



Financial Services Authority

Delivering Solvency II

April 2011

Foreword



Solvency II comes into force in less than two years' time, a challenging timeline and one which means that we and firms have to work together to get to day one. There are areas of the new regime that are known at this point in time, and many that are still to be negotiated and agreed in Europe.

This challenge involves the building of processes and systems to support and deliver the Directive in the UK – the nuts and bolts – at the same time as delivering the cultural change required in firms so that everyone understands their role in delivering the required risk management, governance, reporting and capital requirements.

We must all keep pace with developments in Europe and the UK so that we are clear on what is known, what is not yet known and when we expect further clarity, and this document seeks to set out the current state of play in European policy development. We have also taken the opportunity to clarify the common misunderstandings that we have come across in our engagement with the UK industry – something that will no doubt continue until we get the final policy. We ask the industry to keep telling us about these so that we can set the record straight or seek clarity from others.

This document, along with the Conference materials, will give you a snapshot of current issues, and we encourage firms and others affected by, or interested in, Solvency II to use the dedicated pages on our website (www.fsa.gov.uk/Solvency2) to keep abreast of developments as we continue on the path to delivering Solvency II, in addition to the official European sources of information.

Julian Adams
Solvency II Sponsor and Director of the Insurance Division

Background to Solvency II

Solvency II will set out new, stronger EU-wide requirements on risk management and capital adequacy for insurers with the aim of increasing protection for policyholders. The strengthened regime should reduce the possibility of consumer loss or market disruption in insurance, and should also make it easier for firms and groups to do business across the European Union (EU), by replacing the current disparate local solvency requirements established to supplement Solvency I with more consistent requirements.

Policy timelines

The Solvency II Directive (sometimes referred to as the level 1 text) was adopted by the European Parliament and Council on 25 November 2009 and will be adopted by all 27 EU Member States, plus the three non-EU European Economic Area (EEA) countries. The Directive is expressed to commence on 1 November 2012. Delegated acts (formerly referred to as level 2 implementing measures), implementing technical standards and guidance, will also be developed in Europe concerning specific aspects of Solvency II. More information about these will become available when the Commission's proposal for the Omnibus II Directive (which includes amendments to the Solvency II Directive – see below) is negotiated and adopted by the European Parliament and Council.

The proposal for the Omnibus II Directive was published on 19 January 2011. The proposal amends the Solvency II Directive to:

- i. bring it in line with the new supervisory structure and powers within the European Union, in particular, to facilitate the role of the European Insurance and Occupational Pensions Authority (EIOPA) in Solvency II;
- ii. give the Commission broad powers to specify transitional arrangements for the Solvency II Directive; and
- iii. extend the implementation date by two months to 1 January 2013 to ensure better alignment with the end of the financial year for the majority of insurance and reinsurance undertakings.

The fact that the Omnibus II proposal flags a number of possible areas for transitionals and that in some cases the maximum length of the transitionals is ten years has been misinterpreted by some as meaning that Solvency II is delayed for ten years. This is not the case. It is important to recognise that the proposal creates the ability, and not a requirement, for the Commission to develop transitional measures and their duration. As noted above, the proposed Solvency II implementation date is 1 January 2013 and we and firms are working to this date.

