C L I F F O R D

C H A N C E

Client briefing
February 2011

Solvency II Update

In May 2010 we reported on the key issues facing the industry under Solvency II. Since then there have been a number of key developments (in particular, relating to the Omnibus II Directive, the creation of EIOPA and further debate on third country equivalence), which we look at in this briefing alongside a cross-jurisdictional update on key issues and developments in the UK, Germany, France, Italy, Spain, the Netherlands and Poland.

We are also holding a webinar on Solvency II on Wednesday 16 March 2011 at 11.00 a.m. Further details can be found by clicking on this link.

Background

Where Are We Now, and Next Steps

Key Developments
- Omnibus II Directive
- EIOPA
- Equivalence
- Pension Funds

Solvency II – Cross-Jurisdictional Update
- UK
- Germany
- France
- Italy
- Spain
- Netherlands
- Poland

If you would like to know more about the subjects covered in this publication or our services, please contact:

United Kingdom:
Katherine Coates +44 (0)20 7006 1203
Christopher Marsden +44 (0)20 7006 4852

Germany:
Daniela Weber-Rey +49 697199 1551
Thomas Krecek +49 697199 1524

France:
Sonia Lods +33 14405 2494

Italy:
Lucio Bonavitacola +39 028063 4238

Spain:
Jaime Sánchez +34 91590 7574

Netherlands:
Frank Graaf +31 20711 9150
Erwin Schreuder + 31 20711 9227

Poland:
Marta Bieniada +48 22429 9455

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

BACKGROUND

Solvency II is a fundamental review of the solvency and risk management standards for the European insurance and reinsurance industry, seeking to strengthen prudential regulation and improve policyholder protection. It aims to introduce an entirely new, harmonised EU-wide solvency regime and recasts the 14 existing EU insurance directives (replacing Solvency I).

The new regime represents a significant change in the basis for regulating insurance business in the EEA. Insurers face a challenge in reviewing their regulatory capital structures and implementing the systems, processes and cultural changes necessary to meet the new requirements. The implementation date, by which Member States must bring into force the laws, regulations and administrative provisions necessary to comply with Solvency II, is now expected to be 1 January 2013 (as a result of proposed changes under the draft Omnibus II Directive).

WHERE ARE WE NOW, AND NEXT STEPS

	Where are we now?	Next steps
*Level 1 – the Framework Directive (the "**Solvency II Directive**"): sets out the overarching principles and includes implementing powers for detailed rules at Level 2.*	The final text was published in the *Official Journal* on 17 December 2009.	The Solvency II Directive will be amended by the Omnibus II Directive, a provisional version of which the European Commission (the "**Commission**") published on 19 January 2011. The final implementation date for Solvency II is now expected to be 1 January 2013. This will mean that the new rules apply to the financial year starting 1 January 2013.
*Level 2 – Detailed implementing measures: more detailed technical rules set by the Commission based on the advice of the European Insurance and Occupational Pensions Authority ("**EIOPA**") following a consultation process.*	CEIOPS, following a series of consultations during 2009-2010, published final advice to the Commission on the Level 2 implementing measures. The Commission then carried out a consultation with selected stakeholders on the Level 2 implementing measures in November 2010 - January 2011, but the draft Level 2 measures have not yet been made publicly available.	Publication of the proposed Level 2 implementing measures is expected in June 2011, with a view to these measures being finalised by November 2011 following political negotiations in the European Parliament and European Council.
Level 3 – Supervisory standards: supervisory standards and guidance and interpretative communications produced by EIOPA for national supervisors to ensure that the rules are consistently implemented across Member States.	CEIOPS published Level 3 guidance on the pre-application process for internal models in March 2010, but the Commission has asked EIOPA not to begin public consultation on Level 3 measures until the Level 2 implementing measures have been published in June 2011. EIOPA has initiated a "pre-consultation" phase on Level 3 measures with selected stakeholders, for which the closing date for comments was 11 February 2011.	It is anticipated that EIOPA will publish draft binding technical standards by 31 December 2011 and adopt final level 3 guidelines by March 2012 (although timing is dependent on the publication of the draft Level 2 measures). See "EIOPA" section below.

