CLIFFORD CHANCE

Briefing note

April 2015

Solvency II: Spring 2015 update

The Solvency II regime will apply to all UK insurers in less than one year's time.

This note takes a closer look at some recent notable milestones, including those reached by the Prudential Regulation Authority ("PRA") and the European Insurance and Occupational Pensions Authority ("EIOPA"), in the path towards implementation on 1 January 2016.

Checklist for UK (Re)Insurers

Capital instruments/own funds

- Is there a right to cancel or defer payment of dividends at any point prior to payment? If not, this may have an impact on tier 1 classification of share capital. May be necessary to consider an amendment to articles of association.
- If anticipating a new issue of capital instruments, ensure terms and conditions conform with new rules e.g. references to breach of SCR, MCR as required.
- Have any necessary applications been made for the recognition of Ancillary Own Funds/Matching Adjustment/Undertaking Specific Parameters?

Transitional provisions

- Is it clear when time limits on existing capital instruments qualifying as Solvency II own funds expire? See Article 308b(9)-(10) of the Solvency II Directive.
- Have applications been made to the PRA to use the transitional measures on the risk-free interest rate or on technical provisions? Refer to SS17/15 - Solvency II: transitional measures on risk-free interest rates and technical provisions for PRA expectations in respect of such applications.

Groups

- Has the group supervisor been identified and have any necessary applications to exclude entities from the scope of group supervision made?
- Where PRA is group supervisor, is it clear which method of group solvency calculation (consolidation or deduction and aggregation) will apply?
- For groups based in non-equivalent third countries, is a rule waiver application to the PRA required for an alternative method of group supervision?
- Have applications for centralised risk management / solo SFCR been made?

Reporting templates

- Have final UK specific templates been reviewed to confirm that data collation and processes are in place to ensure timely submission of completed templates?

Firms in run-off

- Is there a plan for transferring or extinguishing liabilities with the time scale specified in the Transitional Measures? See PRA SS7/5 ' Solvency II: supervision of firms in difficulty or run-off'.

PRA milestones

Directive transposition

On 20 March 2015, the PRA published 'Solvency II: A new regime for insurers (PS2/15)'. This policy statement includes the PRA's Solvency II implementing rules and provides feedback on the below consultation papers:

- CP16/14: Transposition of Solvency II: Part 3;
- CP22/14: The PRA's approach to with profits insurance business;
- CP23/14: Solvency II approvals;
- CP23/14: Solvency II: Further measures for implementation; and
- CP3/15: Solvency II: Transitional measures and the treatment of participations.

The final rules provide more certainty in respect of capital instruments, group requirements and transitional provisions. Firms are advised to follow the checklist above to ensure that all relevant documentation is compliant with the new rules.

Accompanying PS2/15 are national specific templates. Following the checklist above, firms should check that internal systems and processes can accommodate the templates and their reporting frequency.

Intelligent copy-out

The PRA followed an 'intelligent copy-out' approach to incorporating the Solvency II Directive ("the Directive") into the PRA Rulebook. As such there are comparatively few differences between the PRA's rules and the Directive.

However, areas which are vague in the Directive are also vague in the PRA rules, for example, Rule 16.2 of the Group Supervision Part of the PRA Rulebook leaves it open to judgement as to what 'significant', 'very significant' and 'as soon as practicable' mean in relation to reporting intra-group transactions.

The rule in question transposes Articles 244 and 245 of the Directive and those articles do not specify the meaning of 'significant', 'very significant' or 'as soon as practicable'. In line with the PRA's intelligent copy-out approach, the PRA does not provide further prescription in the PRA Rulebook, leaving legal uncertainty as to when the requirement in Rule 16.2 is imposed.

Supervisory statements

It is, given potential ambiguity in some rules, the areas of interpretation dealt within the 17 supervisory statements (which accompany the rules) that may be of more interest to firms.

Of particular note is SS17/15 - Solvency II: transitional measures on risk-free interest rates and technical provisions. In this supervisory statement, the PRA confirms that current Pillar 2 insurance liabilities are the starting point for the transitional deduction. This is good news for firms as it increases the size of transitional deductions that the PRA will consider approving.

Further good news is that the PRA will not implement the complicated rules it proposed for the technical provision calculations (see Article 308d of the Directive). Instead, HM Treasury transposed the substance of the Directive requirements via the Solvency 2 Regulations 2015 ("the Regulations 2015").

Solvency 2 Regulations 2015

The Regulations 2015 were laid before Parliament on 9 March 2015. Regulations 1, 2, 38-58 and paragraph 15 of Schedule 1 came into force on 31 March 2015. The rest of the Regulations will come into force on 1 January 2016.

Among other things, the Regulations 2015 will enable firms to apply to the PRA, from 31March 2015, for:

- verification that the Directive does not apply to them;
- permission to apply a matching adjustment or volatility adjustment to a risk-free interest rate term structure;
- approval of its assessment and classification of an own fund item;
- approval to use undertaking specific parameters when calculating life, non-life and health underwriting risk modules;
- approval of a full or partial internal model; and
- permission to calculate the consolidated group solvency capital ratio for the firms in the group and/or the aggregated group solvency capital ratio.

