Published in issue 123 of the Journal of the British Insurance Lawyers Association

The path to Solvency II implementation – rocks and hard places

By Chris Finney

Introduction

Solvency II will create a new prudential regime for insurers.

When the Solvency II Directive[1] was made, the new regime was being created under the Lamfalussy process. The Directive gave us the Level 1 text. We were expecting a Level 2 directive, Level 3 guidance and binding technical standards to complete the regime. We were also expecting compliance to begin on 1 November 2012.

This began to change when the Treaty for the Functioning of the European Union came in to force[2]. That change was accelerated by the EIOPA Regulation[3]. The Omnibus 2 Directive will complete it[4].

Today, we are expecting Omnibus 2 to amend the Solvency II Directive. We are also expecting delegated acts instead of a Level 2 directive[5], and regulatory and implementing technical standards instead of binding technical standards. We are still expecting Level 3 guidance, but there might be rather less of it than we thought. Formal compliance will not begin until 1 January 2014.

This article analyses the new European Union legislative process and the Solvency II difficulties it creates. It also looks at the current notional Solvency II timetable, before explaining why the United Kingdom is stuck between a rock and a hard place, and what that means for firms.

The Treaty for the Functioning of the European Union

Like its predecessors, the Treaty for the Functioning of the European Union (the "Treaty") gives the European institutions the power to adopt regulations, directives, decisions, recommendations and opinions. Regulations, directives and decisions are legally binding. Recommendations and opinions are not[6].

Regulations are legally binding in the Union's Member States. Directives bind the Member States. Each directive requires the Member States to make laws that will achieve a particular outcome, but leaves it to individual States to decide how to do that. Decisions are only binding on those to whom they are addressed[7].

Legislative acts

The Treaty describes regulations, directives and decisions as "legislative acts". Legislative acts are usually made when they are adopted jointly by the European Parliament (the "Parliament") and the Council on a proposal from the European Commission (the "Commission")[8], and they come in to force on the date specified in them.

Delegated acts and implementing acts

Legislative acts can be used to give a power to the Commission to adopt "delegated acts".

Delegated acts can only be used to supplement or amend the non-essential elements of the legislative act that gives the Commission this power. The legislative act must specify the objectives, content, scope and duration of the delegated power. It must also lay down the conditions to which it is subject. One possible condition is that the Parliament and Council may revoke the power to make relevant delegated acts at any time. Another is that the delegated act cannot enter into force if the Parliament or Council object to it within a particular period[9].

Legislative acts can also be used to give the Commission the power to make "implementing acts". This power can only be given if "uniform conditions for implementing [legislative] acts are needed"[10]. If the Parliament and Council give the Commission a power to make implementing acts, they must use a regulation to allow the Member States to control the way the Commission uses it[11].

The European Insurance & Occupational Pensions Authority: standards & guidance

The European Insurance and Occupational Pensions Authority ("EIOPA") was created by regulation[12] (the "Regulation"). The Regulation sets EIOPA's tasks and gives it the powers it needs to carry them out.

In particular, the Regulation gives EIOPA the power to draft Regulatory Technical Standards ("RTS"), draft Implementing Technical Standards ("ITS") and give guidance.

Regulatory Technical Standards

If the Parliament and Council use a regulation or directive to give the Commission a power to adopt RTS as delegated acts, the Regulation automatically gives EIOPA the power to develop draft RTS for possible adoption by the Commission. RTS must be genuinely technical. EIOPA is not empowered to make strategic decisions or policy choices[13].

EIOPA must publicly consult on the draft RTS it prepares. EIOPA must also ask the Insurance and Reinsurance Stakeholder Group (the "Stakeholder Group") for an opinion on its draft RTS and analyse the RTS costs and benefits, unless it would be disproportionate to do so or the matter is urgent[14]. When that process is complete, EIOPA must submit its draft RTS to the Commission.

The Commission has three months from the date of receipt to decide whether to endorse EIOPA's draft RTS or not. It also seems to have the power to adopt EIOPA's draft at any time during this period[15].

