such a transition. A.M. Best believes that volatility in reserves, especially among smaller non-life insurers, will be the main source of rating actions for European companies after the implementation of Solvency II.

### Scope of Solvency II

The Solvency II regime will apply to most insurers and reinsurers domiciled in the EU. It intends to provide the same coverage regardless of the legal form of the regulated entity. This means that some of the existing regulatory discrepancies within the EU will be eliminated: Solvency II will apply to insurers and reinsurers alike; as well, shareholder and mutual companies or captive and open market (re)insurers will be regulated. The only companies to be exempt from the new regulation are:

1. Insurers and reinsurers with annual premiums of less than €5 million.
2. EU-based branches of non-EU groups.
3. Reinsurance companies in run-off prior to Dec. 10, 2007.

One of the issues arising from the implementation of Solvency II is the definition of regulatory capital requirements of (re)insurance groups with entities outside the EU. Both international groups with the parent company outside the EU and non-EU subsidiaries of EU groups will be impacted.

International groups with parent companies outside the EU are likely to be most disadvantaged, as non-EU regulators are likely to insist on capitalisation of (re)insurance entities in their own territories based on their own regulatory systems, thus diminishing any diversification benefit available under Solvency II.

Similarly impacted will be the "third-country" subsidiaries of EU groups with their own regulatory capital requirements being set by their local regulators. However, the diversification benefit to be provided by the

EU regulators under Solvency II is likely to minimise the overall impact to the group.

The proposal to avoid such discrepancies is to create an equivalence network whereby regulators of "third countries" with equivalent regulatory regimes accept the capital requirements of the EU regulators for entities operating within the EU, and vice versa.

**Impact on A.M. Best Ratings:** The implementation of Solvency II and the impact of diversification provided under the regime should not impact companies' A.M. Best ratings; however, note should be taken of the points made on insurers' stand-alone capitalisation under "Group Supervision." A.M. Best's rating methodology is applied on a stand-alone basis to each subsidiary or operating unit in a group, and an internal stand-alone rating is assigned. The parent also is analysed on a consolidated basis to obtain a complete picture of the risk profile of the entire organisation. The final rating of each operating unit is determined by the level of support or drag received from the parent company. In both levels of analysis, credit is given for the diversification of insurance risks underwritten and the calculation of a covariance adjustment recognising the independence of risks accepted by the company. The diversification benefit given is specific to each company, but the principles on which it is based are consistent throughout the world for A.M. Best's analysis.

### Three-Pillar Approach

Regulation under Solvency II will depend on three pillars:

- Pillar I: Providing the quantitative capital requirements.
- Pillar II: Setting the framework for the Supervisory Review.
- Pillar III: Formalising the Disclosure Requirements.

This is a clear move away from the simplified framework of Solvency I and its prescribed capital requirements based on levels of premiums and reserves. Solvency II will provide for greater evaluation of the risks undertaken by each company,

resulting in greater accuracy in the evaluation of regulatory capital requirements. It is also likely to lead to improved ability to manage an insurance company, especially for some of the small to medium-size operators that have not been using internal capital models for setting strategy and making key decisions.

Finally, the greater emphasis on enterprise risk management (ERM) is likely to increase the pressure on both the company's management and regulators alike.

### **Pillar I – SCR and MCR**

Solvency II defines two levels of capital requirement and intervention:

*1. Minimum Capital Requirement (MCR):* The level of capital under which no (re)insurer will be allowed to fall. Breaching this level of capitalisation will result in immediate regulatory intervention.

*2. Solvency Capital Requirement (SCR):* Falling below this level will result in a call to the company to restore its capitalisation within six months, either by reducing the level of risks assumed or by increasing its eligible own funds.

Solvency II is unlikely to result in increased capital requirements for the industry as a whole. Indeed, this has been confirmed by the results of the Quantitative Impact Study 3 (QIS3), which were published in 2007, and by the consultation process that precedes and follows each QIS study. This does not mean there will not be winners and losers from the implementation of Solvency II, as certain company segments are likely to face increased (and others reduced) capital requirements when compared with Solvency I.