Transposition table

A transposition table is available which provides a mapping of the Directive to where it has been transposed in either the PRA rules or in the Regulations 2015.

Firms must remember that Solvency II Regulations (i.e. the delegated acts and technical standards underpinning the Directive) apply directly and do not need to be transposed into the UK. Therefore, to fully understand the detail absent from the Directive (and PRA rules or the Regulations 2015), the Level 2 Solvency II Regulations also require separate examination.

Senior Insurance Managers regime

On 23 March 2015, the PRA published 'Strengthening individual accountability in banking and insurance (PS3/15)'. This policy statement confirms final rules for the PRA's Senior Insurers Managers Regime ("SIMR") and will require insurers to:

- allocate a range of responsibilities to individuals, who are subject to regulatory approval; and
- regularly assess the fitness and propriety of those individuals.

The regime, which implements Solvency II measures on governance and fitness and proprietary, will apply to insurers in the UK (and could be extended to the UK branches of non-UK insurers) on 1 January 2016.

Our briefing note on the SIMR is available here.

Outstanding material

Although the PRA published the bulk of the Solvency II rules before the 31 March 2015 Directive transposition deadline, a few rules remain outstanding. These include the final rules, which are expected in May/June 2015, for non-executive directors in Solvency II firms.

Three supervisory statements, detailed below, are still in draft form and subject to current consultation:

- Solvency II: supervisory approval for the volatility adjustment - CP11/15 - the consultation closes on 20 April 2015.
- Solvency II: treatment of sovereign debt in internal models

March - CP14/15- the consultation closes on 1 May 2015.

- Solvency II: consistency of UK generally accepted accounting principles with the Solvency II Directive - CP16/15 - the consultation closes on 10 July 2015.

EIOPA milestones

Technical Standards

On 31 October 2014, EIOPA submitted set 1 of Implementing technical Standards ("ITS") on approval processes to the European Commission.

The Commission endorsed the ITS and on 25 March 2015, the below ITS were published in the form of a directly binding Regulation in the Official Journal:

- approval of an internal model;
- application to use a group internal model;
- approval procedure to use undertaking-specific parameters;
- approval of the application of a matching adjustment;
- approval for the use of ancillary own-fund items; and
- approval to establish special purpose vehicles

The Regulations implementing the ITS came into force on 26 March 2015.

Guidelines

On 2 February 2015, EIOPA published Set 1 of the Solvency II Guidelines ("the Guidelines") on:

- ancillary own funds;
- application of outwards reinsurance;
- application of life underwriting risk module;
- basis risk;
- classification of own funds;
- contract boundaries;
- group solvency;
- health catastrophe risk sub-module;
- look-through approach;
- operational functioning of colleges;
- ring-fenced funds;
- supervisory review process;
- loss-absorbing capacity of technical provisions and deferred taxes;
- methodology for equivalence assessments by national supervisory authorities under Solvency II;
- treatment of market and counterparty risk exposures in the standard formula;
- the use of internal models;
- treatment of related undertakings, including participations;
- undertaking-specific parameters; and
- valuation of technical provisions

Within 2 months of the issuance of the Guidelines, each competent authority within a Member State must confirm whether it complies or intends to comply with that Guideline. The PRA responded before the 2 month deadline to say that it will comply or that it intends to comply with all the Guidelines.

Before responding to EIOPA, the PRA made clear its compliance in 'Solvency II: applying EIOPA’s Set 1 Guidelines to PRA-authorised firms - CP5/15'. This paper consulted on a supervisory statement which clarified by the PRA expectations in relation to specific EIOPA Guidelines, namely:

- ancillary own-funds;
- classification of own-funds;
- ring-fenced funds;
- treatment of related undertakings, including participations;
- loss-absorbing capacity of technical provisions and deferred taxes; and
- group solvency calculation.

Firms are advised to read this supervisory statement in conjunction with the corresponding Guidelines to fully understand the PRA's approach to Solvency II requirements.

Next steps

Approval applications

On 1 April 2015, the PRA began to formally accept applications for approvals, in particular for internal models and the matching adjustment. The next few months will see extensive activity in relation to these applications.

To ensure timely approval of applications, firms are advised to read and comply with PRA expectations in the relevant supervisory statements.

Set 2 ITS and Guidelines

Set 2 of the ITS (which cover the below) are still outstanding but should, according to EIOPA's timetable, be in place before July 2015.

- Pillar 1 (quantitative basis);
- Pillar 2 (qualitative requirements); and
- Pillar 3 (enhanced reporting and disclosure) and supervisory transparency

Set 2 of the Guidelines (which cover the below) are also outstanding.

- Pillar 2 (qualitative requirements); and
- Pillar 3 (enhanced reporting and disclosure)

These Guidelines should be published by the end of July and competent authorities will then, again, have 2 months to 'comply or explain'.

Given the extensive Solvency II material produced by EIOPA and HM Treasury and the PRA meeting the 31 March Directive transposition deadline, the UK appears to be on course for meeting the 1 January 2016 implementation date.

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