

## Solvency II: A Risk-Based Solvency Framework For The European Union

by Jeremy Hill

The draft Solvency II Framework Directive (the "Directive") was published by the European Commission in July 2007. Although the deadline for implementation of the new regime was originally to be 2010, the sheer scale of the undertaking of implementing radical changes in risk management throughout the European Union (the "EU") insurance and reinsurance industry has already necessitated that implementation of the directive be put back to 2012.

The central proposition behind Solvency II is to introduce a risk-based solvency framework common across the European insurance industry analogous to the framework introduced by Basle II for the banking industry where prudential standards have been upgraded in the EU by the Capital Requirements Directive.

In the EU insurance sector, however, there has been a general consensus that the prudential regime for insurers needs updating for reasons including: (1) the Solvency I regime was last updated in 2004, and generally accepted standards of risk management and internal controls have since outstripped the standards required by the regulations, (2) there has been a different approach to prudential regulation between EU member states, and such lack of harmonisation has led to a degree of "shopping," as insurers and reinsurers select a head office jurisdiction with the regulatory regime they find most appropriate for their business, as well as

holding back full EU integration in the insurance market.

Solvency II will introduce risk-based capital adequacy requirements which go beyond even those applicable in jurisdictions such as the U.K. and the Netherlands, which have already introduced risk-based capital requirements for insurers. In addition, the focus of Solvency II is to encourage the insurance industry to adopt enhanced risk management systems and internal controls which more accurately reflect each insurer's individual needs and risk profile. The draft Directive is based on a "3 pillar" solvency supervisory regime, the 3 pillars being:

**Pillar 1:** Minimum standards (quantitative requirements) to be imposed through regulations on minimum capital requirements, reserving and investment;

**Pillar 2:** Supervisor review (qualitative requirements) to be implemented through regulations on financial services supervision, including as to capabilities and powers of regulators, and applicable areas of activity; and

**Pillar 3:** Market discipline to be upgraded through requirements as to transparency, disclosure and competition-related elements.

The proposed Directive, however, should not be seen as a blunt instrument requiring insurers and reinsurers of whatever size and diversity of business to fit within narrowly defined regulatory requirements. Rather, the

### WHAT'S INSIDE

**3** Life Insurance Embedded Value Securitizations

**7** New York State Commission to Modernize the Regulation of Financial Services Holds First Meeting

**8** Duties of Corporate Directors Under the U.K. Companies Act

**11** SEC Approves NASD Rule Regarding Sales of Deferred Variable Annuities

proposed Directive recognises that whilst the aim is to harmonise insurance solvency regulation throughout the EU, different insurance entities will have different risk profiles and, in keeping with a general principle of EU regulation, the principle of "proportionality" should be applied. Proportionality would potentially mitigate the burden of implementing the requirement for smaller companies whilst giving multi-jurisdictional insurance entities the ability to obtain credits through diversification of risk. The draft Directive also follows the growing trend toward "principles-based" regulation

# Letter from the Editor

Recent events at Société Générale have brought renewed focus on enterprise risk management. Monoline financial guaranty insurers remain in the news.

Meanwhile, during recent months, there have been numerous calls to modernize the regulation of financial institutions. For example, in the U.S., Treasury Secretary Henry Paulson has joined in the discussion through speeches and through the Treasury's publication of an invitation for public comment on questions touching every aspect of how financial institutions are regulated in the U.S. Across the U.S., interest continues to grow in the potential adoption of principles-based regulation on the model of the U.K. Financial Services Authority, but questions remain about how that approach could be made to work in the U.S. This growing interest is reflected in the work of the NAIC to develop principles-based reserving and capital adequacy standards and in the proposals for reinsurance regulatory reform put forth by the NAIC and certain states.

In Europe, insurers and others continue to assess the impact that the European Commission's Solvency II framework, and its "principles-based" approach to solvency regulation, might have on insurers globally. In this issue, we report on legislative and regulatory developments in the U.S. and

Europe, including the first formal meeting of the New York State Commission to Modernize the Regulation of Financial Services and the recent publication by the European Commission and of the draft Solvency II Framework Directive. A principles-guided approach will be among the topics to be considered this year by the New York Commission to Modernize the Regulation of Financial Services.

In this issue, we also present an article discussing an increasingly common type of structured life insurance financing: life insurance embedded value securitizations. Designed to "unlock" expected future cash flows associated with a block of life insurance business, embedded value securitizations can be complex transactions, involving multiple parties and regulators. Although market conditions have recently been difficult, we expect our clients in the life insurance industry to continue exploring this promising new financing technique in the coming months and years.

We will continue to monitor and report on these and other developments in the *Debevoise & Plimpton Financial Institutions Report* and in Client Updates.

Wolcott B. Dunham, Jr.  
Editor-in-Chief

## FINANCIAL INSTITUTIONS PARTNERS AND COUNSEL

The *Debevoise & Plimpton Financial Institutions Report* is a publication of

### Debevoise & Plimpton LLP

919 Third Avenue  
New York, New York 10022  
+1 212 909 6000

www.debevoise.com

Washington, D.C.  
+1 202 383 8000

London  
+44 20 7786 9000

Paris  
+33 1 40 73 12 12

Frankfurt  
+49 69 2097 5000

Moscow  
+7 095 956 3858

Hong Kong  
+852 2160 9800

Shanghai  
+86 21 5047 1800

All contents © 2008 Debevoise & Plimpton LLP. All rights reserved.

Wolcott B. Dunham, Jr.  
*Editor-in-Chief*

Elizabeth K. Brill  
*Managing Editor*

Michael K. McDonnell  
*Deputy Managing Editor*

*The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein. Any discussion of U.S. Federal tax law contained in these articles was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.*

All lawyers based in New York, except where noted.

### Corporate and Capital Markets

Marwan Al-Turki - London  
Ann G. Baker - Paris  
Kenneth J. Berman - Washington, D.C.  
Paul S. Bird  
Michael W. Blair  
Craig A. Bowman  
Thomas M. Britt III - Hong Kong  
Séverine Canarelli - Paris  
Pierre Clermontel - Paris  
Vivienne de Chermont - London  
John Dembeck  
Michael D. Devins  
Wolcott B. Dunham, Jr.  
Sarah A. W. Fitts  
Christopher Henley - London  
Stephen R. Hertz  
Jeremy Hill - London  
Matthew E. Kaplan  
Thomas M. Kelly  
James A. Kiernan III - London  
Antoine F. Kirry - Paris  
Patrick Laporte - Paris  
Heidi A. Lawson - London  
Paul L. Lee  
Linda Lerner  
Guy Lewin-Smith - London  
Li Li - Shanghai  
Byungkwon Lim  
Peter J. Loughran  
Marcia L. MacHarg - Frankfurt  
Ivan E. Mattei

Dmitri V. Nikiforov - Moscow  
Steven Ostner  
Andrew M. Ostrognai - Hong Kong  
Alan H. Paley  
Nicholas F. Potter  
William D. Regner  
Thomas Schürrie - Frankfurt  
James C. Scoville - London  
Steven J. Slutzky  
Andrew L. Sommer  
John M. Vasily

### Employee Compensation & Benefits

Lawrence K. Cagney  
Jonathan F. Lewis  
Elizabeth Pagel Serebransky

### Investments and Workouts

Steven M. Alden  
Katherine Ashton - London  
William B. Beekman  
Hans Bertram-Nothnagel - Frankfurt  
Alan J. Davies - London  
Robert J. Gibbons  
Steven R. Gross  
Richard F. Hahn  
Peter Hockless - London  
Darius Tencza  
My Chi To

