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November 2011

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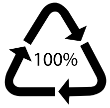

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1 Introduction to the Consultation Process

Subject of the Consultation

1.1 The Solvency II Directive will introduce new rules for insurance and reinsurance undertakings across the European Union. Member States must ensure their legislation complies with Solvency II rules.

Scope of the Consultation

1.2 The consultation seeks responses from interested parties, particularly UK insurance and reinsurance firms that fall within scope of the Solvency II Directive (Directive 2009/138/EC), on the way in which the Government intends to legislate for Solvency II rules through amendments to the forthcoming Financial Service Act or through the addition of freestanding provisions which sit alongside this.

Duration

1.3 The consultation will run for 12 weeks from 23 November 2011. The closing date for responses is 15 February 2012.

Enquiries and How to Respond

1.4 Respondents are encouraged to reply via email to:
solvency2consultation@hmtreasury.gsi.gov.uk

1.5 Alternatively you can reply by post to:

Solvency II Consultation,

c/o The Insurance and Savings Team,

Room 3/19 HM Treasury,

1 Horse Guards Road London,

SW1A 2HQ

1.6 Respondents should address any of the questions in the consultation document where they feel they can make a contribution, as well as offering any further comments they may have as and where appropriate. Please provide basic contact details for yourself and any organisation you represent in your response.

1.7 If you have any questions about the consultation please contact Emily Rayment at Emily.Rayment@hmtreasury.gsi.gov.uk

Telephone (Treasury switchboard) 020 7270 5565

Disclosure of Responses

1.8 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply with and which deals, amongst other things with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential.

1.9 If we receive a request for disclosure of the information you provide we will take full account of your explanation, but we cannot give assurance that confidentiality will be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Department. Your personal data will be processed in accordance with the DPA, and in the majority of circumstances, this will mean that your personal data will not be disclosed.

2 Background Information

The Solvency II Directive

2.1 The European Commission (Commission) established the Solvency II project in the early 2000s, to review and reform the rules governing direct life and non-life insurance undertakings and reinsurance undertakings ((re)insurance undertakings) operating in the European Union (EU).

2.2 The Solvency II Framework Directive (Directive 2009/138/EC) was agreed by the Commission, the European Parliament and the European Council in April 2009, with a date of 31st October 2012 for the Solvency II rules to come into force. By the entry into force date, (re)insurance undertakings established in the territory of an EU Member State or which wish to become established there, that fall in scope of Directive 2009/138/EC[1], are obliged to comply with Solvency II rules.

2.3 At the time it was agreed, it was clear that Directive 2009/138/EC would require further amendments to take account of the Treaty of Lisbon[2] before it was finally implemented.

2.4 In January 2011 the Commission published an amending Directive – Omnibus II, which proposed a number of amendments to take account of the new post-Treaty of Lisbon process, and the establishment of the European Insurance and Occupational Pensions Authority (EIOPA)[3]. Omnibus II also proposes delaying the entry into force date of Solvency II to better fit with the accounting cycles of EU Member States, and to help facilitate a smooth transition to Solvency II rules.

2.5 Omnibus II is currently under discussion and will not be adopted before this consultation is complete. It is therefore not yet clear what the entry into force date of Solvency II will be. Furthermore, the technical details of the Solvency II Directive (the Level 2 implementing measures – please see Box 2.A for more detail), which build on the rules laid out in Directive 2009/138/EC, cannot be formally published by the Commission until Omnibus II has been adopted by the European Council and European Parliament, so there is an inevitable level of uncertainty as to the detailed practical effect of implementing the Solvency II Directive.

2.6 Nevertheless, discussions on Omnibus II and the design of the Level 2 implementing measures have reached a stage where it is clear that the policy set out in Directive 2009/138/EC,

[1] The Solvency II framework Directive (Directive 2009/138/EC) can be accessed via the following hyperlink/website, where more detail on the scope of the Directive and exclusions from scope can be found within Chapter 1, Section 1, Articles 2-4: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

[2] The Treaty of Lisbon, which entered into force on 1st December 2009, has the effect of amending existing EU and Commission treaties. One such effect provides for a new EU supervisory rulebook for financial services.

[3] EIOPA is part of the European System of Financial Supervision. EIOPA's core responsibilities are to support the stability of the financial system, transparency of markets and financial products, as well as the protection of insurance policyholders, pension scheme members and beneficiaries.

and therefore the legislation that needs to be transposed into UK law, is sufficiently stable to allow the necessary transposition.

2.7 Amendments to the Financial Conglomerates Directive (FICOD) will also have the effect of amending aspects of Directive 2009/138/EC, by making many of the provisions which apply to undertakings, the parent of who is an Insurance Holding Company, applicable where the parent is also a mixed financial holding company and inserts a definition of that term.

2.8 The Government has therefore decided to consult now on how it intends to implement Directive 2009/138/EC in order to give (re)insurance undertakings as much certainty and clarity as possible and provide adequate time to prepare for implementation of Solvency II.

Subject Matter

2.9 Directive 2009/138/EC lays down rules concerning the following:

1. The taking-up and pursuit, within the Community, of the self-employed activities of direct insurance and reinsurance.
2. The supervision of insurance and reinsurance groups.
3. The reorganisation and winding-up of direct insurance undertakings.

Solvency II Consultation Document

2.10 The purpose of this consultation is to invite views on the changes the Government is making to UK legislation in order to transpose Directive 2009/138/EC.

2.11 Directive 2009/138/EC is a 'maximum harmonisation' Directive. Consequently, there is limited scope for EU Member States to apply discretion in the way in which it is transposed and implemented. The Government is consulting on the ways in which the changes that are required are transposed into legislation, in order to give stakeholders the opportunity to comment on its proposals. Responses are requested by 15 February 2012. The Government does not propose to use the implementation process to make any changes beyond those required by Directive 2009/138/EC.

Transposition

2.12 For full implementation of Directive 2009/138/EC, the Government needs to make amendments to UK legislation and the Financial Services Authority is required to make changes to their Regulatory Handbook[4]. Most of the requirements of Directive 2009/138/EC can already be achieved using powers provided by the Financial Services and Markets Act 2000 (FSMA) and the FSA's Regulatory Handbook. Therefore, the number of changes that are required to primary legislation is relatively small compared to the amount of provisions in the Directive.

2.13 The Government intends to transpose Solvency II using regulations made under 2(2) of the European Communities Act 1972, as set out in the Statutory Instrument in Annex B, available on the consultation web-page. The Statutory Instrument contains provisions amending FSMA as it will be amended by the forthcoming Financial Services Bill, which is due to be introduced to Parliament in early 2012. The timing of the Bill's progress will then be subject to Parliamentary timetabling considerations. The proposed legislative changes are therefore presented in that

[4] The FSA's Regulatory Handbook presents guidance and regulations for UK (re)insurance undertakings (and other parts of the UK financial sector). More information can be found via the following hyperlink: http://fsahandbook.info/FSA/html/handbook/

context, and grant or amend the powers of the appropriate regulator (in practice, the Prudential Regulatory Authority (PRA), rather than the Financial Services Authority (FSA)).

2.14 The required legislative changes fall into four broad categories:

- The amendments necessary to set out the conditions under which undertakings may be authorised and de-authorised to carry out insurance and reinsurance business;
- New powers for the PRA, aimed mostly at enabling the PRA to approve the instruments (re)insurance undertakings need to calculate their solvency position on a Solvency II basis;
- New duties for the PRA aimed at mandating their participation in the new European supervisory framework; and
- Amendments to align UK terms and definitions with those set out in the Directive 2009/138/EC.

2.15 In the draft Solvency II Statutory Instrument, Part 2 provides for amendments to FSMA (as amended by the Financial Services Bill) where powers and mandates are needed by the PRA which are related to or are an extension of those already provided for in FSMA. Otherwise, where the PRA needs powers and mandates emanating out of Solvency II, or it is necessary to impose obligations on firms, which are distinct from FSMA provisions, Part 3 provides freestanding provisions which are applicable for the purposes of complying with Solvency II only.

Scope of the Consultation

2.16 The scope of this consultation document is restricted to the changes the Government intends to make to FSMA, as amended by the forthcoming Financial Services Bill, and the design and effect of the freestanding provisions, which sit alongside this, to transpose Directive 2009/138/EC, outlined in Chapter 4 of this consultation document.

2.17 Given timetabling issues (see paragraph 2.5), it may be the case that those provisions in the Statutory Instrument which relate to the granting of approvals (Part 3, regulations 16 to 19 and 31 of the Statutory Instrument) will need to be brought into force before the Act amending FSMA has received Royal Assent. If that were the case, the relevant provisions (which do not amend FSMA but are freestanding provisions in Part 3 of the Statutory Instrument in Annex B) will be put into their own instrument and brought into force earlier than the rest of the regulations.

2.18 The Government is not consulting on the changes the FSA is required to make to its Regulatory Handbook in order to complete transposition of Directive 2009/138/EC, and ensure compliance with Solvency II rules. The FSA is consulting separately on the ways in which it will implement these requirements, primarily in the consultation paper CP11/22 *Transposition of Solvency II - Part 1.* A link to the FSA's consultation document, including a cost benefit analysis and draft Handbook text, is available on the consultation web-page.

2.19 This consultation does not cover the Level 2 Implementing Measures which will provide the technical details and processes through which Directive 2009/138/EC will take effect. The Commission has indicated that the Level 2 measures will be made by regulation once they are finalised, and they will not therefore need transposing into UK law, but will apply automatically.

2.20 The Solvency II Impact Assessment, published alongside this consultation document (please see Annex A on the consultation web-page), will consider the effect the introduction of Directive 2009/138/EC will have in the round, including the changes to legislation both the Government and FSA plan to make.

Box 2.A: Solvency II Directive – The Lamfallusy process

Solvency II is being developed in four distinct levels, as per the Lamfallusy process for designing Financial Services Directives in the EU:

- Level 1 was completed in April 2009, when the Commission's Framework Directive (Directive 2009/138/EC) was agreed by the Commission, the European Council and the European Parliament. The Framework Directive sets out the high level principles of Solvency II.
- Level 2 builds on Directive 2009/138/EC, adding technical detail to its framework in legally binding form, probably regulations. Following ratification of the Treaty of Lisbon, the Level 2 text will comprise of a combination of delegated acts and implementing acts, with some of these acts being in the form of Binding Technical Standards drafted by EIOPA but adopted by the Commission.
- Level 3 facilitates the implementation of the Level 2 text. This entails EIOPA developing guidelines and standards and adding further non-binding technical detail to the Level 2 text as and where necessary, assisting (re)insurance undertakings in their preparation to comply with Level 2 rules by the entry into force date.
- Level 4 is the process of verifying Member States' compliance with Solvency II rules.

The UK Insurance Market in context

2.21 The UK insurance industry is an important part of the UK's financial services sector, and plays a key role in the economy of the UK. The UK's insurance industry is the third largest in the world, and is a major exporter, with 28% of its net premium income coming from overseas business. There are more than 700 UK-based companies employing 290,000 people in the UK, which manage total investments in excess of £1.7 trillion[5], equivalent to approximately 26% of UK total net worth.

2.22 The industry also acts as a stable, long-term investor – providing supply of the sort of investment that is needed for long-term economic growth. Regulation of insurance therefore needs to strike the right balance between providing adequate protection for policyholders while allowing the industry to thrive, compete effectively, and contribute to economic growth in a sustainable way.

Overview of the Current Supervisory Regime

2.23 The existing EU regulatory regime, Solvency I, was introduced in 2002, and established a basic prudential framework for the insurance and reinsurance industry. Since 2002, several EU Member States imposed additional regulatory requirements to better capture the underlying risks of (re)insurance undertakings, to keep pace with market developments and practice, and to enable firms to use their capital more efficiently.

[5] Figures taken from the Association of British Insurers' September 2011 report 'UK Insurance – Key Facts'. Figures correct at time of publication.

2.24 Since 2004, the FSA has operated an Individual Capital Adequacy Standards (ICAS) framework[6]. In many ways the ICAS framework is similar to the framework underpinning Solvency II. Critically, this includes:

- Requirements on (re)insurance undertakings to undertake regular assessments of the amount and quality of capital which, in their view, is adequate for the size and nature of their businesses, with review by the FSA and potential imposition of additional requirements. This is very similar to the internal model process in Solvency II. Please see paragraphs 4.22 to 4.27 of the consultation document for more information.

- Incentives for undertakings to measure and assess their risks in a more sensitive way, including a market consistent valuation of assets and liabilities. Please see paragraph 3.4 for more information on Solvency II's 'market consistent' approach.

- A dual supervisory intervention mechanism (Enhanced Capital requirement and Minimum Capital Requirement), not dissimilar to the Solvency Capital Requirement and Minimum Capital Requirement of Solvency II. Please see paragraphs 4.15 to 4.34 for more information on Solvency II's Solvency Capital Requirement and Minimum Capital Requirement.

2.25 These inherent similarities make the move from Solvency I to Solvency II a much smoother passage for the insurance industry in the UK than for (re)insurance undertakings in the majority of EU Member States that have remained closely aligned with the minimum requirements of Solvency I.

2.26 The changing of the current system of financial regulation in the UK will not affect this. The FSA will cease to exist in its current form once the new Financial Services Bill is enacted, and the Government will create two new financial regulators in its place: the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Both the PRA and FCA will have an important role in the regulation of the UK insurance industry, as directed by their objectives, but the PRA will be solely responsible for the prudential supervision of (re)insurance undertakings.

[6] More information on the ICAS framework can be found via the following hyperlink, a December 2006 Policy Statement from the FSA on the 'Prudential Changes for Insurers': http://www.fsa.gov.uk/pubs/policy/ps06_14.pdf

3 Introduction to Solvency II

Solvency II

3.1 Solvency II will create a harmonised, single EU (re)insurance market, bringing all Member States up to the same level of prudential regulation and displacing the patchwork of rules that currently exists across the EU.

3.2 The primary objective of Solvency II is to ensure policyholders and beneficiaries are appropriately protected. Solvency II achieves this through introducing more risk-sensitive prudential requirements, which better consider the overall financial soundness of (re)insurance undertakings and account for risk in a more proportionate way.

Strengthening policyholder protection

3.3 The financial crisis of 2008 highlighted the importance of a robust financial system. Solvency II seeks to ensure the insurance industry remains able to withstand market pressure in the future, and to protect policyholders' interests and investments.

3.4 Solvency II starts from the EU wide adoption of mark to market, or market consistent, accounting standards, which introduces greater risk-sensitivity. Market consistent principles require (re)insurance undertakings to account for the fair value of assets and liabilities based on current market prices. This means the valuation of insurers' assets and liabilities is more reflective of prevailing market conditions.

3.5 In addition, Solvency II introduces a two-tier capital requirement across Europe - the Solvency Capital Requirement, and the Minimum Capital Requirement. This gives (re)insurance undertakings more flexibility to withstand and manage market pressures, and gives EU supervisory authorities the opportunity to take a graduated approach to intervention when problems are encountered.

3.6 Solvency II introduces greater qualitative requirements also, which incentivises effective risk management and improves transparency across the industry. Improving supervisors' ability to review and compare industry-wide data will give supervisors a better understanding of risks both within individual firms and across the industry.