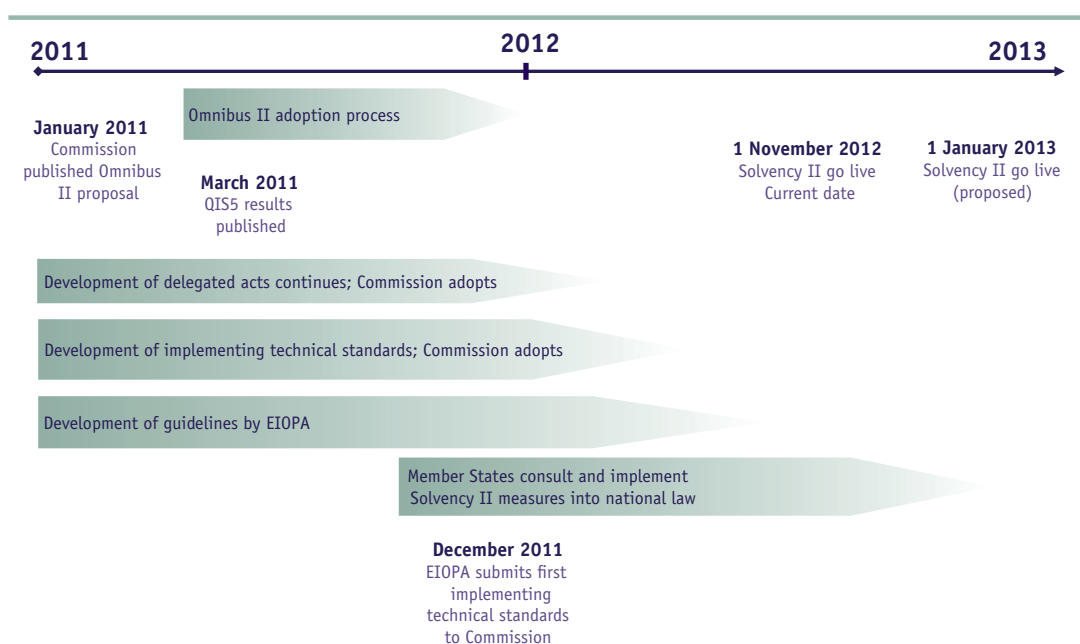
Consequently, the sequence of European policy development is as follows:

- i. the proposal for the Omnibus II Directive has to be adopted through the European process;

- ii. the delegated acts can only be published after the Omnibus II Directive has been adopted; and
- iii. it is expected that implementing technical standards and the majority of guidance by EIOPA will only be able to be finalised once the delegated acts have been published by the Commission.

We await clarity from the Commission on the timetable and, in the meantime, have reproduced here our indicative expectations, which reflect our own planning assumptions.

European process



NB: on current plans as at 10 March 2011, and incorporating EIOPA's medium-term work plan dates.

Transposition of the Directive

While the Solvency II Directive is mainly maximum harmonising and we have limited scope for discretion in implementation, we are obliged under the Financial Services and Markets Act 2000 (FSMA) to undertake a cost benefit analysis and consultation on the changes that will be required to be made as a consequence of Solvency II to the FSA Handbook.

Assessing the overall benefits of Solvency II is a complex exercise and the answer on a pan-European basis could well be different from the results on a national basis alone. However, the goal of Solvency II is not necessarily to increase the amount of capital supporting the insurance industry across the board, but rather to ensure that capital is more appropriately aligned with the risks. Our cost benefit analysis (CBA) will reflect both the potential additional capital requirements, and the administrative costs of implementation.

Implementing the Solvency II framework into the UK's regulatory regime will necessitate significant changes to the FSA Handbook as it applies to affected firms. It is our intention to replace the current Prudential sourcebook for Insurers (INSPRU) and the parts of the General Prudential sourcebook (GENPRU) which are applied to firms within the scope of Solvency II with a new Solvency II sourcebook. There are also likely to be a number of changes to other areas of the Handbook, e.g. systems and controls (SYSC), conduct of business (COBS) and consequential changes. We intend to adopt a 'copy-out' approach to drafting the rules (i.e. following the words of the level 1 text) as far as possible.

To the extent that the FSA does not currently have the relevant rule-making power to implement the requirements of the Directive, the Treasury will have responsibility for implementation of the necessary statutory instruments and/or legislative amendments, and we are co-ordinating with them closely on this aspect.

The FSA's consultation process will relate to transposition of the level 1 text and consequential changes to the Handbook. We will publish our consultation timeline on our [website](#) in due course. Our consultations are likely to remain open for three months and we currently anticipate publishing policy statements, which will include final rules, as soon as practicable following the closure of each consultation.