### Litigation

Molly S. Boast

Anne E. Cohen  
Frederick T. Davis - Paris  
Donald Francis Donovan  
Martin Frederic Evans  
Mark W. Friedman - London  
Robert D. Goodman  
John H. Hall  
Donald W. Hawthorne  
John S. Kiernan  
Gary W. Kubek  
Carl Micarelli  
John B. Missing - Washington, D.C.  
Joseph P. Moodhe  
Peter Rees - London  
Lorin L. Reisner  
David W. Rivkin  
Edwin G. Schallert  
Lorna G. Schofield  
Colby A. Smith - Washington, D.C.  
Mary Jo White  
Bruce E. Yannett

### Tax

Pierre-Pascal Bruneau - Paris  
Peter A. Furci  
Friedrich E.F. Hey - Frankfurt  
Seth L. Rosen  
Hugh Rowland, Jr.  
Peter F.G. Schuur  
Richard Ward - London

# Life Insurance Embedded Value Securitizations

by *Thomas M. Kelly, Seth L. Rosen, Elizabeth K. Brill and Michael K. McDonnell*

A life insurance embedded value securitization is a type of capital markets offering designed to monetize the future profits expected to be realized over time from a defined block of life insurance business. By completing an embedded value securitization, a life insurance company can immediately release the expected value of future cash flows associated with a defined block of life insurance business, or its “embedded value,” without waiting for those cash flows to emerge over time.

## Transaction Structures

Embedded value securitizations are similar in some respects to “XXX” or “AXXX” “excess reserve” securitizations, which have become increasingly common in recent years. In an excess reserve securitization, a ceding life insurance company securitizes that portion of the reserves held in connection with its term and universal life insurance business that exceeds the level of economic reserves expected to be required to fund future policy obligations. In contrast, in an embedded value securitization, the life insurance company securitizes the entire embedded value of a defined block of business. Despite the contrast in purpose, embedded value securitizations and excess reserve securitizations often employ similar transaction structures.

Typically, the life insurer forms a new special-purpose captive reinsurer and cedes the business to be securitized, which is often referred to as the defined block business, to the newly-formed captive reinsurer on an indemnity reinsurance basis. The embedded value of the defined block business is then securitized by issuing debt securities in the capital markets. For example, the captive reinsurer may issue

surplus notes to a special-purpose vehicle, which in turn issues notes to investors via a private offering. If the captive reinsurer is domiciled in the U.S., approval of the captive reinsurer’s domiciliary regulator is required prior to each payment of principal or interest on the surplus notes. In some cases, the captive reinsurer’s domiciliary state regulator may pre-approve a payment formula for payments on surplus notes. In either case, no separate regulatory approval would be required in connection with payments on the notes sold to investors (see the accompanying diagram entitled

**Embedded value transactions frequently have an extended time horizon, involving the issuance of debt securities with a thirty-year term (or longer), and are complex transactions often involving multiple parties and regulators.**

“Transaction Structure One”). Another commonly used structure interposes an intermediate holding company, usually organized as a limited liability company, between the life insurer and the captive reinsurer. The captive reinsurer pays dividends to the intermediate holding

company, subject, in the case of U.S. domiciled reinsurers, to the prior approval of each dividend payment, or in some cases to the pre-approval of a dividend payment formula, by the captive reinsurer’s domiciliary state regulator (see the accompanying diagram entitled “Transaction Structure Two”). Embedded value securitizations may also be accomplished using other structures.

Depending on the nature of the block of business being securitized and the structure of the reinsurance transaction between the life insurance company and the captive reinsurer, a single beneficiary reinsurance trust, often referred to as a “Regulation 114” trust, may be established or a qualifying letter of credit may be purchased so that the ceding insurer can take reinsurance reserve credit for the business ceded on its statutory financial statements.<sup>1</sup> Alternatively, the reinsurance may be entered into on a “funds withheld” or “modified coinsurance” basis, such that the assets supporting the ceded reserves are retained by the ceding life insurance company. This structure would also permit the ceding insurer to take reserve credit on its statutory financial statements for the business ceded. It is also possible to combine different methods of security for reinsurance, for example through a combination of assets in a reinsurance trust and funds withheld assets that together are sufficient to secure 100% credit for the ceded reserves.

Cash flows generated from investment earnings and the release of reserves over time fund payments by the captive reinsurer, either in the form of payments on the captive reinsurer’s surplus notes or in the form of dividends to its intermediate holding company. These payments by the captive reinsurer, in turn, fund payments of principal and interest to the ultimate investors.

EMBEDDED VALUE SECURITIZATIONS  
CONTINUES ON NEXT PAGE

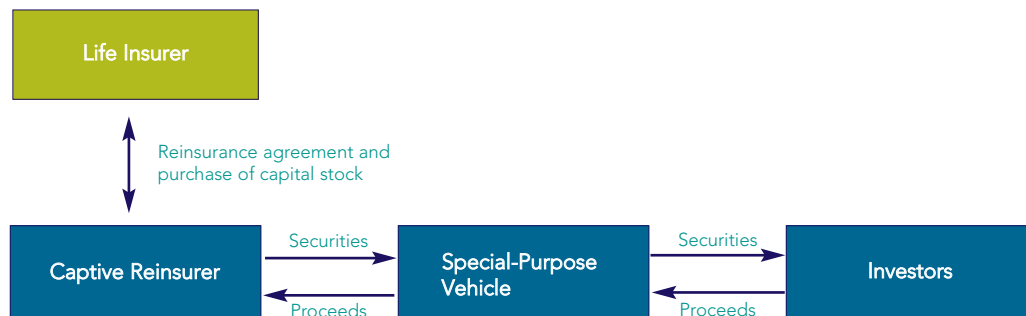
# Embedded Value Securitizations

(CONTINUED FROM PREVIOUS PAGE)

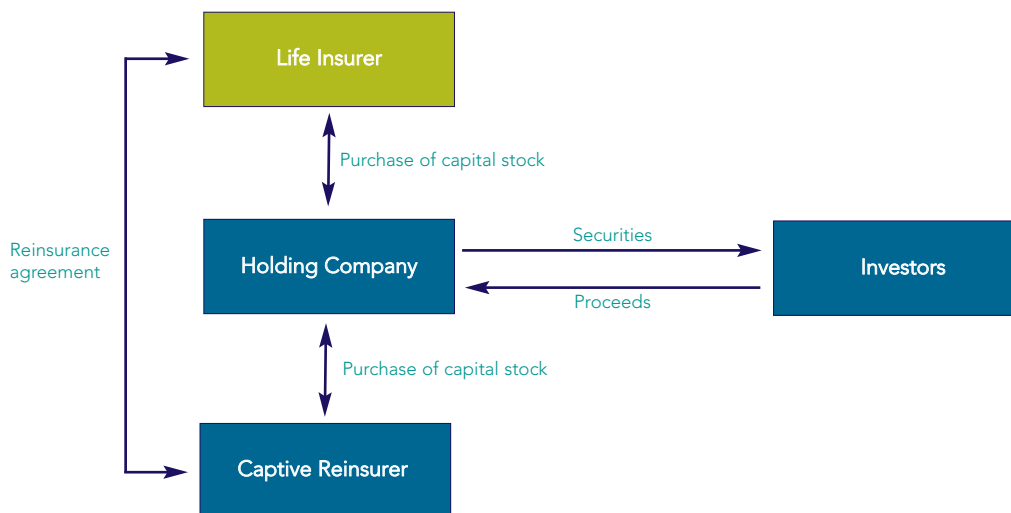
Depending on the size and nature of the defined block business, notes may be issued to investors in multiple tranches, with varying levels of subordination. Some transactions may also include preferred equity issuances.