3.7 And, importantly, Solvency II recognises the economic reality of how insurance groups operate. Solvency II will strengthen the powers of the group supervisor - ensuring group-wide risks are not overlooked, and will require more cooperation between supervisors. Further, the establishment of supervisory colleges seeks to better facilitate the exchange of information between supervisory authorities, and improve its effectiveness.

3.8 Solvency II also considers the equivalence of certain regulatory regimes of non-EU jurisdictions to Solvency II, to help mitigate against any adverse effects EU (re)insurance groups could be forced to withstand whilst operating outside of the EU, and to support their ability to compete effectively in global insurance markets.

Supporting a sustainable and competitive industry

3.9 As well as improving policyholder protection, the enhanced sensitivity of risk assessment and management required under Solvency II will also act to improve the efficiency and competitiveness of the industry.

3.10 The introduction of a pan-European risk-sensitive regime enables (re)insurance undertakings to hold more proportionate and appropriate levels of capital against their risks. In particular, undertakings will be incentivised to undertake a more tailored assessment of their risks by developing and using (once approved by the PRA) their own full or partial internal models, and undertaking specific parameters. This allows undertakings to assess their Solvency Capital Requirement in a way that is tailored to the nature and reality of their business, and, with group-wide models, allows better assessment of the benefits of diversification, and risks of correlation, at group level.

3.11 Lastly, a deeper, single EU insurance regime better facilitates cross-border activity and enables firms to compete in a broader range of markets.

4 Technical Detail of Solvency II

4.1 This chapter covers some of the technical detail of Solvency II. Readers who already have an understanding of some of the more technical aspects of Solvency II may wish to skip to Chapter 5, 'Content of Consultation and Process for Responding'.

Architecture of Solvency II

4.2 The architecture of Solvency II, and the set of rules underpinning it, is built on a 3 pillar framework:

- Pillar I – contains the quantitative requirements;
- Pillar II – contains the qualitative requirements; and
- Pillar III – contains disclosure and reporting requirements

4.3 There are also specific rules for reinsurance and insurance groups ((re)insurance groups), laid out in Directive 2009/138/EC, and rules for EU based (re)insurance groups with businesses in non-EU jurisdictions, and non-EU based (re)insurance groups with businesses in the EU.

Pillar 1 – Quantitative Requirements

4.4 Pillar I covers the quantitative requirements a (re)insurance undertaking is expected to meet. Broadly speaking, this covers the amount and quality of capital a (re)insurance undertaking is required to hold after undertaking a market consistent valuation of its assets and liabilities, and determining its requirements for Own Funds.

Assets and Liabilities

4.5 A (re)insurance undertaking is required to undertake a market consistent valuation of its assets and liabilities under Solvency II, in order to determine its solvency position. Solvency requirements are based on an economic valuation of the whole balance sheet. As such:

- Assets shall be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction, and
- Liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction.

Technical Provisions

4.6 A (re)insurance undertaking is required to establish technical provisions to cover its reinsurance and insurance liabilities (liabilities), corresponding to the current amount a (re)insurance undertaking would have to pay to transfer its liabilities immediately to another (re)insurance undertaking.

4.7 The value of technical provisions is equal to the sum of a (re)insurance undertaking's best estimate of its liabilities, plus a risk margin. The best estimate (of a (re)insurance undertaking's

liabilities) corresponds to the probability weighted average of future cashflows, taking account of the time value of money, using a relevant risk-free interest rate term structure.

4.8 The risk margin is calculated to ensure that the value of technical provisions is equivalent to the amount that a (re)insurance undertaking would be expected to require in order to take over and meet another (re)insurance undertaking's obligations.

Own Funds

4.9 A (re)insurance undertaking's own funds form the difference between the sum of a market consistent valuation of its assets, less the sum of a market consistent valuation of its liabilities. Own funds can comprise of basic own fund items (the excess of assets less liabilities, or subordinated liabilities) and ancillary own fund items (unpaid share capital; letters of credit; or any other legally binding commitments received by (re)insurance undertakings).

4.10 (Re)insurance undertakings are obliged to hold a certain quantity and quality of own funds to act as an asset or capital buffer above the value of their liabilities, and provide cover against significant, adverse events which could affect the values of their assets and liabilities and, therefore, the (re)insurance undertaking's solvency position.

4.11 The *quantity* of own funds that (re)insurance undertakings are required to hold is determined by the Solvency Capital Requirement and Minimum Capital Requirement, which represent two distinct thresholds of capital requirement and two different levels of supervisory intervention.

4.12 The Solvency Capital Requirement and Minimum Capital Requirement must comprise of a certain *quality* of own funds, or capital, too. Basic and ancillary own fund items are classified into three tiers (tier 1, 2 or 3) depending on their permanent availability and subordination.

4.13 Broadly speaking, the highest quality of own fund or capital, Tier 1 capital, substantially possesses the characteristics of being permanently available and subordinated. Tier 2 capital, the next highest quality of capital, substantially possesses the characteristic of subordination. And tier 3 capital comprises of (any basic and ancillary) own fund items which are not classified as tier 1 or 2.

4.14 Ancillary own fund items cannot be classified as tier 1 capital, but are classified as tier 2 where they substantially possess the characteristics of being permanently available and subordinated.

Solvency Capital Requirement and Minimum Capital Requirement

4.15 Solvency II establishes a dual supervisory intervention mechanism for (re)insurance undertakings through the creation of a Solvency Capital Requirement and a Minimum Capital Requirement. One of the objectives of Solvency II's two-tiered approach for supervisory intervention is to help ensure supervisors are made aware of the difficulties faced by (re)insurance undertakings at an advanced stage i.e. when a (re)insurance undertaking breaches the higher of the two thresholds, the Solvency Capital Requirement. This will give the (re)insurance undertaking and the supervisor time and opportunity to take steps to help mitigate the possibility that the (re)insurance undertaking may breach the Minimum Capital Requirement, which is the lower of the two thresholds.

4.16 The dual supervisory mechanism also acts to protect the policyholders of (re)insurance undertakings which are in difficulty, and thus which may be unable to meet their insurance obligations. The Minimum Capital Requirement is a less flexible requirement, which, when breached, gives supervisory authorities the ability to withdraw a (re)insurance undertaking's authorisation.

Calculation of the Solvency Capital Requirement and Minimum Capital Requirement

4.17 The Solvency Capital Requirement covers all the quantifiable risks a (re)insurance undertaking faces (taking into account any risk-mitigation techniques) and determines the amount of capital which (re)insurance undertakings have to hold to back their risks.

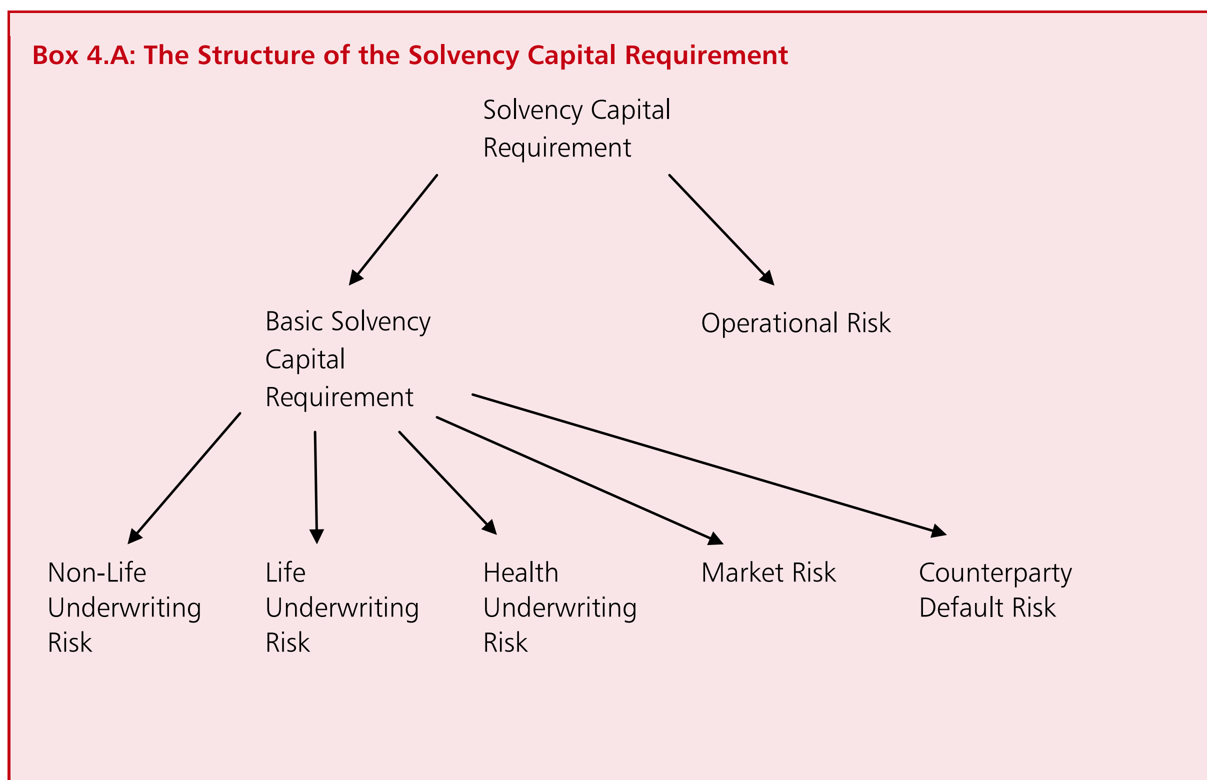
4.18 The calibrations for each specific risk are designed so that the (re)insurance undertakings hold 'economic capital to ensure that ruin occurs no more often than once in every 200 cases or, alternatively, that those undertakings will still be in a position, with a probability of at least 99.5% to meet their obligations to policyholders and beneficiaries over the following 12 months'. For the purposes of this document, the level to which a (re)insurance undertaking's risks are calibrated to under Solvency II will be referred to as the 'Value-at-Risk of the basic own funds to a confidence level of 99.5% over a one-year period'.

4.19 Though the rules have yet to be finalised it is probable a (re)insurance undertaking will calculate their Minimum Capital Requirement to be 25-45% of their Solvency Capital Requirement, without prejudice to a defined floor and cap as set out in Directive 2009/138/EC.

4.20 The precise quantity of the Solvency Capital Requirement and of the Minimum Capital Requirement will vary depending on the underlying structure, business and risks of the (re)insurance undertaking.

4.21 The various risks that firms may have to consider when deriving their Solvency Capital Requirement can be observed from the diagram of the risk modules of the Solvency Capital Requirement below. Firms will also have to consider the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes.

Box 4.A: The Structure of the Solvency Capital Requirement



The Standard Formula, Full and Partial Internal Models and Undertaking Specific Parameters

4.22 Solvency II sets out two methods for the calculation of the Solvency Capital Requirement: The standard formula method and the internal model process.

4.23 The standard formula is intended to reflect the risk profile of most (re)insurance undertakings. However, the standard formula is a standardised approach, and there may be occasions when its calibrations do not adequately reflect the specific risk profiles of a (re)insurance undertaking.

4.24 The internal model process, the alternative method to calculate the Solvency Capital Requirement, enables (re)insurance undertakings to derive their own calibrations which may reflect the risk profiles and specificities of their businesses better than the standardised calibrations of the standard formula can. This enables (re)insurance undertakings to hold capital more proportionate to the nature of their risks, while also encouraging undertakings to better assess and understand the risks which they are exposed to.

4.25 (Re)insurance groups are able to develop and use group-wide models, which allows for better assessment of the benefits of diversification, and risks of correlation, at group level.

4.26 There are other tools that (re)insurance undertakings can use to derive their Solvency Capital Requirement:

- Partial internal models can be used to complement the standard formula, and used by the (re)insurance undertaking to calibrate specific risks of their business (as opposed to a 'full' internal model, which calibrates all risks); and
- Undertaking specific parameters which can be used in specific instances by a (re)insurance undertaking to enable their true underwriting risk profile to be better reflected.

4.27 (Re)insurance undertakings will also be able to take account of the principle of proportionality when deriving their Solvency Capital Requirement, to reflect the nature, scale and complexity of their business, risk mitigation techniques and other offsetting actions such as diversification effects.

Eligibility of own funds comprising the Solvency Capital Requirement and Minimum Capital Requirement

4.28 There are limits to the amount of tier 2 and tier 3 capital which a (re)insurance undertaking may use to meet their Solvency Capital Requirement and Minimum Capital Requirement, to ensure that eligible own funds are of a sufficient quality to be able to 'absorb significant losses, and to give reasonable reassurance to policy holders and beneficiaries that payments will be made as they fall due'. While the precise limits are yet to be finalised, there are criteria laid down in Directive 2009/138/EC which dictate that:

- The proportion of tier 1 capital comprising the Solvency Capital Requirement will be greater than or equal to one third of the total amount of eligible own funds, and the proportion of tier 3 capital comprising the Solvency Capital Requirement less than one third of the total amount of eligible own funds.
- The proportion of tier 1 capital comprising the Minimum Capital Requirement is greater than one half of the total amount of eligible basic own funds, and the Minimum Capital Requirement cannot comprise of tier 3 capital.

Supervisory approval and action

4.29 Supervisory authorities, amongst other responsibilities, will be required to review and evaluate (re)insurance undertakings' compliance with the rules for estimating technical provisions, capital requirements, and the quality and quantity of own funds as set out in Directive 2009/138/EC.

4.30 As part of this, supervisory authorities will be required to assess the assumptions underlying (re)insurance undertakings' Solvency Capital Requirement, calculated using the standard formula or a full or partial internal model. If a supervisory authority deems that there is a significant deviation in a (re)insurance undertaking's Solvency Capital Requirement from the assumptions within Directive 2009/138/EC, the supervisory authority may, in specific circumstances, set a capital add-on to require the (re)insurance undertaking to increase their Solvency Capital Requirement to correspond to the Value-at-Risk of the basic own funds to a confidence level of 99.5% over a one-year period.

Breach of Solvency Capital Requirement and Minimum Capital Requirement

4.31 A breach of the Solvency Capital Requirement or Minimum Capital Requirement occurs when a (re)insurance undertaking's eligible basic own funds decreases to an amount below the relevant threshold.

4.32 If a (re)insurance undertaking breaches their Solvency Capital Requirement, it is obliged to inform the supervisory authority and to restore the level of eligible own funds covering the Solvency Capital Requirement, or reduce its risk profile to ensure compliance with the Solvency Capital Requirement, within a period of six months. The supervisory authority has discretion to extend the six month period by three months if appropriate. In the event of an exceptional fall in financial markets, the period can be extended further.

4.33 The Minimum Capital Requirement is a lower requirement and its breach could trigger the ultimate supervisory intervention: the withdrawal of authorisation. When the amount of a (re)insurance undertaking's eligible basic own funds fall below the Minimum Capital Requirement, the supervisory authority is able to withdraw authorisation if the (re)insurance undertaking is unable to re-establish the amount of eligible basic own funds at the level of the Minimum Capital Requirement within three months from the observation of non-compliance with the Minimum Capital Requirement, or if the finance scheme designed to restore eligible basic own funds to the level of the Minimum Capital Requirement is manifestly inadequate.