If the Commission intends not to endorse a draft RTS, or to endorse it in part or with amendments, it must return it to EIOPA explaining why. EIOPA then has six weeks to

respond. If EIOPA amends the draft in the way the Commission has proposed and resubmits it, the Commission will probably adopt it. (The Regulation does not seem to require it to do so.)

If EIOPA does not submit an amended draft, or it submits a draft that does not match the Commission's amendments, the Commission may adopt an RTS with the amendments it considers relevant or reject it. However, it is probably only entitled to amend EIOPA's draft RTS and to adopt that version if it is in the European Union's interests to do so[16]. Perhaps strangely, it seems to be for the Commission to decide what is in the Union's interests, and what is not.

If EIOPA submits a second draft RTS, which is not in the form suggested by the Commission, and the Commission rejects it, it must give its reasons for doing so. The Parliament and Council may then invite the European Commissioner and the chair of EIOPA to attend an ad hoc meeting of a Parliamentary committee to present and explain their differences[17]. The Regulation does not say what should happen after that. There is, perhaps, an implied assertion that the committee meeting will lead to resolution and RTS adoption. Whether or not that is right, the Regulation seems to assume these differences will rarely emerge.

If the Commission chooses to adopt an RTS, it must do so by regulation or decision. The adopted regulation or decision will be published in the Official Journal and come in to force on the date specified in it[18].

The Parliament and Council used the Regulation to give the Commission the power to adopt RTS, and the Regulation allows them to withdraw that power at any time.[19] The Regulation also provides that, if the Commission adopts an RTS, it will not come in to force if the Parliament or Commission object to it within three months of the Commission adopting it. The Parliament or Council may extend this time limit may by three months on their own initiative. However, each of these time limits is reduced to one month if the Commission adopts EIOPA's first draft of an RTS[20].

Implementing technical standards

Legislative acts can also give EIOPA a power to develop ITS for possible adoption by the Commission as implementing acts.[21]

The process for making ITS is identical to the process for making RTS, save that, where the process for making RTS gives the Commission three months to decide whether to adopt an RTS and a power to extend the initial period by three months, the Commission may only extend the process for making ITS by one month. In addition, there is nothing in the Regulation that allows the Parliament or Council to revoke the Commission's power to adopt ITS and there are no objection provisions either.

Guidance

The Regulation gives EIOPA the power to issue guidance and recommendations to Member States and financial institutions. The guidance and recommendations should be used to establish consistent, efficient and effective supervisory practices and to help ensure the common, uniform and consistent application of Union law[22].

If EIOPA if proposing to issue guidance or a recommendation, it is required to consult on its proposals and to analyse their costs and benefits (if it is appropriate to do so). It is also required to ask the Stakeholder Group for an opinion on its proposals[23].

The supervisory authorities in the Member States and the relevant financial institutions are required to make every effort to comply with EIOPA's guidance and recommendations. Within two months of the issue of guidance or recommendations, supervisory authorities must tell EIOPA whether they comply, or intend to comply. If they do not comply or intend to comply, they must explain why. If the guidance or recommendations require it, relevant financial institutions must also report whether they comply or not[24].

Omnibus 2

If Omnibus 2 is adopted by the Parliament and Council in its present form[25], it will require the Commission to adopt delegated acts to further specify:

- The information each firm must give to its supervisor to enable effective supervision[26];
- When a capital-add on can be imposed and how it should be calculated[27];
- The elements and standards required of the firm's governance arrangements, risk management and internal control systems, internal audit and actuarial functions and the conditions under which outsourcing may be performed[28];
- The information to be included in a firm's Solvency and Financial Condition Report, when the report must be disclosed and how[29];
- The methods and assumptions to be used to value assets and liabilities and calculate technical provisions[30];
- The criteria to be applied when a supervisor considers whether to approve a firm's assessment and classification of its own funds, the use of ancillary own funds and, in each case, the quantitative limits to be applied to the different tiers of capital[31];
- The methods, assumptions, adjustments and parameters to be used when calculating the Solvency Capital Requirement ("SCR") or basic SCR (as the case may be)[32];

- The tests an internal model must meet before approval can be given, and the process to be followed when an application for approval is being considered[33]; and
- The Minimum Capital Requirement calculation[34].