© Clifford Chance LLP February 2011

	Where are we now?	Next steps
	Topics for consideration included the use test, calibration, profit and loss attribution and validation. EIOPA directed that no public debate should be started on the proposals in these pre-consultations.	
Quantitative Impact Studies (QIS): intended to assess the practicability and quantitative impact of the proposals by asking market participants to apply the proposals to their own businesses.	The most recent QIS (QIS 5) ran between August and November 2010.	It is expected that EIOPA will report to the Commission on its findings on QIS 5 by April 2011. The Commission has indicated that a sixth QIS cannot be ruled out if QIS 5 were to lead to the conclusion that the proposed Solvency II regime in its current state is not satisfactory.
National implementing measures		In late 2011 and in 2012 Member States will draft, and consult on, provisions to implement Solvency II into national law. The approach taken will depend on whether the Level 2 measures are implemented as a directive (which needs to be implemented into national law by Member States) or a regulation (which has direct effect in Member States).

KEY DEVELOPMENTS

We have set out below an update on the key developments that have taken place since our last briefing and anticipated future developments and steps in these areas.

Omnibus II Directive

On 19 January 2011 the Commission published the draft Omnibus II Directive, which will make a limited number of amendments to the Solvency II Directive. It is anticipated that the draft Omnibus II Directive will be considered for approval by the European Council and the European Parliament, following which the amendments will be incorporated into the Solvency II Directive.

One of the key amendments to the Solvency II Directive is the extension of the implementation date of the Solvency II Directive by two months to 1 January 2013. This has been anticipated for some time, but has now been formally confirmed. It is intended to better align the start of the various new reporting, calculation and other obligations of the Solvency II regime with the end of the financial year for the majority of insurers.

© Clifford Chance LLP February 2011

A second key amendment introduced by the Omnibus II Directive is the option it provides for the Commission to specify transitional measures in certain areas. Again, this has been anticipated to some extent. These measures are justified by the Commission on the basis that (a) there should be a smooth transition to the Solvency II regime (b) market disruption should be avoided (c) impacts on insurance products should be able to be taken into account and (d) it should be possible for proper consideration to be given to information obtained from QIS 5. The explanatory memorandum to the draft Omnibus II Directive states that:

- transitional requirements should be possible in relation to (a) valuation (b) governance (c) supervisory reporting and public disclosure (d) the determination and classification of own funds (e) the standard formula for the calculation of the Solvency Capital Requirement ("**SCR**") and (f) the choice of methods and assumptions for the calculation of technical provisions, including the determination of the relevant risk-free interest rate term structure;

- it is also necessary to enable Level 2 measures to specify transitional arrangements in relation to the treatment of third country regimes in order to acknowledge that some third countries may need more time to adapt and implement a solvency regime that would fully satisfy the criteria for being recognised as equivalent (see "Equivalence" section below);

- the transitional requirements must be at least equivalent in effect to the existing framework on (re)insurance directives and should not result in more favourable treatment for (re)insurers, or lower protection for policyholders, than currently exists; and

- the transitional requirements should encourage (re)insurers to move towards compliance with the particular requirements of the new regime as soon as possible.

There has been much commentary on the impact of transitional provisions in Omnibus II, and on the extent to which they may have the effect of extending the implementation period for Solvency II in practice. It is important to emphasise, though, that Omnibus II does not itself include transitional arrangements. It gives powers to the Commission to make transitional arrangements in certain areas (and subject to maximum periods and minimum requirements) through delegated acts, and it remains to be seen the extent to which the Commission will choose to use these powers. The draft delegated acts are expected to be published for consultation in June 2011 and finalised by the end of the year. The position should therefore become clearer by mid-2011.

EIOPA

EIOPA (The European Insurance and Occupational Pensions Authority) was established on 1 January 2011 as part of the financial sector reforms initiated by the Commission. It is one of three European Supervisory Authorities ("**ESA**") which form the European System of Financial Supervisors, the other two being the banking sector and the securities sector supervisory authorities (the European Banking Authority and the European Securities and Markets Authority). The ESAs replace and have additional powers and responsibilities to the existing 'Level 3' committees, with EIOPA replacing CEIOPS in the insurance and occupational pensions sector. Delivery on Solvency II is one of four key priorities for EIOPA in 2011.

