CLIFFORD
CHANCE

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Solvency II Update

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1. Introduction and Summary

Since our last Solvency II client briefing in July 2011, there have been a number of developments in relation to the implementation of the Solvency II Level 1 Directive ("Solvency II"). This briefing provides an update on these developments and a discussion of the key outstanding issues and expected next stages in the implementation process.

Key points to note are:

(a) it now looks very likely that the Solvency II requirements will come into force for firms on 1 January 2014 (although this is subject to the Omnibus II Directive ("Omnibus II") being agreed and adopted) - see section 3;

(b) during 2013 it is likely that firms will be required to prepare implementation plans and may be able to apply some Solvency II requirements - see section 3;

(c) the Level 2 delegated acts have not yet been made publicly available, but draft versions of these level 2 measures have been shared and consulted on with various industry participants – see section 4;

(d) there have been recent developments in some areas including third country equivalence, reporting and disclosure – see section 4;

(e) there remain a number of outstanding issues which are still being negotiated at EU level - see section 5;

(f) the FSA have released two consultation papers on proposed changes to the FSA Handbook relating to Solvency II - CP11/22 and CP 11/23 - see section 6; and

(g) HM Treasury has released a consultation paper on proposed changes to UK legislation relating to Solvency II - see section 6.

2. Terminology

The terminology used in relation to Solvency II and Omnibus II, sometimes confusing, has been amended in some cases in connection with Omnibus II. For clarity, therefore, we have set out below a brief summary of the key terms. Where we have listed more than one term, that reflects the fact that those terms have the same meaning.

Level 1	The Solvency II Directive, which must be implemented into national law in EEA member states. It is referred to as the "*Level 1 Directive*", the "*Framework Directive*" or the "*Solvency II Directive*". The final text was published in the *Official Journal* on 17 December 2009 (although it is expected to be amended by Omnibus II).
Level 2	Referred to as both "*implementing measures*" and as "*delegated acts*". These measures are expected to take the form of a Regulation, which would have direct effect in EEA member states.
Binding Technical Standards	Also referred to as "*implementing technical standards*" or "*regulatory technical standards*" (depending on the Article in the Level 1 Directive under which they are made) or, more informally, as "*Level 2 ½ measures*". These will be prepared by EIOPA and approved by the Commission.
Level 3	Guidance prepared by EIOPA for national supervisors to ensure that the rules are consistently implemented across Member States. Insurers must comply with the guidance or explain why they have not done so.
National Implementing Measures	Provisions to implement Solvency II into national law in EEA Member States (e.g. in the UK, this is expected to include changes to the FSA Handbook and the Financial Services and Markets Act 2000).

3. Update on Timing and Implementation Delay

As most industry participants will be aware, there has been a great deal of speculation in recent months about further delay to the implementation of Solvency II. The current position is set out below:

(a) There has been agreement in principle between EEA Member States for some time that the Solvency II implementation date will need to be delayed but, as yet, it has not been amended in the legislation (currently the Level 1 Directive remains, as it was when the final text was published, with an implementation date of 31 October 2012). Practically, in order to delay the implementation date of Solvency II, the Level 1 Directive needs to be amended and can only be amended by another EU Directive. It is for this reason that Omnibus II, another EU Directive, has received much attention in the context of Solvency II implementation, because it is the Omnibus II Directive which is intended to amend the Solvency II Directive to, among other things, delay the implementation date.

(b) The Omnibus II Directive is still in draft form. The Omnibus II draft Directive originally proposed by the European Commission set out provisions delaying the implementation date of Solvency II by two months to 1 January 2013. Recently, however, there has been an increasing consensus towards pushing back the Solvency II implementation date by another year to 1 January 2014. The European Parliament's Economic and Monetary Affairs Committee's ("**ECON**") draft report on the Omnibus II Directive used the 1 January 2014 date for implementation. Furthermore,

the Presidency compromise text for Omnibus II published on 21 September 2011 included the 1 January 2014 implementation date and the accompanying progress report indicated that this compromise text now has the support of a qualified majority (74%) of Member State delegates of the Council.