Omnibus 2 also allows the Commission to adopt delegated acts specifying quantitative limits and asset eligibility criteria to address risks not adequately covered by the SCR sub-modules, if that is necessary[35].

Omnibus 2 requires EIOPA to prepare draft ITS. Most of EIOPA's ITS will add detail to the delegating acts prepared by the Commission, although some will supplement the Solvency II directive without delegated acts intervening. EIOPA is required to prepare its ITS to a timetable, which requires the first drafts to be submitted by 30 September 2012, with the balance to follow by 31 December 2014 or 31 December 2016 (the date varies according to the subject matter).

Omnibus 2 does not currently require EIOPA to develop any RTS, although the final version will probably do so[36].

The Commission's power to adopt delegated acts lasts for five years from the date Omnibus 2 comes in to force (expected to be early 2012); but it is automatically renewed in five year periods, unless it is revoked by the Parliament or Council.

The Commission's power to adopt draft ITS is not time limited.

Omnibus 2 and the path to implementation

Omnibus 2 lays out a basic Solvency II implementation timetable, which is designed to ensure that all Member States and all relevant firms progress towards implementation day and Solvency II compliance together. The implementation timetable requires[37] Member States to:

- Adopt and publish the laws they will use to implement the Solvency II Level 1 directive by 31 March 2013;
- Adopt and publish laws by 1 April 2013 that will require each relevant firm to submit an implementation plan to its supervisor by 1 June 2013. The plan must evidence the firm's progress towards Solvency II compliance and explain how it will ensure full compliance by implementation day;
- Switch some of their implementing rules on so that, from 1 June 2013, firms can apply for and (if appropriate) secure an approval which is effective from 1 January 2014 to:
    - Count ancillary own funds as capital;
    - Secure supervisory approval of their own fund assessments and classifications;
    - Use undertaking specific parameters when they calculate their SCR;

  - Use a full or partial internal model;
- Require relevant firms to comply with Solvency II from 1 January 2014.

So when will Solvency II compliance have to begin?

The European Authorities have not published a comprehensive implementation timetable for Solvency II. From what has been published, and what seems to have been said (or at least implied) by European officials, most commentators now expect:

- The Presidency, the Council and the Parliament's Committee on Economic and Monetary affairs to agree a final version of Omnibus 2 before the end of 2011;
- The Parliament to vote on and adopt Omnibus 2 in December 2011 or January 2012;
- Omnibus 2 to be published in the Official Journal shortly after Parliamentary adoption, and to come in to force the same day;
- The most implementation critical delegated acts to be published in the first quarter of 2012, with adoption of the final texts to follow from September 2012;
- EIOPA's draft Level 3 guidance to be published from the first quarter of 2012 (EIOPA cannot publish its draft Level 3 guidance until after the Commission has published the relevant delegated acts);
- EIOPA's draft RTS and ITS to be published according to the Omnibus 2 timetable;
- The most implementation critical RTS and ITS to be adopted by the Commission from October 2012;
- Solvency II compliance to begin on 1 January 2014, 14 months after the Solvency II directive envisaged.

In strict legal theory, the delegated acts, and draft RTS and ITS cannot be developed and published until after Omnibus 2 has come into force - it is only at that stage that the Commission and EIOPA will have the powers they need to do the work. Some commentators have suggested that the Parliament and Council have already given the Commission and EIOPA special dispensation so they can start work much sooner than the law would allow and that must be right – otherwise, meeting the timetable would be impossible. Those commentators have also suggested that a dispensation will also be given so that implementation critical delegated acts can be published before Omnibus 2 comes into force. Whether that is also right remains to be seen.