EIOPA's main goals include (a) better protection of consumers, and rebuilding trust in the financial system (b) ensuring a high, effective and consistent level of regulation and supervision (c) greater harmonisation and coherent application of rules (d) strengthening oversight of cross-border groups and (e) promoting a coordinated supervisory response. EIOPA’s core responsibilities are to support the stability of the financial system, transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries.

© Clifford Chance LLP February 2011

While there is clearly some continuity of personnel between CEIOPS and EIOPA, there are also differences:

- EIOPA is a permanent body with its own 'identity' (whereas CEIOPS was a committee made up of representatives from different Member States);
- importantly, EIOPA also has the power under the draft Omnibus II Directive to produce binding technical standards. The Solvency II Directive, pre-Omnibus II, provided for CEIOPS to prepare non-binding Level 3 guidance which local regulators must take into account, but CEIOPS had no power to make binding rules. In contrast, the draft Omnibus II Directive gives EIOPA the power to (i) develop binding technical standards in certain areas and (ii) prepare Level 3 guidelines, and Member States must ensure that local regulators comply with these guidelines or explain why they have not done so;
- EIOPA also has the power to resolve disputes between Member State regulators in certain areas (e.g. regarding approval of group internal models); and
- it should also be noted that the amendments introduced by the Omnibus II Directive somewhat blur the lines between the separate levels of the Lamfalussy Process. The binding nature of EIOPA technical standards makes them more akin to Level 2 implementing measures, while the EIOPA guidelines have been given more weight due to the "comply or explain" approach summarised in (b) above.

The draft Omnibus II Directive provides that EIOPA will be required to draft binding technical standards by 31 December 2011. These will cover at least 16 identified areas, including: transparency and accountability of supervision; supervisory disclosure; capital add-ons; solvency and financial condition report; valuation of assets and liabilities other than technical provision; valuation of technical provisions; own funds; solvency capital requirements; internal models; special purpose vehicles; cooperation and exchange of information between supervisory authorities; and group solvency and financial condition reports.

Level 3 guidelines will be prepared simultaneously and adopted by EIOPA by March 2012, allowing Member States time to decide whether they will comply or explain. EIOPA has advised that the preparation of binding technical standards and guidelines will be prioritised according to how essential they are for the implementation of Solvency II. In its 2011 Work Programme EIOPA categorises all binding technical standards as high priority, but a number of Level 3 guidelines are identified as being medium priority. EIOPA may not open public consultation on the guidelines or technical standards until the Level 2 implementing measures are published in June 2011, and it has therefore been carrying out a "pre-consultation" phase with selected stakeholders.

Equivalence

Introduction

Equivalence provisions in Solvency II are relevant in three areas:

- reinsurance by third country entities (Article 172);
- group solvency for EEA insurance groups with a third country subsidiary (Article 227); and
- group supervision for third country insurance groups (Article 260).

© Clifford Chance LLP February 2011

Equivalence Assessments

In a letter of October 2010 from the Commission to CEIOPS, the Commission requested CEIOPS to carry out equivalence assessments on the following third countries in the areas listed in the table below:

Third Country	Article 172 (Reinsurance)	Article 227 (Group solvency)	Article 260 (Group supervision)
Bermuda	✓	✓	✓
Japan	✓	×	×
Switzerland	✓	✓	✓

The criteria and methodology that EIOPA will use to make its assessments was set out in CEIOPS' final advice to the Commission in Spring 2010. In relation to each article EIOPA has established a set of principles and objectives, drawn from the text of the Solvency II Directive. For each principle there is a corresponding set of indicators that will be examined in order to ascertain whether the principle has been met. For example, in relation to Article 260, EIOPA will look to see whether the third country regulator has an adequate method for the calculation of group solvency. Indicators of adequacy would include provisions relating to the valuation of assets and liabilities and provisions concerning the level and quality of own funds. More general criteria will also assess the legal basis, competence and enforcement powers of the third country regime. In terms of the duration of an assessment, EIOPA has advised that for particularly complex third country solvency regimes, assessment may take between 40 and 42 weeks.

The Commission had asked for EIOPA to provide its final advice on its assessment of equivalence in Bermuda, Japan and Switzerland by July 2011. However, in a letter of November 2010, the Commission recognised that EIOPA may need time to reconsider its recommendations in light of the final level 2 implementing measures for equivalence assessments from the Commission, which are due to be published in June 2011. The new deadline for EIOPA's final advice will therefore be extended to September 2011. However, no further extension is likely to occur given the Commission's commitment to publish its decisions on equivalence by July 2012.