In certain embedded value securitizations, highly-rated financial guaranty insurance companies have issued financial guaranty insurance policies “wrapping” the notes issued to investors in order to enhance credit quality. These “wraps” are meant to provide assurance to investors that they will receive scheduled payments of interest and repayment of principal at maturity regardless of the actual performance of the defined block business and, in the case of a U.S. captive reinsurer, whether or not the captive reinsurer’s domiciliary regulator approves payments on the surplus notes or dividends to the intermediate holding company. This has allowed the notes to be issued with a credit rating equal to the credit rating of the financial guaranty insurer. In other transactions, notes have been offered to investors without a financial guaranty “wrap.” Depending on the circumstances, an “unwrapped” issuance structure could include a holding company guarantee or keepwell arrangement. In that case, a holding company parent of the life insurer may guarantee scheduled payments of principal and interest to investors, or agree to maintain specified balances in funding accounts of the captive reinsurer or the

## Transaction Structure One



## Transaction Structure Two



issuing entity, or commit to make funds available to these entities under other specified circumstances. “Unwrapped” issuance structures could also involve other forms of credit enhancement.

### Key Considerations

Embedded value transactions frequently have an extended time horizon, involving the issuance of debt securities with a thirty-year term (or longer), and are complex transactions often involving multiple parties and regulators. Key issues for an insurer to

consider in connection with a potential embedded value securitization include the following:

**Identifying a Block of Business.** Typically mature “seasoned” blocks of business are best suited to securitization transactions. Such blocks are established and therefore exhibit fairly predictable cash flows, which are used to fund interest and principal payments to investors. It is also helpful if the underlying business is well diversified, as diversification decreases the volatility of cash

EMBEDDED VALUE SECURITIZATIONS  
CONTINUES ON NEXT PAGE

# Embedded Value Securitizations

(CONTINUED FROM PREVIOUS PAGE)

flows. Additionally, once a block of business is identified, it may need to be adequately segregated from the insurer's other business in order to assure investors that the future cash flows attributable to the block will not be used to fund obligations unrelated to the block of business.

**Retained Liabilities.** What, if any, liabilities relating to the defined block business should be retained by the ceding life insurance company? Depending on the nature of the defined block business and other considerations, extra-contractual liabilities, liabilities in excess of certain specified per life or per event limitations, liabilities relating to increased costs or credit risk associated with third-party reinsurance may be retained.

**Actuarial Analysis.** The structure and pricing of an embedded value transaction is based on a sophisticated actuarial analysis of the defined block business, often generated by or with the assistance of an independent actuarial consulting firm. The actuarial analysis assesses the adequacy of expected future cash flows from the block of business across a variety of scenarios and thus estimates the expected performance as well as the potential downside risk associated with the block of business. The analysis is summarized in a detailed actuarial report, which may be used by investors, rating agencies, financial guaranty insurers and others to evaluate the defined block business and the notes.

**Regulatory, Rating Agency and Financial Guaranty Insurer Review.** Since embedded value securitizations involve the reinsurance of the defined block business, regulatory approvals typically are required in multiple jurisdictions, including the states of domicile of the ceding life insurance company and the captive reinsurer and sometimes other jurisdictions such as California, New York and

Wisconsin, which have broad statutes regulating insurance ceded by foreign licensed insurers operating in those states.

One or more rating agencies may be involved. Additionally, if one or more financial guaranty insurers "wraps" the notes issued to investors, such insurer (or insurers) is likely to play an active role in structuring and executing the transaction. Apart from the often complex legal, accounting, actuarial and statistical modeling issues involved in these transactions, the sheer number of interested parties increases their level of complexity and the tactical difficulties involved in their execution.

**Ongoing Administration.** Following an embedded value securitization, the ceding life insurance company will often remain responsible for administering the securitized block of business. Given that the expected time horizon of the defined block business, and the transaction, is generally quite long, these administration responsibilities can be significant, and may last for thirty or more years.

## Key Tax Considerations

From a federal income tax perspective, the goal in an embedded value securitization is to achieve a "tax neutral" structure – so that the federal income tax consequences to the life insurer are similar to those that would result from a simple borrowing against the future cash flows from the defined block business.

To achieve this result, it is (in very general terms) necessary to ensure that: (1) the captive reinsurer and the life insurer can be included in the same consolidated federal income tax return each year (including the year in which the transaction is consummated); (2) reserving requirements in the captive jurisdiction will not limit the maintenance of the full statutory reserve

formerly carried by the ceding company with respect to the defined block business; and (3) the securities sold to investors will likely be respected as debt instruments for federal income tax purposes (and not treated as equity in the captive or limited liability company issuer).

**Consolidation.** Payment of a ceding commission from the captive reinsurer to the ceding insurance company with respect to life insurance or non-qualified annuity policies (or the release of reserves formerly held by the ceding company to support the defined block business) will generally result in taxable income to the ceding insurance company and an equal deduction to the captive reinsurer. If the ceding insurer and the captive reinsurer are included in the same consolidated federal income tax return, then the income and deduction will offset, resulting in zero incremental federal income tax paid in the year of the transaction. Instead, the group will have positive taxable income as the profits emerge from the defined block – just as it would if the securitization had never occurred. In contrast, a bulk reinsurance transaction to a true third party or a non-consolidated affiliate would result in taxable income to the ceding company equal to the full amount of the ceding commission, and a loss in the reinsurer that would be of little value to that entity on a stand-alone basis in the year of the transaction, but would create an "operations loss" carryforward that would be available to shelter future taxable income emerging from the block in the following 15 years.

As a result, absent federal income tax consolidation, the reinsurance transaction that is used to isolate the defined block business in the captive reinsurer and transfer the securitization proceeds to the ceding life insurance company would effectively

EMBEDDED VALUE SECURITIZATIONS  
CONTINUES ON NEXT PAGE



# Embedded Value Securitizations

(CONTINUED FROM PREVIOUS PAGE)

accelerate the federal income taxes on future cash flows expected to emerge from the block.

Complex tax rules govern the inclusion of a newly-formed life insurance or reinsurance company in the consolidated federal income tax return filed by a group that includes both life insurance companies and corporations that are not life insurance companies. Each group will have a different solution that will facilitate the inclusion of the captive reinsurer in the same consolidated return with the ceding insurance company. Additional complexity may arise if the captive is to be formed outside the United States, or if the captive reinsurer will be held through a limited liability company (and not directly by a corporate or insurance company member of the consolidated group).

**Reserving.** Life insurers and reinsurers are generally permitted a federal income tax deduction for increases in their life insurance reserves (and recognize taxable income when those reserves are reduced). However, the amount of life insurance reserves that will be recognized for federal income tax purposes is generally capped by the “statutory reserve” – which is the amount set forth in the insurer or reinsurer’s annual statement submitted to its insurance regulators. In addition, in order to be taken into account for tax purposes, a life insurance reserve must be “required by law” – which generally means that the reserve must be required by an express statutory provision or by rules and regulations of the insurance department of the insurer’s domiciliary jurisdiction. While these rules are complex and subject to varying interpretation, it generally is desirable to establish that under applicable law and regulations (and perhaps under the licensing order of its governing regulatory body) the captive reinsurer is required to maintain (and

report on its annual statement) life insurance reserves that are calculated under the same principles that apply to the ceding insurance company in its domiciliary state.