4.34 Withdrawal of authorisation may have the effect of prohibiting the (re)insurance undertaking's pursuit of, and agreement of, new insurance or reinsurance business, and could lead to the winding-up of the undertaking.

Pillar II – Qualitative Requirements

4.35 Pillar II covers the qualitative or governance requirements the administrative, management or supervisory body of a (re)insurance undertaking is expected to meet to ensure compliance with Directive 2009/138/EC. This includes, but is not limited to, requirements around:

- Written policies in relation to risk management, internal control and internal audit;
- Ensuring the continuity and regularity in the performance of a (re)insurance undertaking's activities; and
- The evaluation of emerging risks.

4.36 As part of its risk management system, every (re)insurance undertaking shall conduct its own risk and solvency assessment (ORSA), which must consider the risk profile of the business,

compliance with capital requirements, and any deviations from the assumptions underlying the Solvency Capital Requirement. The ORSA is expected to form an integral part of a (re)insurance undertaking's business strategy and the results of the assessment will have to be reported to the relevant supervisory authority.

4.37 Supervisory authorities will be required to assess the effective governance of (re)insurance undertakings, and can take steps to ensure a (re)insurance undertaking's system of governance is appropriate and effective, including, for instance, applying a capital add-on.

Pillar III – Disclosure and reporting requirements

4.38 Pillar III concerns disclosure and reporting requirements, which are designed to ensure that supervisory authorities have all the information they need for the purposes of supervision. Disclosure of information enables supervisory authorities to assess (re)insurance undertakings':

- Systems of governance;
- Businesses they are pursuing;
- Valuation principles for solvency purposes;
- Risks faced and risk management systems; and
- Their capital structures, needs and management.

4.39 Furthermore, (re)insurance undertakings will be required to publicly disclose certain information, to help facilitate a transparent EU reinsurance and insurance market.

5 Purpose of the Consultation and Legislative Changes

5.1 As noted in paragraph 2.11 above, Solvency II is a maximum harmonisation Directive. Consequently, there is very limited scope for the Government to apply discretion in the way in which it is implemented, and no scope for the Government not to implement the legislation without transgressing its treaty obligations. In that context, the purpose of the consultation is to invite views on the precise changes the Government is making to UK legislation to implement Directive 2009/138/EC, and on the ways in which those changes are being implemented. The deadline for responding to this consultation is 15 February 2012.

5.2 The required legislative changes fall into four broad categories:

- The amendments necessary to set out the conditions under which undertakings may be authorised and de-authorised to carry out insurance and reinsurance business;
- New powers for the PRA, aimed mostly at enabling the PRA to approve the instruments (re)insurance undertakings need to calculate their solvency position on a Solvency II basis;
- New duties for the PRA aimed at mandating their participation in the new European supervisory framework; and
- Amendments to align UK terms and definitions with those set out in the Directive 2009/138/EC.

5.3 The draft Statutory Instrument published alongside this consultation document in Annex B show the specific drafting changes the Government is proposing to make to UK legislation.

6 Conditions for Authorisation and De-authorisation

Implementing the powers to withdraw authorisation

6.1 Article 144 Directive 2009/138/EC specifies that the supervisory authority of the home Member State may withdraw the authorisation granted to a (re)insurance undertaking in the following cases:

1. The undertaking concerned does not make use of the authorisation within 12 months, expressly renounces it or ceases to pursue business for more than six months, unless the Member State concerned has made provision for authorisation to lapse in such cases;
2. The undertaking concerned no longer fulfils the conditions for authorisation;
3. The undertaking concerned fails seriously in its obligations under the regulations to which it is subject.

6.2 In addition, Article 144 Directive 2009/138/EC specifies that supervisory authorities of the home Member State shall withdraw authorisation granted to a (re)insurance undertaking in the event that the undertaking does not comply with the Minimum Capital Requirement and the supervisory authority considers that the finance scheme submitted is manifestly inadequate or the undertaking concerned fails to comply with the approved scheme within three months of the observation of non-compliance with the Minimum Capital Requirement.

6.3 In the event of withdrawal or lapse of authorisation, the supervisory authority of the home Member State is obliged to notify the supervisory authorities of the other Member States in order to prevent the (re)insurance undertaking from commencing new operations within their territories. The supervisory authority of the home Member State shall, together with those authorities, take all measures necessary to safeguard the interests of insured persons and, in particular, shall restrict the free disposal of the assets of the insurance undertaking in accordance with Article 140 Directive 2009/138/EC – the prohibition of free disposal of assets located within the territory of a Member State.

6.4 In the UK, the FSA already has various supervisory tools that act to help safeguard the interests of policyholders and beneficiaries. For instance, part IV section 44 of FSMA already permits the FSA to withdraw authorisation granted to a (re)insurance undertaking in cases 1) and 2) above. However, at present the regulator has no power by which it can remove authorisation where 'the undertaking concerned fails seriously in its obligations under the regulations to which it is subject', as per case 3) above. As such this power shall be conferred on the PRA by an amendment to the relevant FSMA provision.

6.5 Similarly, the Minimum Capital Requirement is a new requirement being brought in under Solvency II and, therefore, amendments to UK legislation are necessary to mandate the PRA to withdraw authorisation granted to a (re)insurance undertaking in the event that the undertaking does not comply with the Minimum Capital Requirement as laid out in Article 144 Directive 2009/138/EC.

6.6 If an authorisation has been withdrawn following an irrevocable breach of the Minimum Capital Requirement, the authority should be able to petition the court for the winding up of the undertaking. An extra ground for winding up has therefore been added to section 367(3) of FSMA.

6.7 The Government is proposing to make the necessary amendments to sections 55J, 55K and 367(3) of FSMA as amended by the Financial Services Bill (FSMA) as set out in Part 2, regulation 4(2) and (3) of the Statutory Instrument in Annex B. In Part 3, regulation 10 provides a power for the FSA to verify that the Directive should cease to apply to a firm.

Questions under heading: Implementing the powers to withdraw authorisation

6.8 Do you agree with the way in which the Government is proposing to amend FSMA as per Part 2, regulation 4(2) and (3) of the Statutory Instrument in Annex B, to enable the PRA to withdraw authorisation of a (re)insurance undertaking in instances where the undertaking concerned fails its obligations under the regulations to which it is subject, and/or where the supervisory authority considers that the finance scheme submitted by the (re)insurance undertaking is manifestly inadequate or the undertaking concerned fails to comply with the approved scheme within three months of the observation of non-compliance with the Minimum Capital Requirement as laid out in Article 144 Directive 2009/138/EC?

6.9 Do you agree with the way in which the Government is proposing to amend FSMA as per Part 2, regulation 4(2) and (3) of the Statutory Instrument in Annex B, to enable the PRA to initiate winding up proceedings in certain circumstances on (re)insurance undertakings that have had their authorisation withdrawn?

6.10 If you disagree with either of the above questions, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Article 144 Directive 2009/138/EC.

6.11 Do you have any other comments in relation to the legislative changes the Government is making in relation to Article 144 Directive 2009/138/EC, and in relation to the ability of PRA to perform winding up proceedings in certain circumstances on (re)insurance undertakings that have had their authorisation withdrawn?

7 PRA Powers to Comply with Solvency II

Amendments to give PRA powers needed to allow undertakings to calculate their capital requirements on a Solvency II basis

Conferring approval powers on PRA

7.1 In order for the PRA to be able to perform their role as the UK's financial services supervisory authority as envisaged in Directive 2009/138/EC, and to ensure that the PRA is able to provide the support and supervision undertakings need to calculate their solvency on a Solvency II basis, specific approval powers need to be conferred on them, as outlined in paragraphs 7.5 to 7.36 of this chapter.

7.2 Furthermore, the PRA requires additional approval powers to perform other supervisory functions, as outlined in paragraphs 7.37 to 7.40 of this chapter.

7.3 Questions around the approval powers have been bracketed together at the end of Chapter 7, paragraphs 7.41 to 7.43. The necessary amendments to UK legislation are set out in Part 3, regulations 16 to 19 and 31 of the Statutory Instrument in Annex B.

7.4 The Statutory Instrument also confers a right onto relevant persons to refer the decisions of the PRA to the Upper Tribunal.

The case for specific approvals powers

7.5 To comply with Directive 2009/138/EC, the PRA must approve a firm's partial or full internal model; the amount of each ancillary own fund item a (re)insurance undertaking can take into account when it calculates its own funds; and the classification of certain own fund items into tiers. FSMA gives the PRA two sets of powers that could in theory be used to do so. These two powers are:

- The Variation of Permission (VOP) and Own Initiative Variation of Permission (OIVOP) powers that allow the PRA to impose a requirement on a firm's 'Permission to Carry on Regulated Activities' under FSMA (Part IV) sections 43 to 45; and
- The power to modify or waive PRA rules under FSMA section 148.

7.6 However, the existing VOP and OIVOP powers were intended and designed only to enable the FSA to approve undertaking-specific *variations* to standard rules, not *the* standard rules per se. Furthermore, the section 148 rule variation/rule waiver power(s) only permits the FSA to vary or waive rules if the rule is unduly burdensome or not achieving its purpose, and the waiver or modification will not result in undue risk to persons whose interests the rule is intended to protect.

7.7 Bespoke Solvency II approval powers for the PRA would reconcile more easily with the requirements of the Directive, in particular, with regard to the supervision of groups. Introducing specific approval powers as outlined in this chapter should help to improve the efficiency, clarity and transparency with which decisions are made.

7.8 In addition, the forthcoming Financial Services Bill introduces a power for the PRA to place a requirement on a regulated person. This power will be used extensively for applying requirements which the regulator is obliged to do under Solvency II.

Supervisory approval of ancillary own funds

7.9 Ancillary own fund items are capital items other than basic own funds which a (re)insurance undertaking can call upon to absorb losses. They can comprise of the following items, to the extent that they are not basic own fund items:

- Unpaid share capital or initial fund that has not been called up
- Letters of credit and guarantees
- Any other legally binding commitments received by insurance and reinsurance undertakings.

7.10 Article 90 Directive 2009/138/EC requires supervisory authorities to approve the amounts of ancillary own fund items which (re)insurance undertakings can take into account when determining their own funds.

7.11 Supervisory authorities are required to approve either a monetary amount for each item, or a method of calculating the amount. The amount ascribed will reflect the loss absorbency of the item and be based upon realistic and prudent assumptions. The approval process will consider the counterparty's status, the recoverability of the funds, and information about the (re)insurance undertaking's past calls for ancillary own funds.

7.12 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 16 of the Statutory Instrument in Annex B.

Classification of own funds into tiers

7.13 Article 95 Directive 2009/138/EC requires supervisory authorities to approve the classification of own fund items, which are classified on the basis of the criteria laid down in Article 94 Directive 2009/138/EC and not covered by the list of own fund items referred to in Article 97(1)(a) Directive 2009/138/EC. As outlined in Chapter 4, the classification of the own fund items into tiers of capital is determined on the basis of the own fund item's permanent availability and subordination.

7.14 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 17 of the Statutory Instrument in Annex B.

Supervisory approval of undertaking specific parameters

7.15 Article 104(7) Directive 2009/138/EC permits firms to replace a subset of its parameters within the design of the standard formula with undertaking specific parameters, when calculating the life, non-life and health underwriting risk modules. Undertaking specific parameters can be used by firms to apply calibrations which are more representative of their risk profile, compared to the calibrations and parameters of the standard formula.

7.16 Undertaking specific parameters shall be 'calibrated on the basis of the internal data of the undertaking concerned, or of the data which is directly relevant for the operations of that undertaking using standardised methods'.

7.17 Article 104(7) Directive 2009/138/EC requires supervisory authorities to approve the use of undertaking specific parameters, and to verify the completeness, accuracy and appropriateness of the data used.

7.18 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 18 of the Statutory Instrument in Annex B.

Supervisory approval of full and partial internal models

7.19 (Re)insurance undertakings are obliged to calculate a Solvency Capital Requirement to cover all the quantifiable risks they may face. In doing so, (re)insurance undertakings can use the EU standard formula, or develop their own internal model. Alternatively, (re)insurance undertakings can opt to model only some risk modules or sub-modules of the Basic Solvency Capital Requirement, or model the operational risk module, using a partial internal model. Partial internal models can be used in conjunction with the EU standard formula to quantify all aspects of the Solvency Capital Requirement.

7.20 (Re)insurance undertakings may apply a partial internal model to their whole business, or to one or more business units. (Re)insurance undertakings may also use a partial internal model to model the loss-absorbing capacity of technical provisions and deferred taxes - the compensation for unexpected losses through a simultaneous decrease in technical provisions or deferred taxes or a combination of the two.

7.21 As with a full internal model, using a partial internal model to model aspects of the Solvency Capital Requirement may enable (re)insurance undertakings to quantify their risks in a way that better reflects their risk profile than the EU standard formula can.

7.22 Article 112 Directive 2009/138/EC permits firms to use a full or partial internal model to calculate their Solvency Capital Requirement, as approved by the supervisory authorities. With regard to the full internal model, in order for the supervisory authorities to begin their assessment and formulate a decision, the (re)insurance undertaking must submit, as a minimum, documentary evidence that the full internal model meets the requirements as set out in Articles 120 to 125 Directive 2009/138/EC. Where a partial internal model is used to model only aspects of the Solvency Capital Requirement, the (re)insurance undertaking is obliged to evidence how the partial internal model meets the requirements of Articles 120 to 125 Directive 2009/138/EC in a way which is consistent with the limited scope of application of the model.

7.23 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 19 of the Statutory Instrument in Annex B.

Specific provisions for supervisory approval of partial internal models

7.24 Further to Article 112 Directive 2009/138/EC, which covers general provisions for the approval of full and partial internal models, Article 113 Directive 2009/138/EC outlines specific provisions for the approval of partial internal models.

7.25 In addition to meeting the requirements of Articles 120 to 125 Directive 2009/138/EC in a way which is consistent with the limited scope of the partial internal model, a (re)insurance undertaking seeking approval of a partial internal model must meet the additional following conditions:

- The reason for the limited scope of the application of the model is properly justified by the undertaking.
- The resulting Solvency Capital Requirement reflects more appropriately the risk profile of the undertaking and in particular complies with the principles set out in Subsection 1, Articles 100 to102 Directive 2009/138/EC (General provisions for the solvency capital requirement using the standard formula or an internal model).

- Its design is consistent with the principles set out in Subsection 1 Articles so as to allow the partial internal model to be fully integrated into the Solvency Capital Requirement standard formula.

7.26 When assessing an application for the use of a partial internal model, supervisory authorities may require the (re)insurance undertaking concerned to extend the scope of the model in order to ensure that the model covers a predominant part of their insurance operations. To do so, the (re)insurance undertaking may be required to submit a realistic transitional plan outlining how they plan to extend the scope of the partial internal model to other sub-modules or business units.

7.27 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 19 of the Statutory Instrument in Annex B.

Supervisory approval of changes to the internal model

7.28 As per Article 115 Directive 2009/138/EC, as part of the initial approval process of an internal model, the supervisory authorities are obliged to assess and decide on the (re)insurance undertaking's policy for changing their internal model. (Re)insurance undertakings may change their internal model in accordance with that policy.

