

Solvency II – what is in it for me ?

By Lieve Lowet, partner, ICODA European Affairs, for BIPAR

January 2012

BIPAR is the European Federation of Insurance Intermediaries. It groups 51 national associations in 32 countries. Through its national associations, BIPAR represents the interests of insurance agents and brokers and financial intermediaries in Europe.

Besides some large multinationals, the insurance intermediation sector is composed of hundreds of thousands of SMEs and micro-type operators. It accounts for 0.7% of European GDP, and over one million people are active in the sector. Insurance and financial intermediaries facilitate the insurance and financial process for several hundreds of millions of customers. The variety of business models, the high level of competition and the geographical spread in the sector ensure that everyone in Europe has easy access to tailor-made insurance and financial services.

BIPAR is a member of the World Federation of Insurance Intermediaries (WFI).

BIPAR
Av. Albert-Elisabeth 40
B-1200 Brussels

Tel: +32/2/735 60 48
Fax: +32/2/732 14 18
bipar@skynet.be
www.bipar.eu

Although the Solvency II project is targeted to insurance and reinsurance undertakings, and has no explicit requirements towards the insurance intermediaries, this doesn't mean it will not have implications for the insurance intermediary, whether directly or indirectly. But it will not have the same effects on all kinds of intermediaries.

The Solvency II directive, which will need to be transposed into national law by 1 January 2013, and probably fully applied by insurers and reinsurers one year later (pending adoption of the Omnibus II directive), is composed of 3 pillars. During 2013 (re)insurers will need to prepare all dossiers for supervisory authorizations and start Solvency II reporting. Not all pillars will have implications for the intermediary. Also, implications will not be the same for each intermediary. Let's examine pillar per pillar what it could mean? But let's at the same time not forget that the (re)insurance undertaking remains the final Solvency II responsible.

Implications of quantitative requirements of pillar 1

The first pillar relates to risk-based capital requirements. Insurers will have to hold capital for different risks, also for counterparty risk. Intermediaries may pose a counterparty risk regarding receivables from intermediaries. These receivables will need to be monitored more closely.

But more importantly, Solvency II will require insurers to consider in which business lines they really want to play, as capital requirements, to be calculated per business line, (and declining investment results) will make cross-subsidization and loss leaders more visible and oblige re-focus. Will the diversity of offer suffer? The jury is still out. Although the makers of the directive have tried carefully to assure continuity of smaller players, it is expected that this may not necessarily be the case given the extensive amount of requirements, processes and procedures.

Implications of qualitative requirements of pillar 2

The second pillar relates to qualitative requirements relative to the governance of the (re)insurer, including risk management, actuarial management, internal control and compliance, whether performed in-house or outsourced. Especially in case any of these key functions or activities or other critical or important operational functions or activities such as underwriting or claims management (although the latter one is not fully clarified yet) are outsourced, there will be obligations impacting intermediaries and underwriting agents. Also intermediary houses with other businesses besides intermediation (e.g. actuarial services) will be implicated.

Article 49 of the directive, titled 'Outsourcing' explains that in the future any outsourcing contract of a critical or important operational function or activity will need to be notified to the supervisor ex ante (a draft suggests 6 weeks) while being subject to a series of conditions, although the (re) insurer which outsources remains fully responsible. Article 49 also requires that the (re)insurer understands the impact on the governance system of the outsourced function or activity, that the operational risk is not increased, that the supervisors can still monitor compliance (even if outsourced outside the EU) and that

policyholders aren't worse off. It means that the (re)insurer understands what he outsources or delegates and that such business organisation is an integral part of the (re)insurer's different policies and systems. Obviously the materiality principle should not be overlooked but it still implies that e.g. the risk management function identifies, measures, monitors, manages and reports for example underwriting and reserving risk and also operational risk.

This means in practice at least two potential major revision streams: data and contracts.

In terms of data, the tougher standards in terms of completeness, accuracy and appropriateness of data will mean that (re)insurers will want to have more detailed and more up to date information from all their intermediaries. They will have to make sure that their own data capture and analysis will meet the (re)insurer's requirements. But these requirements for tougher standards of data will be even more the case in situations of binding authority delegated to the intermediary: (re)insurers will want to collect as much detailed information as possible about underlying risks while ensuring that the analytical techniques used by their underwriting agents stand up to rigorous scrutiny. As underwriting agents provide outsourced underwriting services, they may also need to bring in or develop better risk management capabilities.

As a result, insurers will therefore demand more refined and disaggregated information about the risks that certain type of intermediaries are accepting as if all was done in-house, while making sure that data is correctly stored and treated. This will be an important logistical challenge as the same data quality standards as to internal data will be asked from external parties.

In terms of contracts, insurers will also want to review the delegations (and have probably already started to do so). Draft supervisory guidelines currently point towards obligations for (re)insurers concerning their written outsourcing policy to include: a selection procedure including financial and technical ability, control framework, and management of conflict of interests (in case of contracts with competitors), all this be specified in the contract. Contracts should further also include all relevant responsibilities, a commitment to comply with all applicable laws and regulatory requirements, goals, processes (including dispute resolution) and reporting procedures, all in line with business strategy; management and monitoring of outsourcing including the involvement of insurer's internal audit; and an exit strategy: insurers must develop a business contingency plan and in that planning foresee how to take the outsourcing away from the service

provider (termination must be of sufficient notice to allow the insurer to find an alternative service provider). Further, the (re)insurer's management body must approve outsourcing of all critical or important functions/activities; a process for monitoring and reviewing quality of outsourced service needs to be set up; regular reports must be drawn up for the insurer's management body when outsourcing is operational. This implies also the need to document the review to a standard acceptable to the supervisor.

As all measures of Solvency II are not known yet, insurers would do best to ensure therefore sufficient flexibility in new outsourcing contracts to cater for additional future requirements. Such review, although a legal and operational challenge, may be an opportunity for a revision of the product offerings.

The directive thus has indirect implications for all (non-salaried) intermediaries, and may result in a reshuffling of the number of relationships as well as re-examination of the depth and breadth of such relationships.

Implications of reporting requirements of pillar 3

The third pillar relates to reporting, both to supervisors and to the public. Also here there are implications, directly, through art 35,2,b as supervisory authorities will be given the power "to obtain any information regarding contracts which are held by intermediaries or regarding contracts which are entered into with third parties". Current draft measures detail that supervisors expect to obtain this information if necessary and important for the purposes of supervision. Supervisors could request such information, as deemed necessary during the course of the Supervisory Review Process. This could include "material insurance or reinsurance contracts (both written or accepted), details of financial arrangements such as committed borrowing facilities or debt raising, contracts relating to the outsourcing of critical or important functions etc.. If contracts are held by third parties, for example, if a broker is writing business on behalf of the insurer, supervisors expect that the insurer either has, keeps copies of or has immediate access to, these contracts as part of its records management procedures. The information to be obtained from undertakings on contracts which are held by intermediaries or regarding contracts which are entered into with third parties shall be requested where it is considered necessary and important for the purposes of supervision. The undertaking shall have, keep copies of or have immediate access to, contracts held by third parties."

But these challenges are also opportunities for (re)insurers and intermediaries alike to revisit their contracts and their relationships.