**Debt/Equity Analysis.** Treatment of the securities issued to investors as “debt” for federal income tax purposes can be important for several reasons. Interest deductions on debt can shelter investment and operating income earned by the captive reinsurer. Distributions on equity securities are generally not deductible. Treatment of securities issued to third party investors as equity instruments can also affect federal income tax consolidation. In addition, distributions on equity securities may be subject to United States withholding taxes if paid to non-U.S. investors, whereas interest payments on debt are much more likely to be exempt from withholding as a matter of law or under bilateral tax treaties.

The treatment of a security as “debt” or “equity” for federal income tax purposes is an inherently factual question that must be determined under the facts and circumstances of each offering. There is no mechanical test for making the determination – rather, Internal Revenue Service (“IRS”) rulings and case law identify a number of factors that must be taken into account in making the determination. The IRS has noted that “[n]o particular factor is conclusive...[and] the weight given to any factor depends on all the facts and circumstances and the overall effect of an instrument’s debt and equity features must be taken into account.”

In very general terms, however, in order to establish that the security issued in an embedded value securitization will be respected as “debt” it is necessary to show that at the time of issue there is a very high likelihood that scheduled payments of interest and principal will be made on a

timely basis from operating cash flows. This is usually established by analyzing the actuarial model for the defined block business, which should demonstrate that payments of interest and principal are expected to be made on a timely basis under the “base case” scenario for the development of the business, and under all alternative scenarios (including scenarios involving changes in mortality, persistency, interest rates and other factors) that are realistically possible to occur over the term of the transaction and that could materially impair the issuer’s ability to make timely payments on the notes. In order to achieve this result, it will generally be necessary for the captive reinsurer (or its limited liability company parent) to be capitalized with a substantial cushion of equity that can absorb losses and be used to smooth cash flows in extreme circumstances. It will also usually be beneficial to the analysis if the rating agencies provide an “investment grade” rating or shadow rating for the securities at the time of issue. However, credit enhancement provided by a financial guarantor is generally not relevant to the debt/equity tax analysis. Additional analysis will be required if the debt issued is a “surplus note” governed by state insurance law or regulation.

**Tax Sharing.** In most transactions, the captive reinsurer will enter into a tax allocation agreement with other members of its consolidated group that will govern the sharing of the group’s combined federal income tax liabilities. Investors and financial guarantors will usually be interested in reviewing the terms of these arrangements to ensure that the captive will be compensated appropriately for tax losses it generates that are used by other group members and, in some cases, that there is adequate security for payments that may be made in later years.

EMBEDDED VALUE SECURITIZATIONS  
CONTINUES ON NEXT PAGE

## Embedded Value Securitizations

(CONTINUED FROM PREVIOUS PAGE)

### Other Insurance-Linked Securitizations

Structured life insurance financings have grown significantly in recent years. In addition to increasing interest in embedded value securitizations, the following types of securitizations have become increasingly common:

- “XXX” and “AXXX” securitizations, described above, in which “excess reserves” relating to term and universal life insurance business are securitized;
- closed block securitizations, which are a specific type of embedded value transaction securitizing future cash flows associated with closed blocks of life insurance business created in connection with the demutualization of mutual life insurance companies;

- catastrophe bonds that transfer certain low-frequency, high-severity property and casualty risks to capital markets investors;
- mortality bonds that transfer catastrophic life insurance mortality risks to capital markets investors; and
- the securitization of variable annuity fees to finance initial new business cash strain.

Though the transaction structures are often complex and can raise many issues, including those described above, experience suggests that investors and other market participants are becoming more familiar with, and receptive to, complex insurance securitizations, including embedded value transactions. ■

*Thomas M. Kelly and Seth L. Rosen are partners, and Elizabeth K. Brill and Michael K. McDonnell are associates, in Debevoise & Plimpton LLP's New York office.*

*tmkelly@debevoise.com*

*slrosen@debevoise.com*

*ebrill@debevoise.com*

*mmcdonnell@debevoise.com*

---

<sup>1</sup>*These trusts are referred to as “Regulation 114” trusts because they are designed to comply with New York’s Regulation 114 (N.Y. COMP. CODES R. & REGS. tit. 11, pt. 126) and similar regulations in other states, which set forth certain required criteria for trusts established to permit a ceding insurer to take statutory reserve credit. These regulations generally are based on the NAIC Credit for Reinsurance Model Regulation.*

## New York State Commission to Modernize the Regulation of Financial Services Holds First Meeting

The New York State Commission to Modernize the Regulation of Financial Services (the “Commission”), established by an executive order issued by Governor Eliot Spitzer in May 2007, held its first formal meeting on January 18, 2008. The Commission is chaired by New York Insurance Superintendent Eric R. Dinallo and includes Debevoise partner Wolcott B. Dunham, Jr. In advance of the January 18, 2008 meeting, Commission staff met with Commission members on a one-on-one basis to discuss key issues.

The Commission is charged with reexamining New York State’s regulation of financial services firms, including insurance companies, banks and securities firms, with a view toward enhancing New York’s role as a leading financial center in an

increasingly competitive global marketplace and rationalizing and coordinating regulation of various types of financial institutions. During its initial meeting, hosted by Governor Spitzer, Hector Sants, CEO of the U.K. Financial Services Authority, described the FSA’s transition to a more principles-based approach. The Commission discussed potential reforms. The Commission will consider:

- Developing “principles-guided” regulation, designed to focus on outcomes rather than process. Under such a principles-guided approach, the principles would provide guidance for interpreting existing regulations and statutes, and serve as key objectives for developing any future regulation.

- Having a single state regulator for all financial services to facilitate similar treatment of similar financial products, regardless of the nature of the selling company.
- Instituting a risk-based approach to regulation.
- Eliminating out-of-date rules that are unnecessarily burdensome.

The Commission is expected to continue its work via various working groups, organized by industry (insurance, banking and securities) and by topic (for example, principles-guided regulation, single state regulator, registration and licensing, and regulation of retail versus wholesale transactions).

# Duties of Corporate Directors Under the U.K. Companies Act

by Christopher Henley

Until the Companies Act 2006 (the "Act") there had never been any statutory definition of the basic duties owed by a director of a company under English law. The Act includes the first statutory statement of directors' general duties, and refines certain common law and equitable rules previously only found in case law. Under the Act, a director must now in good faith fulfill his duties in a manner that he considers would be most likely to promote the success of the company for the benefit of its members as a whole. (For a company with shares, its members are its shareholders.) In fulfilling this duty, the director must, so far as reasonably practicable, have regard to: (1) the likely consequences of any decision in the long term; (2) the interests of the company's employees; (3) the need to foster the company's business; (4) relationships with suppliers, customers and others; (5) the impact of the company's operations on the community and the environment; (6) the desirability of the company maintaining a reputation for high standards of business conduct; and (7) the need to act fairly as between members of the company.

Notably, this provision requires a director in the decision-making process to take into account broader concepts of corporate social responsibility. The U.K. government has advised that the list of factors is not exhaustive but merely highlights areas of particular importance, reflecting their wider expectations with regard to responsible business behaviour.

In some situations however, any two or more of the interests of the intended beneficiaries could conflict. For example,

there are different kinds of shareholders with potentially opposing interests; some are short term, whilst others are long term. The overriding purpose of serving shareholders and making a profit may sometimes be difficult to balance against the needs of the members, employees, community and environment. The Explanatory Notes related to the Act make it clear that the decision as to what will promote success and what constitutes success is one for the director's judgement, to be made in good faith. However, although business decisions of strategy and tactics are primarily for the directors, and not the courts, compliance with this duty may create a difficult balancing act for directors. The Act further complicates the decision of a director by not allocating any particular weight to the various individual factors. What seems clear is that there is a two-part test: a director must act in good faith and must "have regard" to all of the factors listed above.