In the longer term, more informed management decisions likely will result from the ways in which SCR/MCR are calculated. Overall, the greater granularity provided by Solvency II is likely to result in:

- *Emphasis on product profitability and capital efficiency.* Companies facing increased capital requirements are likely to be among the first to take corrective action.
- *Greater focus on risk-reward strategies.*

The standard formula will provide for greater granularity of risks assumed and for a link between risk and capital requirements, which means that even companies without the need or the ability to build an internal capital model can better decide on their risk-reward strategy.

**Impact on A.M. Best Ratings:** In determining a company's ability to meet its current and ongoing obligations, A.M. Best evaluates a company's business profile, financial performance and balance sheet strength. One of the primary tools utilised in the analysis to evaluate balance sheet strength is Best's Capital Adequacy Ratio (BCAR). In the course of the analysis, input from external models – e.g., catastrophe, ALM models, etc. – is utilised as needed.

Similarly, in cases where there are significant differences between BCAR and the regulatory view under Solvency II, or in cases where the regulators express concerns, A.M. Best will conduct additional analysis to ensure no risks are omitted in its analysis and that their impact is evaluated correctly. Furthermore, A.M. Best will be evaluating the company's plans to take corrective action and its time frame.

### **Pillar I – Valuation Of Assets & Liabilities**

Assets and liabilities are to be valued on a market-consistent basis. Part of this work already has been undertaken under IFRS, where most of the assets are at market value. However, the valuation of liabilities on a market-consistent, "fair value" basis is a new development for European (re)insurers. Technical provisions are to be split into two categories according to their ability to be hedged or not, and they will be treated as follows:

1. Hedgeable risks: The provisions for such risks will be valued on a "mark-to-market" basis. This category will encompass the majority of life insurance liabilities.
2. Non-hedgeable risks: The provisions for these risks will be valued at a discounted best estimate. On top of the discounted value, there should be an added risk margin based on the "cost-of-capital" method.

The definition of liabilities under IFRS and

Solvency II, while based on the same principles, is likely to have some significant differences arising from the different scope of the two systems (see **Table 1**). The most important variations are likely to be the difference in the definition of insurance contracts, with many pensions and life policies not recognised as insurance contracts under IFRS, and the different margins that are stipulated. This will result in the effective creation of a second balance, a regulatory one under Solvency II, which will have some significant differences from that published under IFRS.

The current balance sheet volatility observed under IFRS is likely to be reduced for life insurers in their realistic – regulatory – balance sheet. Under current IFRS provisions, asset values fluctuate according to the prevailing market conditions, while liabilities are valued on a prescribed, and therefore, inflexible basis, resulting in exacerbated volatility. Under Solvency II, this volatility will be reduced on the regulatory balance sheet as life liabilities, being mostly hedgeable, will be impacted by the prevailing conditions in a way similar to the assets.

One of the key elements of evaluating insurance liabilities is the cost of capital used to calculate the risk margin of non-hedgeable liabilities. This is particularly important for companies with significant non-life exposures, given that non-life risks are mostly non-hedgeable. There are several ways of calculating the cost of capital, but the more pertinent question seems to be whether the definition of cost of capital should be marketwide or company-specific. It is not yet certain which of the two methods will be utilised. A marketwide definition can be seen to provide for a more level playing field, but at the same time, it would encourage a more inefficient use of capital. On the other hand, a company-specific definition of cost of capital would tend to benefit larger insurers with their more efficient capital structures, which utilise instruments that in many cases are not available to smaller companies.

The discounting of reserves is in line with a principles-based approach to regulation. However, most companies are coming from a very crude parametric model that

**Table 1**  
**Defining Insurance Liabilities - Main Differences Between Solvency II and IFRS**

	<b>SOLVENCY II</b>	<b>IFRS</b>
Scope	All liabilities underwritten by the entity	Only contracts transferring significant risk
Margin included	Risk margin	Service margin and margin for bearing the risk
	Calculated on a cost-of-capital basis	Calculation basis yet uncertain
Adjustment for credit standing of liabilities	Specifically excluded	Based on several factors, mainly:  Creditworthiness of insurer  Regulatory environment impact
Calculating future cash flows	No restriction	Principle of “guaranteed insurability”

has encouraged the buildup of “prudent margins.” Volatility in reserves, especially among smaller insurers, is likely to far exceed that seen in the past.