Bifurcation / "Soft Launch"

Although the direction of travel appears to be towards a Solvency II implementation date of 1 January 2014, there is also a move towards a "bifurcation" approach under which there will be a split between:

(a) the date of transposition of Solvency II into national legislation (probably 1 January 2013); and

(b) the implementation date, i.e. when the Solvency II requirements are "switched on" for firms (probably 1 January 2014).

The timing of these different stages, however, is yet to be formally agreed between the EU Commission, the Council and Parliament. The table below sets out the current proposals from each institution based on their public documents.

	Commission	Parliament	Council
Transposition of Directive into national law	1 January 2013	1 January 2013	31 March 2013
Implementation of Directive's full requirements	1 January 2013	1 January 2014	1 January 2014

It is also expected that during 2013 regulators in EEA Member States (such as the FSA) will be given the power to grant certain approvals required under Solvency II (e.g. use of internal models, ancillary own funds and use of undertaking specific parameters in the standard formula SCR). Again, this remains under discussion but the table below sets out the current proposals from each EU institution based on their public documents. The "FSA Assumptions" section below sets out more detail on the approach which the FSA may take in this context.

	Commission	Parliament	Council
Power of granting supervisory approvals	1 January 2013	1 January 2013	1 June 2013

Implementation Plans

In order to avoid any further delay and to ensure that firms are ready by 1 January 2014, both the Presidency compromise text and ECON's proposed text for Omnibus II envisage additional provisions being incorporated into Solvency II which will require firms to provide an implementation plan to supervisory authorities during 2013.

The September 2011 Presidency compromise text for Omnibus II proposes that an implementation plan is to be provided to supervisory authorities by 1 June 2013 in which the firm is to set out its state of preparedness with respect to, among other things, (i) its valuation of assets and liabilities; (ii) its calculation of capital requirements; (iii) its adaptation of a system of governance including the Own Risk and Solvency Assessment; (iv) its adaptation of processes and procedures for supervisory reporting and public disclosure; and (v) details of whether the firm intends to take advantage of certain provisions under the new regime.

The table below sets out the current position for each EU institution in relation to pre-implementation reporting based on their public documents. Again, this issue remains under discussion at EU level.

	Commission	Parliament	Council
Implementation Plans	1 January 2013	As of 1 July 2013. Firms required to provide full Solvency II balance sheet, SCR, MCR and own funds. Firms also to provide Regular Supervisory Report (RSR), although this requirement may be waived by Member States for insurers which do not have the necessary systems and structures in place.	1 June 2013. Implementation plans to be provided as set out above.

Transitional Measures

Potential transitional measures have been the subject of much discussion at EU level for some time. They are also relevant to the timing of Solvency II implementation insofar as they could, practically, mean further delay in certain Solvency II requirements coming into force. Our client briefing in February 2011 set out more information on the approach to and intention behind transitional measures.

The Commission's original Omnibus II proposal gave the Commission power to apply transitional provisions over limited specified periods but did not specify whether or how these powers should be exercised. Parliament and the Council are currently proposing that Omnibus II set out transitional measures in more detail and there is broad agreement as to the scope of these transitional measures. The table below highlights the current approaches taken by both the Council and Parliament to transitional measures in particular areas, based on their public documents.

Transitional Measures	Council	Parliament
Third Country Equivalence	5 years	5 years
Non-compliance with SCR	1 year	2 years
Systems and controls for production of Report to Supervisors (RSR) and Solvency and Financial Condition Report (SFCR)	—	2 years
Technical provisions – Risk-free interest rate term structure	7 years	—
Insurers in run-off	3 years/5 years	—

As you can see, there remains some uncertainty as to many of the details, but the general direction of travel appears fairly clear.

4. Solvency II Rules and Requirements – Recent Developments

Level 2 Measures

The Solvency II Level 2 delegated acts (formerly known as "implementing measures") were originally due to be published in the second half of 2011 with the final measures to be adopted in 2012. However, with the delays introduced by the recent draft texts of Omnibus II these delegated acts are not now expected to be publicly available until Q2 2012 (after the Omnibus II Directive has been finalised).