Even if one of the factors is irrelevant and outweighed by other considerations, a director will be required to have due regard to all of the factors in every decision. This could potentially cause the decision-making process to become burdensome, and certainly slower. Further, the new requirements leave a number of questions unanswered in relation to the responsibilities of directors. For example, what does "to have regard" to a particular factor mean? Can a director "have regard" to a factor without fully and properly investigating every facet of that factor? Some guidance is found in the Department of Trade and Industry's (the "DTI") guidance on key clauses.<sup>1</sup> The DTI stresses

that the obligation to "have regard to" the statutory factors cannot be discharged merely by paying lip service to them: directors must exercise the same level of skill, care and diligence as they would in carrying out any other function, at least as far as is "practically possible in the circumstances of any particular business decision." Directors are therefore expected to do all that they reasonably can to take these factors into account.

It is important in this context that directors document that they have actively considered how a particular decision will impact the company's employees, customers, suppliers, the environment and its commercial reputation.<sup>2</sup> However, since a directors' obligation is limited to "having regard," it may be sufficient for the board minutes to state that the directors have considered the six factors in reaching their decisions, and limit the recording of specific consideration of a factor to situations in which it was particularly relevant.

## Class Actions

The Act aims to "strip away outdated regulation and generate savings for business," and the principle of "enlightened shareholder value" requires greater corporate social responsibility. It is possible though that these new requirements could expose companies organized under English law to class action litigation as experienced by companies in the U.S.

As a general rule of English law, if a wrong is done to a company, only the company itself (and not a shareholder) can bring an action for damages or some other remedy.

**U.K. COMPANIES ACT CONTINUES ON NEXT PAGE**



# U.K. Companies Act

(CONTINUED FROM PREVIOUS PAGE)

In practice, the directors must decide whether or not to bring a claim. Clearly, if the wrong was done by the directors themselves, or a majority of them, no claim is likely to be pursued. Unless shareholders are able to force the board to bring a claim, either by passing an ordinary resolution to replace the existing directors with new appointees, or by giving a direction to the board by means of a special resolution, the company and the shareholders will have no remedy in respect of any loss that the company has suffered. Minority shareholders can therefore find it difficult to force directors to overturn their decision not to bring an action. However, where it can be shown that an act amounts to a "fraud on the minority" and that the wrongdoers are in control of the company, the courts have for some years allowed minority shareholders to bring a "derivative action," in effect allowing the shareholder to prosecute a claim on behalf, and for the benefit, of the company.

**The Act includes the first statutory statement of directors' general duties, and refines certain common law and equitable rules previously only found in case law.**

Prior to the Act there were four main courses of action available to an aggrieved minority shareholder: (1) a claim for a

breach of statutory contract; (2) a claim for the company to be wound up on the grounds that it is just and equitable to do so; (3) a common law right to bring a derivative action brought on behalf of the company (provided that the company is entitled to the relief sought, and that no other remedy is available); and (4) a claim that a company's affairs are being conducted in a manner which is unfairly prejudicial to the interests of some or all of its members by the member on its own behalf.

All of these actions were difficult to bring and rarely used. The reasons for this diffidence and almost total absence of contemporaneous litigation over takeovers in Britain when compared to the U.S. include:

- The reluctance of British judges to interfere in market operations; the courts acknowledge that directors are in control of an entrepreneurial venture and that a degree of commercial risk-taking is a necessary part of earning a sufficient return on the capital invested. Further, it has long been accepted that directors are not liable for mere errors of judgment, nor will a director be disqualified from holding office on the grounds of "ordinary commercial misjudgment;"
- The shareholders can ratify the transaction;
- No treble or punitive damages, or jury trials;
- English lawyers cannot take a share of the damages (although they are able to charge an uplift of up to 100% on their fees) and thus lawyers' charging structures are different;
- Claims in England are now front-loaded as to costs;

- There is a lesser duty of care in the context of takeovers than in the U.S.;
- Action in Britain is taken against the directors on behalf of the company, so that there is no real prospect of direct personal benefit;
- The circumstances enabling shareholders to sue in Britain are much more limited;
- The duties imposed on corporate fiduciaries at common law and by statute are very different;
- There is no English equivalent of general corporate constituency statutes;
- The corporate opportunities doctrine is much less developed and extensive in Britain, partly owing to the historic hostility towards shareholders' claims that pervades English company law;
- Major difficulties obtaining evidence to support the alleged wrongdoing. The case is almost always heard at an interlocutory stage for the purpose of determining the *locus standi* without discovery. In the U.S. the issues of *locus standi* are a mixture of substance and procedure, with issues of fact and law. British courts treat the matter as being one of procedure only.

The new Act will replace all of the common law on derivative claims. Under the Act, a derivative claim can now be brought in respect of a cause of action arising from a default by a director of the company. It is immaterial whether the cause of action arose before or after the person seeking to bring the action became a member of the company. Although under the Act a director's general duties will continue to be owed to the company, and not to individual shareholders, the Act provides shareholders

**U.K. COMPANIES ACT CONTINUES ON NEXT PAGE**

# U.K. Companies Act

(CONTINUED FROM PREVIOUS PAGE)

with a statutory right to bring an action to enforce the company's rights. In cases of negligence, default, breach of duty (including breach of the proposed codified duties) or breach of trust, the Act will allow shareholders to sue directors, on behalf of the company and with the consent of the court. Any damages awarded would be payable to the company. Since there will no longer be a need to show any fraud on the minority, minority shareholders will be able to sue directors more easily.

When hearing these types of actions, a court must take into account:

- whether the member is acting in good faith;
- the importance of the duty to promote the success of the company;
- whether the cause of action results from an act or omission that is yet to occur, and whether this is likely to be authorised by the company before it occurs or ratified afterwards; and
- whether the actual omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right, rather than on behalf of the company.

The situations in which a shareholder could bring an action are wider ranging than currently is the case, extending beyond fraud to include claims for negligence, default, breach of duty or breach of trust.

Of course, until the new rules are applied in practice, it is difficult to know whether the number of derivative claims is likely to increase. The possibility of bringing claims with respect to directors' negligence or breach of duty without having to show any 'fraud on the minority', potentially means

that more claims are likely. But even activist shareholders are still likely to be discouraged from bringing such claims by the fact that any damages recovered will go to the company, and not the shareholder personally. Nevertheless, even before the Act there seemed to be a growing interest in large scale shareholder activism, including a number of class actions. Under the Act, it will be easier for those with a different agenda to promote that agenda by challenging *bona fide* commercial decisions. One fear surrounding the Act is that shareholders with short-term interests could hijack the decision-making process simply with the threat of legal action

**Until the new rules are applied in practice, it is difficult to know whether the number of derivative claims is likely to increase.**

against directors. Equally, advocacy groups will no doubt be considering the new legislation, including groups focused on the environment.

However, one key potential reason for the lack of future class actions is the "loser-pays all costs" rule that keeps the English courts less cluttered than those jurisdictions which allow unfettered access to their courts. The underlying rationale is that if one party causes another unreasonably to incur legal costs, he ought as a matter of justice to indemnify that party for those costs.

Funding by a third party used to be difficult to structure. However, third party funding is now a viable method of financing a claim, and the courts have recently confirmed that where the funded claim is unsuccessful and results in a costs order against the funder, its costs will be capped at the amount of its investment. Further, the ready involvement of the courts to administer multi-party litigation more effectively, their belief that access to justice through the medium of third party funding is in the public interest, and the interest of regulators in seeing miscreants pay out as damages the actual loss suffered by their victims may enable shareholders to adopt a more active front, which means that third party funding could become more important in the future.

