CAPTIVE REVIEW CAMPAIGN SOLVENCY II

Regulatory developments

Tom Carney of Dillon Eustace tells how Ireland has stepped up its regulatory regime in its insurance sector post the recent economic crisis and outlines how Solvency II will affect the state

The past 18 months have witnessed significant commercial, legal and regulatory developments in Ireland's insurance sector. Measures pursued through necessity by the Irish government to tackle the country's economic recession coupled with the adoption at EU-level of several sector specific legislative instruments have resulted and will continue to result in increased and sustained regulatory enforcement. Notwithstanding greater future regulatory intervention in the insurance market, Ireland continues to be a location of choice for the establishment and operation of European-based insurance activities.

It goes without saying that the state's favourable corporation-tax rate is a significant factor in attracting leading international insurance operators to this jurisdiction, but there are several others. The free movement of insurance services guaranteed by the treaties establishing the EU ensures that insurance operations established in Ireland can provide their services across all 27 member states of the EU, Norway, Iceland and Liechtenstein. For US insurers, in particular, Dublin offers the prospect of a well-educated English-speaking labour force with convenient access to well-established and highly skilled third-party service providers to support the provision of all insurance services.

Maximising opportunities

At European level, there are strong indications of increased restructuring activities as insurance companies are exploring to a greater extent the opportunities afforded by the EU's cross-border merger framework to optimise the competitiveness of their service provision.

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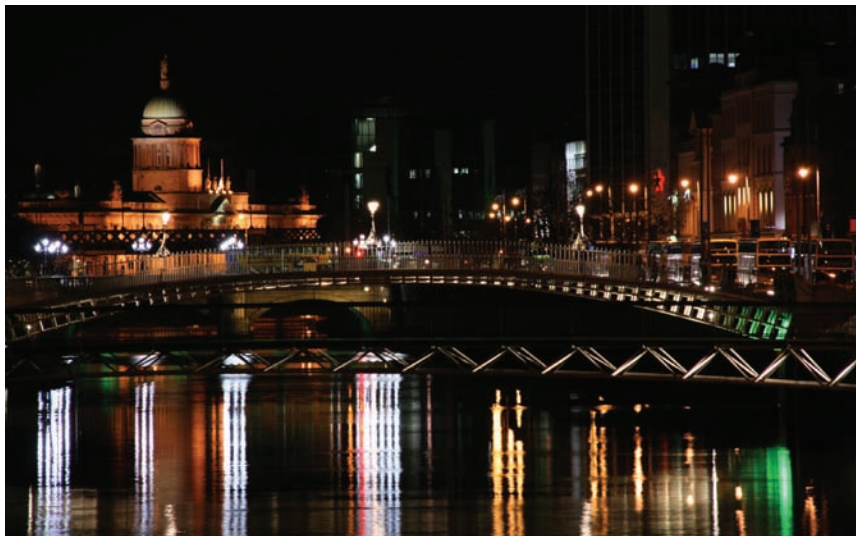
One of the most significant recent legislative developments in the EU is undoubtedly Solvency II, the adoption of which will result in increased compliance obligations for all Irish insurance providers. The future transposition of Solvency II into Irish law will, in due course, require insurance companies established in Ireland to take all appropriate steps to ensure that they are able to meet its requirements. Irish insurance undertakings will have to put in place adequate transparent organisational structures which provide for (i) clear allocation and appropriate segregation of internal responsibilities and functions; and (ii) an effective system for ensuring the intra-company transmission of information subject to internal review and regulatory scrutiny.

Despite all the jargon, it is important not to forget that Solvency II is a legislative framework laid down by the institutions of the European Community in the form of a directive. An EU directive is bringing on the EU member state to



which it is addressed as to the objective to be achieved, while leaving to the national governments discretion with regard to how to achieve those objectives. The Solvency II framework is laid down in Directive 2009/138/EC, adopted on 25 November 2009. Ireland will have until 31 October 2012 to give effect to the provisions of the Directive within its jurisdiction.