7.29 The policy shall include a specification of minor and major changes to the internal model. Major changes to the internal model, as well as changes to that policy, shall always be subject to prior supervisory approval, as laid down in Article 112 Directive 2009/138/EC, whereas minor changes to the internal model shall not be subject to prior supervisory approval, insofar as they are developed in accordance with the agreed policy.

7.30 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 19 of the Statutory Instrument in Annex B.

Supervisory approval of group internal models

7.31 Insurance and reinsurance groups ((re)insurance groups) may make an application to their group supervisor to use an internal model to calculate their consolidated group Solvency Capital Requirement, as well as the Solvency Capital Requirement of (re)insurance undertakings in the group. In order to undertake an assessment of the group internal model, the supervisory authorities concerned shall cooperate with one another to decide whether or not to grant permission for the use of the model. If permission is granted, the supervisory authority can determine the terms and conditions, if any, to which such permission is subject.

7.32 Article 231 Directive 2009/138/EC outlines the requirements of the group supervisor and supervisory authorities once the group supervisor has received a group internal model application:

- The group supervisor shall inform the other supervisory authorities concerned of its receipt of an application for a group internal model, without delay.
- The supervisory authorities shall do everything within their power to reach a joint decision on the application within six months from the date of receipt of the complete application by the group supervisor.
- The group supervisor shall forward the complete application to the other supervisory authorities concerned without delay.
- And ultimate responsibility for the decision on the approval of the group internal model, and for providing the applicant and other supervisory authorities with the outcome of the decision, resides with the group supervisor.

7.33 Directive 2009/138/EC sets out additional steps the group supervisor or other supervisory authorities can take should they wish to consult with EIOPA with regard to approval of a (re)insurance group's internal model.

7.34 Furthermore, where any other supervisory authorities concerned consider that the risk profile of the (re)insurance undertaking under its supervision deviates from the assumptions underlying the group internal model, the authority may be able to impose a capital add-on to the Solvency Capital Requirement to the (re)insurance undertaking, in accordance with Article 37 Directive 2009/138/EC.

7.35 In exceptional circumstances, where such a capital add-on would not be appropriate, the supervisory authority may require the (re)insurance undertaking concerned to calculate its Solvency Capital Requirement on the basis of the standard formula, as per Articles 100 to 111 Directive 2009/138/EC. In accordance with Article 37(1) (a) and (c), the supervisory authority may impose a capital add-on to the Solvency Capital Requirement of that (re)insurance undertaking resulting from the application of the standard formula.

7.36 The Government proposes to confer the specific power on the PRA as outlined in Part 3, regulation 31 of the Statutory Instrument in Annex B.

Amendments to give PRA powers needed to perform other supervisory functions

Supervisory Powers for Outsourced Activities

7.37 Article 34(7) Directive 2009/138/EC requires that supervisory authorities have the general supervisory powers outlined in Articles 34(1) to 34(5) Directive 2009/138/EC in respect of outsourced activities of (re)insurance undertakings.

7.38 The Government needs to ensure that the PRA's general supervisory powers apply to outsourced activities. The Government is proposing to make the following amendments to FSMA as outlined in Part 2, regulation 4(7) of the Statutory Instrument in Annex B.

Power to carry out on-site inspection of outsourced functions and activities

7.39 Article 38 Directive 2009/138/EC requires the Member State where a service provider is located to permit the supervisory authorities of the (re)insurance undertaking to carry out on-site inspections at the premises of the service provider, where (re)insurance undertakings outsource a function or a insurance or reinsurance activity. The supervisory authorities of the Member State of the (re)insurance undertaking may delegate such on-site inspections to the supervisory authorities of the Member State where the service provider is located.

7.40 Amendments to FSMA Part XI are necessary to enable the PRA to (a) ensure that unauthorised UK service providers contracting with non-UK EEA firms will permit the EEA firms' supervisors and the PRA to carry out on-site inspections and (b) allow the PRA to carry out delegated on-site inspections for EEA firms' supervisors and (c) give PRA the power to delegate non EEA on-site inspections to EEA regulators. The Government is proposing to make the following amendments to FSMA as outlined in Part 2, regulation 4(8) of the Statutory Instrument in Annex B.

Questions under Chapter 7: PRA Powers to comply with Solvency II

7.41 Do you agree with the ways in which the Government is proposing to amend FSMA as drafted in Part 2, regulation 4(7) and (8) and Part 3, regulations 16 to 19 and 31 of the Statutory Instrument in Annex B, in order to confer the specific approval powers on the PRA outlined in this chapter?

7.42 If you disagree, please could you specify in which instance(s) you disagree and, if appropriate, elaborate on why you disagree and what you think may be a more suitable means of adhering to and/or transposing Directive 2009/138/EC in respect of the articles outlined in Chapter 7.

7.43 Do you have any other comments in relation to the ways in which the Government is proposing to amend legislation to give the PRA powers to comply with Solvency II as outlined in this chapter?

8 Mandating the PRA to Work Within the New European Supervisory Framework

Amendments to mandate the PRA to work within the new European supervisory framework

Supervisory approval of the transfer of portfolio

8.1 Article 39 Directive 2009/138/EC requires that Member States authorise (re)insurance undertakings with head offices within their territory to transfer all or part of the portfolios of contracts, concluded either under the right of establishment or the freedom to provide services, to an accepting undertaking established within the Community.

8.2 Such transfer shall be authorised only if the supervisory authorities of the home Member State of the accepting undertaking certify that after taking the transfer into account the accepting undertaking possesses the necessary eligible own funds to cover the Solvency Capital Requirement referred to in the first paragraph of Article 100 Directive 2009/138/EC.

8.3 Amendments to UK legislation are necessary to require the PRA to consult with the host state regulator to authorise the transfer.

Questions under heading: Supervisory approval of the transfer of portfolio

8.4 Do you agree with the way in which the Government is proposing to amend FSMA in Part 2, regulation 6(3) of the Statutory Instrument in Annex B, to provide for the consultation set out therein when (re)insurance undertakings to transfer all or part of their portfolios of contracts, consistent with Article 39(3), (4) and (5) Directive 2009/138/EC?

8.5 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Article 39 Directive 2009/138/EC.

8.6 Do you have any other comments in relation to the ways in which the Government is proposing to amend legislation to mandate the PRA to consult with the host state regulator as laid out in Article 39 Directive 2009/138/EC?

Notifying the host Member State(s) and designating sequestered assets when prohibiting the free disposal of assets.

8.7 Directive 2009/138/EC specifies that the supervisory authority in the home Member State of a (re)insurance undertaking may prohibit the free disposal of assets, where a (re)insurance undertaking has not complied with rules relating to technical provisions, the Solvency Capital Requirement or the Minimum Capital Requirement, as set out in Articles 137 to 139 Directive 2009/138/EC, or proceeding the withdrawal or lapse of a (re)insurance undertaking’s authorisation, as set out in Article 144(2) Directive 2009/138/EC. The supervisory authority of the

home Member State is required to communicate their intentions to the supervisory authorities of the host Member State(s) and designate the assets to be covered by such measures.

8.8 Amendments to UK legislation are necessary to mandate the PRA to notify the supervisory authorities of the host Member State(s) in instances where they, as the home Member State supervisor, prohibit the free disposal of assets and designate the sequestered assets. The Government is proposing to amend FSMA as outlined in Part 2, regulation 4(3) of the Statutory Instrument in Annex B.

Questions under heading: Notifying the host Member State(s) and designating sequestered assets when prohibiting the free disposal of assets

8.9 Do you agree with the way in which the Government is proposing to amend FSMA, as set out in Part 2, regulation 4(3) of the Statutory Instrument in Annex B, to mandate the PRA to notify the supervisory authorities of the host Member State(s) in instances where the PRA, as the home Member State supervisor, prohibits the free disposal of assets and designates the sequestered assets?

8.10 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Articles 137 to 139 and 144(2) Directive 2009/138/EC.

8.11 Do you have any other comments in relation to the way in which the Government is proposing to mandate the PRA to notify the supervisory authorities of the host Member State(s) in instances where the PRA, as the home Member State supervisor, prohibits the free disposal of assets and designates the sequestered assets?

Supervisory authorities consulting and performing their duties

8.12 There are several articles in Directive 2009/138/EC which require the PRA to consult with supervisory authorities of other Member States, insurance or reinsurance groups, or CEIOPS (replaced by EIOPA post-Lisbon) (Articles 214, 215, 216, 219 and 247). Furthermore, there are several articles in Directive 2009/138/EC which require the PRA to consult and perform their duties as a supervisory authority (Articles 248, 249, 250, 251 and 254) which they are not obliged to do under existing legislation.

8.13 Amendments to UK legislation are necessary to mandate the PRA to comply with the requirements of Directive 2009/138/EC, and consult and perform their duties as envisaged under Directive 2009/138/EC, as outlined above. The Government proposes to amend UK legislation as set out in Part 3, regulations 22 to 25, 37 and 38 to 41 of the Statutory Instrument in Annex B.

Questions under heading: Supervisory authorities consulting and performing their duties

8.14 Do you agree with the way in which the Government is proposing to amend UK legislation to mandate the PRA to comply with the requirements of Directive 2009/138/EC, and consult and perform their duties as envisaged under Directive 2009/138/EC in respect of the articles outlined in paragraphs 8.12 and 8.13?

8.15 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing the articles in Directive 2009/138/EC.

8.16 Do you have any other comments in relation to the way in which the Government is proposing to amend UK legislation to mandate the PRA to comply with the requirements of Directive 2009/138/EC, and consult and perform their duties as envisaged under Directive 2009/138/EC in respect of the articles outlined in paragraphs 8.12 and 8.13?

Inclusion of proportional share

8.17 Article 221(2) Directive 2009/138/EC requires the group supervisor to determine, after consulting the other supervisory authorities concerned and the group itself, the proportional share of capital, (held by the participating undertaking), to be taken into account (in the calculation of group solvency) in the following cases:

- Where there are no capital ties between some of the undertakings in a group;
- Where a supervisory authority has determined that the holding, directly or indirectly, of voting rights or capital in an undertaking qualifies as a participation because, in its opinion, a significant influence is effectively exercised over that undertaking;
- Where a supervisory authority has determined that an undertaking is a parent undertaking of another because, in the opinion of that supervisory authority, it effectively exercises a dominant influence over that other undertaking.

8.18 Amendments to UK legislation are necessary to mandate the PRA, when group supervisor, to comply with the requirements of Article 221 Directive 2009/138/EC, and determine the inclusion of the proportional share of capital, after consulting with the relevant supervisory authorities, in the cases outlined in paragraph 8.17 above. The Government is proposing to amend UK legislation as outlined in Part 3, regulation 27 of the Statutory Instrument in Annex B.

Questions under heading: Inclusion of proportional share

8.19 Do you agree with the way in which the Government is proposing to amend UK legislation to mandate the PRA to comply with the requirements of Article 221 Directive 2009/138/EC, as laid out in Part 3, regulation 27 of the Statutory Instrument in Annex B?

8.20 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Article 221 Directive 2009/138/EC.

8.21 Do you have any other comments in relation to the way in which the Government is proposing to amend UK legislation to comply with Article 221 Directive 2009/138/EC?

Obligation to recognise decision of group supervisor as determinative

8.22 Solvency II introduces new concepts to enhance the supervision of (re)insurance groups, including requirements around cooperation between supervisory authorities in a supervisory college and the decision-making processes.

8.23 Articles 216(3), 231, 237 and 238 of Directive 2009/138/EC require supervisory authorities to recognise decision(s) of the group supervisor (that is, the competent appropriate regulator responsible, under Article 247 of the Directive for the exercise of group supervision in accordance with Title 3 of the Directive) as determinative and to be applied by the supervisory authority in the Member State concerned unless a supervisory authority has remitted to EIOPA in accordance with Article 19 of ESMA regulation.

Questions under heading: Obligation to recognise decision of group supervisor as determinative

8.24 Do you agree with the way in which the Government proposes to amend UK legislation to mandate the PRA to comply with the requirements of Articles 216(3), 231, 237 and 238 of Directive 2009/138/EC, as set out in Part 3, regulations 24, 31, 32 and 34 of the Statutory Instrument in Annex B?

8.25 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Articles 216(3), 231, 237 and 238 of Directive 2009/138/EC.

8.26 Do you have any other comments in relation to the way in which the Government proposes to amend UK legislation to comply with Articles 216(3), 231, 237 and 238 of Directive 2009/138/EC?

9 Mandating the PRA to Perform Other Supervisory Functions

Amendments to mandate the PRA to perform other supervisory functions

Obligation to review capital add-on at least once a year

9.1 A capital add-on can be applied to a (re)insurance undertaking's Solvency Capital Requirement to increase the capital requirement to a level which the supervisory authority (or supervisory authorities where a 'group SCR' is concerned) believes corresponds to a Value-at-Risk of the basic own funds commensurate to a confidence level of 99.5% over a one-year period.

9.2 While the detail around the circumstances under which a capital add-on may be imposed, and the methodologies for the calculation thereof, are yet to be finalised, Article 37 Directive 2009/138/EC entitles supervisory authorities, in specific circumstances, to set a capital add-on for a (re)insurance undertaking.

9.3 The forthcoming Financial Services Act will enable the PRA to set capital add-ons as envisaged in Directive 2009/138/EC by using its requirement power under section 55M. However, the Act will not directly mandate the PRA to review capital add-ons at least once a year and remove capital add-ons when the undertaking has remedied the deficiencies that led to its imposition. Therefore, the government is proposing legislation to this effect.

9.4 The Government needs to mandate the PRA to undertake such action for any capital add-on it sets, and, therefore, proposes UK legislation as set out in Part 3, regulation 13 of the Statutory Instrument in Annex B.

Questions under heading: Obligation to review capital add-on at least once a year

9.5 Do you agree with the way in which the Government proposes to amend UK legislation as set out in Part 3, regulation 13 of the Statutory Instrument in Annex B to mandate the PRA to review capital add-ons at least once a year and remove capital add-ons when the undertaking has remedied the deficiencies that led to its imposition as per Article 37 Directive 2009/138/EC?

9.6 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Article 37 Directive 2009/138/EC in respect of reviewing capital add-ons.

9.7 Do you have any other comments in relation to the way in which the Government proposes to amend UK legislation to comply with Article 37 Directive 2009/138/EC in respect of reviewing capital add-ons?

Financial stability and pro-cyclicality

9.8 Article 28 Directive 2009/138/EC requires supervisory authorities to consider the potential impact of their decisions on the stability of the financial systems in the European Union, particularly in emergency situations, and to take into account the potential pro-cyclical effects of their actions in times of exceptional movements in the financial markets.

9.9 Article 71(2) also requires that supervisory authorities take into account, in an appropriate way, a European Union dimension.

9.10 The Government needs to mandate the PRA to consider these factors, in the exercise of their general duties. The Government is proposing to make the necessary amendments to UK legislation as set out in Part 3, regulation 11 of the Statutory Instrument in Annex B.