**Impact on A.M. Best Ratings:** Balance sheets have been volatile after the introduction of IFRS. This has been accentuated by the fact that currently, under IFRS, assets are on a mark-to-market basis, while liabilities are on a “prudent” basis. The introduction of realistic liability valuation is likely to provide additional information and reduce volatility to the “regulatory balance sheet,” even if that is not likely to be exactly reflected in the IFRS balance sheet. This will provide for greater clarity and ability to distinguish between short-term fluctuations and long-term impairments that are likely to result in rating actions.

To ensure consistency among rated companies, A.M. Best adjusts discounted reserves so that all rated companies are analysed based on comparable levels of liabilities.

The discounting of reserves is likely to result in greater rate volatility than any of the other provisions of Solvency II. Based on A.M. Best’s impairment studies, insufficient reserves is one of the main reasons for non-life (re)insurers’ defaults. Volatility in reserving, especially that driven by wrong levels of cost of capital and assumptions, will be the main source of rating actions.

### Pillar I – Available Capital

Solvency II defines three tiers of capital depending on their nature and quality. The funds’ nature and quality are to be evaluated according to five characteristics:

1. Subordination
2. Ability to absorb losses
3. Permanence
4. Perpetuality
5. Absence of mandatory service costs and encumbrances.

Furthermore, the funds are divided into Basic Own Funds and Ancillary Own Funds. **Table 2** shows the tiers and the characteristics they must possess:

Table 2

Quality	On Balance Sheet (basic own funds)	Off Balance Sheet (ancillary own funds)
High	<b>Tier I</b> Must possess 1-3 and significant degree of 4-5	<b>Tier II</b> Must possess 1-3 and significant degree of 4-5
Medium	<b>Tier II</b> Must possess 1-2 and significant degree of 4-5	<b>Tier III</b> Assets not possessing 1-2
Low	<b>Tier III</b> Assets not possessing 1-2	

Table 3  
Classification of Funds in QIS4

Tier I	<ul style="list-style-type: none"> <li>· The excess of assets over liabilities: paid up capital and called up common equity and reserves available to absorb losses (retained earnings, share premium account, surplus funds, revaluation reserves other reserves with restricted loss absorption)</li> <li>· Subordinated mutual member accounts</li> <li>· Hybrid capital instruments with loss-absorbency equivalent to common equity</li> </ul>
Tier II (Own Funds)	Hybrid capital instruments and subordinated liabilities with a duration of at least 5 years from the issue date, provided they fulfil certain criteria to ensure coverage of the insurance liabilities they back
Tier II (Ancillary Funds)	<ul style="list-style-type: none"> <li>· Unpaid common share capital, unpaid initial fund, unpaid non-cumulative preference share capital</li> <li>· Unpaid and callable hybrid capital instruments eligible for inclusion in Tier 1</li> <li>· Letters of credit and guarantees</li> <li>· Future claims by way of “unbudgeted” supplementary calls that a mutual insurer can make on its members, e.g., P&amp;I Claims</li> <li>· Other commitments with equivalent loss absorption to ancillary own fund</li> </ul>
Tier III	Hybrid capital instruments and subordinated liabilities with duration of less than 5 years

The classification of funds into tiers is yet to be finalised. Probably the best indication is to be found in the guidance provided with the current Quantitative Impact Study 4 (QIS4) (see **Table 3**). While there are likely to be changes between the provisions of QIS4 and the final provisions of Solvency II, one thing is certain: instruments that until now have received no credit under most EU regulatory regimes will count toward an insurer’s available capital under Solvency II.

Ancillary own funds will need prior supervisory approval to be submitted. To avoid overdependence on alternative sources of capital, the regulation stipulates that only TI and TII own funds can count toward the MCR, while there are other limitations on what counts toward a company’s SCR.

It is clear that the new regime will, in most cases, provide greater financial flexibility for (re)insurers. Currently, only the larger groups of companies and insurers based in regulatory regimes that give credit for Tier II capital (e.g., the United Kingdom) use financial instruments in their capital structure other than shareholders funds. Some of the instruments will remain beyond the reach of smaller companies, at least in the beginning, mainly because of their cost and complexity.

Reinsurance is likely to remain the first port of call, while the attractiveness of other instruments will depend on their tier.