Nevertheless, although there is now considerable focus on good corporate governance, it is unlikely that shareholder derivative actions in Britain will acquire the prominence of those in the States. Speculative actions will remain checked by the overriding discretion of the court to award costs in full against the losing party, and by the differences between the U.K. and the U.S. outlined above.

Finally, two questions must be asked: what can any director do to protect his position, and what might this change in the law mean for providers of directors and officers liability insurance? A director should in any event obtain an indemnity from her employer and if she has any concerns about its capability to pay out (whether financial or because it may well be the company that is suing her), she should also become the beneficiary of directors and officers liability insurance. Many of the obstacles to the effectiveness of this insurance were removed in 2005 and many directors'

**U.K. COMPANIES ACT CONTINUES ON NEXT PAGE**

## U.K. Companies Act

(CONTINUED FROM PREVIOUS PAGE)

contracts of employment set out their requirements precisely, so that the second answer follows affirmatively from the first. A director would be well advised to ensure that she is to be indemnified to the fullest extent permitted by law, both in the Articles of Association and in her service contract. This will protect her personal position but may be resisted by institutional shareholders. One way of providing continuing flexibility will be to allow the indemnity to extend to the fullest extent permitted by law but subject to such

exclusions as the board of directors may from time to time determine, which enables the board as a whole to consider the nature and extent of the exclusions, and whether to add to or reduce them. The director would also be well advised to ensure that the indemnity continues following termination of her appointment. ■

*Christopher Henley is international counsel in the London office of Debevoise & Plimpton LLP.*

*chenley@debevoise.com*

<sup>1</sup> The DTI was replaced by the Department for Business, Enterprise and Regulatory Reform on June 28, 2007.

<sup>2</sup> The government has suggested that the Bill does not require any paper trail, and that to maintain a paper trail is "excessively cautious," but the fact is that the practice is likely to emerge as a matter of protection whereby more recordings of all these considerations are actively made and retained.

## SEC Approves NASD Rule Regarding Sales of Deferred Variable Annuities

by Linda Lerner

On September 7, 2007, the Securities & Exchange Commission approved NASD Rule 2821 (the "Rule" or "Rule 2821"),<sup>1</sup> which sets forth the new rules applicable to members of the Financial Institutions Regulatory Authority, Inc. ("FINRA") related to sales of deferred variable annuities. Rule 2821 contains requirements with respect to (1) determining the suitability of the transaction for the customer; (2) principal review and approval of each sale of a deferred variable annuity; (3) supervisory procedures for variable annuity sales and exchanges; and (4) training for both registered representatives and reviewing principals.<sup>2</sup> Rule 2821 has been the subject of much industry debate. Originally proposed in 2004, the rule was scaled back in a series of four amendments. The proposed rule and amendments were hotly debated, generating 3,450 comment letters from the public. On November 6, 2007, in Notice to Members 07-53 ("NTM 07-

53"), FINRA set forth guidance as to the interpretation of the Rule's requirements and announced that the Rule will become effective on May 5, 2008. On December 21, 2007, FINRA filed a proposed rule change with the SEC to delay the effective date of paragraph (c) of the Rule, dealing with principal review and approval, until August 4, 2008, to permit further consideration of certain concerns regarding subsection (c) raised by member firms (discussed below), as well as to provide additional time for firms to make systems changes.

### Applicability of the Rule

Rule 2821 is applicable to all purchases and exchanges of deferred variable annuities and initial subaccount allocations. It is not applicable to: (1) subsequent reallocations of subaccounts; (2) funds paid after the initial purchase or exchange, or to sales only unaccompanied by a purchase (substitution);

or (3) transactions made in connection with a tax-qualified, employer-sponsored retirement or benefit plan that is a "qualified plan" (as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934, as amended, or that meets the requirements of Internal Revenue Code (the "Code") Sections 403(b), 457(b) or 457(f)) unless a FINRA member or any person associated with a FINRA member makes recommendations to an individual plan participant regarding a particular deferred variable annuity, in which case the Rule would apply as to that individual participant to whom the recommendation was made.

### Requirements for Recommendations of Deferred Variable Annuities

Rule 2821 requires members to give the customer information regarding deferred variable annuities generally, and the specific product being recommended. Additionally,

DEFERRED VARIABLE ANNUITIES  
CONTINUES ON NEXT PAGE

# Deferred Variable Annuities

(CONTINUED FROM PREVIOUS PAGE)

the member must obtain from the customer information adequate to make a suitability determination. Subsection (b)(1)(A) of the Rule describes the information that must be given to the customer prior to making a recommendation and the analysis of the customer's needs that must be made by the broker before making such a recommendation. The Rule does not specify the form of disclosure required, but mere delivery of the prospectus ordinarily will not provide a reasonable basis to believe that the customer has been educated or informed about the material features of a deferred variable annuity.<sup>3</sup>

Prior to making a recommendation, the registered representative must have a reasonable basis to believe that the transaction is suitable, in accordance with the general suitability requirements set forth in NASD Rule 2310, and must also have a reasonable basis to believe the following:

**1. The Customer is Informed Generally About Features of Deferred Variable Annuities** such as the potential surrender period and surrender charge, potential tax penalty for sales or redemptions prior to age 59 ½, mortality and expense fees, investment advisory fees, potential charges for and features of riders, the insurance and investment components of deferred variable annuities, and market risk. NTM 07-53 cautions that registered representatives and principals may not ignore product-specific features.

**2. The Customer Would Benefit From a Variable Annuity**, including tax-deferred growth, annuitization, and/or a death or living benefit. This requirement relates to deferred variable annuities generally.

## Rule 2821 requires the registered representative making the recommendation to sign a written document setting forth his or her determinations regarding suitability.

**3. The Particular Variable Annuity and its Features Are Suitable for the Customer;** that is, the *particular annuity* being recommended, as a whole, the *underlying subaccounts* to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and *riders* and similar *product enhancements*, if any, are suitable for the particular customer, based on the information set forth below that must be gathered about the customer.

NTM 07-53 cautions that a firm and its brokers cannot adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question.<sup>4</sup>

### Specific Requirements for Exchange Recommendations

Subsection (b)(1)(B) of the Rule sets forth the factors that must be taken into consideration when determining whether an exchange of one deferred variable annuity for another is consistent with the suitability determination described above and whether the transaction as a whole is suitable for the particular investor. Factors to be taken into consideration include:

- Surrender charges imposed with respect to the annuity being exchanged, the commencement of a new surrender period for the new annuity, the loss of existing benefits and increased fees or charges.
- Whether the customer would benefit from product enhancements and improvements.
- Whether the customer's account has had another deferred variable annuity exchange within the preceding 36 months. The firm must check its own records and ask the customer whether an exchange has occurred at any other brokerage firm.

### Information That Must Be Obtained From the Customer

Subsection (b)(2) of the Rule requires the member firm or one of its associated persons, prior to recommending the purchase or exchange of a deferred variable annuity, to make reasonable efforts to obtain a variety of information regarding the potential purchaser and to consider that information in making the suitability determination. Certain of this information, such as the customer's age, annual income, investment objectives, liquid net worth, risk tolerance and tax status may already have been required to be obtained in connection with the firm's account opening and maintenance processes, but other information, such as financial situation and needs, investment experience, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), and liquidity needs may not currently be included in the firm's customer account documentation. Thus, members may wish to revise their new account information form and, if that form is populated from a website

DEFERRED VARIABLE ANNUITIES  
CONTINUES ON NEXT PAGE

# Deferred Variable Annuities

(CONTINUED FROM PREVIOUS PAGE)

questionnaire filled out by the customer or the representative, the underlying questionnaire. NTM 07-53 points out that deferred variable annuities are generally considered to be long-term investments and thus are not typically suited for investors with short-term investment horizons.