Questions under heading: Financial stability and pro-cyclicality

9.11 Do you agree with the way in which the Government is proposing to mandate the PRA to consider the above factors around financial stability and pro-cyclicality in their general duties, and to consider, in an appropriate way, a European Union dimension, as per Part 3, regulation 11 of the Statutory Instrument in Annex B?

9.12 If you disagree please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Directive 2009/138/EC in respect of the Articles 28 and 71 Directive 2009/138/EC.

9.13 Do you have any other comments in relation to the ways in which the Government is proposing to amend legislation to mandate the PRA to consider the above factors around financial stability and pro-cyclicality in their general duties, and to consider, in an appropriate way, a European Union dimension, as per Part 3, regulation 11 of the Statutory Instrument in Annex B?

Related third country (re)insurance undertakings

9.14 Solvency II rules, in respect of the calculation of the group solvency of a participating undertaking, apply to participating undertakings of EU (re)insurance undertakings operating in non-EU jurisdictions or, as referred to in Directive 2009/138/EC, third countries. However, if the solvency regime of the third country is deemed to be 'equivalent' to Solvency II, Member States may provide that the calculation take into account, as regards that participating undertaking and in accordance with Article 233 Directive 2009/138/EC, the Solvency Capital Requirement and the own funds eligible to satisfy that requirement as laid down by the third country concerned.

9.15 Article 227 Directive 2009/138/EC requires the group supervisor of a (re)insurance undertaking to verify the third country's solvency regime is at least equivalent to Solvency II, at the request of the participating undertaking or on its own initiative.

9.16 Article 227 Directive 2009/138/EC also gives Member States discretion to determine whether requirements around the Solvency Capital Requirement and the own funds of (re)insurance undertakings can be fulfilled by the participating undertaking's application of the rules of the third country. A participating undertaking can only use the rules of the third country where the third country's solvency regime is at least equivalent to Solvency II or has met the criteria for inclusion in the third country equivalence transitional regime, and where the undertaking has been approved the use of a method to calculate group solvency which is not exclusively the default method. Therefore, where the requirements for a participating undertaking's use of the rules of the equivalent third country to calculate its contribution to group solvency have been met, Directive 2009/138/EC envisages that Member States can determine that rules equivalent to Solvency II should apply.

9.17 While the circumstances in which Member States can determine that the rules of the equivalent third country should not apply are not defined in the Directive 2009/13/EC, it is clear that an assessment of the appropriateness of the use of those rules will initially have been performed and their use approved (using equivalence criteria). Therefore, the ability of Member States to determine that a third country's rules should not apply should be limited to situations

where there is a significant change in the solvency regime of the third country which could have a detrimental effect on EU or UK policyholders.

9.18 Similarly, Article 225 Directive 2009/138/EC envisages that Member States have discretion to permit related (re)insurance undertakings to use the Solvency Capital Requirement and the own funds eligible to satisfy that requirement in that other Member State or not, where the related (re)insurance undertaking has its head office in a Member State other than that of the (re)insurance undertaking for which the group solvency calculation is carried out. The ability of Member States to determine that a host Member State's rules should not apply should be limited to situations where there is a significant change in the solvency regime of that Member State which could have a detrimental effect on EU or UK policyholders.

9.19 Section 148 FSMA 2000 already enables the FSA to waive their rules. The PRA will have a default rule that the rules from the third country or other Member State are applied. However, they need flexibility to change this where it is more appropriate that Solvency II rules apply following a significant change in the solvency regime of the third country. The government has provided that where the appropriate regulator wishes to waive the default rule, it may do so without having to obtain the consent from the authorised person.

9.20 Further, Solvency II rules in respect of group supervision, and in accordance with Articles 260 to 263 Directive 2009/138/EC, apply to (re)insurance undertakings, the parent undertaking of which is an insurance holding company having its head office outside the Community or a third-country (re)insurance undertaking, unless the third country is deemed to be equivalent to Solvency II. If the third country is at least equivalent to Solvency II, the (re)insurance undertaking can be subject to supervision by a third-country supervisory authority upon verification by the supervisory authorities concerned, as outlined in Directive 2009/138/EC.

9.21 Amendments to UK legislation are necessary to require the PRA, when group supervisor, to verify that a third country's regime is at least equivalent to Solvency II in respect of Articles 227 and 260 Directive 2009/138/EC. The Government is proposing to amend UK legislation as outlined in Part 3, regulations 28, 30 and 42 of the Statutory Instrument in Annex B.

Questions under heading: Related third-country (re)insurance undertakings

9.22 Do you agree with the way in which the Government is proposing to amend UK legislation, as per Part 3, regulations 28, 30 and 42 of the Statutory Instrument in Annex B, to require the PRA to comply with the requirements of Articles 227, 225 and 260 Directive 2009/138/EC?

9.23 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more suitable means of adhering to and/or transposing Articles 227, 225 and 260 Directive 2009/138/EC.

9.24 Do you have any other comments in relation to the way in which the Government is proposing to amend UK legislation to comply with Articles 227, 225 and 260 Directive 2009/138/EC?

10 Terminology Consistent with Solvency II

Redefining certain terms to be consistent with Solvency II

Redefining certain terms to be consistent with Directive 2009/138/EC?

10.1 Solvency II introduces a list of definitions under Article 13 Directive 2009/138/EC and Article 212 Directive 2009/138/EC. In order for these terms to be consistent with UK legislation, the Government proposes to insert some new defined terms into FSMA as outlined in Part 2, regulation 4(15) and define terms for the purposes of the freestanding provisions in Part 3 as set out in regulations 8 and 9 of the Statutory Instrument in Annex B.

Questions under heading: Redefining certain terms to be consistent with Directive 2009/138/EC

10.2 Do you agree with the way in which the Government is proposing to amend FSMA, as set out in Part 2, regulations 4(15) in the Statutory Instrument in Annex B, in the interest of maintaining consistency with the definitions of certain terms within Directive 2009/138/EC?

10.3 If you disagree, please could you specify why and, if appropriate, elaborate on what you think may be a more appropriate means of adhering to and/or being consistent with Articles 13 and 212 Directive 2009/138/EC.

10.4 Do you have any other comments in relation to the way in which the Government is proposing to amend UK legislation in the interest of maintaining consistency with the definitions of certain terms as set out in Articles 13 and 212 Directive 2009/138/EC?

A Impact Assessment

A.1 The following pages contain the Government's consultation stage impact assessment for the proposals contained in this consultation document.

Title: Transposition of the Solvency II Directive (2009/138/EC)	**Impact Assessment (IA)**
IA No:	**Date:** 01/01/2011
Lead department or agency: HM Treasury	**Stage:** Consultation
	Source of intervention: EU
Other departments or agencies: Financial Services Authority	**Type of measure:** Primary legislation
	Contact for enquiries: frank.carson@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: AMBER

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£-61m	£-61m	£-7m	No	NA

What is the problem under consideration? Why is government intervention necessary?

Previous EU insurance directives have aimed to create an effective single market for insurance whilst increasing consumer protection. However, the current EU minimum standards are not risk-sensitive, and do not incentivise pro-active management of risk, which has led many member states to conclude that they are inadequate and to supplement them with their own domestic regimes (e.g. the Individual Capital Adequancy Standards or "ICAS" regime in the UK). This has resulted in a "patchwork" of regulatory requirements for insurers across the EU, hampering the functioning of the single market. The Solvency II Directive aims to build on previous insurance directives to create risk-sensitive, harmonised requirements for EU insurers.

What are the policy objectives and the intended effects?

The key policy objective is to develop the single market in insurance services and to increase the level of policyholder protection. Other intended effects are to: ensure the soundness of insurance firms and that they can withstand difficult periods; protect the stability of the financial system; improve firms' risk management processes; increase confidence of policyholders in insurance products; increase competition, particularly in mass retail lines of business, leading to reduced prices; encourage product innovation to increase consumer choice.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The Directive is maximum harmonising, and is clear on what must be achieved, so the Government has no effective discretion in terms of policy choices for transposition (in particular, there is no scope for pursuing alternatives to regulation). A copy-out approach will be followed, and the approach will not go beyond the minimum required by the Directive.
As a result there are only two policy options: (1) Transpose the Directive, and (2) Do Nothing, where the second option is not a genuine policy option but is included as the baseline.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 01/2019

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Date: 11/11/2011

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** -£61

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	1,619		-251	**-395**
High	2,401	5	818	**8,978**
Best Estimate	2,010		198	**3,600**

Description and scale of key monetised costs by 'main affected groups'

In 2011 present values to nearest £10m for Best Estimate: One-off transition cost to industry £1,900m (NPV over 5yrs), one-off transition cost to FSA £110m (NPV over 5yrs), ongoing cost to industry £1,530m (NPV over 10 yrs), ongoing cost to FSA £60m (NPV over 3 yrs), incremental capital cost to industry £0m (NPV of cost over 10 yrs). NB: most one-off costs to industry are already committed (so would be incurred even in the "Do Nothing" option) but have been included for the sake of clarity.

Other key non-monetised costs by 'main affected groups'

N/A.

NB: The 'low' cost estimate above is negative because in the low cost scenario, capital is assumed to be released rather than raised, and so the incremental average annual capital 'cost' is a negative amount. Also note that costs to the FSA are passed on to firms via levies so are included in the Equivalent Annual Net Cost to Business on page 1. After 3yrs, there are no incremental ongoing costs to FSA above BAU costs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		240	**1,928**
High	0		619	**4,973**
Best Estimate	0		440	**3,537**

Description and scale of key monetised benefits by 'main affected groups'

In 2011 present values to nearest £10m:

Reduced cost of capital for industry £320m (NPV of benefit over 10 yrs)

Efficiency gains to industry £3,200m (NPV of benefit over 10 yrs)

Other key non-monetised benefits by 'main affected groups'

Averted loss/reduced probability of insurer default (benefit for industry, policyholders, regulators and investors); Administrative benefits to industry (improved risk modelling, enhanced governance etc.); Level playing field across Europe (benefit to industry, policyholders, regulators, investors); Increased policyholder protection (benefit to consumers and regulators); Product innovation (benefit to consumers).

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Analysis is based on draft implementing measures; the final measures (not yet agreed) will differ and this will substantially affect the actual impact. Sample data has been extrapolated and there may be sample bias or extrapolation error. Results of fifth Quantitative Impact Study have been used but data submitted by firms may be incorrect, may be based on estimates, and only reflect market conditions at end 2009. Results are indicative only and are subject to a high level of uncertainty.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:						In scope of OIOO?	Measure qualifies as
Costs:	432	**Benefits:**	425	**Net:**	-7	No	NA

Evidence Base (for summary sheets)

1. Problem Under Consideration

Previous European Union (EU) insurance directives have aimed to create an effective single market for insurance services whilst increasing consumer protection. However, many member states have concluded that the existing EU minimum requirements are insufficient and have supplemented them with domestic regimes (such as Individual Capital Adequacy Standards, or "ICAS", in the UK). This has resulted in a "patchwork" of regulatory requirements across the EU, hampering the functioning of the single market.

2. Rationale for Intervention

The current EU-wide solvency regime for insurers is based on the principles of minimum harmonisation[1] and mutual recognition via a single license or "EU passport".

The minimum standards are not risk sensitive and do not consider certain key risks such as credit risk (the risk that third parties cannot pay their debts), market risk (the risk of a decline in the market value of investments) or operational risk (caused by factors such as system breakdowns or maladministration), all of which have been demonstrated to be material threats to insurers' solvency positions. The current rules tend to be backward-looking rather than prospective in nature, and do not incentivise the proactive assessment and management of risk.

The additions that individual member states have made to these minimum standards are heterogeneous and have resulted in an unlevel playing field, affecting cross-border competition, the costs of compliance for cross-border groups, and the extent of supervisory co-operation and convergence across Europe.

The European Commission ("the Commission") established the Solvency II project in the early 2000s to review and reform the rules that govern direct life and non-life insurance firms and reinsurers operating in the EU.

The Solvency II framework Directive (Directive 2009/138/EC[2], "the Directive"), which was agreed in April 2009, builds on and consolidates the existing EU insurance directives, and lays down rules for:

1) The taking-up and pursuit, within the [European] Community, of the self-employed activities of direct insurance and reinsurance.
2) The supervision of insurance and reinsurance groups.
3) The reorganisation and winding-up of direct insurance undertakings.

HM Treasury, as the UK's Ministry of Finance, is obliged to implement the Directive into UK law by the agreed transposition date in order to fulfil its obligations under the EU Treaty. The transposition and implementation date in the Directive is 31st October 2012, but this is subject to ongoing discussion[3].

3. Policy Objective

Changes introduced by Solvency II

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[1] That is, it sets down minimum standards which individual member states must meet, but does not preclude these from being exceeded.

[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

[3] The proposed Omnibus II Directive, which will amend the Solvency II Directive, may change the dates for transposition and implementation. Our current understanding, [based on the published versions of the Council's and Parliament's compromise texts], is that the transposition deadline is likely to fall within 2013, with full implementation of the Directive on 1st January 2014, but we will only have certainty when Omnibus II is agreed.

Solvency II will introduce economic risk-based solvency requirements for insurers and reinsurers across all EU member states that will be significantly more sophisticated and risk-sensitive than the current minimum standards. The framework will require market-consistent valuation of all assets and liabilities.

The regime is intended to apply to all EU insurance and reinsurance firms, regardless of size. However, the 'principle of proportionality' will apply, meaning that the application of the requirements will be proportionate to the nature and scale of the risks faced by individual firms. The very smallest firms (with premium income less than €5m and technical provisions of less than €25m) will be exempted by *de minimis* criteria.

There will be a dual system of capital requirements – a Solvency Capital Requirement (or "SCR") and a lower Minimum Capital Requirement (or "MCR"), creating a 'ladder' of supervisory intervention and allowing early action by supervisors when a firm's solvency position begins to deteriorate.

Firms will be able to calculate the amount of regulatory capital they require using a standardised formula or alternatively develop their own internal models, which will require supervisory approval.

The regime takes a 'three pillar' approach. Under Pillar 1 (quantitative requirements), the risks to an insurer's assets will be considered alongside the liability risks, under a so-called 'total balance sheet' approach. For the first time, market, credit and operational risks will be covered by the EU-wide regime for insurers. Pillar 2 will place a new focus on risk management and governance, and Pillar 3 will bring a greater level of market disclosure, which it is hoped will bring increased 'market discipline'.

The supervision of insurance groups will be strengthened, and it is intended that the regime will result in increased convergence between the supervisory regimes and practices of member states.

UK firms will be well-positioned to make these changes because the current ICAS regime was deliberately designed to better align regulatory capital with the risks faced by individual firms (including asset-side risks), and to encourage firms to make their own assessments of their risks and capital needs[4]. Solvency II is therefore consistent with the direction of travel of the UK financial regulator and industry in seeking a more risk sensitive and economic way of determining capital adequacy standards for insurers.

It is expected that between 550 and 600 individual firms will be in the scope of Solvency II in the UK. This figure includes individual Lloyd's syndicates and firms in run-off.