It is worth noting that because the assessments under each article are different and discrete, it is possible that one country may be determined equivalent in respect of say, reinsurance, but not in terms of group supervision.

The US and Transitional Provisions

Despite its identification as an important jurisdiction for EEA insurers, it is not anticipated that the US will be assessed for equivalence in the first wave of assessments. EIOPA has stated that the multiplicity of separate state regulators and lack of a central supervisory authority poses great difficulties in terms of making an assessment. The National Association of Insurance Commissioners (the "**NAIC**") acts as a forum for co-ordinating policy on the development of the supervisory regime, but is not a supervisory authority in its own right. Professional secrecy is also a difficulty, as EIOPA members may not exchange information with the NAIC, as it is not a "competent authority".

Nevertheless, there appears to be political will to find an appropriate solution which will enable the US to be treated as equivalent for the purposes of Solvency II. In its advice to the Commission of 31 August 2010, CEIOPS gave recognition to the methods used by the IMF to conduct an examination of the US insurance

© Clifford Chance LLP February 2011

regime and postulated that it could use a similar approach to assess equivalence under Solvency II. However, it also remarked that the NAIC's roadmap for group supervision was some way off, so an assessment under Article 260 would not be appropriate. CEIOPS suggested that a tightly drafted memorandum of understanding with US state regulators collectively should be considered if equivalence for the US as a whole is to be determined. An alternative solution may be for the Commission to reach an agreement with the recently created US Federal Insurance Office. However, while it is empowered to enter into international agreements, the Federal Insurance Office's authority does not extend to supervision of insurance companies and it is therefore questionable whether it would be considered a competent authority.

It has been suggested that the freedom for local regulators to carry out their own assessments in the absence of an EIOPA assessment will mean a number of individual jurisdictions will recognise the US as equivalent, thus giving it de facto equivalence status. In this context, the European Insurance and Reinsurance Federation has warned EIOPA that it must take a coordinating role to ensure that group supervisors reach the same conclusion on a jurisdiction. The Association of British Insurers (the "**ABI**") has also voiced concern that while it is clear that local regulators may make their own assessment of equivalence in relation to group solvency for EEA insurance groups with a third country subsidiary (Article 227) and group supervision for third country insurance groups (Article 260), it is not clear that they are able to do so in relation to reinsurance (Article 172).

A by-product of the omission of the US from the initial assessment proposals has been an increase in urgency for EIOPA to set out clear transitional provisions relating to third countries that have not been assessed. EIOPA acknowledged in a letter of October 2010 that such provisions would be necessary and, as noted above, Omnibus II allows for transitional arrangements to be put in place for the treatment of third country regimes which are not assessed as equivalent in the "first wave". The intention is that during the relevant transitional period (which for equivalence must be 5 years or less) the relevant third countries will be treated as if they had been assessed as equivalent in the "first wave". It is for the Commission to determine both (a) at Level 2, the criteria which will need to be satisfied in order for a third country to benefit from these transitional arrangements and (b) the countries to which these transitional arrangements will apply.

It is not yet clear which countries will be the subject of such transitional provisions on equivalence, but it is likely to include some of those countries which were identified in the CEIOPS/EIOPA advice to the Commission on 31 August 2010 as being particularly important markets, i.e. Australia, Brazil, Canada, China, India, South Korea and Turkey.

It is also not yet clear whether the US will be the subject of transitional provisions on equivalence. Although the criteria for such transitional provisions has not yet been finalised, given that it appears likely that countries which receive the benefit of transitional provisions will need to be capable of meeting the equivalence assessment criteria by the end of the transitional period, it may be difficult for the US to met those criteria. In practice, the importance of the US market may lead to a bespoke approach being adopted.

Pension Funds

For the pensions industry, solvency capital requirements are currently calculated in accordance with the provisions of the Institutions for Occupational Retirement Provision (IORP) Directive. From the early days of the Solvency II Directive, the occupational pension funds and insurance industries have been divided as to whether similar provision should be applied to occupational pension funds.