**Impact on A.M. Best Ratings:** A.M. Best analyses the features and characteristics of all instruments within an insurer’s capital structure and adjusts the reported surplus and financial leverage by giving or removing equity credit for certain instruments. The guidelines used for this analysis are similar to the characteristics stipulated in Solvency II, i.e. the loss protection such instruments may provide and the favourable impact that the ability to defer cash payments may have on an organisation’s ability to service all obligations or to fund internal growth.

Solvency II, like most regulatory regimes, is focused on the minimum requirements for the ongoing operation of companies. However, A.M. Best focuses on making distinctions in compa-

nies' financial strength and the levels of leverage acceptable for each rating level. In that respect, certain instruments that qualify for regulatory credit may not receive credit under A.M. Best's analysis, either because the maximum limits for the given rating level already are exceeded, or because their characteristics are not seen to provide sufficient policyholder protection.

### **Pillar I – Use of Internal Capital Models**

Under Solvency II companies will be allowed to utilise internally developed capital models to define their regulatory capital requirements. These will have to be approved by the regulator to ensure that they cover appropriately the risks assumed by the (re)insurer. Internal models can be either fully customised or partial models that utilise the “standard formula” with some customisation. Further, the internal models can apply to specific entities or to the group as a whole.

Internal capital models will have to be reviewed by the regulators before they are accepted. For the utilisation of an internal capital model in the regulatory process, companies need to pass a usability test. The use test depends on documentation of processes to demonstrate that the model plays a central role in management actions. However, it specifies a minimum once-a-year download of data to the model, which is a low requirement for a use test.

Even after fulfilling the above requirements, companies still will have to submit their results to the regulator for the next two years, based on both their own, internal capital model and the “standard formula.”

Based on the latest results, internal capital models tend to provide for 25%-35% lower capital requirements than the “standard formula,” mainly because they better capture diversification. This clearly can provide a significant competitive advantage, meaning any company that has or will have an internal capital model will be seeking to get it accepted by the regulator.

Regulators will have to decide how many companies they are prepared to allow to be regulated based on an internal model at the beginning. If the implementation of

Basel II in the banking sector is a guide for that, then less than 5% of companies initially will be allowed to use an internal model. They will tend to be among the largest (re)insurers in Europe, which already use internal models. If that is the case, it will accentuate the current benefit of lower cost of capital experienced by larger (re)insurers.

One of the main concerns is the ability of all regulators to audit all capital models. Intra-regulatory audits and exchange of skilled staff (both planned) will help to improve the skills of smaller regulators and consistency among regulators. Larger regulators are likely to face greater pressure, having to both audit more internal models and provide the majority of the skilled personnel to ensure regulatory consistency.

**Impact on A.M. Best Ratings:** The utilisation of internal capital models for regulatory and rating purposes is a topic that transcends the implementation of Solvency II, with many companies throughout the world using such models for a number of years. A.M. Best will continue utilising its proprietary Best's Capital Adequacy Ratio (BCAR) for the foreseeable future, while at the same time evaluating the use of companies' own, internal capital models. The criteria for credit and the level of credit provided to internal capital models will be specified in a separate methodology paper.

### **Pillar II – System of Governance**

Pillar II of Solvency II moves its focus away from the quantitative elements of regulation. The first provision under this pillar is for an internal System of Governance, meaning that companies will have to have the following functions:

- Risk Management
- Compliance
- Internal Audit
- Actuarial

These functions do not have to be internal to the company; for smaller operations, they can be outsourced. In such cases, the company will have to obtain prior regulatory approval.

All who are responsible for running the company or key functions will have to pass

the “fit and proper” standards of integrity and professionalism. There are new obligations on actuaries to assess overall underwriting policies and the adequacy of reinsurance coverage. Failure to comply may result in supervisory intervention and could lead to additional capital requirements imposed by the regulator.

Many companies would argue that most of these provisions already are in place. This is certainly true of the larger companies. It is mainly smaller companies that have a shortfall in their current governance systems, and the cost of implementation will be significant for them.

Again, this will be a new area of activity for the regulators. While they may have had to assess systems of governance for start-ups, this was not the case for most regulators and definitely not on an ongoing basis.