The Commission has, however, been entering into informal consultations with industry participants in relation to the delegated acts and drafts of the delegated acts have been shared with industry participants in February 2011, and again in November 2011, but have not yet been made publicly available. The Level 2 delegated acts are expected to take the form of a Regulation which will have direct effect in EEA Member States, so will not need to be implemented into national legislation.

The draft Level 2 measures apparently contain proposals relating to certain outstanding issues including matching premium, recognition of profits in future premia, contract boundaries and the calibration of the market risk module (please see further below).

EIOPA Binding Technical Standards

The draft Omnibus II Directive also grants additional powers to EIOPA to resolve disputes between national supervisors and to develop binding technical standards (sometimes referred to as "**Level 2 ½ Measures**"). These binding technical standards are designed to cover a number of the most fundamental areas of Solvency II making it important for the insurance industry to know the detail of these as soon as possible.

The Presidency's compromise text for Omnibus II proposes that the timetable for submission of these binding technical standards will be staggered between 30 September 2012 and 31 December 2016. Parliament's proposal, on the other hand, is for all draft technical standards to be submitted by EIOPA to the Commission at the latest by 1 July 2012. Clearly, for the insurance industry, it is preferable for these binding technical standards to be drafted as soon as possible to avoid uncertainty, although we will not know the final timeline until Omnibus II has been agreed.

Third Country Equivalence

Under Solvency II, the Commission may determine that certain countries outside the EEA ("**third countries**") have regulatory regimes which are "equivalent" to those of countries within the EEA under Solvency II. Where the Commission determines that a third country is equivalent in relation to Article 172, Article 227 or Article 260 of Solvency II (the "**Equivalence Articles**"), that third country shall be dealt with as follows:

Article 172 - Reinsurance by third country entities

Member States will be required to treat reinsurance contracts concluded with reinsurers in equivalent third countries in the same manner as reinsurance contracts concluded with EEA undertakings.

Article 227 - Group solvency for EEA insurance groups with a third country subsidiary

When calculating the group solvency of an EEA insurance or reinsurance group which has a subsidiary in an equivalent third country, the EEA group may use the capital adequacy calculation carried out by that regime in relation to that subsidiary.

Article 260 - Group supervision for third country insurance groups

If the parent company of an insurance group is based in an equivalent third country, Member States will be required to rely on the supervision of the group by the regulator of that third country.

The criteria used to assess whether a third country is equivalent in relation to an Equivalence Article ("**Equivalence Criteria**")

will ultimately be determined by the Commission. The Commission is expected to finalise the Equivalence Criteria in September 2012, as part of the Level 2 Implementing Measures. It is possible that one country may be determined equivalent in relation to one Equivalence Article but not another.

First wave of equivalency assessments (Switzerland, Bermuda and Japan)

In June 2010, the Commission asked CEIOPS for advice as to what countries should be assessed in the first round of equivalency assessments. CEIOPS recommended that equivalency assessments should be conducted in respect of Switzerland and Bermuda as they both formed major reinsurance markets outside the EU, were home to significant groups active in the EU and were home to subsidiaries for EEA insurance groups based across the EEA. It advised that these assessments should be carried out in respect of all the Equivalence Articles. CEIOPS further noted in its advice that Japan formed a major reinsurance market outside the EU. In its 29 October 2010 letter instructing EIOPA (formerly CEIOPS) to begin its assessments the Commission requested that EIOPA assess Switzerland and Bermuda in relation to all the Equivalence Articles and Japan in relation to Article 172 (the "**First Wave**"). It noted that, although it would be important to determine the equivalence of other third countries (particularly the US), limited time and resource meant that it was important to focus on Switzerland, Bermuda and Japan initially.

EIOPA delivered these First Wave assessments to the Commission in October 2011. EIOPA classified each First Wave country's equivalence status under each applicable Equivalence Article as either (i) equivalent without any caveat; (ii) equivalent subject to caveats; or (iii) needing to undertake changes in specified areas in order to meet the Commission criteria for equivalence.