On the one hand, insurance industry representative groups such as the CEA have argued for a harmonisation of approach between the insurance and pension funds industries in Europe. In 2008, the CEA issued a position paper arguing that in many EU states where insurance companies are the dominant

© Clifford Chance LLP February 2011

institutional providers of pensions, such as France, beneficiaries of pension funds have a lower security level than beneficiaries of insurance companies. The CEA suggested that application of Solvency II to the pension fund industry would therefore be of benefit to consumers.

On the other hand, European pension fund associations, including the NAPF in the UK, oppose the application of Solvency II-style solvency requirements as this would severely alter the type of investments they could make. In particular it would make investment in equities more difficult as this would push up funds' solvency requirements. In response to a European Commission Green Paper, in November 2010, the NAPF argued that occupational pension funds operate in a fundamentally different way from insurance companies and that in the UK the system already provides strong beneficiary protection through the employer covenant, the Pensions Regulator and the Pension Protection Fund. Other national industry bodies have also been vocal in opposing any moves towards a Solvency II style approach. In January 2011, Phillip Neyt, Chairman of the Belgian Association of Pension Institutions warned in the *FT* that if Solvency II rules applied to European pension funds, €1,200bn of equity holdings would have to be sold off.

The Commission has indicated that Solvency II will not be directly applied to pension funds but that reform in the solvency capital regime will be carried out by a new IORP directive. In a recent speech in the Netherlands, EU commissioner Michel Barnier gave some indication of proposed changes. As with Solvency II, the EU legislators are moving towards a risk-based approach but will not "copy-in" all the Solvency II rules. The European Association of Paritarian Institutions is expected to send its proposals for reform to the Commission in June 2011 while Michel Barnier said he hoped that the Commission would have a revised version of the IORP Directive ready by the end of 2011.

In January 2011, EIOPA stated that it will consider whether Solvency II should apply to defined contribution schemes and in doing so will embark on an impact assessment from March 2011.

SOLVENCY II - CROSS-JURISDICTIONAL UPDATE

UK

The Financial Services Authority (the "**FSA**"), HM Treasury, the ABI and other industry bodies have been actively participating in the debates and negotiations on Solvency II implementation at EU level since its early stages. UK insurers were strongly encouraged to participate in QIS 5 by the FSA, which described it as a "cornerstone" of firms' own implementation programmes for Solvency II, and it is estimated that over 70% of UK insurers did so.

A particular area of interest for UK insurers has been the debate over whether an "illiquidity premium" should be included in the risk free rate for discounting technical provisions for certain types of contracts, particularly annuities. This is of particular importance in the UK due to the significance of the annuity market and the concern that it would significantly increase the cost of UK annuities.

As we discussed in our May 2010 Solvency II Update, in March 2010 the task force set up by CEIOPS to look at this issue opposed the inclusion of an illiquidity premium in valuing technical provisions as they believed there were no reliable methods to assess suitability for inclusion. However, the final draft QIS 5 specifications permitted the discounting of liabilities for current and future business by including in the risk free interest rate structures an illiquidity premium of (i) 100% for single premium contracts that only cover longevity and expense risk, do not pay discretionary benefits and do not incur any risk for the insurer on surrender (ii) 75% for life insurance contracts with profit participation and (iii) 50% for all other liabilities. Most recently, in its consultation document of November 2010, the Commission indicated that an illiquidity premium for all insurance liabilities in situations of stressed liquidity in the financial markets should be allowed, and the draft Omnibus II Directive gives EIOPA responsibility for publishing information relating to

© Clifford Chance LLP February 2011

the illiquidity premium in periods of stressed liquidity. This approach does not appear to go as far as the UK industry would want, but the position will hopefully become clearer when the draft Level 2 measures are published by EIOPA in June 2011. The FSA, in the meantime, are pressing the Commission for a 12 year transitional provision for the back book of annuities and a clear formula at Level 2 for the front book of annuities, although they have acknowledged that this will be difficult to achieve.

Internal model approval is also a crucial element of Solvency II implementation for most UK firms. In the UK, the FSA, like other EU regulators, have established their own "Internal Model Approval Process" (the "**IMAP**") as a "pre-application" stage (as recommended by CEIOPS in its Level 2 advice). The FSA regard the IMAP as an "essential element" of the internal models regime, which is actually a stronger position than that taken by CEIOPS (which said in its Level 2 advice that the "pre-application" process was optional for firms).