**Impact on A.M. Best Ratings:** Stipulating the existence of risk functions and a system of governance is likely to result in improved management for the insurance industry as a whole. However, the impact on ratings can only be assessed in the context of all the Pillar II provisions, together with the impact of the Own Risk and Solvency Assessment below.

### **Pillar II – Own Risk Solvency Assessment**

Probably the most challenging part for companies will be their Own Risk and Solvency Assessment (ORSA), under which companies will have to perform regular reviews to assess “whether the particular risk profile of an undertaking deviates from the assumptions underlying the regulatory capital calculation.”

The results of ORSA will have to be disclosed to the regulator. At the same time, the process will have to be forward-looking, accounting for both the short- and long-term risks that the company may face and their impact on it.

ORSA, the supervisory process and the system of governance are likely to be the main drivers for the regulation of the industry as a whole. They are the main incarnations of the move from rules-based to principles-based regulation, and as such,

they are likely to define the role of companies and regulators for the future.

Very few companies can claim now to be fully compliant with ORSA. Excluding the development and use of an internal capital model, it may be among the greatest costs associated with companies’ implementation of Solvency II. Implementation of ORSA also will mean that governance and ERM have to be better embedded than they are in most companies now. Companies with successful governance systems likely will be able to argue for lower capital requirements in the future.

Similarly, the implementation of ORSA demands additional resources from most regulators. It is possible that some regulators will be failing their peer review, and ORSA – together with the validation of internal capital models – are likely to be the two areas of potential regulatory failure.

**Impact on A.M. Best Ratings:** All of the provisions of Pillar II under Solvency II point toward a greater embedding of ERM in companies’ operations. A.M. Best will consider allowing companies to maintain lower BCAR levels relative to the guideline for their ratings based on a case-by-case evaluation of an insurer’s overall risk management capabilities – relative to its risk profile.

A.M. Best evaluates the country risk under which a company operates. Companies based in countries with higher risk likely will have lower ratings than similar companies established in countries with lower risk. As part of its assessment of the country risk, A.M. Best evaluates the experience and effectiveness of regulatory bodies. This is of particular importance for principles-based regulatory regimes that emphasise robustness of processes and internal controls.

### **Pillar III – Public Disclosure**

The disclosure requirements under Solvency II are expected to be very stringent and, if implemented rigorously, are likely to provide for greater transparency in the industry. Companies will be required to report annually on both group and entity levels. The information they need to provide will cover the:

- Type and performance of the business.
- Description of Governance Systems and their adequacy.
- Bases of valuation of assets, technical provisions and other liabilities, as well as an explanation of the differences between Solvency II reporting and the financial statements.
- Description of capital management, including:
  - Composition and quality of own funds.
  - MCR and SCR levels.
  - Information pertaining to the differences between own capital model used and the standard formula.
  - Amounts of any noncompliance with MCR/SCR during the reporting period.

The reporting of MCR/SCR should indicate any capital add-ons imposed by the regulators. However, countries have the right to defer the implementation of this disclosure for a transitional period of five years.

Companies may apply not to disclose information that would be deemed to constitute a competitive advantage.

It is clear that regulated companies will face an increased reporting burden, and it becomes imperative that all the effort and the associated costs result in greater transparency for the industry as a whole. Even with the best intentions, this is likely to be a few years farther away than the 2012 implementation date would seem to indicate.

The reporting of differences between IFRS and Solvency II is a great idea, the success of which will depend on both the convergence of the two regimes and the consistency of reporting among different national markets. Based on the current position, it would seem that liabilities under IFRS and Solvency II will differ so significantly that any reporting would be either too cumbersome or ineffective. Further, if the current implementation of IFRS is an indication of things to come, then the level of reporting will vary significantly from one national market to another.

The reporting of capital add-ons is a drastic but positive measure. Again, based on

the experience of similar implementations of regulatory changes in the EU, most countries will be applying for the full five-year transitional period.

**Impact on A.M. Best Ratings:** A.M. Best, in its analysis, will be asking rated companies to provide their MCR and SCR levels, as well as any add-ons imposed by the regulators and their reasoning.

Where there are significant shortfalls in the company's capitalisation identified by the regulator, there will be additional analysis to ensure there is no omission or misunderstanding of the assumed risks and their impact.