Equivalence of Switzerland (regulated by the Swiss Financial Market Supervisory Authority ("FINMA")

The Swiss regulatory regime was assessed as equivalent to the Solvency II regime in relation to Article 227 without caveat and in relation to Articles 172 and 260, subject to caveats. Equivalence under Articles 172 and 260 was subject to the caveat that Swiss governance and public disclosure requirements were only partly equivalent because (a) public disclosure requirements under the Swiss regime are not as extensive as those under Solvency II and (b) under the Swiss regime, insurers are not currently required to have compliance or internal audit functions comparable to that required by Solvency II. EIOPA noted that FINMA was reviewing its rules on disclosure and proposed to revisit this caveat when undertaking its next assessment.

Equivalence under Article 172 was also subject to the caveat that the regime governing reinsurance captives who were exempt from the Swiss Solvency Test was only partly equivalent to Solvency II because the "confidence levels" required for such reinsurance captives was lower than that required under Solvency II.

Equivalence of Bermuda (regulated by the Bermuda Monetary Authority ("BMA"))

The Bermudan regulatory regime was assessed as equivalent to the Solvency II regime in relation to Article 260 for all classes of insurers, subject to caveats. The Bermudan regulatory regime for commercial insurers (Classes 3A, 3B and 4) was assessed as equivalent to the Solvency II regime in relation to Articles 172 and 227, subject to caveats but as not equivalent for captive insurers (Classes 1, 2 and 3), special purpose insurers and long-term insurers. EIOPA further noted that the lower capital requirement (applicable to insurers of classes 1, 2 and 3) can be very low for insurers with a high risk profile as it is not risk based.

Equivalence under Article 172 in respect of commercial insurers was subject to several caveats, the most significant of which were that (i) under the BMA regime there is no legal requirement that an insurer's head and registered offices be in the same country and (ii) the regime allows both insurance and non-insurance business to be carried out in a single company, which poses a potential risk for reinsurance cedents. Equivalence under Article 227 in respect of commercial insurers was subject to the caveat that the BMA's solvency regime for insurance undertakings is only largely equivalent. Equivalence in relation to Article 260 was subject to various caveats, the most significant of which was that the BMA's regime is not equivalent in its requirements around changes in business, management and qualifying holdings.

Equivalence of Japan (regulated by the Japanese Financial Services Agency ("JFSA"))

The Japanese regulatory regime was assessed only with regard to Article 172. EIOPA found it to be equivalent under Article 172 subject to the caveats that the JFSA's regime is only partly equivalent in its authorisation and solvency requirements of

reinsurance business and is only largely equivalent with regard to its governance and public disclosure requirements and requirements regarding changes in business, management and qualifying holdings. EIOPA noted that it expected the Japanese regime to become largely equivalent in solvency requirement terms following an expected move to market consistent valuations of liabilities.

Next steps

The Commission has asked EIOPA to update its advice regarding the equivalence of the Swiss, Bermudan and Japanese regimes once the Equivalence Criteria have been finalised. This will allow EIOPA to cover those elements of the three regimes which have changed since their initial assessment. If one of the First Wave countries is found to be not equivalent in respect of an applicable Article, the Commission's October letter to EIOPA states that it will consider including that third country within the transitional regime considered below to allow more time to reach equivalence.

To deal with third countries who have not been assessed in the First Wave, the Commission intends to introduce a transitional regime under Omnibus II. The intention is that during the relevant transitional period (which for equivalence must be 5 years or less), third countries assessed as equivalent under the transitional regime will be treated as if they had been assessed as equivalent in the First Wave. The criteria for assessing a third country's equivalence under the transitional regime is yet to be determined. More detailed equivalence assessments will later need to be carried out in relation to third countries assessed as equivalent under the transitional regime to determine whether they can retain their equivalent status beyond the transitional period. Although the US was not included in the First Wave of assessments, it is likely that it will be one of the third countries covered by the transitional regime.

The Commission has invited EIOPA to provide it with advice as to (i) the equivalence of professional secrecy obligations in certain third countries and (ii) the areas where the regulatory regime of certain third countries does not currently meet the Equivalence Criteria and the additional steps required to reach equivalence. The Commission requested that such assessment be a higher level analysis than the detailed assessment undertaken for the First Wave. The Commission has identified 16 third countries as candidates for a transitional regime and plans to provide EIOPA with a final list of third countries by the end of January 2012. The Commission has asked EIOPA to complete its assessments by the end of 2012 to allow the Commission to take its decisions on equivalence by mid-2013.