Interestingly, we understand that a number of UK firms which originally expressed an interest in applying for an internal model have subsequently decided to use the standard formula and not to continue with the IMAP process. This may be due to a number of factors, including the results which those firms obtained from QIS 5 or the risk that their models would not be approved in time for the implementation date of 1 January 2013. It is certainly a lengthy and complex process to obtain approval for an internal model and, in this context, many firms may be taking the view that using the standard formula is a preferable option.

Another key consideration for UK insurers is the scope of their internal model. Many insurers are applying for partial internal models, or several different partial internal models for different areas of their business. The challenge in this context is to satisfy the "use" test (i.e. demonstrate that the internal model is widely used and plays an important role in the insurer's system of governance) and to justify the scope of the partial internal model and satisfy the relevant regulators that they are not "cherry-picking". There is also a challenge in integrating a partial internal model with the standard formula (which is used in the rest of the business) and CEIOPS' final advice to the Commission set out suggested integration techniques in this context. When defining the scope of their internal models insurers must strike an appropriate balance between (a) a narrow approach which will be less used as a business tool but is easier to adapt to business changes and will not need to be amended as frequently and (b) a wider approach which will be more used as a business tool but will be subject to more frequent amendments, will be more complex and will require more resources. It is anticipated that Level 2 measures and Level 3 guidelines will expand the principles in the Solvency II Directive, particularly relating to the "use" test and the approval process.

Germany

Around 60% of German insurance undertakings have participated in QIS 5. The key areas of concern and interest are set out below.

The risk-free interest rate term structure proposed by QIS 5 is considered to be too volatile. The methodology proposed by QIS 5 in this respect is considered to be inappropriate: in particular, the data on which it is based is considered to be erroneous and extrapolation is considered to start too late. Therefore, unless the Commission modifies the respective rules, there is concern within the German industry that customers may face a massive decrease of supply and a steep increase in the price of private pension products. Furthermore, the calibrations for deferred taxes, the spread risk, the catastrophe risk and the property risk in particular are considered to be too high.

More generally, the standard formula as such is considered to be too complex. Especially for small and medium-sized undertakings, this constitutes a considerable burden. The industry is therefore lobbying for the principle of proportionality to be applied more rigorously. In particular, the Single Equivalent Scenario

© Clifford Chance LLP February 2011

(SES) and the calculation of the counterparty default risk as well as the lapse risk have been identified as being overly complex. Both the Commission and EIOPA (in their 2011 work plan) have acknowledged that one of the key areas of work during the next year will be to scrutinise whether and in which respects the complexity of the standard formula could be reduced.

Similar suggestions for a broader use of the principle of proportionality have been voiced by the industry as regards the future governance requirements. In particular, the requirements regarding the organisational independence of internal revision are considered to be burdensome on small and medium-sized insurers.

In addition, with respect to Pillar III in particular, the scale of the documentation requirements is considered to be excessive. The necessity for explaining differences in the valuation of assets and liabilities for regulatory and accounting purposes, as well as the detail in which investments need to be disclosed, are considered to be too onerous.

Finally, in the view of large parts of the German insurance industry, experience gained from the QIS 5 exercise have highlighted the need for transitional periods for the full implementation of Solvency II. This applies in particular to the solvency capital requirements and the treatment of hybrid capital with a view to the eligibility of own funds.

France

Participation in QIS 5 shows the increasing involvement of the French insurance industry in the Solvency II implementation process, as more than 500 companies have responded, double the participation in QIS 4. Although most companies already appear to be in good shape to meet the new requirements, mutual companies, which have long been critical of Solvency II, continue to voice their concerns on the financial difficulties to which the future regime may give rise for small and medium size mutual companies. In particular, they anticipate that the tremendous complexity of the new mechanisms will produce extra costs and accordingly a need for more capital that they may not be able to satisfy.

More generally, the main topic being debated by the French insurance industry is the need to reduce the required SCR and the harmful consequences of overly stringent requirements in this respect. In particular, some life companies draw attention to the fact that the new rules will penalise equity and other "risky" investments, which will almost certainly result in decreased returns for holders of with-profit policies. They anticipate that one of the consequences will be of a commercial nature, and in particular that insurers will be put under pressure to completely rethink their product offer. As regards non-life insurance, some stakeholders are calling for a review of the calibration of long-tail risks, particularly with respect to civil liability. The need to put in place appropriate transitional measures has also been raised by many companies (see "Omnibus II" section above).