Either way these arrangements create many problems for firms. In particular, requiring them to comply with Solvency II from 1 January 2014 is both too soon and too late.

It is too soon because, even if EIOPA and the Commission keep to the current timetable, the last of EIOPA's draft ITS will not be available until 31 December 2016, and they will

not be adopted until 2017 or 2018. That means it could easily be another seven years before Solvency II is fully made and in force (even if potential transitional arrangements are left to one side). One consequence is that policyholders and their beneficiaries will have to wait for the enhanced protection Solvency II is intended to give them. Another is that firms and their supervisors will have a wide margin of discretion when Solvency II first comes in to force, but that margin will gradually be eroded as EIOPA's RTS and ITS are adopted. This phasing may help some firms, but it will be inefficient and wasteful for others.

It is too late because many firms' Solvency II preparations are very advanced. It will be expensive for those firms to continue to comply with the current regime and to delay formal Solvency II compliance until 2014. Implementation fatigue means that it will also be difficult and frustrating to try.

The FSA's path to implementation – rocks and hard places

In recognition of these issues, or in spite of them, on 4 October 2011 the FSA changed its implementation assumptions.

The FSA now intends to transpose the Solvency II Directive into FSA rules by 1 January 2013, and to require firms to comply with them from 1 January 2014. The FSA also expects to be able to receive applications:

- From 1 January 2013, from firms that will use the standard formula to calculate their SCR but still need other supervisory approvals by 1 January 2014 (for example, approval to 'count' ancillary own funds or to use undertaking specific parameters in the SCR calculation instead of the standard parameters); and
- Between 30 March 2012 and mid-2013, from firms that want to use an internal model to calculate their SCR. Firms that are already in the pre-application phase of the internal model approval process will be given a submission slot. If they want the FSA to consider their application for approval to use an internal model and (if appropriate) to grant it before 1 January 2014, these firms must submit a complete set of applications for approval during their slot. For these purposes, a complete set of applications means the application for approval to use the internal model and any other applications the firm would like the FSA to grant before 31 December 2013. This will allow the FSA to consider the firm's applications as a package and (if appropriate) to grant them on consistent and appropriate terms.

This creates other difficulties. The FSA has pressed firms hard, at the behest of the Commission and others, to prepare for Solvency II compliance on 1 January 2013. Firms have worked hard and spent a great deal of money preparing for compliance by that date. Many have also begun to restructure their groups and change their investment strategies in ways that will deliver better outcomes under Solvency II than will be available under

the current regime. Many of these firms will be left wondering why the FSA has chosen to "punish" them for their "good behaviour" by delaying implementation by a year instead of allowing or requiring them to comply from 1 January 2013 in any event.

The same firms will also be wondering what happens now. There is a significant risk, which has not been been publicly addressed by the FSA, that these firms will have to comply with the current regime (including preparing their Individual Capital Assessments ("ICA") and responding to the FSA's Individual Capital Guidance ("ICG")) and Solvency II (if they want to embed, refine and keep their internal models up to date for reliable use in 2014).

Things are not much easier for the FSA. It has diverted scarce resource away from considering firms' ICAs and giving ICG so that it can be used to develop and implement Solvency II. Cranking ICA/ICG back up would be wasteful, but failing to do so could be negligent. Allowing some firms to comply with the current regime and others to opt in to Solvency II would also generate risk as firms choose the regime that gives them the best outcome and makes meaningful comparisons between firms all but impossible in the meantime.

The FSA is almost certainly considering how best to resolve these issues today. It has already said it will take a pragmatic approach to Solvency II implementation when it can. Doing that here might mean allowing firms that want to use an internal model to "opt in" to Solvency II from 1 January 2013 to avoid "double regime" costs, complications and risks. Whether that can be done seems to depend on the availability of European policy and relevant firms being able to satisfy the FSA that their models meet the relevant (but only partially available) Solvency II tests. Success would save time and money for these firms and that might be a just reward for the time and effort they have invested. But will it also lead to ICG "lite" and even less FSA interaction for standard formula firms, as the FSA focuses on internal model approvals?