The maximum harmonising nature of the regime means that there is likely to be limited policy discretion at a domestic level, and limited ability to 'gold plate' the Solvency II regime by introducing additional requirements. It is anticipated that the delegated acts will take the form of an EU Regulation and, as such, they will apply directly to firms without the need to be transposed into domestic law.

Policy issues: The top five

There are a number of areas where policy uncertainties persist. We list below some of the uncertainties that have been identified in our ongoing engagement with the UK industry and from the recent fifth quantitative impact study (QIS5). These will, by and large, be clarified when the delegated acts, implementing technical standards and guidance is agreed, and we will update our [website](#) when we have more information.

a) Standard formula solvency capital requirement (SCR)

Correctly calibrating the standard formula is a key priority for firms. Whilst some firms may wish to use an internal model, many will still rely on parts or all of the standard formula. As a result we are committed to dealing with areas of both over-calibration and under-calibration and we continue to press the Commission for appropriate capital requirements adequately calibrated to a 99.5% Value at Risk (VaR) measure for each risk sub-module. For example, we have already highlighted non-life catastrophe risk as a particular area for further work.

b) Illiquidity premium in technical provisions

We are fully aware of the importance of the illiquidity premium to UK annuity writers, and continue to press the Commission for both a 12 year transitional for the back book of annuities, and a clear formula for the front book. The Omnibus II proposal provides for a transitional for technical provisions which holds the door open to the possibility of a potential increase in the seven year transitional for the illiquidity premium originally proposed in the draft delegated acts. However, we recognise that no illiquidity premium for either the front or back book is currently guaranteed and we will continue to press for a 12 year transitional in negotiations, both of the Omnibus II Directive and delegated acts.

c) Contract boundaries

The definition of contract boundaries is ambiguous for both life and non-life firms. It is crucial that the contract boundary definition is practicable for all firms and correctly captures the obligations to the firm (and avoids imprudence). There is also a risk that firms will change terms and conditions of contracts to move contract boundaries to achieve a more favourable balance sheet position. Clear guidance is sought in Europe.

d) Equivalence assessments

We recognise that third country equivalence is an important issue for many firms in the London market and more widely. The European Commission has begun the process of undertaking equivalence assessments and agreed the initial wave of countries to be assessed. Bermuda and Switzerland will undergo full assessment; Japan for reinsurance only. The Commission has decided that there will not be any further waves before Solvency II implementation. The proposal for the Omnibus II Directive contains transitional provisions in the three areas of equivalence, namely reinsurance with third country reinsurers (Article 172), subsidiaries in third countries (Article 227) and groups with parent undertakings in third countries (Article 260). The effect of these proposed transitional provisions is to treat the relevant third countries as if they had been assessed as equivalent under Article 172, 227 or 260 (as applicable) for a limited period of time, even though such equivalence assessments will not have been carried out.

In preparation, we have asked our supervisors to gather information from their discussions with firms about which are the most important third countries in the context of Articles 227 and 260 so that we have an informed list of priorities. This will prove helpful if any EU/EEA group supervisor decides to undertake an equivalence assessment under Article 227 or 260 (where no decision has already been made by the Commission and the relevant third country is not within the scope of the transitional provisions referred to above). However, any assessment by the group supervisor will only be initiated after the publication of the Commission's criteria for assessing equivalence and in light of the operation of the transitional arrangements referred to above.

According to current timelines, EIOPA will be delivering its advice to the Commission regarding the initial equivalence assessments by September 2011. At this stage it is expected that the Commission will release the third-country equivalence assessment criteria for Articles 172, 227, and 260 later this year. Note the Commission's plan (at the time of writing) is to publish mid to late next year the final results of the initial wave of assessments and the countries to which the abovementioned transitional provisions will apply.

e) Data collection and reporting

It is expected that EIOPA will conduct formal consultation on the generic templates for each of the seven broad reporting areas after the delegated acts have been published.

In addition to the European templates, we will be developing national specific reporting templates. It is beneficial for firms to understand the reporting requirements in their entirety and we will be consulting on the national specific templates as part of our domestic consultation process.