On the whole, the French Government agrees with these causes for concern. In April 2010, the French Minister of Economy and Finance sent a letter to Michel Barnier, the Commissioner for Internal Market and Services, suggesting in particular the easing of the following requirements: procyclicality prevention conditions (particularly in respect of the illiquidity premium), the calibration of capital requirements (in particular, removal of the volatility measure) and the own funds eligibility criteria (expected future profits and eligibility of hybrid debt). In December 2010, France and Germany also jointly suggested to the Commission possible new ways to simplify the standard formula used to calculate the SCR.

The new French regulator, the *Autorité de Contrôle Prudentiel* (the "**ACP**") has adopted a framework procedure in respect of the pre-approval of internal models, which was presented during a conference for insurers held on 22 November 2010. In particular, in order to ensure that the pre-approval process is efficient, the ACP has set a timetable and provided guidelines on the documentation and the explanatory

© Clifford Chance LLP February 2011

notes to be provided by insurance companies. As a consequence, insurers that intend to apply an internal model as from January 2013 must comply with a tight timeframe. Insurers will have to hold preliminary discussions with the ACP and present their work schedule before 31 March 2011. The schedule will have to set the dates by which the different parts of the model will be ready (i.e. finalised and approved internally) and binding on the insurance company and constitute the basis on which supervision will be carried out by the ACP. The parts of the internal model that an insurer wants the ACP to review will have to be ready by 31 March 2012. Failure to comply with the timetable will result in insurers being obliged to apply the standard formula, which may increase their capital requirements.

Italy

There is currently no Italian Solvency II implementation bill available, but it is in the process of being drafted. As in other Member States, a key area of focus in Italy for the *Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo* (the "**ISVAP**") – the competent Italian regulator – has been the implementation of the Solvency II provisions on internal models. The ISVAP has set out the general rules governing the use of internal models (in its publication dated 26 January 2010) and has introduced a "pre-application period" to provide the ISVAP, on an informal basis, with insurance companies' plans for preparing their own internal models, along with the relevant terms and conditions.

In order to participate in the "pre-application period", the ISVAP required insurance companies to:

- satisfy certain requirements (e.g., having an effective risk management system in place; providing documentation giving an outline of the theory, assumptions, and mathematical and empirical bases underlying the internal model); and
- submit notice to the ISVAP by 31 July 2010, together with a general meeting resolution setting forth the terms and conditions of the implementation process for their internal models. The ISVAP has published guidelines (dated 19 May 2010) on the content of the general meeting resolution and the accompanying ancillary documentation.

Spain

The Solvency II Directive will be implemented in Spain by means of a new insurance supervision law (the "**New Insurance Supervision Law**") which will replace the current Spanish Royal Legislative Decree 6/2004 on the ordination and supervision of Spanish private insurance.

A working draft of the New Insurance Supervision Law is already available, and was discussed on 22 December 2010 at a meeting of the Advisory Insurance Board (*Junta Consultiva de Seguros*) with industry representatives, representatives of consumer associations and public administrative bodies, among others. The legislative process for enacting the New Insurance Supervision Law is expected to begin in the last quarter of 2011 and will be completed in 2012.

Some of the key areas of discussion that have arisen in relation to Solvency II and the New Insurance Supervision Law are set out below.

One of the main topics for debate has been the impact of the new capital requirements and technical provisions on the Spanish insurance industry. Life insurance companies have raised concerns that the new rules will penalise equity and other "risky" investments, and affect the pricing and sale of insurance products.

© Clifford Chance LLP February 2011

Internal models are also a key issue. The Spanish insurance regulator, the *Dirección General de Seguros y Fondos de Pensiones* (the "**DGSFP**"), has introduced a procedural framework for the pre-approval of internal models for insurance entities in two phases:

- In the first pre-application phase, firms under supervision were invited to file all information and documentation relating to self-assessment of their proposed internal models between 1 September 2010 and 1 December 2010. According to the DGSFP's proposed timetable, analysis of the information received was due to have been completed by 1 February 2011.

- The second pre-application phase began on 1 February 2011. Participating firms should submit their internal models to the DGSFP for further analysis before 1 April 2011, which will recommend changes where required. The formal approval process for internal models is expected to begin by mid 2012. It should be noted that, in accordance with CEIOPS' guidance, a positive opinion resulting from the pre-application process will not guarantee a positive decision by the DGSFP in the formal approval process.