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Endnotes

[1] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking up and pursuit of the business of Insurance and Reinsurance (the "Solvency II Directive")

[2] The Treaty for the Functioning of the European Union (the "Treaty") is sometimes called the Lisbon Treaty. It was agreed in Lisbon in 2007 and came in to force on 1 December 2009

[3] Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision number 716/2009/EC and repealing Commission Decision 2009/79/EC

[4] At the moment, the Omnibus 2 directive is at the proposal stage: Proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority – institutional file 2011/0006 (COD)

[5] For a long time, we were expecting a Level 2 Regulation, and an implementation date of 1 January 2013. The Commission prepared a draft of the Level 2 Regulation, and has distributed for pre-consultation to Member State Regulators on a confidential basis. That draft is now available publicly (http://217.71.145.20/TRIPviewer/show.asp?tunniste=E+177/2010&base=ueasia&palvelin=www.eduskunta.fi&f=WORD - You have to go through about 18 pages in Finnish before you get to it. You can also access it via the PDF icon at the top of the page). The draft Regulation is likely to be used as the base text for the Commission's delegated acts.

[6] Article 288 of the Treaty

[7] Article 288 of the Treaty

[8] Article 289(3) of the Treaty

[9] Article 290 of the Treaty. A Parliamentary objection must be a majority. A Council objection must be by a qualified majority

[10] This probably means the power can only be given to the Commission if the Parliament and Council want to be sure their legislative acts are implemented and applied in the same way across the Union

[11] Article 291 of the Treaty

[12] See footnote 3

[13] Article 10(1) of the Regulation

[14] Articles 10(1) and 37 of the Regulation

[15] Article 13(1) of the Regulation

[16] Articles 10(1) and 13(1), and recitals 22 and 23

[17] Article 14 of the Regulation

[18] See Article 10(4) of the Regulation

[19] See Article 12 of the Regulation

[20] Per article 13(1) the one month time limit applies if "the Commission adopts [an RTS] which is the same as the draft [RTS] submitted by [EIOPA]. Per article 10(1), paragraph 6, the resubmitted draft must be "in the form of an opinion". In other words, it is different to (and may no longer be) "a draft"

[21] See Article 15 of the Regulation and Article 290 of the Treaty

[22] See Article 16(1) of the Regulation

[23] See Article 16(2) of the Regulation

[24] See Article 16(3) of the Regulation

[25] By this, I am referring to the proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority – Presidency Compromise text dated 21 September 2011

[26] Article 2(4) of Omnibus 2 and article 35 of the Solvency II Directive

[27] Article 2(5) of Omnibus 2 and article 37 of the Solvency II Directive

[28] Article 2(7) of Omnibus 2 and articles 41 to 49 of the Solvency II Directive

[29] Article 2(10) of Omnibus 2 and articles 51 to 56 of the Solvency II Directive

[30] Articles 2(14) and (16) of Omnibus 2 and articles 76 to 85 of the Solvency II Directive

[31] Articles 2(17) to (19) of Omnibus 2 and articles 86 to 99 of the Solvency II Directive

[32] Articles 2(20) and (21) of Omnibus 2 and articles 100 to 111 of the Solvency II Directive

[33] Article 2(22) and (23) of Omnibus 2 and articles 112 to 127 of the Solvency II Directive

[34] Article 2(27) of Omnibus 2 and articles 128 to 130 of the Solvency II Directive

[35] Article 2(21) of Omnibus 2

[36] On 23 September 2011, the Committee on Economic and Monetary Affairs of the European Parliament published its proposed amendments to the Presidency's Omnibus 2 compromise text (the Presidency's Omnibus 2 proposal is referenced in end note 25). The Committee's proposed amendments include changing the implementing technical standards on capital add-ons, the valuation of assets and liabilities and the calculation of the standard formula SCR into regulatory technical standards

[37]Articles 2(72) to (74) of Omnibus 2