Policy Aims

The Commission have stated[5] that the rationale for EU insurance legislation is to facilitate the development of a Single Market in insurance services, whilst at the same time securing an adequate level of consumer protection. Further, the aims of a solvency regime are to:

- Ensure the financial soundness of insurance firms, and in particular that they can survive difficult periods;
- Protect policyholders and the stability of the financial system as a whole;
- Stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed;
- Lay down the principles guiding insurers' overall risk management so that they can better anticipate any adverse events.

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[4] More on the ICAS regime can be found in section 4.

[5] See the Commission's publication *Solvency II: Frequently Asked Questions* at http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf

In replacing the existing regime with more harmonised requirements across the EU, the intention is to:

- Ensure a uniform and enhanced level of policyholder protection across the EU, reducing the likelihood that policyholders lose out if insurers get into difficulties, and giving policyholders greater confidence in the products of insurers;
- Increase competition, especially for mass retail lines of business, such as motor and household insurance, putting downward pressure on prices;
- Encourage product innovation that will give consumers more choice.

Alongside these aims, the Government has an objective to transpose the Directive in such a way that it meets its Treaty obligations, and in doing so, to allow the UK's insurance industry and policyholders to recognise the full extent of the available benefits, whilst not being placed at a disadvantage versus other member states. Any additional regulatory burden will be minimised.

4. Description of Options Considered

The Directive is maximum harmonising, and is clear on what must be achieved, so the Government has very little discretion in terms of policy choices for transposition (in particular, there is no scope for pursuing alternatives to regulation). A copy-out approach will be followed. As a result we only have two policy options: (1) Transpose the Directive, and (2) Do Nothing, where the second option is not a genuine policy option but is included as the baseline.

Option 1 – Transpose the Directive

Transposition will require the Government to amend UK legislation, and the Financial Services Authority (FSA) (and/or the successor body after the regulatory reform, the Prudential Regulatory Authority (PRA)) to amend the Regulatory Handbook[6]. The FSA is consulting separately on Handbook changes.

Most of the requirements of the Directive can already be met using powers provided by the Financial Services and Markets Act 2000 ("FSMA") and the current Handbook, so the number of changes required to primary legislation is relatively small compared to the number of provisions in the Directive.

The required legal changes can be categorised as:

i. New conditions for the authorisation and de-authorisation of firms.
ii. New powers for the PRA, chiefly:
   - Powers of supervisory approval (e.g. for firms' use of internal models, partial internal models, Undertaking-Specific Parameters[7] (USPs) or ancillary own funds[8]);
   - Powers relating to the outsourced activities of insurance firms.
iii. New mandates for the PRA, chiefly:
   - Requirements to consult, communicate or co-operate with supervisors in other member states in certain specified circumstances;
   - Requirements to review certain regulatory decisions at pre-defined intervals, or to make verifications.
iv. Alignment of definitions.

[6] The FSA's Regulatory Handbook contains guidance and regulations for UK (re)insurance undertakings (and other parts of the UK financial sector): http://fsahandbook.info/FSA/html/handbook/

[7] As an alternative to a full or partial internal model, firms have the option to use the standard formula but with some of the standard parameters replaced by ones specific to their own risk profiles; these will, however, require supervisory approval.

[8] Ancillary own funds are only eligible to count as regulatory capital if they have received supervisory approval that they meet the relevant criteria.

In keeping with the Government's Guiding Principles for EU Legislation[9], the proposed legal changes do not go beyond the minimum that is required to implement Solvency II in the UK, i.e. no gold-plating will be introduced. "Copy-out" has been used wherever possible. This will not leave UK firms at a disadvantage versus their European counterparts.

The Government's micro-business moratorium will not apply in this case; however, micro-businesses should automatically be exempted by the *de minimis* criteria that define the scope of the Directive. More information is in the Small Firms Impact Test, annexed.

The proposals are out of scope of 'One-in-one-out' (OIOO) because they relate to the transposition of an EU Directive, and the Government is not proposing to introduce any gold-plating.

There will be a ministerial duty to review after 5 years, and every 5 years thereafter.

Option 2 – Do Nothing (Baseline)

This is not a genuine policy option, because it would violate the UK's Treaty obligations, but is included as the baseline for assessing the impact of transposition.

Baseline prudential regime: Individual Capital Adequacy Standards (ICAS)

The ICAS regime was introduced by the FSA in 2004 and supplements the existing minimum EU requirements. Insurers produce an Individual Capital Assessment (ICA)[10] setting out their risks and the capital they believe is needed to support these risks over a one-year timeframe. The FSA then reviews the ICA and gives the firm Individual Capital Guidance (ICG). Neither the ICA nor ICG are publicly disclosed. If a firm's capital falls below the ICG, the FSA may intervene to ensure that the firm takes action to restore its capital position.

The similarities between the ICAS regime and Solvency II should mean that UK insurers are well-placed to make the transition in comparison to insurers operating in member states whose prudential regimes have remained closer to the pre-existing (Solvency I) EU minimum requirements.

Difficulties in establishing a wider baseline landscape for the UK

If the Directive were not implemented, UK insurers would still face regulatory, accounting, tax and legal changes in the next few years. Examples are the Retail Distribution Review, the Test Achats judgement on gender and pricing, and changes to International Financial Reporting Standards (IFRS).

These changes may drive IT system upgrades, recruitment of additional resource, changes to pricing and product offerings, entry to and exit from markets, and asset allocation shifts. There may be changes to the competitive environment and effects on policyholders.

Because Solvency II is also likely to drive such changes, it is very hard to identify the baseline level of change that would have 'happened anyway'. When estimating the costs of Solvency II, insurers are likely to be including costs that they would have incurred regardless, because Solvency II will act as a catalyst in bringing forward or accelerating planned change programmes. This blurring of boundaries will inevitably be reflected in the overall cost estimates for implementing the regime.

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[9] http://www.bis.gov.uk/policies/better-regulation/policy/european-legislation/guiding-principles-eu-legislation

[10] The assessment of a firm's capital adequacy must: reflect the firm's assets, liabilities, intra-group arrangements and future plans; be consistent with the firm's management practice, systems and controls; consider all material risks that may have an impact on the firm's ability to meet its liabilities to policyholders; and use a consistent valuation basis throughout.

Other aspects of the baseline

Rather than setting them out here, other aspects of the baseline position for the UK insurance industry (such as level of capital surplus, asset allocation, competitive environment) are mentioned at appropriate junctures in the cost-benefit analysis.

5. Cost Benefit Analysis (CBA)

Introduction

Because there is only a single proposed policy option for transposition, the cost benefit analysis looks at the impact of transposing the Directive in the UK versus a baseline of doing nothing. The intention is to consider the cumulative impact of the new measures.

The overall impact of the transposition will be far wider than just the direct impact of the legal changes proposed by the Government in the consultation document. Further, an assessment of the individual effects of each legal change would not be meaningful; the changes are intended to integrate with existing UK law and with the FSA's handbook changes, and would not be introduced individually or outside of this framework. For this cost benefit analysis, the proposed legal changes have been considered as a package, the combined purpose of which is to allow the Solvency II regime to be introduced in the UK; in other words, we have treated the impact of transposing the Directive as synonymous with the impact of introducing Solvency II in the UK.

Basis for the CBA

Although the Directive has been agreed, the actual impact of introducing Solvency II will depend heavily on the final shape of the implementing measures and guidance, which have not yet been agreed at the European level. The Omnibus II Directive will also affect the impact because it will set down the implementation date and the length and nature of any 'transitional' arrangements.

Agreement of Omnibus II is not expected until early in 2012, with agreement of the implementing measures to follow thereafter. Delaying the consultation until that point would not have allowed adequate time for the transposition process, and would have left firms uncertain as to the Government's intentions for transposition.

In the absence of these factors, we have had to base the CBA on the latest complete package of proposed implementing measures to have been comprehensively modelled by industry, namely the Technical Specification for the Fifth Quantitative Impact Study[11] (QIS5). However, it should be noted that a large number of these measures have since been amended; we discuss this, and other limitations of this approach, in Section 6: Risks and Assumptions.

In preparing the CBA we have worked closely with the FSA, and have also drawn on some extensive research conducted by Ernst & Young on the FSA's behalf.

Wherever discounting has been applied, this has been at 3.5% p.a. in line with HM Treasury's Green Book recommendations. All present values are in 2011 terms.

Structure of the CBA

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[11] QIS exercises have been used to assess the impact of successive iterations of the proposed framework. The fifth and final exercise for Solvency II, QIS5, was conducted between July and October 2010.

The costs of Solvency II can be split into two categories: the cost of any additional capital that needs to be raised, and the administrative costs of implementing the new regime. These administrative costs can be subdivided into costs to industry and costs to the regulator on a one-off and ongoing basis.

Not all of the main benefits are quantifiable, so we consider both monetised and non-monetised benefits in the analysis.

We also consider the wider effects of implementation, including the impact on small firms, competition and equality, which are dealt with in separate annexes. The structure is as follows:

A. Costs
A1. Capital Impact
A2. Administrative Impact
One-off administrative cost for industry
Ongoing administrative cost for industry
Direct costs to the FSA(/PRA)

B. Benefits
B1. Monetised Benefits
Reduced cost of capital
Improved efficiency and capital allocation
B2. Non-monetised Benefits

C. Wider Impacts
C1. Asset Allocation
C2. Financial Market Impacts
C3. Consumer Impacts: Product Price and Quality
C4. Insurance Market Impacts

Annex: Equality Impact
Annex: Small Firms Impact
Annex: Competitive Environment

A1. Capital Impacts

In terms of capital, Solvency II is likely to affect:

- the amount of regulatory capital that individual firms need to hold;
- the size of any 'buffer' of additional capital that firms voluntarily choose to hold above the regulatory minimum; and
- the cost to firms of raising and holding capital.

The baseline for assessing capital impacts should be the UK's ICAS regime, since for the majority of firms the current 'biting[12]' capital requirement is ICAS Individual Capital Guidance, rather than the statutory Solvency I (EU minimum) requirement. The Solvency I position is shown for completeness.

QIS5 results (which are as at year-end 2009) have been used as the best available indication of firms' capital positions under Solvency II, although the true position may be substantially different, as discussed later.

[12] 'Biting' in the sense that it results in a lower level of surplus capital, and so will be the dominant requirement that firms manage their capital around.

Impact on Capital Surplus

Free capital, or 'capital surplus', is the excess of available capital resources over the regulatory capital requirement.

The data in the table below is from 177 UK solo insurance entities for which Solvency I, ICAS and QIS5 data is available as at year-end 2009. This subset of firms represents the majority of the UK market, but necessarily excludes those firms that did not complete QIS5, and also any firms that completed QIS5 but on a basis that is not comparable with the way their business is currently supervised (since this would preclude a comparison with ICAS or Solvency I). No scaling-up has been applied.

Table 1 – Available and Required capital for 177 firms under different regimes as at 31/12/2009
Source: FSA

Regime	Solvency I	ICAS	QIS5 (proxy for Solvency II)*
Available capital resources	104	112	100
Regulatory capital requirement	44	71	72
Capital surplus	60	41	28
Change in capital surplus on moving to QIS5 basis	(33)**	(14)**	N/A
% Change in capital surplus on moving to QIS5 basis	(54%)	(34%)	N/A

*The QIS5 figures are based on the standard formula, and so do not take into account internal models, or the effect of transitional arrangements which may be in place when Solvency II comes into force.
**Inconsistency with the figures in the row above is introduced by rounding to nearest £m.

Solvency I versus QIS5

It can be seen that for these 177 firms there is a large (£33bn, or 54%) reduction in aggregate capital surplus when moving from a Solvency I to a QIS5 basis. However, much of the £60bn surplus shown on a Solvency I basis is not genuinely 'free' capital, because firms will be holding most of this capital in order to meet the (usually much higher) ICG. This makes it difficult to meaningfully compare Solvency I and QIS5 levels of surplus[13].

Analysis suggests[14] that certain types of firm experienced particular capital pressure when moving from a Solvency I basis to QIS5; annuity writers, P&I Clubs, and firms with a large amount of unrated internal reinsurance.

ICAS versus QIS5

The aggregate capital requirement for these 177 firms is broadly similar between ICAS and QIS5, but the amount of available capital reported is substantially lower under QIS5 than ICAS. This is possibly at least in part because of the restrictions that Solvency II will place on capital instruments (capital must be placed into 'tiers' according to its ability to absorb losses, and there are limits on the eligibility of lower tiers of capital), but there will also be changes resulting from the move to a fully market-consistent balance sheet.

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[13] More detailed commentary and comparisons can be found in Ernst & Young's Capital Impact Assessment, annexed to the FSA's consultation document.
[14] See FSA QIS5 report at http://www.fsa.gov.uk/pubs/international/qis5_mar11.pdf

In aggregate these 177 firms show a £14bn, or 34% reduction in surplus when moving from an ICAS to a QIS5 basis.

The table below shows approximately how the reduction can be broken down, firstly by type of firm and secondly by size.

Table 2 – Percentage Change in Surplus from ICAS to QIS5

	Percentage Change in Surplus from ICAS to QIS5 as at 31/12/2009
Size of Firm	
Small	+22%
Medium	-19%
Large	-39%
Type of Firm	
Life	-39%
Non-Life	-14%

Source: FSA (based on the 188 firms[15] for which both ICAS and QIS5 data was available as at 31/12/2009)

It can be seen that *on average*, the larger the size of firm, the greater the reduction in surplus, and that *on average*, Life firms experienced a greater reduction in surplus than non-Life firms. These general trends at the aggregate level mask a significant amount of variation at the level of individual firms.

These trends concern the standard formula as tested under QIS5, and so do not take into account the effect of internal models. Firms for which the standard formula appears to lead to a significant reduction in surplus may be more likely to use an internal model.

Small firms, who are perhaps more likely to use the Standard Formula for Solvency II because of the development costs of internal models, do not seem to be disproportionately affected on aggregate, in fact seeing an increase in capital surplus versus ICAS. The effect on small firms is considered further in Annex 4.

How much capital might need to be raised as a result of Solvency II?

It is not possible to determine the amount of new capital that will be raised by the UK insurance industry in response to the Solvency II requirements at this stage, for a number of reasons:

- The QIS5 results only give an estimate of the final Solvency II requirements, at a single point in time, and the final requirements at the implementation date are likely to be very different;
- Internal models and transitional measures will have a significant impact, but there is not enough information to estimate their impact at this stage;
- For firms that are part of larger groups, the first source of additional capital is likely to be from within the group structure, reducing or eliminating the need for external capital raising;
- Groups may decide to restructure to realise capital efficiencies;
- Firms may choose to de-risk and reduce their capital requirement rather than raise additional capital;
- Firms typically hold a 'buffer' above the minimum regulatory capital requirement, for several reasons, and firms may choose not to retain the same 'buffer' under the new regime.

We explore some of these issues further below.

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[15] Data from this slightly larger sample of 188 firms suggested an aggregate reduction in surplus of around £15bn from ICAS to QIS5. 11 of these firms did not submit reliable Solvency I figures and so were excluded from the earlier comparison table.

Capital Buffers

Literature on capital buffers for insurers[16] suggests that rating agency requirements and business planning decisions are usually the dominant factors in determining the size of any buffer held. Regulatory requirements only become a dominant factor when firms are close to breaching the regulatory minimum.

