

*Over the past quarter, whilst attention in this country has been drawn increasingly towards the forthcoming General Election, over in Brussels the new European Commission has been quietly bedding itself in. Not least M Barnier, who as the new Internal Market and Services Commissioner has been getting to know people including paying a goodwill visit to the City of London. As an experienced French politician, he will need all his negotiating skills in dealing collectively with the European Council of Ministers, the European Parliament and a multitude of different international and national organisations. No 1 on his list of priorities is implementing the financial reform package including the new framework of regulation to avoid a re-occurrence of the crisis that rocked EU institutions over the last couple of years.*

*Elsewhere, steady progress continues to be made on Solvency II with the project still on-track to achieve implementation in late 2012/early 2013. Within the next few months the draft Level II implementing directive should be issued following the final advice submitted by CEIOPS earlier this year. The all-important QIS5 is soon to be underway whilst preliminary work has also started on Level III convergence stage to ensure that national regulators are all pulling in the same direction.*

*All in all, the new Commission has an ambitious work programme in financial services ahead not just on major regulatory and prudential issues but extending to internal retail-related issues including a review of MiFID and IMD legislation.*

*This edition brings readers up-to-date with the latest developments.*

### **New financial regulation**

Speaking at his initial meeting in February with ECOFIN (European Council of Finance Ministers), Michel Barnier, the new EC Commissioner for Internal Market and Services stated that his immediate priority was to equip Europe with an effective supervisory system.

Since then EC working groups have been hard at work devising the detail of the new regulatory structure which will include establishing new and stronger organisations to replace the existing Lamfalussy technical committees of CEBS (banking), CESR (securities) and CEIOPS (insurance and pensions). The powers and constitution of the new European Supervisory Authorities bodies (ESAs) will be enshrined in a so-called *Omnibus II* directive due to be published and adopted this summer with the objective of being in place by 1 Jan. 2011. However, final agreement will rest as much on the attitude of the European Parliament as ECOFIN, as over 1500 amendments tabled by MEPs had still to be resolved by the EP Economic and Monetary Committee (ECON) at its meeting this week.

On a visit to the City of London at the end of last month, M Barnier made clear that he was not intending to replace self-regulation with over-regulation and that regulation can never cover everything that is happening in the markets. Nevertheless, supervision was central to the strategy of financial regulation and that the new ESAs would have a key role in:-

- putting in place a single rulebook
- solving disagreements between national supervisors
- monitoring the correct application of EU law
- intervening in emergency situations

Day-to-day supervision would however remain national.

Only this week, M Barnier, during another speech, reiterated the importance of setting up the new ESAs by stating that the EU could not afford failure and that with a bit of flexibility, quick agreement was possible and essential. He foresaw that more effective regulation was the starting point of any “new deal” between the world of finance and society, a new deal that was aimed at restoring trust.

## **Solvency II**

Following a series of consultations with industry stakeholders over the course of 2009, CEIOPS has published its final advice that has now been sent to the EC designed to assist the drafting of the Solvency II implementing directive. As a result of feedback (including from ILAG) a number of changes – both major and minor - have been made to the original draft advice including ensuring a consistent relationship between the Minimum Capital Requirement (MCR) and Solvency Capital Requirement (SCR), and the use of wider, more representative data in calibrating non-life and health underwriting risks.

In addition, CEIOPS has more recently endorsed the calibrations used in successive QIS studies in determining technical provisions on liabilities, the risk margin, SCR and MCR. Amongst the more controversial areas, CEIOPS has re-affirmed the cost-of-capital rate (i.e the cost of holding an amount of eligible own funds for an insurance or reinsurance undertaking being capitalised corresponding to a confidence level of 99.5% Value-at-Risk over a one year time horizon) in the light of concerns expressed by certain industry organisations that a lower level (in the range of 2<sup>1/2</sup> – 4<sup>1/2</sup> %) might be more suitable. In maintaining the figure at 6% - linked to BBB-rated undertakings - CEIOPS nevertheless concedes that a regular 5 year review might be appropriate.

The technical analysis also confirms the arithmetic simulations used to test both the various risk modules associated with the standard formula under the SCR and the linear formula used for evaluating the MCR within a range of the prevailing SCR (25-45%) though with the proviso that should the calibrations used in the former change at any time then the latter should be adjusted accordingly.

The EC is expected to produce the draft implementing Solvency Level II directive in June which will then be subject to public consultation and co-decision procedures in the EU Council of Ministers and European Parliament culminating in a final decision by the end of the year. A public hearing on the Level II directive, organised by the EC, is being held in Brussels on 4 May at which ILAG will be represented.