## Documentation by Registered Representatives of Suitability Determination

Rule 2821 requires the registered representative making the recommendation to sign a written document setting forth his or her determinations regarding suitability. The signed document must provide the reviewing principal with enough information to adequately assess whether the registered representative complied with the Rule.

## Principal Review and Approval

Subsection (c) of the Rule requires that prior to submitting the application to the insurer, but no later than seven business days after the customer signs the application, a Series 24 or 26 registered principal must complete a review of the application to determine whether the transaction is suitable for the customer based on the factors set forth above. The principal's determination must be documented and signed.

Implicit in the seven day review requirement is the utilization of some form signed by the customer that will start the application process and the running of this seven day period. If the member firm does not currently utilize a customer application form, it should consider developing a document the customer will sign that will commence the application process and the principal's seven day review period. In its December 2007 filing to delay the effective date of subsection (c), FINRA noted that some firms believed that seven business days from signing would not allow for adequate

principal review and requested that a different timing mechanism be used.

All transactions must be treated as if they were recommended. However, in a case where the principal determines that the transaction was not recommended and does not approve it, if the customer, after being informed of the reason for the principal's disapproval, affirms that he or she wishes to proceed, the application may be forwarded to the insurance company. In its December 2007 filing with the SEC, FINRA noted that some firms had questioned whether broker-dealers that make no recommendations to customers and generally do not employ principals to perform suitability reviews should be subject to this provision.

To avoid conflict with NASD Rule 2330 prohibiting improper use of customer funds and Rule 2820 requiring broker-dealers to promptly transmit funds, a broker-dealer is permitted to hold an application for a deferred variable annuity (and the customer's non-negotiated check payable to the insurance company) for up to seven business days to allow time for the principal to complete the Rule 2821 review.

An SEC exemption from its interpretation of "promptly transmits" for purposes of the net capital rule was also provided so as not to subject member firms to higher net capital requirements because customer checks for variable annuities will be held during the review period. To avail itself of this exemption, the transaction must be reviewed by a principal within seven business days, the customer's check must be transmitted no later than noon of the day following the principal's review, and the broker-dealer must maintain a copy of each such check and a record of the dates it was received from the customer, and sent to the insurance company or returned to the customer, if the application is rejected by the broker-dealer.

In cases of captive broker-dealers that share personnel with insurance companies that issue deferred variable annuities, NTM 07-53 states that FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer principal, acting as such, has approved the transaction provided that there are safeguards in place to insure that the policy is not issued prior to principal approval.<sup>5</sup>

In its December 2007 filing with the SEC, FINRA noted that a number of member firms had informed FINRA that insurers permit firms to hold customer funds in a suspense account at the insurer and had requested that this efficient practice be permitted to continue.

## Surveillance for Inappropriate Exchange Transactions

Subsection (d) of Rule 2821 requires member firms to establish surveillance procedures to review for variable annuity exchanges that are inappropriate because they violate NASD or SEC rules and to have policies and procedures in place to implement corrective measures against registered representatives who engage in inappropriate exchanges.

## Training

Subsection (e) of Rule 2821 requires member firms to institute training programs to familiarize registered representatives and principals with (1) the requirements of the Rule and (2) the features of the variable annuity products offered by the firm.<sup>6</sup> The firm's Continuing Education Plan will have to be amended to provide for such training.

## New Supervisory Procedures

Firms will need to update their written supervisory procedures to demonstrate compliance with the Rule, including a description of the steps the registered representative must take to transmit to the

DEFERRED VARIABLE ANNUITIES  
CONTINUES ON NEXT PAGE



## Deferred Variable Annuities

(CONTINUED FROM PREVIOUS PAGE)

client the information about deferred variable annuities generally and the particular annuity being sold, obtain the required information from the client, review that information, make a suitability determination, document the entire information sharing and determination process, describe how such documentation will be maintained, and timely transmit the necessary documentation to the principal who will review the registered representative's initial suitability determination. The firm's written supervisory procedures will also need to be revised to account for any new documentation to be signed by the customer to commence the application process, to outline the steps a principal must take in reviewing the registered representative's suitability determination, to maintain evidence of the principal's review of the suitability of the

transaction for the customer and the annuity exchange activity of the representatives submitting proposed transactions for review, and to set forth which principals will conduct such reviews. ■

---

*Linda Lerner is counsel in Debevoise & Plimpton LLP's New York office.*

*llerner@debevoise.com*

---

<sup>1</sup> *The National Association of Securities Dealers ("NASD") has changed its name to Financial Institutions Regulatory Authority, Inc. or FINRA, but, until the NASD and New York Stock Exchange rule books are combined, the FINRA rules will continue to be known as NASD rules.*

<sup>2</sup> *Includes persons registered as General Securities Sales Supervisors (Series 9/10), General Securities Principals (Series 24) and Investment Company Products/Variable Contracts Principals (Series 26).*

<sup>3</sup> *NTM 07-53, endnote 8.*

<sup>4</sup> *See NTM 07-53, footnote 9. The failure of brokers to understand the features of the variable annuity products they are selling was noted by FINRA in its Rule Proposal.*

<sup>5</sup> *However, to minimize the time required for issuance, the broker-dealer may insert information into a shared data base provided no further steps are taken in the issuance process.*

<sup>6</sup> *Examples of features FINRA believes are not understood by brokers and investors include the fact that a minimum holding period is often necessary before tax benefits outweigh higher fees imposed by deferred variable annuities as opposed to other investments and that a lower tax bracket of a senior citizen might render tax benefits marginal or negative. NTM 07-53, endnote 10.*

---

## Solvency II

(CONTINUED FROM COVER)

and affords increased flexibility to regulators in the manner they apply Solvency II. Such a "principles-based" approach has already been adopted by the Financial Services Authority in the U.K. (the "FSA") but is an almost alien concept for regulators in some other EU member states.

In the face of concerns as to the cost of implementing Solvency II, the European Commission has been at pains to point out that, as well as offering incentives to insurers (in the form of reduced capital requirements) if they implement suitable risk management and internal controls, the commercial effect of implementing the Solvency II Directive will be to enhance the international competitiveness of the EU insurance sector. As EU Internal Market Commissioner Charlie

McCreevy noted, Solvency II would represent a particular challenge to U.S. insurers: "There is a growing nervousness in the U.S. about the EU surging ahead while the U.S. itself is stuck with highly-fragmented insurance regulation. This proposal represents yet another opportunity to give European enterprises a head start in the global economy."<sup>1</sup> Solvency II also seeks to eradicate the regulatory duplication borne hitherto by multi-jurisdictional insurance groups within the EU which have had to contend with different capital regulations in different jurisdictions. Following the implementation of Solvency II, such groups would in the future be supervised by a new "Group Supervisor" located in the insurer's home territory.

### Key Changes

To a significant extent, the Solvency II proposals follow the "principles-based" approach to regulation already implemented by the FSA and as proposed in the State of New York by the Superintendent of Insurance, Eric R. Dinallo. Whereas the driver behind Solvency I had been capital adequacy, the European Commission has clearly accepted that capital adequacy alone is insufficient to protect consumers and that the emphasis of Solvency II should be to place a greater degree of reliance on risk management and increased governance and transparency as the basis for ensuring adequate solvency, such solvency in future to be based on the risk profile of each individual undertaking.