We anticipate that any specific issues relating to reporting will also be addressed in these consultations. However, firms should already be working on their data sources, ensuring that there is transparency and quality in the data gathered so that it is understood by the business, and can be processed for both regulatory and business purposes.

Policy – influencing the debate

It is really important that the UK industry continues to engage with the policy debate as we further develop the Solvency II policy landscape. There are a number of ways to do this, including keeping pace with European policy developments at EIOPA and the Commission, channelling comments through trade organisations and the Treasury.

We strongly encourage the industry to take part in our consultations on country-specific issues and implementation when they are published.

Implementation

Implementing Solvency II is a major challenge for the FSA, and is the largest programme of its type we have ever undertaken. While the Solvency II regime is in many ways consistent with the way we have been supervising insurance companies in the UK for a number of years, there are a number of significant changes for which we and firms need to be ready.

We have been engaging with firms since 2008 on implementing Solvency II, principally in the area of internal model approval, but also more broadly on firms' preparedness for the new regime. As we move closer to the implementation date, it is necessary for us to increase our efforts to ensure that both we and firms have completed work that

needs to be done before January 2013, as well as putting in place the capabilities that will be needed to ensure ongoing compliance after implementation.

As is the case for firms, we are building our approach to implementation without full certainty about the final requirements of the regime. This means that we are designing our approach with a degree of flexibility, which will allow us to accommodate any future changes arising in the delegated acts, implementing technical standards and guidance. It is not possible for us or firms to wait until there is full certainty, as this would not allow sufficient time for implementation.

We have also looked again at our ability to execute all aspects of our plan, to make sure that it is realistic and achievable while also compatible with the risk-based approach we take to all of our supervisory responsibilities. The immediate impact of this will be in internal model approval, where there will be a more graduated approach to the level of resources we are able to devote to individual firms during the pre-application phase. For those to whom we are able to devote less resource, we are developing a suite of tools to assist us in assessing model adequacy; we will also introduce a system whereby we will take account of external review of the suitability of some model components. We will share information with firms should they wish to take the tools into account in their model development and testing.

Whatever the scale of their participation in pre-application, all firms in pre-application will be able to submit an application for model approval at the time that we are open to receive such applications. We have previously indicated that this would be in October 2011 (12 months in advance of the implementation date of 1 November 2012 set out in the Directive), but changes in the European policy timetable mean that we will not have full certainty on all aspects of the new regime by that date. We will therefore be open to receive formal applications nine months before the implementation date, which will be 30 March 2012 (based on the proposed commencement date of 1 January 2013) for internal model approval. By this time, we expect that there will be significantly more certainty about the shape of the final regime and also around what other sorts of applications and processes there may need to be for other provisions of the Directive, which envisage our approval.

In the meantime, we expect firms to continue their planning for implementation, both for internal model approval and other aspects of the regime. We will implement a fully compliant regime on the implementation date, and will expect firms to be in a position to comply with their obligations on that date also.

Getting involved in FSA forums

We have a number of forums where firms, trade bodies and other stakeholders are invited to discuss key developments and issues in the policy negotiations and implementation of Solvency II. These include:

- the Insurance Standing Group; and
- various expert groups, including internal models, Pillar 5 (covering Pillars 2 and 3), operational risk, life and non-life insurance groups.

If you are interested in finding out more, please complete the form on our [website](#).

Contact us

It's really important that we continue to hear views and questions from the UK industry. This informs our thinking and identifies areas where we may need to give either general messages and updates, or specific responses.

Please email:

- Solvency2@fsa.gov.uk for general queries about the Directive.
- IMAP@fsa.gov.uk for queries about the Internal Model Approval Process (IMAP).
- S2Comms@fsa.gov.uk for general questions, concerns or suggestions.

Your usual supervisory contact is available to speak to you about Solvency II and what it means for you and your firm.

Further information

- www.fsa.gov.uk/Solvency2
- www.eiopa.europa.eu
- www.ec.europa.eu/internal_market/insurance/solvency/index_en.htm

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