The EC has also requested CEIOPS to run a fifth quantitative impact study (QIS) from August to November 2010 in order to test solvency levels on the basis of the Level II draft directive and to inform future developments. In drafting the specifications, CEIOPS believes that solvency requirements will increase but at the same time they are expected to lead to a decrease in technical provisions. It is hoped that at least 60% of EU insurance firms and 75% of insurance groups will participate in this study, the outcome of which should be known by April 2011.

Meanwhile, in March, CEIOPS moved on to preparing guidance on the Level III stage designed to foster co-operation between national supervisors and ultimate convergence. It's first set of guidance deals with the pre-application process for internal models which insurance firms can opt to use in measuring the SCR as opposed to the standard formula. However, the paper makes clear that pre-application does not automatically mean pre-approval and that firms should also set up processes to calculate the standard formula in the event that the internal model is not approved.

The ILAG Prudential Regulation Focus Group believes that the guidance is both sensible and practical. In particular, it was felt that within the time frame of a six month assessment period, most firms would opt initially for *partial* internal models and that within this process, it was hoped that regulators would exercise discretion in imposing specific numbers regarding solvency levels.

Finally in a busy period for CEIOPS, it published the results of stress testing carried out with 28 large insurance groups, representing 60% of total EU premiums, as to their respective ability to withstand financial shocks - either a repetition of the recent financial crisis, a deep economic recession or a period of sudden and rising inflation. The tests carried out on a Solvency I basis concluded that only 3% of available capital would be lost under the first scenario, but up to 25% under the other two scenarios.

All CEIOPS recent publications can be viewed on:  
<http://www.ceiops.eu/content/blogsection/9/1/5/5/>

## **MiFID review**

The Markets in Financial Instruments Directive (MiFID) is now in its third year and the EC has requested CESR (European Committee for Securities Regulation) to examine its performance and recommend any changes for the future. In consequence, CESR has issued three consultation papers this month dealing respectively with investor protection and intermediaries, equity markets and transaction reporting.

ILAG's primary interest is in the first paper particularly in respect of possible changes to the definitions of complex and non-complex products and the scope of appropriateness requirements, personal recommendations and tied agents' controls.

On the treatment of products, CESR is suggesting that shares in unregulated collective products (non-UCITS), convertible shares and shares embedded in derivatives should no longer be classified as 'automatically non-complex' and, according to circumstances, be subject to the investor appropriateness test as complex products. Similarly with other market instruments, CESR feels that asset-backed securities, structured products and certain types of bonds justify use of the appropriateness test and be re-classified as complex products. A question mark is

also raised against UCITS products but for the time being CESR is not proposing any change to their non-complex status.

On the subject of personal recommendations, CESR is now seeking to remove the use of 'distribution channels' from the directive as a recognised method of providing non-investment advice and that in future using the internet and direct mailings will constitute a personal recommendation and thus investment advice.

On tied agents, CESR believes that the controls have worked well since the implementation of MiFID and that there is no need to change the rules governing tied agents' supervision and investment firms' oversight of their tied agents.

The full set of CESR consultation papers on MiFID can be viewed on [http://www.cesr-eu.org/index.php?page=home\\_details&id=470](http://www.cesr-eu.org/index.php?page=home_details&id=470)

### **Other Insurance regulation**

The EC has requested CEIOPS to provide technical advice on the framework and workings of the **Insurance Mediation Directive** (IMD) in order to develop an IMD2.

Amongst aspects that CEIOPS has been asked to examine is the scope of the directive and whether direct sales of insurance policies by provider firms should be incorporated alongside intermediary sales in the cause of achieving a level playing field. Additionally, as adviser qualifications differ throughout the EU, CEIOPS will be assessing whether common qualifications should be introduced as well as studying:-

- possible conflicts of interest between the sale of investments packaged as life insurance products and conventional protection policies
- how to achieve greater transparency in terms of adviser remuneration, and
- areas in which costs of application could be reduced to match intended benefits

The EC hopes to receive the advice by the summer with a view to legislating in 2011. CEIOPS has yet to publish any progress report or papers on the subject.

In the meantime, as a result of consultation, the EC has introduced a new **insurance sector block exemption regulation** to run from 2010-2017. The insurance BER exempts certain aspects of the insurance industry from the EU prohibition on restrictive agreements. The headline points of the new insurance BER are that it:

- renews exemption for joint compilations, tables and studies;
- renews exemption for co-(re)insurance pools, subject to some amendments;
- no longer exempts standard policy conditions; and
- no longer exempts agreements on security devices.

This outcome was widely anticipated following the draft proposals issued last year. In passing it should be noted that standard policy conditions are not necessarily declared illegal but will be subject to regular competition analysis and the industry has six months to adapt and modify agreements to meet the new rules.

*End.*

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