Reporting and Disclosure

On 7 November and 8 November 2011 respectively, EIOPA released Consultation Papers regarding (i) proposals for Level 3 guidelines on how the Own Risk and Solvency Assessment ("**ORSA**") is to be interpreted, and (ii) a series of documents relating to the Solvency II Pillar 3 reporting requirements, including (a) a consultation paper on the proposal on Quantitative Reporting Templates ("**QRTs**"), (b) a consultation paper on the draft proposal for guidelines on Narrative Public Disclosure & Supervisory Reporting, Predefined Events and Processes for Reporting & Disclosure, (c) QRTs for solo companies, (d) QRTs for groups, (e) reporting instructions to accompany the QRTs, and (f) an impact assessment on the Solvency II reporting package. EIOPA have requested comments on the consultation papers by 20 January 2012.

ORSA

EIOPA's ORSA consultation represents the first public consultation we have seen on the draft Solvency II Level 3 text (other than the Level 3 consultation on the pre-application process for internal models in March 2010). The focus of the consultation paper is on what is to be achieved by the ORSA, not on how it is to be performed, and so requires firms to interpret what is expected in the context of their own business.

The consultation paper includes 24 guidelines, many of which are quite general in scope (e.g. proportionality). It also includes some more specific requirements, such as the relevant documentation of the ORSA process and outcome, and for stress-testing of identified risks.

Quantitative Reporting Templates (QRTs)

As noted above, consultation papers and draft forms for QRTs have also been released. The QRTs capture information on balance sheet, assets, solvency capital requirements ("**SCR**"), minimum capital requirements ("**MCR**"), technical provisions and reinsurance. They are a set of 62 forms of which up to 52 will be required to be completed by individual insurers and up

to 38 by insurance groups, although the number of publicly-reported forms has been significantly reduced from previous proposals.

5. Key Outstanding Issues

Illiquidity Premium / Discount Rate

Towards the end of 2009 EIOPA (as CEIOPS) released its final advice on the illiquidity premium. It suggested, at that time, that if an illiquidity premium were to be allowed at all it should only be applied as a transitional measure in relation to certain annuity business in force as at 31 October 2012. In response, the Commission asked EIOPA to establish a task force and its report was published in March 2010. The report accepted (i) the principle of an illiquidity premium (ii) that an illiquidity premium should be permitted in the valuation of long-term (re)insurance liabilities and (iii) that the value of this premium should be determined by reference to illiquidity premia on corresponding and ring-fenced assets (referred to as the matching premium concept). The conditions for the matching premium to apply are strict and limited to longevity risk, expense and revision risk. We understand that the Commission's latest proposal on the details of the matching premium are contained in the draft Level 2 Regulation distributed privately to certain industry participants. The final decision on how the matching premium will in fact apply within Solvency II remains with the Commission. This issue has been a key area of focus for UK lobbying by the ABI and others.

Contract Boundaries / Future Profits Recognition

Defining each contract boundary is critical for the calculation of technical provisions under Solvency II because that boundary sets the point at which premiums can be recognised on existing contracts and, as such, determines the cash flows to be included in the technical provisions and also impacts on the extent of recognition available for future profits.

The issue of the extent to which future profits will be eligible as tier 1 capital currently remains unclear although it is an important issue for many EEA life assurers.

Market Risk and Catastrophe Risk

Market risk, which includes spread risk, is the largest component of the standard formula for the life industry both before and after diversification. The spread risk sub-module attracted criticism from the industry, particularly due to its calibration (considered either too high or too low) and its complexity, especially in the area of structured products. The market risk sub-module from QIS5 favoured government bonds and short-term corporate debt although it appears some changes have been made in the draft Regulation to reduce somewhat the spread risk charge on 5 – 10 year bonds. The treatment of loans backed by mortgages also appears to have changed, separating the treatment of residential mortgage loans (to be assessed under the counterparty risk module if they meet certain conditions) and commercial mortgage loans (to be assessed under the spread risk module together with other loans and bonds).

