Speech Willis 4th June

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Firstly, my thanks to Willis for the invitation to speak to you today..

Whilst the core part of my speech covers the issues posed by, and the significance of, Solvency 2. I would like to begin by talking a little about the general approach of the FSC and recent changes we have gone through.

Regulatory overkill is identified as the greatest risk facing the insurance industry by the Centre for the Study of Financial Inovation's latest Banana Skins survey, in it more than 100 respondents to the survey say that excessive regulation is endangering the industry by loading companies with costs, distracting management and creating barriers to competition and innovation. This finding is linked to concern about growing political interference, particularly in markets where governments regulate insurance products and prices.

Over-regulation is widespread. With responses from 21 countries, the survey shows it to be a major issue in North America, Europe, South Africa and the Asia Pacific. Sectorally, concern is strongest among life insurance companies, followed by the property & casualty sector.

The survey quotes the chief executive of a major UK life insurer as saying: "Regulation is becoming ever more intrusive, time-consuming and box-ticking. This is despite the rhetoric about principles-based regulation." More than 80 per cent of the insurance industry respondents were senior executives or directors.

Climate change ranked the 4th greatest risk, Fraud 30th and Terrorism 18th. Too little regulation ranked 32nd narrowly beating asbestos, and had the list been any longer, presumably just above alien abduction

If I can now move to the issue of solvency. My apologies if I don't go into actuaral level of detail, but I am not an actuary and certainly do not have their grasp of numbers

The existing solvency margin requirements were established in 1973 under the First Non-Life Directive (73/239/EEC) and in 1979 under the First Life Directive (79/267/EEC). The third generation of life (92/96/EEC) and non-life (92/49/EEC) insurance Directives fully established the single market for insurance in the mid-1990s. This gave the EU one of the most competitive insurance markets in the world.

Insurance undertakings, on the basis of authorisation in any one Member State, are entitled to sell throughout the entire EU without any price control or prior notification of terms and conditions (except for compulsory insurance). Under this 'single passport' system, insurance undertakings authorised by prudential authorities in one Member State can sell into another Member State, either directly (e.g. by telephone or internet), or by setting up a branch or a subsidiary there.

This cross border ability is one of the, if not the, greatest driver in the growth of the Gibraltar insurance sector. Anything that further enhances it is to be welcomed.

This system relies on mutual recognition of the supervision exercised by different national authorities according to rules harmonised to the extent necessary at the EU level. The requirement for insurance undertakings to establish an adequate solvency margin is one of the most important common prudential rules.

The solvency margin is only one aspect, albeit an important one, of the financial position of an insurance undertaking. The current Solvency I framework, uses a simple and robust model to calculate capital requirements. This current framework is too simple and does not direct capital accurately to where the risks are.

As the capital required under Solvency I is inadequately allocated so regulation in several countries has been strengthened, resulting in a patchwork of rules in place across Europe. A set of simple factors, as used for Solvency I, cannot cope well with the diversity of risks in typical insurance portfolios. Hence the need for Solvency 2.

In 2000 The European Commission presented two proposals for Directives to amend the solvency margin requirements for life and non-life assurance undertakings. The solvency margin is the extra capital that insurance undertakings are required to hold as a buffer against unforeseen events such as higher than expected claims levels or unfavourable investment results. The proposals aimed to strengthen the existing solvency margin requirements for insurance undertakings so as to reinforce safeguards for policyholders' interests. These proposals were priority measures under the Financial Services Action Plan that the Lisbon European Council said should be implemented by 2005

The development follows the Lamfalussy framework’s four-level approach:

- Level 1 – Primary legislation to define broad 'framework' principles.
- Level 2 - Technical implementing measures to be adopted by the Commission assisted by a regulatory committee and an advisory committee.
- Level 3 – Cooperation among national regulators to ensure consistent interpretation of Level 2 rules.
- Level 4 – Enforcement to ensure consistent implementation of EU legislation.

Level 3 in particular is being taken forward by CEIOPS the Committee of European Insurance and Occupational Pensions Supervisors

CEIOPS *was established under the terms of the European Commission Decision 2004/6/EC of 5 November 2003* and is composed of high level representatives from the insurance and occupational pensions supervisory authorities of the European Union's Member States. The authorities of the Member States of the European

Economic Area also participate in CEIOPS. We are not part of the negotiations and therefore rely, like you on information as it comes out from CEIOPS and the FSA.