Solvency II carries out a root and branch repeal of all major EU insurance legislation and lays down harmonised community rules which consolidate earlier insurance rules in one legislative text. In simple terms, it adopts enhanced rules for the effective supervision of all insurance companies with the aim of affording greater protection for policyholders.

The Solvency II framework has been introduced at EU-level to address recent market developments in recognition that the existing insurance regulatory framework does not adequately protect policyholders. It seeks to lay down rules to establish a robust solvency regime for the protection of consumers together with enhanced governance and risk-management requirements which were absent in earlier community directives. Solvency II implicitly accepts the key finding of the Sharma Report of 2002, namely that the majority of insolvencies are preceded by governance-type shortcomings. The Sharma Report recommends a reduced dependency on capital requirements as the only early warning signal to preempt or prevent insolvencies. Instead, additional focus on qualitative measures such as governance and public disclosure is recommended to supplement capital maintenance and solvency capital rules. Solvency II, it is hoped, will operate as a risk-based system where risk measurement and capital requirements will intertwine under effective regulatory enforcement to protect better the interests of policyholders and the integrity of the financial markets.

Solvency II applies to all insurance companies except those benefiting from the de minimis exception of Article 4 of Directive 2009/138/EC (which includes insurance companies with gross annual written-premium income of less than €5m and with technical provisions not exceeding €25m).

Three-pillar approach

Solvency II is constructed on three pillars, reflecting an approach similar to Basel II. The objective of the three-pillar approach is to build a harmonised, codified and holistic regulatory framework for insurance in Europe. Pillar I consists of the quantitative requirements which will apply uniformly across the EU with regard to the requirements in respect of technical provisions, own funds, solvency capital and minimum capital to be applied to all insurance companies falling within the scope of Directive 2009/138/EC. Pillar II lays down the qualitative requirements for effective governance and risk management, recognising that some risks may only be properly addressed through qualitative governance procedures as opposed to quantitative capital requirements. Pillar III focuses on the disclosures which must be made by insurers to the regulators and to the public.

With the arrival of Solvency II and recent developments in Ireland's financial sector, increased focus has been put on the requirement that all persons who run the business of insurance must be fit and proper. It is worth underlining that fitness as a matter of Irish law is established by reference to qualification, knowledge and experience while probity entails sound reputation and integrity. It would be prudent for all insurers to have regard to the Irish Financial Regulator's current practice in the financial services sector which pursues the approach of interviewing and approving candidates for senior banking positions. One of the key obligations on insurance companies under the Solvency II framework is to prepare an own risk-solvency assessment. This assessment must at least address the following (i) the overall solvency needs of the company taking account of its specific risk profile; (ii) compliance with capital requirements and the technical provisions of the Directive 2009/138/EC; and (iii) the significance with which the risk profile of the company deviates from the assumption underpinning the solvency capital requirement for the company. Arising from these developments, insurance companies will be faced with increased challenges of compliance.

Separately, EU legislators also adopted a new insurance-block exemption which entered into force on 1 April 2010 and which will expire on 31 March 2017. Commission Regulation 267/2010 replaces Regulation 350/2003 and exempts from Article 101(1) of the Treaty on the Functioning of the European Union (i) any agreement between insurance undertakings relating to the compilation of joint statistical tables and mortality rates among others, and (ii) certain agreements between undertakings relating to the coverage of certain pooled risks. The older exemption that applied to agreements on standard policy conditions and security devices has now been abolished.

Finally, in the field of health insurance, on 11 February 2010, the European Commission instituted proceedings before the European Court of Justice against the Irish State relating to the exemption of the Voluntary Health Insurance Board ('VHI'), Ireland's state-owned health insurance provider from the EU's non-life insurance rules. The VHI is currently conditionally exempted from the solvency requirements of the EU's Non-Life Directives provided it does not engage in activities outside the health insurance market. The strength of the European Commission's case rests in the fact that since 1996, the VHI with the authority of the Irish State has operated as a multi-agency intermediary and has entered the travel insurance market while simultaneously operating primary health care clinics.

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