This suggests that firms' behaviour in terms of buffers may be divergent. Firms that find themselves close to the regulatory minimum under Solvency II are likely to want to maintain or increase their existing buffer, to provide protection against a breach, particularly given the greater balance sheet volatility that may arise from a move to a market-consistent framework.

On the other hand, firms with a healthy existing buffer, and who partly hold this buffer because of a belief that they are exposed to risks other than those captured by the ICAS regime, may be content with a smaller buffer once they have moved to a Solvency II framework, if they (and their rating agencies) believe these risks are now adequately captured within the Solvency Capital Requirement.

Internal Models

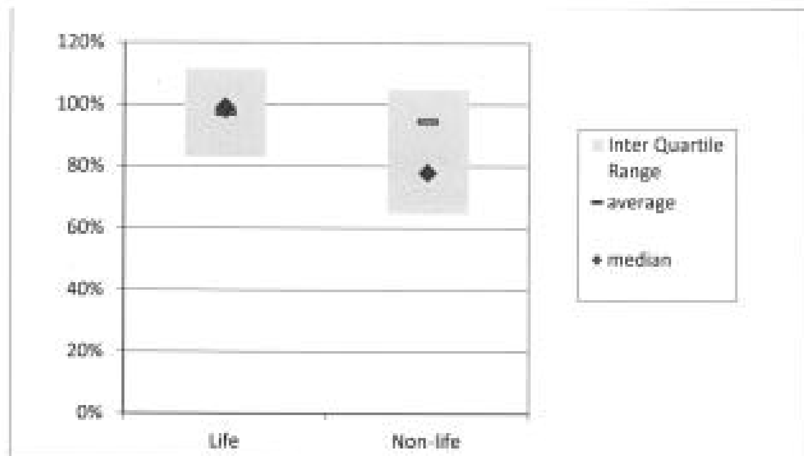
The FSA expects that ultimately around 100 firms will use an internal model under Solvency II, with around a third of these likely to apply for model approval from 'day one' of the new regime. Because of the costs involved in developing an internal model, most firms will only do so if the capital 'saving' that results is in excess of the development cost, suggesting that internal models will tend to reduce the aggregate capital requirement – although there will be some exceptions to this rule.

Because firms are still developing their internal models, there is only very limited data available to assess the likely impact on firms' capital requirements.

The QIS5 exercise did ask firms to submit results on an internal model basis where available. However, few firms did so, since even those firms intending to seek 'day one' approval for their internal models will have been at a relatively early stage of model development when the exercise was undertaken. The results that were submitted will be at best only indicative, because firms will continue to change and refine their models before the implementation date, particularly in response to the agreement of the implementing measures. With these caveats, the graph below shows the distribution of the ratio of internal model to standard formula capital requirements, for the subset of firms that did provide internal model results.

Graph 1: Ratio of Internal Model SCR to QIS5 Standard Formula SCR
Source: FSA QIS5 report

[16] See for example the DNB Working Paper *Are non-risk based capital requirements for insurance companies binding?* available at http://www.dnb.nl/binaries/Working%20Paper%20145 tcm46-159718.pdf



The graph shows considerable variation in these ratios. For non-Life firms, the internal model SCR was generally smaller than the standard formula SCR, whereas for Life firms the distribution is more symmetrical about the 100% mark.

Analysis from the Bank for International Settlements (BIS), undertaken by the Committee on the Global Financial System (CGFS) in their July 2011 paper *Fixed Income Strategies of Insurance Companies and Pension Funds*,[17] suggests that internal model requirements might be 20% lower than the standard formula on average across the EU, but it is difficult to determine whether this would read across to the UK.

Transitional Arrangements

Transitional measures, which will be agreed as part of the Omnibus II Directive, will phase in some aspects[18] of the new regime, so any capital impacts may be spread out over time. Any capital-raising activity could be pushed further out into the future, or firms may use the extra time to pursue alternatives to capital-raising (such as de-risking, group restructuring, or seeking to merge with or be taken over by another firm).

Conclusions on Capital Raising

Although on aggregate across the UK industry the QIS5 exercise showed a capital surplus, 20% of solo firms were unable to meet the QIS5 standard formula capital requirement as at year end 2009. The combined reported capital deficit below the SCR for these firms was £12.5bn, breaking down as follows:

Total (£m)	12,455
Split by sector:	
Life	87%
Non-Life	13%
Split by size:	
Small	13%
Medium	51%
Large	35%

However, it cannot be concluded that the introduction of the new regime would cause this amount to be raised as new capital:

[17] http://www.bis.org/publ/cgfs44.pdf

[18] Areas where transitional measures are possible include the eligibility of certain Own Funds items, the discount rate for long-term business, and the treatment of branches that operate outside of the geographical scope of the regime.

- Much of the reported deficit related to firms that are part of larger groups (which is not unexpected since the closer alignment of capital with risk under Solvency II could reasonably lead to a redistribution of capital requirements across group entities). Actions by the group (in the form of direct capital injections and/or restructuring activity to achieve greater capital fungibility) would be likely to significantly reduce the aggregate shortfall;
- Internal models, de-risking and restructuring would likely be used by some solo firms under capital pressure in order to lower the SCR, reducing any deficit further; and
- The actual requirements and economic conditions at implementation and over the years covered by this mpact Assessment will be different than those tested by QIS5 at year-end 2009.

Bearing in mind the many significant uncertainties already discussed, the wide scope for firms' individual choices in responding to the new regime, and the consequent lack of conclusive evidence at this time, we cannot say with confidence that there will be net capital-raising by UK industry, or that there will be a net release of capital. For the purposes of this Impact Assessment, it has therefore been assumed that there will be zero impact.

Scenario Analysis

If in fact there is net capital-raising (releasing) by UK insurance firms in aggregate in response to Solvency II, this will represent a cost (saving) to the industry. Because of the many uncertainties outlined above, we have investigated two scenarios to derive a higher and lower estimate of the potential impact. These estimates are necessarily indicative only, and should not be taken as an assessment of the upper and lower bounds.

The following scenarios were considered:

Lower Scenario: Assumes £10bn of capital is released following implementation due to (e.g.) increased capital efficiencies, restructuring, use of internal models, consolidation activity leading to greater diversification benefit arising.

Higher Scenario: Assumes industry capital requirements at implementation are as reported in QIS5 at 31/12/2009, and there is no reallocation of capital within groups, use of internal models, transitional arrangements, de-risking, restructuring, or consolidation activity. Further assumes that there is no capital release by those firms in surplus, but that the 20% of solo firms at a capital deficit raise £12.5bn of new capital in order to meet the SCR.

Any cost would be made up of both the one-off fees for capital raising services and the ongoing cost of servicing the net new capital issued. It is assumed that fees are charged at 5%[19] of the amount raised, and that the cost of capital is 4%[20] per annum.

		A	B	A + B
Scenario	Net capital required (£m)	2011 PV of Fees @ [5%] (£m)	2011 PV of Cost of Capital @ [4%] p.a. for 10yrs (£m)	2011 PV of Total Cost (£m)
Lower	(10,000)	N/A	(3,214)	(3,214)
Higher	12,500	583	4,018	4,601

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[19] The Institutional Investor Council's *Rights Issue Fees Inquiry* (published in December 2010 and available at http://www.iicomm.org/docs/rifireport.pdf) suggested that post-2007, the gross underwriting fees for rights issues were between 3 and 4%. 5% has been chosen as a prudent estimate.

[20] This is consistent with the weighted average cost of capital used by the FSA in previous consultations. The figure of 4% is net of the return that firms are assumed to earn from investing the capital in financial assets.

Capital-raising could affect areas such as product pricing and availability; see section C4. The potential impact on the UK capital markets is considered in section C2.

A2. Administrative Impact

Direct costs to the FSA

One-off

The FSA have estimated their total one-off or transition cost for implementing Solvency II at £110m. The estimate was arrived at using data from staff timesheets. Staff members were asked to estimate what proportion of the work charged to Solvency II time-codes was likely to be incremental to 'business as usual' (that is, would not have been undertaken otherwise). The number of Full-Time Equivalent (FTE) resources needed from within each division was then multiplied by an average annual salary for that division to arrive at the overall cost estimate.

Table 3 – direct one-off costs to the FSA

		£m	£m	£m	£m	£m	£m
		09/10	10/11	11/12	12/13	13/14	**Total**
Resource costs	Insurance Risk Specialist	1.1	4.7	10.2	13.4		29.3
	Supervision	1.1	3.7	4.9	7.0		16.6
	Policy	2.2	3.5	4.2	3.3		13.2
	GCD	0.6	0.7	1.3	1.5		3.9
	International Division	0.0	0.0	0.0	0.0		0.0
	Authorisations	0.1		0.0	0.4		0.5
	Programme Office	0.9	1.6	3.3	3.5		9.4
	Training & Comms	0.1	0.2	0.2	0.2		0.6
	Other	0.2	1.0	0.9	0.3		2.4
	Information Services	0.2	1.6	3.3	2.2		7.4
Non Staff Costs	Professional Fees	0.3	0.8	3.0	1.0		5.0
	Recruitment & Retention	0.3	1.0	1.0	0.8		3.0
	Training	0.0	0.0	0.3	0.2		0.5
	Travel		0.3	1.0	0.1		1.4
	Other			0.4	0.2		0.6
	Contingency			2.9	3.7		6.6
	Information Services			3.2	5.4	1.1	9.8
	Total	7.0	19.0	40.0	43.1	1.1	**110.3**

This cost includes: supervisory and actuarial resources; project management resources; resource used for the design and implementation of the internal model approval process; consultation with regulated firms (e.g. via Industry Standing Groups); liaising with overseas regulators; supervisory visits to discuss firms' implementation plans; policy development work; and costs associated with participating in European-level negotiations.

This cost is passed on to industry by way of a "special project fee", which is charged to firms within scope of Solvency II as an addition to the usual FSA levy. For this reason the costs to the FSA have been included in all estimates of the net costs to business used in the summary sheets.

Ongoing

The FSA has estimated ongoing incremental Solvency II costs for the regulator of £22m in 2013/14, £23m in 2014/15 and £23m in 2015/16, which are reflective of the supervisory approach that will be

taken by the PRA (and FCA) in compliance with the parameters of the Directive. After this, Solvency II will become a 'business as usual' cost, and so will not be funded by a special project fee. Beyond 2016 there will be no incremental cost for Solvency II relative to the current cost of the FSA's supervision of the UK insurance industry.

The cost estimates can be broken down as follows:

Table 4 – direct ongoing costs for the FSA

	Estimated Resource Required				Estimated Total Cost		
	FTE	FTE	FTE	£m	£m	£m	£m
	2013/14	**2014/15**	**2015/16**	**Estimated cost of 1 FTE per annum**	**2013/14**	**2014/15**	**2015/16**
Insurance Risk Specialist	78	78	78	0.14	10.9	10.9	10.9
Insurance Division	59	59	59	0.10	5.9	5.9	5.9
Policy Division	28	28	28	0.10	2.8	2.8	2.8
General Counsel Division	8	8	8	0.10	0.8	0.8	0.8
International Division	1	1	1	0.10	0.1	0.1	0.1
Authorisations	8	8	8	0.10	0.8	0.8	0.8
Programme Office	3	0	0	0.10	0.3	0	0
Training & Comms.	1	0	0	0.10	0.1	0	0
Information Services (IT)	N/A	N/A	N/A	N/A	0	2	2
Total	**186**	**182**	**182**		**21.7**	**23.3**	**23.3**

The 2011 present value of these costs is £61m.

It can be seen that around half of this figure represents the projected cost of the incremental actuarial resource needed to assess firms' internal models (included as 'Insurance Risk Specialist' resource), and that there will also be a significant increase in supervisory resource (included as 'Insurance Division' resource). There is a projected £2m of investment in IT in each of 2014/15 and 2015/16, which has not been estimated in terms of FTE resource.

Sensitivities

The costs above are based on the FSA's best estimates. To allow for uncertainty we also calculate higher and lower cost estimates by assuming a [+/-10%] variation in these costs respectively.

Scenario	**One-off cost (£m)**	**2011 present value of ongoing cost (£m)**
Low (90% of best estimate)	99	55
Best Estimate	110	61
High (110% of best estimate)	121	67

<u>**Direct Administrative Cost to Industry**</u>

This section draws on the results of extensive research conducted by Ernst & Young (EY) on behalf of the FSA in July 2010[21].

EY asked 26 firms to estimate the administrative impact that they would face as a result of Solvency II. The firms were drawn from a cross-section of the market, were of various sizes, and represented just less than 50% of total UK insurance liabilities.

The firms were asked to estimate:

i. **total one-off transition costs** to deliver Solvency II, during the period from September 2008 to 1 January 2013 (when Solvency II was assumed to go live);
ii. **incremental costs of maintaining regulatory compliance** with Solvency II following implementation; and
iii. **incremental administrative benefits** resulting from ongoing regulatory compliance with Solvency II.

Firms did not provide enough data on points (ii) and (iii) to enable a quantitative analysis. The FSA conducted some follow-up work in July 2011 which did provide data on point (ii) and which updated the estimates for point (i); we reflect this work in our conclusions.

EY used the following definitions:

Administrative impacts – the additional administrative costs and benefits of complying with the Solvency II regime that are incremental to complying with the UK's current ICAS regime. These include:

- **Business and technical resource** – technical resources (e.g. actuarial, risk and finance); business change resources (responsible for defining and implementing the people, process and cultural change resulting from Solvency II);
- **Technology and data resource** – those resources responsible for the design, delivery, test and roll-out of the technology and data solution to meet the requirements of Solvency II;
- **Programme and governance resource** – those resources responsible for managing the overall delivery of the Solvency II programme; and
- **Non-resource costs** – costs relating to the purchase of toolsets and license fees, software and hardware, third-party development costs, development of test environments, recruitment and other costs (e.g. training, travel, FSA special project fees[22]).

<u>Total estimated one-off administrative cost to industry</u>

For each of the three resource areas defined above (business and technical, technology and data, and programme and governance), firms were asked to estimate:

- The person-days of effort required;
- The split of person-days by internal, external contractor and external consultant resource used;
- The average person-day rates that applied for internal, external contractor and external consultant resource;
- The total cost in respect of that area;
- An indicative split of what constituted the total cost in that area.

[21] For full details of the methodology, and the full data request sent to firms, see Ernst & Young's Compliance Impact Assessment, annexed to the FSA's consultation document.

[22] In this analysis we have considered direct costs to the FSA separately, and so have stripped the special project fees out of the total cost to industry to avoid double counting. However, the graphs provided by E&Y will still include the special project fees.

For non-resource costs, firms were asked to provide a cost estimate and an indicative split of the costs making up the total.

The estimates provided by the 26 firms in summer 2010 were grossed up to industry level by EY, using factors for each sub-sector that were agreed with the FSA. This gave a total one-off administrative cost to UK insurers over the period from September 2008 to 1 January 2013 of approximately £1.8bn (some breakdowns of this cost are shown below).