Another important debate concerns the best way for Spanish insurance firms to update their governance structures. The Spanish insurance industry has seen initiatives in the past in this area, such as the publication of best practice guidelines on good governance and internal controls, and further developments on this matter are expected.

Finally, a further important issue is the distribution of regulatory powers among the Ministry of Finance, the DGSFP and regional regulators (Comunidades Autónomas), and whether the independence of the DGSFP should be reinforced along the same lines as other financial services regulators in Spain. Under the New Insurance Supervision Law it is currently proposed that regional supervisors will authorise mutual benefit companies (mutualidades de previsión social) and insurance cooperatives registered in their territories where at least 75% of the risks and undertakings assumed by such entities are located within their region. It should also be noted that the New Insurance Supervision Law will have radical implications for the current regulation of mutual benefit companies, mutual companies and cooperative insurance entities with floating premiums, which will disappear and must be converted into another form of insurance entity.

Netherlands

The prudential supervisor, the Dutch Central Bank (the "**DCB**"), has established an internal project group to prepare for the implementation of Solvency II in January 2013. In March 2010, the DCB published guidance on Solvency II ("*Implementatie Solvency II*") which describes the different elements of the new regime, e.g. the use of internal models, governance/ORSA, reporting requirements, group supervision, and the principle of proportionality in relation to smaller insurance companies. The document also explains how insurers are expected to comply with the requirements, e.g. by reference to advice or consultation papers published by CEIOPS/EIOPA.

In the summer of 2010, the DCB conducted an investigation among insurers, which pointed to a wide variation in the current level of expertise among insurers. More than half of the respondents indicated that they had not yet established an internal audit function or an actuarial function. In its October 2010 feedback document, the DCB indicated that Solvency II would become a regular item on the agenda in the DCB's supervision of individual firms.

In order to expedite the implementation of internal models used for calculating solvency requirements, the DCB has started the project "Pre-application process for internal models", providing insurers with the opportunity to pre-test their internal models, in line with CEIOPS Level 3 guidance.

© Clifford Chance LLP February 2011

The provisions of the Solvency II Directive and Level 2 implementing measures will eventually be incorporated into the Dutch Financial Supervision Act (*Wet op het financieel toezicht*) and/or its corresponding subordinate legislation, for which the Dutch Ministry of Finance has responsibility.

Poland

Polish insurance companies are actively engaged in the Solvency II implementation process. Market research shows that only 18 per cent of Polish insurance companies have not yet commenced implementation procedures and about half of Polish insurance companies began the process without any form of pressure being applied by the Polish Financial Supervisory Authority (the "**KNF**"). This compares favourably with other Central Eastern European jurisdictions where about 44 per cent of companies have not yet started implementation procedures.

As part of the implementation preparations, the KNF has organised meetings and training for insurance company personnel and provided additional knowledge support on Solvency II. The KNF participated in QIS 5 and has organised stress testing to demonstrate the implications of various catastrophe situations to insurance companies.

The majority of insurance companies in Poland have concerns about the requirements and implications for IT systems, the Own Risk and Solvency Assessment process and the Supervisory Review and Evaluation Process, and the associated costs of their implementation.

The KNF has also put in place a pre-application process for internal model approval. It issued a statement on 31 January 2011 advising that insurance companies aiming to participate in the pre-application process should submit covering letters by no later than 30 April 2011 and supporting documentation by no later than 30 September 2011. Applications can be submitted at a later date, but the KNF does not guarantee that sufficient resources can be allocated to review submissions received after the above deadlines. KNF plans to conclude all proceedings started in 2011 by 30 June 2012.

The primary purpose of the pre-application procedure is for insurance companies to obtain a reliable opinion on their preparation for the internal model approval process. As in other Member States, a positive opinion received following the pre-application process does not guarantee a positive decision from the KNF on internal model approval. Insurance companies aiming to participate in the pre-application procedure must submit, among other things, a description of their structural organisation, information on human resources, the scope of the internal model and a technical description of the internal model.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571.

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

* Clifford Chance also has a co-operation agreement with Al-Jadaan & Partners Law Firm in Riyadh.

© Clifford Chance LLP February 2011