It is important to remember the final framework will be the result of negotiations. CEIOPS has provided much technical advice on the drafting of the Solvency 2 to the Commission, and has been the forum to date for forging a common view amongst EU supervisors. But clearly, negotiations proper will commence in the Council of Ministers and the European Parliament, when the Commission's Proposal for a Framework Directive proposal emerges. And that stage of the process will clearly be subject to its own dynamics and attendant uncertainties. Based on the Commission's stated timetable, we expect the Directive Proposal to emerge in July.

Solvency II is both a concept and a process. The concept is very simple: that insurers and reinsurers should understand the risks inherent in their businesses and allocate enough capital to cover those risks.

The process of putting it into practice, however, is much more complex. It involves regulators from all EU countries plus Switzerland, Norway, Lichtenstein and Iceland. Although the basic principles are agreed, there are still differences over implementation, which will not take place until 2010 at the earliest.

The aim of Solvency II is not to increase overall levels of capital, but rather to ensure a high standard of risk assessment and efficient capital allocation.

Solvency II is intended to introduce across the EU a most sophisticated, risk based approach to supervision and capital assessment, using modern techniques for market – based valuation of assets and liabilities.

The new framework is meant to promote higher quality risk management and ensure that the assessment of regulatory capital is integrated with a firm's wider capital management processes.

Solvency 2 is of huge significance for the insurance industry – not only because it will set prudential standards within Europe that are unlikely to be revised further for some considerable time, but because the approach adopted may well influence global standards more widely.

It is proposed that a Basel II – type framework (ie that used for banking) should be used consisting of three 'pillars'. Pillar 1 sets out the minimum capital requirements firms will be required to meet for insurance, credit, market and operational risk. Pillar 2 will be the supervisory review process – because of this, supervisors may decide that a firm should hold additional capital against risks not covered in pillar 1. The aim of pillar 3 disclosures is to harness market discipline by requiring firms to publish certain details of their risks, capital and risk management.

Pillar 1 contains two capital requirements, the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR). The MCR reflects an absolute minimum level of required capital below which supervisory action will automatically be triggered. The SCR represents additional capital to firms to absorb significant unforeseen losses.

The exact relationship between the Minimum Capital Requirement (MCR) and Solvency Capital Requirement (SCR) has yet to be determined, but the SCR will be the key driver. Unlike the MCR it will be fully risk-based, taking into account all the risks inherent in a business, mainly underwriting, credit, operational, liquidity and market risk. A firm that cannot demonstrate capital levels adequate to meet these risks will have to submit a concrete plan to their regulator for approval with a realistic timeframe included.

Calculating the SCR

Insurers and reinsurers will be required to measure their risks and ensure that they have sufficient capital to cover them. Firms are likely to have two options. They will be able to adopt a standardised approach or an internal model.

The standardised approach is closer to the system of regulation currently in force in most EU states. It is less time-consuming, but is based on averages and there is a considerable amount of guesswork involved. To compensate for this uncertainty and for the greater margin of error, Solvency II is likely to build in additional capital requirements for those using the standardised approach.

For companies choosing the modelling route, regulatory approval will be required before a firm is able to use its internal model to calculate SCR. Models are more time-consuming, though they have a number of compelling business advantages quite apart from regulatory drivers.

Solvency II will also permit a hybrid approach involving simplified models with an element of standardisation. This may be attractive to smaller and medium-sized insurers unable to justify investment in full-scale models.

Pillar 2 will focus on the qualitative aspects of a company's internal controls,risk management processes and the supervisory activities of regulators such as ourselves, with the aim of identifying firms with a higher risk profile. Those firms may be required to hold capital at a higher level than the amount suggested by the SCR calculation and/or to take steps to reduce identified risks.

Pillar 2 has two main aims:

• to ensure that a firm is well run and meets adequate risk management standards;

• to ensure that it is adequately capitalised.

The first of these represents a major development since Solvency I and will encourage firms to adopt Risk Management. It will be much more than a question of going down a list and ticking boxes. We will want to be satisfied about the quality of data and estimation procedures, the systems in place to manage risk and action plans in the event of certain risks materialising. An understanding of how different risks inter-relate may also be necessary.