The QIS5 results also highlighted remaining issues with the calculation of catastrophe risk. The results indicated that European non-life insurers need to allocate around a quarter of their entire risk capital to catastrophe risks, which many insurers commented was an inappropriately large component of SCR. There is continuing pressure from the industry to revise the valuation method. The Commission set up a working group, the Catastrophe Task Force, which has now been joined by representatives from insurance companies and the CRO Forum. At this stage, the final shape of the market and catastrophe risk modules remains unclear.

6. UK Implementation

FSA Assumptions

In light of the discussions in Europe regarding the bifurcation of Solvency II, the FSA published revised implementation assumptions which currently anticipate that (a) 1 January 2013 will be the date at which responsibilities will be switched on

for national supervisors and EIOPA, and (b) 1 January 2014 will be the date upon which insurers will need to comply with Solvency II.

However, presumably in response to concerns raised by the UK insurance industry regarding the likely further delay to Solvency II, the FSA has been considering options whereby UK insurers would be able to apply parts of the Solvency II regime before 1 January 2014. The FSA has stated that, while it cannot and will not waive the Solvency I requirements until the Solvency II regime comes into effect for firms, it is exploring whether and how it may be able to allow internal models developed under Solvency II as a proxy for ICA/ICG during 2013. The FSA is still in the process of defining its position in this regard and will inform firms once finalised, which we expect to be after the finalisation of Omnibus II.

The FSA appears to be acknowledging the frustration of the industry over the current unpredictability of timing and are trying to be pragmatic and provide guidance where possible, although clearly its freedom of manoeuvre is restricted to a large extent by what takes place at EU level.

FSA Consultations

In November 2011 two consultation papers relating to Solvency II implementation in the UK were released by the FSA (in addition to the HM Treasury paper – see "HM Treasury Consultation" below): FSA Consultation Paper 11/22, "Transposition of Solvency II" ("**CP 11/22**") and FSA Consultation Paper 11/23, "Solvency II and linked long-term insurance business" ("**CP 11/23**"). We have set out below key points relating to these consultations.

Background

There are two elements to the process of transposing the Directive into UK national law:

(a) changes to the FSA Handbook: the FSA is responsible for consulting on this area; and

(b) changes to primary legislation: HM Treasury is responsible for consulting on this area - see "HM Treasury Consultation" below.

These proposed changes to UK primary legislation and to the FSA Handbook are to implement the terms of the Solvency II Level 1 Framework Directive into national law. As noted above, the Level 2 delegated acts, which are expected to take the form of a Regulation, will not need to be implemented by HM Treasury and the FSA because Regulations have direct effect in EEA Member States.

In this context, it is worth emphasising that the FSA and HMT have limited discretion in its transposition and implementation of the Directive because the Directive requires "maximum harmonisation", i.e. the FSA will not have the scope to set higher standards/additional requirements. The rules must be implemented as they are set out in Solvency II.

CP 11/22

In CP 11/22 the FSA sets out an explanation of, and draft rules for, a new prudential sourcebook for insurers in the FSA Handbook which implements Solvency II: SOLPRU. As mentioned above, the FSA has limited scope for discretion and has therefore adopted an "intelligent copy-out" approach. The proposed provisions of SOLPRU are therefore, as you would expect, very similar to the words of the Level 1 Directive and the FSA has only departed from copy-out (a) where necessary to provide greater clarity and (b) if necessary, where the Directive requires the FSA to make a discretionary decision. The FSA's discretion may be further limited by the Level 2 and Level 3 measures if they prescribe further detail on the interpretation of the Level 1 Directive.

The FSA has emphasised that, given the ongoing uncertainty around European policy timelines, it is taking an iterative approach to the consultation process. It is fair to say, therefore, that this CP provides only limited additional guidance above what was already included in the EU level documents.

It is worth noting that in 2013 the FSA will be replaced by two successor bodies, the Prudential Regulation Authority ("**PRA**") and the Financial Conduct Authority ("**FCA**"). The consultation paper confirms that (a) Solvency II insurers will be prudentially supervised by the PRA and (b) the FCA, which will supervise from a conduct perspective, will work with the PRA to ensure that the objectives of Solvency II are achieved in the broader context.