SOLVENCY II CONTINUES ON NEXT PAGE

# Solvency II

(CONTINUED FROM PREVIOUS PAGE)

The key changes to be introduced by Solvency II include:

**Supervisory Review Process ("SRP")**. Each insurance entity will have a supervisor with broad investigative and regulatory powers. The supervisor will be responsible for evaluating the risk profile of the insurer and the risks, present and future, that the insurer faces through regulatory review by the supervisor, in conjunction with the firm. The SRP will enable the supervisor to consider the insurer's ability to withstand losses and adverse economic conditions and enable the management and governance of the insurer to be considered alongside its capital requirements, insurance technical provisions and investment rules. In connection with the SRP, the supervisor will have wide powers to require changes and improvements, including the right to impose increased capital requirements and enhanced internal risk-management procedures.

**Risk Management and Internal Governance Procedures**. Each firm will be required to develop, make public and implement a transparent and well documented internal system of governance to demonstrate sound and prudent management of the company and to be proportionate to the scale, complexity and diversity of its insurance operations. The SRP will include a review of such internal risk management including as to underwriting, risk concentration, reserving and liquidity, as well as risk mitigation management within the company. As U.K. insurers have already become aware following the implementation of "principles-based" regulation by the FSA, one consequence of the heightened emphasis on risk management is to identify clearly the individuals within the organisation with whom responsibility lies, and accordingly increase the risk to senior management in becoming directly responsible for internal risk-management procedures.

**Solvency Capital Requirement ("SCR")**. A new solvency standard, to be calculated at least once a year and made public, will be introduced for all EU insurance companies. The SCR is a higher level of capital sufficiency than the minimum capital requirement, which is the level of capital below which the insurer may not fall if it is to continue to be authorised. The SCR is intended to reflect all quantifiable risks that the insurer might face

**The focus of Solvency II is to encourage the insurance industry to adopt enhanced risk management systems and internal controls which more accurately reflect each insurer's individual needs and risk profile.**

including underwriting risk, market risk, credit risk and operational risk as part of the overall approach in Solvency II, whereby the specific insurer is to be reviewed according to its own business profile and risk management processes. Rather than imposing a "one size fits all" model, individual insurers will have the ability, subject to agreement with their supervisor, to develop and apply for an internal regulatory capital requirement of their own which can either be an internal model or a hybrid which includes some of the standard formulae from the SCR and some internal model elements. Due to the publicity requirements surrounding the SCR,

it will be possible for third parties to have wide access to information demonstrating how an insurer's SCR has been comprised.

**Own Risk and Solvency Assessment ("ORSA")**. As part of the reporting process to supervisors, insurers will have to develop and report by means of an ORSA, which will provide a detailed internal assessment by the insurer as to the risks it faces. Additionally, the ORSA will demonstrate how those risks are being measured and taken into account in the assessment of the insurer's solvency requirement. The ORSA will clearly highlight the depth and quality of internal risk assessment and reporting procedures and will be an important tool in the supervisory process.

**Annual Report on Solvency and Financial Condition**. In furtherance of the third pillar of Solvency II and the aim for heightened transparency, each EU insurer will have to prepare and publish annually a report on its solvency and financial condition. This report will be public and will describe the insurer's financial performance, its governance system and the risks faced by the insurer. The specific requirements as to content of the annual report on solvency and financial condition have yet to be determined by the European Commission, but the requirement to make public such level of information will be a significant step forward in allowing transparency, particularly since capital management and risk exposure and concentration information has to be made public.

**Group Supervision**. In addition to the introduction of a supervisor for each insurer, Solvency II provides for supervision at the group level by the appointment of a "Group Supervisor" to be the single supervisor for the group as a whole. The Group Supervisor will be provided with information on a group basis, including a group-level SCR

SOLVENCY II CONTINUES ON NEXT PAGE

# Solvency II

(CONTINUED FROM PREVIOUS PAGE)

calculation. In addition to giving groups the benefit of diversification credits in the calculation of a group level SCR, the directive also will enable groups to cover their SCR through providing group support in addition to individual insurance assets.

## Effects of Solvency II

Solvency II will have a significant impact on insurers throughout the EU, but the effects of Solvency II and the necessary mindset to move to a risk-based regulatory capital and reporting regime will require greater change in those countries that have not yet adopted a risk-based approach, particularly a risk-based capital adequacy standard. Some EU member states have already anticipated the reforms introduced by Solvency II, particularly the U.K. and the Netherlands (and Switzerland which, although not a member of the EU, has followed the EU's single market directives in implementing similar regulation of its own). For insurers in these countries, and for their regulators, the changes brought about by Solvency II will be much less dramatic than the impact that will be felt in Spain, Greece and Portugal for example.

There is much additional detail to be provided by the EU over the years leading up to the planned implementation of Solvency II

in 2012, but commentators are already identifying those who are likely to benefit from Solvency II as including insurance groups with a diversified portfolio which will now reap the rewards of diversification credits in their capital adequacy requirements and insurance groups generally, which will be able to benefit from a single Group Supervisor and group regulation as opposed to the current diversity of regulation across different EU territories.

Although small insurers may bear a disproportionate cost in connection with the implementation of Solvency II, and monoline and non-diverse insurers will not benefit from diversification credits, at least the smallest insurers have the ability to opt out of Solvency II if they wish. The cost burden on smaller and monoline insurers, and lack of diversification credits in assessing regulatory capital requirements, has been highlighted as a trigger for possible consolidation in the European insurance sector through increased M&A activity.

For the regulators themselves, the multi-faceted approach under Solvency II will test the regulatory culture in some EU jurisdictions as well as highlighting what industry observers already believe is a

shortage of skilled regulatory and compliance specialists both in the industry at large and within regulatory authorities.

For the consumer (i.e., the policyholder), the short term risk is likely to be that the cost of implementation of Solvency II will be passed on by way of increased premiums or lower returns; the benefits, at least for the more discerning, will be greater access to information and the benefits of greater risk management, as well as heightened levels of risk understanding, within insurance groups. ■

*Jeremy Hill is a partner in Debevoise & Plimpton LLP's London office.*

[jhill@debevoise.com](mailto:jhill@debevoise.com)

1. *Charlie McCreedy, European Comm'r for Int'l Mkt. and Serv., Address Before the European Parliament: 'Solvency II' Launch Event (July 10, 2007), [http://ec.europa.eu/commission\\_barroso/mcCreedy/allspseeche\\_s\\_en.htm](http://ec.europa.eu/commission_barroso/mcCreedy/allspseeche_s_en.htm) (follow "SOLVENCY II Launch Event" hyperlink; then follow "PDF: EN" hyperlink).*

## Did you know you can receive the Debevoise & Plimpton Financial Institutions Report by email?

If you would like to take advantage of this service, indicate the delivery method you prefer and your email address. Please also take this opportunity to update your contact information or to add additional recipients by copying and filling out the following form and returning it to us.

### I would like to receive my reports:

- via email
- via email and regular mail
- via regular mail

Name of Contact \_\_\_\_\_  
Title \_\_\_\_\_  
Company Name \_\_\_\_\_  
Address \_\_\_\_\_  
City \_\_\_\_\_ State or Province \_\_\_\_\_ Postal Code \_\_\_\_\_  
Country \_\_\_\_\_ E-mail Address \_\_\_\_\_  
Telephone \_\_\_\_\_ Direct Dial \_\_\_\_\_  
Fax \_\_\_\_\_ Direct Dial Fax \_\_\_\_\_

**To reply, please send information by fax to 1 212 521 7366 or by email to [financialinstitutions@debevoise.com](mailto:financialinstitutions@debevoise.com)**

**By mail:**  
**Carmen Garcia, Marketing Department**  
**Debevoise & Plimpton LLP**  
**919 Third Avenue, New York, NY 10022**