### Overall – Group Supervision

Currently, the supervision of (re)insurers in the EU is based exclusively on the supervision of entities. Under Solvency II, this will change as equal emphasis is placed on the supervision of both the entity and the group.

The powers of the group regulator will extend to the regulation of its EU subsidiaries. Assuming the group regulators are satisfied with the risk management of the group, they can allow it to use waivers under which individual entities' SCR is calculated at group level. Under these, individual entities will be required to cover their MCR in their own locality, while the SCR can be covered on a groupwide basis. Even the MCR may be allowed to be covered under parental guarantees.

National regulators still retain the right to ask for increased MCR, or for the SCR to be kept locally or calculated based on the standard formula. They will need to justify this to both the company regulator and the lead (group) regulator.

In principle, the establishment of group regulators will provide the conditions for greater capital efficiency, especially for groups with subsidiaries in several EU countries. The ability of groups to only hold the MCR at their subsidiary level, or even to cover this MCR with guarantees, will increase the mobility of capital from the current levels where the regulators require all the regulatory capital to be held locally. Furthermore,

the establishment of group regulators eventually will result in more efficient use of regulatory resources and probably greater consistency of regulation.

If the directive were to be taken at face value, then it would be very difficult for most national regulators to argue for additional charges or deviation from the stipulations of the group regulator. It would, in practice, be very difficult for a regulator located in one of the smaller EU countries to argue a case for additional charges on a group subsidiary against a much larger regulator acting in agreement with the subsidiary's parent. It is not surprising, therefore, that concerns already expressed about how the establishment of a lead regulator may weaken not only the national regulators but also the national insurance industries.

**Impact on A.M. Best Ratings:** The debate over the establishment of lead (group) regulators and their impact on national industries points to significant political decisions that will have to be made. Based on the current provisions, Solvency II will result in greater fungibility of capital, at least within the EU. However, the greater the role of local regulators, the less fungible capital will be for the group.

Conversely, having local subsidiaries hold only their MCR locally, or even worse, having the MCR provided by forms of guarantees, may be counterproductive, especially for companies that need – as part of their business profile – to show increased ability to meet policyholder obligations.

### Conclusion

The implementation of Solvency II in 2012 will provide more consistent regulation of insurance companies throughout the EU merely by replacing a series of overlapping and often conflicting regulatory provisions. The establishment of “lead regulators” will help enhance the application of the new regime's provisions.

Pillar I is attracting the majority of attention and debate. While the level of SCR and the method of its calculation still is to be defined, it is certain that the “standard formula” will provide a greater management tool than Solvency I's provisions ever did. However, the deeper and longer

lasting effects of the new regulation are likely to come out of what today seem like the “soft elements” of its provisions, i.e. the definition of the new supervisory regime and the market disclosures. ORSA seems to place proper reporting and analysis of risks squarely on the companies' shoulders. At the same time, regulators will have to perform much more involved audits of their regulated entities than they have done to date. This will tend to increase the potential for regulatory failure if the regulator does not have the expertise to handle higher levels of sophisticated audits. Equally important are the reporting requirements, which should help improve the transparency of the industry (currently considered one of its weak points). Unfortunately, the effectiveness of the reporting may not depend on Solvency II, regulators or companies, but on convergence with IFRS and, in some cases, the political will of individual member states to accept full reporting as early as 2012.

However, even if Solvency II were to be implemented fully by all EU member states, there still would be winners and losers. The current state of play indicates there are certain segments of companies that, for different reasons, may face increased capital requirements. These include non-life, monoline insurers, which would get less benefit from diversification than the multiline ones; companies from currently lenient regulatory regimes; some annuity writers, because of reduced discounting; and some mutuals, which are less likely to use many of the capital instruments stipulated.

In such cases, corrective management actions will depend on the severity of the shortfall and could range from more efficient reinsurance structures to raising capital or being acquired. On the other hand, reinsurers and larger groups are likely to be the greatest beneficiaries. Reinsurers are likely to remain the first port of call for alleviating regulatory capital pressures. Large groups, meanwhile, are likely to benefit as their existing, sophisticated capital models are accepted as the models for the definition of their SCR, and as their capital structures are rendered more effective.



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