The FSA has requested responses to the consultation paper, and to CP 11/23, by 15 February 2012 and intends to publish a Feedback and Policy Statement in Q2 2012. There is also an intention to publish a further consultation paper once agreement has been reached on the Omnibus II Directive and Level 2 delegated acts.

CP 11/23

In CP 11/23 the FSA has put forward proposals for changes to the FSA's rules and guidance relating to the operation of unit-linked and index-linked insurance business, in particular in relation to the assets which are permissible for benefits to be linked to (which are listed in COBS 21.3). Key points to note are:

(a) the FSA proposes to expand the list of assets in COBS 21.3 to include, where appropriate, assets allocable in UCITS funds that are not currently in COBS 21.3;

(b) the FSA does not, however, propose to introduce UCITS asset diversification requirements, except in the case of assets that are allocable under UCITS but not currently allowed by COBS 21.3;

(c) the FSA has, in this context, examined every asset class in turn to ensure that the definitions currently in place are sufficient to encompass assets allowable under UCITS and, where they are not, to propose amendments to COBS 21.3. For example:

  (i) the FSA proposes adding a new category of money-market instruments, which are currently allowed as investments in UCITS but are not on the list of assets in COBS 21.3, to COBS 21.3 (but the FSA emphasises that residential mortgage-backed securities are not eligible to be used in linked funds); and

  (ii) EIOPA is carrying out work on permitted stock lending and derivatives, and the FSA will bring forward proposals in this area in its second consultation paper which is scheduled for 2012.

HM Treasury Consultation

On 23 November 2011, HM Treasury published a consultation paper on the changes the Government is planning on making to UK legislation to transpose the Solvency II Directive. The number of changes required to primary legislation is relatively small (as the majority of Solvency II requirements will be contained in the FSA Handbook) and the scope of the consultation is limited to amendments the Government intends to make to FSMA. The consultation does not cover the Level 2 implementing measures as the Commission has indicated that these measures will be made by regulation which will have direct effect in the UK. The closing date for responses to the consultation is 15 February 2012.

The consultation includes a draft Statutory Instrument setting out the proposed changes to FSMA (as amended by the forthcoming Financial Services Bill which is due to be introduced into Parliament in early 2012). The changes fall into four categories:

- Amendments necessary to set out the conditions under which undertakings may be authorised and de-authorised.
- New powers for the PRA. The new powers are primarily intended to enable the PRA to provide the support and supervision required for (re)insurance undertakings to calculate their solvency position under Solvency II.
- New duties for the PRA aimed at mandating its participation in the new European supervisory framework.
- Amendments to align UK terms and definitions with those set out in Solvency II.

Conditions for Authorisation and de-Authorisation

The Solvency II Directive specifies a number of circumstances where a supervisory authority of a member state may withdraw the authorisation granted to a (re)insurance undertaking. The FSA already has powers that cover a number of these circumstances, for example, where the undertaking no longer fulfils the conditions for authorisation. The PRA will be given additional powers to remove authorisation where the undertaking concerned seriously breaches its obligations under the regulations to which it is subject. In addition the PRA will be required to remove authorisation where the undertaking

does not comply with its MCR and the PRA considers that the finance scheme submitted is manifestly inadequate or the undertaking fails to comply with the approved scheme within three months of the determination that the undertaking has not complied with the MCR.

Powers to help undertakings to calculate their Solvency II capital requirements

These powers will enable the PRA to approve:

- The amounts of ancillary own fund items that can count towards the undertaking's own funds.
- The classification of certain own fund items into tiers.
- The use of undertaking specific parameters in the calculation of life, non-life and health underwriting risk in the SCR calculation instead of using the parameters in the standard formula.
- Full and partial internal models for the calculation of the undertaking's SCR and group internal models for the calculation of the group SCR.

The PRA will also be given a power to perform supervisory functions for outsourced activities provided to a UK authorised firm, and will be given specific powers to carry out on-site inspections of an EEA outsourcing provider's premises wherever it is based.

Mandating the PRA to work within the new European supervisory framework

There are various amendments to FSMA which are intended to require the PRA to consult or co-operate with other EEA supervisors as contemplated in Solvency II and generally these are consistent with the drive to encourage a more collegiate approach to cross-border regulation. We have set out a couple of examples below.