Pillar 3 requires disclosure of additional information that supervisors feel they need in order to perform their regulatory functions. Essentially it is about disclosure and demonstrating to the regulator that the analysis supporting the other two pillars is dependable. It requires insurers to provide key, verifiable information relevant to their capital adequacy. In broad terms, these would cover:

• measures of financial condition and performance;

• measures of risk profiles and the data and other assumptions upon which they are based;

• measures of uncertainty, including the accuracy or otherwise of previous estimates and the sensitivity of the calculations to market volatility.

As the banana skin survey shows, insurers and reinsurers around the world view any new rules with understandable suspicion. Solvency II is one of those rare cases, however, where regulations can actually help to improve the business. The principles behind the process are increasingly recognised as best practice by rating agencies, regulators outside Europe, actuaries and indeed anyone with an interest in the stability and profitability of the re/insurance industry.

Understanding the risks inherent in your business lies at the heart of Solvency II (mainly Operational Risk, Group Risk, Insurance Risk, Market Risk, Credit Risk and Liquidity Risk). For all but the smallest of companies, the only effective way to do this is to create financial models of the company, involving analysis of all your business processes.

This can be quite time-consuming, but the information and analysis involved has far-reaching uses. Above all, it can help you to manage your capital effectively by underpinning many core strategic activities.

So what can we do now?

As I mentioned, the draft Directive is now due to be published in July 2007. members of the insurance division attended a London course in March on the likely form of Solvency II.

We are awaiting the publication of the Draft Directive before commencing our preparatory work. This may seen to be reactive but we have little choice. Our founding statute requires us to “match” the UK. We must therefore monitor what theyare doing before acting ourselves. We simply do not have the resources to focus people exclusively on this area.

What we can do however is ensure our culture is right for its smooth introduction.

What is helpful is the use by CEIOPS of Impact assessments.

An Impact Assessment has three key ingredients:

- Firstly, an analysis of the reasons why a market (or existing regulation) does not work well and of the possibility of improving the situation by some carefully chosen regulatory or supervisory action
- secondly, public consultation about the regulatory policy proposed
- thirdly, as appropriate a review of the effectiveness of the policy implemented

These bring much needed transparency to the process.

CEIOPS is undertaking a Quantitative Impact Study and very much encouraging smaller European insurance companies to participate. Through the Gibraltar Insurance Association we are promoting the participation of Gibraltar companies and those likely to do so will probably take part in the ABI's initiative since many Gibraltar companies are members of that association and the timescale is short – 29 June 2007.

One are we are watching is how convergence will work

Convergence in regulatory requirements should be welcome news for both the industry and consumers – it promotes competition and aids transparency. Given the fragmented nature of the current European insurance regulatory framework, with varying national standards and approaches, a common set of objectives and conceptual approach will be a major step forward. And it will be a good springboard from which to make further progress in achieving real convergence in supervisory practice. But it is also important to remember that there remain those who argue that, if harmonisation of objectives and concepts turns into a search for harmonisation at every level of detail we somehow risk losing a risk sensitive regime and that the capital requirements for each firm may no longer reflect the local or sectoral markets in which that firm operates.

I do not accept this and it must not be used to reassert goldplating.

Overall then, much has been achieved but there are some remaining hurdles to jump. And, while negotiations continue, , I would like to take this opportunity to emphasise to firms the benefits of participating in CEIOPS third quantitative impact study. Of course, participation in QIS3 is voluntary. But I would encourage firms to take part if at all possible, and for two reasons.

First, the results of QIS 3 will inform negotiations and influence the final form of the new regime. Decision-makers need data to make sensible choices between options. The results of QIS 3 will coincide perfectly with the start of negotiations. It does not matter that they will follow publication of the Framework Directive in July - if the results indicate that there are big problems, there will still be time to change the framework.

Second, participating in QIS will help you understand the likely impact of Solvency 2 on your firm and will help you plan for implementation of the directive. It is a very practical way to get Solvency 2 on your Board's radar.

Some firms, I know, will consider that they do not have enough resources to commit to a complete execution of all aspects of QIS 3. To those firms I would say that it is still important that you participate, even on a partial basis. Partial results may still yield useful information and are certainly better than none. In particular, I would advise you to concentrate on those aspects which are the most material for you. While this approach will not tell you (or us) the full impact of Solvency 2 on your firm, it should yield useful information on the suitability and practicality of the proposed calculations. We are aware that QIS represents a big resource commitment for firms, and we are appreciative that firms are prepared to commit resources.

In conclusion , remember, the Commission has an ambitious timetable and, in practice, implementation may be less than four years away.