A. Prohibition on disposal of assets

Under Solvency II, where the PRA is the home state supervisory authority, it may prohibit the free disposal of assets if the undertaking has not complied with the rules on technical provisions, SCR or MCR or if the undertaking's authorisation terminates. The PRA will be required to notify the supervisory authorities of host member states and designate the relevant assets and the amendments to FSMA will give effect to these requirements.

B. Transfers of business

Under the amended provisions of Schedule 12 of FSMA, where an undertaking is authorised in the UK and is using a UK business transfer scheme under FSMA to transfer the business of a branch in another member state, the PRA will need to consult with and obtain the consent of (i) the host state regulator where the branch is situated, (ii) the regulators of any member states where policies were concluded and (iii) if the transfer is to a branch of the transferee, the regulator of the member state where it is situated. If the relevant host state regulator has not responded within 3 months from the request for consultation, it is deemed to have consented. The current provisions of FSMA relating to notifying, and obtaining the consent of, the regulators of states of commitment (for long-term contracts) or risk (for general contracts) are retained without amendment.

Although the drafting of the proposed amendments to FSMA, and their interaction with the other relevant provisions of FSMA, are not entirely clear (see below), the effect of the amendments relating to consultation and consent broadly represents the consultation and consent practice the FSA has tended to adopt to date, even though the current provisions of FSMA:

- Require the FSA to *notify* rather than *consult* the relevant host state regulators before approving a transfer.
- Require the FSA to wait for a *response* rather than *consent* in the case of host state regulators of branches whose businesses are transferring.
- Do not require consultation with and consent of the regulator of the state in which the branch to which the business is transferred is established (although the home state regulator of the transferee firm has to provide a certificate of solvency).

The new requirement to consult with the regulator of the state of establishment of a branch to which a branch business is being transferred has been introduced by HMT despite the fact that it is not contained in Solvency II. It also introduces an inconsistency as the requirement does not apply to a transferring business that is not itself written through a branch of the transferor.

In Solvency II the concept of consulting with states *where policies were concluded* appears to replace the concepts in the Solvency I directives of consulting with the states of the *commitment* (for long-term contracts) or the *risk* (for general contracts). However, the proposed FSMA provisions have retained the states of commitment and risk concepts, although they also apply the "state where the contract was concluded" concept for transfers of branch businesses. The approach of HMT is therefore inconsistent with Solvency II which treats business conducted under the right of establishment in the same manner as business conducted under the right to provide cross-border services and also treats long-term contracts in the same manner as general contracts.

In practice the amount of resource that is often spent by transferors in determining the state of commitment or risk of transferring policies would be reduced if the transferor only needed to determine where its contracts were concluded (for example the states in which it has or had permission to write business). The uncertainty around identifying the states of commitment or risk has often resulted in transferors making notifications in multiple member states even though they might never have written business there. Solvency II and the HMT consultation should be used as an opportunity to simplify Schedule 12 of FSMA to remove the current complexities brought about by the state of risk and state of commitment notification provisions and the new provisions should not introduce unnecessary differences between the treatment of business conducted through a branch and that conducted on a cross-border basis. The Solvency II Directive does however, retain the state of commitment and state of risk concepts in relation to publication of notices.

7. Conclusion

2012 looks likely to be a busy year for those involved in Solvency II implementation. Although there appears to be an increasing consensus in pushing back the implementation date of Solvency II to 1 January 2014, there remains a large amount of work to be done in advance of that date. As noted above, during 2012 the Omnibus II Directive needs to be finalised and agreed (now expected in Q2 2012), the Level 2 Regulation needs to be finalised, binding technical standards and Level 3 guidance need to be consulted upon and finalised and the national implementing measures in all member states need to be agreed and come into force. There are still a number of outstanding issues which need to be agreed between the Commission, the Presidency and Parliament, which will need to be resolved before these various implementing measures can be adopted. Insurers will, however, be expected to demonstrate their preparedness for Solvency II in 2013, in implementation plans, and may be able to apply certain parts of Solvency II in 2013. Firms should continue their Solvency II preparations, taking into account the detailed requirements as they become clearer during 2012, in order to be prepared for the new regime.

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