Follow-up work by the FSA in July 2011, based on updated cost estimates received from 12 of the original 26 sample firms, then put this figure at closer to £2bn. When special project fees payable to the FSA are stripped out (to avoid double-counting), this reduces to £1.9bn. Note that although special project fees are presented and estimated separately (in the section on costs to the FSA), since they represent a levy on firms, they have been included in the net cost to business figures used in the summary sheets at the front of this document.

Table 5: Sectoral breakdown of one-off administrative cost estimate
Source: EY compliance impact assessment for FSA, FSA analysis

Sub-sector	EY's original cost estimate (£m)	FSA's revised cost estimate[23] (£m)	Percentage Increase
Reinsurance	150		
Mutuals	24		
Commercial London Market	213		
General insurance	288		
Life and pensions	693		
Health	77		
Run-offs	39		
Composites	293		
Total (inc. Special Project Fee)	**1,777**	**2,044**	**15%**
Special Project Fee	**110**	**110**	**-**
Total (exc. Special Project Fee)	**1,667**	**1,934**	**16%**

The revised cost estimate of £1.9bn is significantly higher than some other previously-quoted transition cost estimates, including that contained in a partial impact assessment published by HM Treasury[24] in 2008. However, as was acknowledged by the previous assessment, a significant increase on that figure is not unexpected:

i. The previous cost estimate was based on data submitted by firms on a 'best efforts' basis for the QIS3 exercise in mid-2007, and so only related to the cost of fulfilling the Pillar 1 (quantitative) requirements as assessed in the QIS 3 exercise; and
ii. At the time of the previous estimate, the Directive was yet to be signed, and few firms had started material Solvency II activities or analysed the required changes to their businesses. Conversely, most firms are now well underway with their implementation programmes, and the level of detail and certainty is now a lot greater, allowing firms to make more accurate estimates of their implementation costs.

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[23] The revised cost estimate has not been broken down by sector to preserve data confidentiality for the firms that provided updated cost estimates. The 12 firms were representative of a cross-section of the industry.
[24] http://www.hm-treasury.gov.uk/d/solvencyii_finalia_090608.pdf

The updated estimate will include some costs that are not genuinely incremental and 'would have been incurred anyway' (see section on sensitivities and limitations, below). Further, there is evidence to suggest that some firms have made a commercial decision to develop internal models that go well beyond the minimum requirements of the regime; in such cases it is arguable that the discretionary element of the associated development cost should be excluded. The estimate also includes sunk costs, which are likely to account for a significant proportion. Sunk costs and discretionary spending have not been stripped out, in order to maintain consistency with our overall approach in providing a comprehensive picture of the costs and benefits.

Depending on future developments, the updated figure could also still prove to be an underestimate.

Breakdown of total estimated one-off administrative cost to industry

The graphs below give a breakdown of EY's original cost estimate (before FSA revisions and removal of special project fees), firstly by industry sector and then by type of cost.

Figure 1: Total estimated one-off transition costs by sector (in £m)
Source: EY Compliance Impact Assessment for FSA

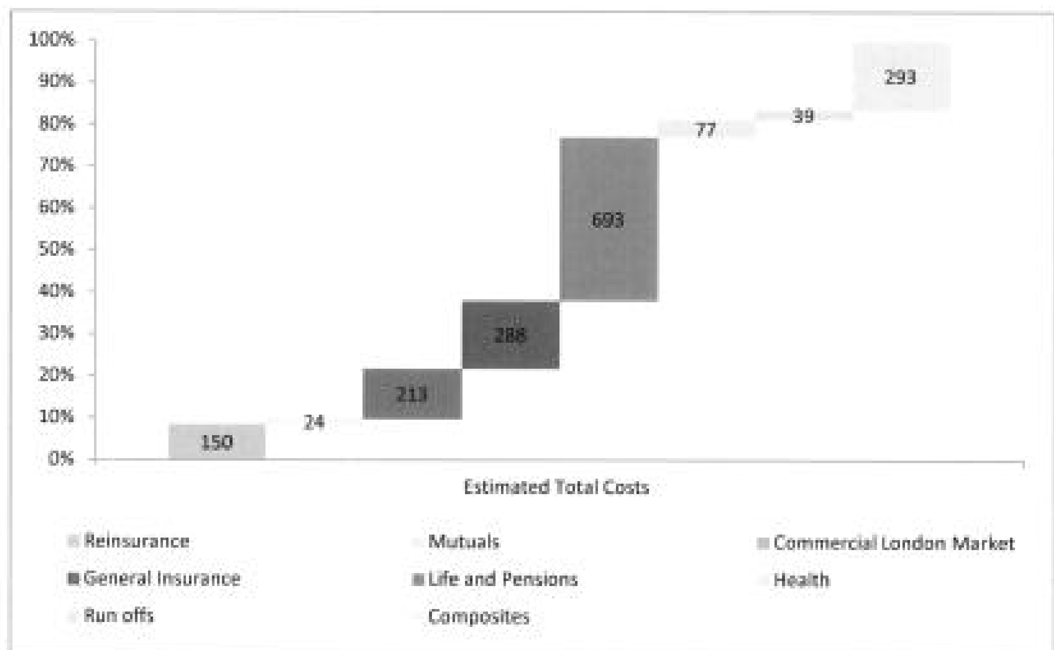
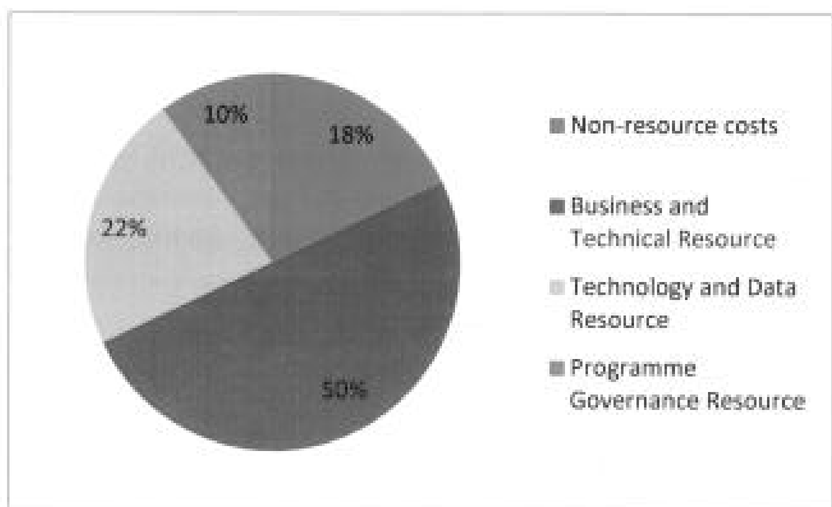
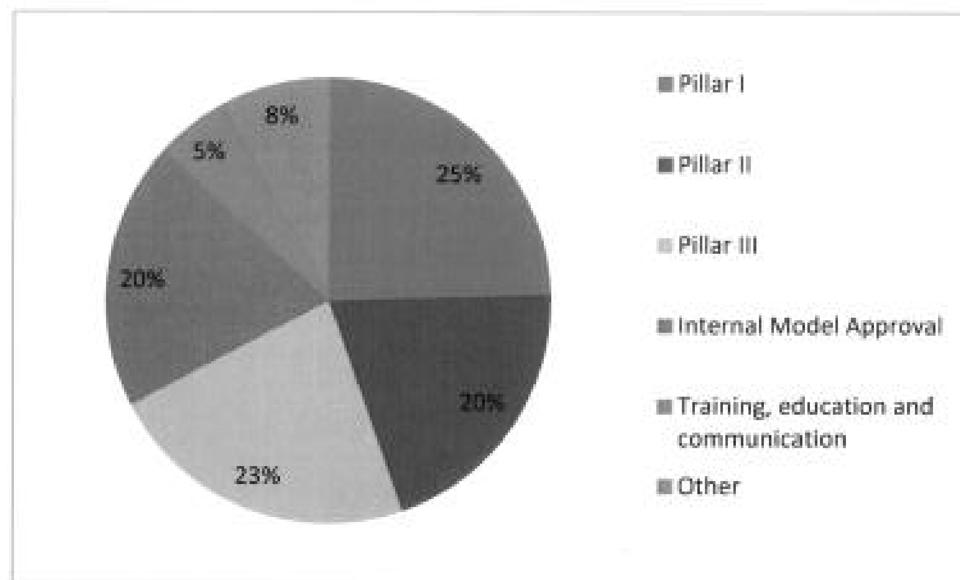


Figure 2: Split of total estimated one-off transition cost by type
Source: EY Compliance Impact Assessment for FSA



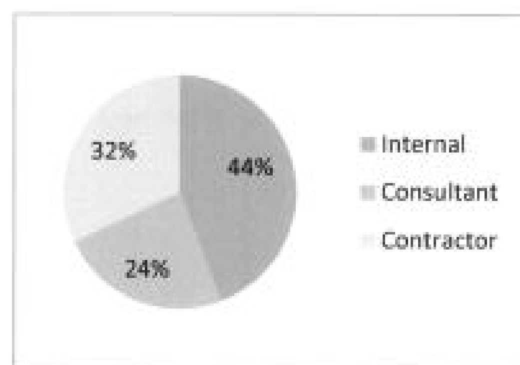
It can be seen that almost half of the total cost estimate is for business and technical resource, which can be broken down as follows:

Figure 3: Business and technical resource cost breakdown
Source: EY compliance impact assessment for FSA



It is also possible to look at the average split between the internal and external resources expected to be employed by firms:

Figure 4: Split of resources employed
Source: EY compliance impact assessment for FSA



<u>Total estimated ongoing administrative costs to industry</u>

At the time of EY's research, firms were unable to quantify their ongoing incremental administrative costs. However, the FSA's July 2011 follow-up work with 12 of the original 26 sample firms did yield ongoing cost estimates that were then grossed up to industry levels using the same methodology as for the one-off costs.

Firms were asked to include in their ongoing cost estimates:

- Additional business resources e.g. actuarial, risk, reporting, document management resources;
- Additional data and IT resources e.g. data cleansing, data governance and IT support resource;
- Other expenses, including ongoing annual software license fees and reporting costs.

The FSA's estimate based on firms' sample data was for a £193m per annum ongoing incremental cost. At the FSA's request this has not been shown broken down by sector in order to preserve data confidentiality for the contributing firms.

Assuming £190m of additional administrative costs per annum for 10 years from 2013 gives a present value of approximately £1.5bn.

Sensitivities and limitations of the industry administrative cost estimates

The methodology used to derive the industry cost estimates is subject to several sensitivities:

'Point-in-time'	The Solvency II requirements are not yet finalised and firms will be reviewing their business plans and budgets before implementation, particularly now that the implementation date may change.
Multi-national firms	Some firms were only able to provide an indicative split of costs between UK and non-UK aspects of their programmes.
Overlap	Because of overlaps with other change projects, the disentanglement of pure Solvency II costs was not always possible.
Extrapolation	Industry-level estimates have been extrapolated from samples, which may introduce distortion, particularly where the sample size is small. The analysis is based on the views of individual firms which have not been independently validated.
Sample bias	Only two firms in the research sample intend to use the standard formula, so it has not been possible to take into account the relative cost of using an internal model versus the standard formula in the industry estimate.

Because of these limitations, we have also considered higher and lower estimates around the best estimates discussed above.

One-off administrative cost to industry

Scenario	Estimated Cost (£m)
Low (80% of Best Estimate)	1,520
Best Estimate	**1,900**
High (120% of Best Estimate)	2,280

Ongoing administrative cost to industry

Scenario	Estimated 2011 Present Value of Cost (£m)
Low (75% of Best Estimate)	1,145
Best Estimate	**1,527**
High (125% of Best Estimate)	1,908

The percentage range either side of the best estimate is wider for the ongoing cost than for the one-off cost to reflect the fact that a smaller sample was used to derive the ongoing cost estimate and so there is greater potential for sample bias and extrapolation uncertainties.

B. Benefits

There are some key difficulties with assessing the benefits of implementing Solvency II in the UK:

Lack of source data: At the time of Ernst & Young's cost-benefit analysis study for the FSA, firms were unable to assess the monetary value of benefits when asked. To date, analyst reports on Solvency II have tended not to focus on benefits, and most discussion has been qualitative.

Dependence on insurer behaviour: The benefits actually experienced will depend on insurer behaviour, for instance whether firms go beyond the minimal amount of effort needed to comply with the new regulation, and whether they choose to compete in new markets.

Nature of benefits: Some types of benefit are difficult to quantify. (For example, a very likely benefit is a general improvement in the resilience of the European insurance sector, and as a result, a reduced probability of a severe market crisis. Models of low probability/high severity occurrences are by nature extremely sensitive to assumptions made and there is very scant data to use for parameterisation. This makes such a benefit difficult, if not impossible, to model with any degree of confidence, and so we have not attempted to do so here.)

Lack of clarity: The details of the regime are not finalised. Based on the current European timetable, details are unlikely to be clarified until at least mid-2012.

Benefits have been assessed on a 'best efforts' basis using a mixture of quantitative and qualitative analysis, and the quantified benefits are indicative only.

B1. Monetised Benefits

The methodology in this section is based on the Impact Assessment[25] produced by the European Commission to accompany the publication of the Solvency II Directive, with some adjustments to reflect the UK rather than EU-wide position. It echoes the benefits analysis from HM Treasury's 2008 partial impact assessment for Solvency II[26].

We attempt to monetise:

- A perception by providers of capital that insurers are more robust and better managed than prior to the introduction of Solvency II; and
- An improvement in the efficiency of firms' risk and capital management.

The former benefit is assumed to arise from the enhanced risk-sensitivity and robustness of the new capital rules, combined with the intensified focus on risk management and good governance, and the increased and more harmonised disclosure of information to investors (which will increase transparency and comparability and reduce information asymmetry). The assumed result is a reduced cost of capital for UK insurers.

The latter benefit is modelled by using improved investment returns as a proxy for the savings arising from improved risk and capital management practices within firms.

The ICAS regime will already have brought a portion of these benefits to UK firms, so the incremental benefit in the UK will be smaller than that available in other EU countries whose current regimes are closer to the Solvency I requirements. We take this into account in the calculations that follow by

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[25] http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf

[26] As referenced earlier.

making prudent assumptions about the reduction in cost of capital and efficiency gains(/improvement in returns) that are likely to emerge.

Reduction in cost of capital

A potential reduction in UK insurers' cost of capital has been modelled by considering:

i. how much capital is likely to be held by the industry when the new regime is implemented; and
ii. the annual savings that would result from a range of plausible reductions in the cost of servicing this capital.

For (i), the amount of available capital resources reported by firms in the QIS5 exercise has been used as a best estimate. A range of +/-10% has been considered to allow for the uncertainty inherent in this estimate[27].
For (ii), reductions in the range of 0 to 10 basis points[28] per annum have been investigated. This range was chosen to be consistent with the assumptions used in both the Commission's and HM Treasury's previous impact assessments. The annual savings that result have been converted into 2011 present values assuming that savings persist for 10 years after implementation in 2013.

A table summarising the results is below.

Table 6: potential benefit arising from reduction in UK insurers' cost of capital
Source: QIS5 data and own calculations

		Assumed reduction in cost of capital per annum (bps)				
		0	3.75	5	7.5	10
Capital Scenario	Total available capital (£m)	2011 present value of saving arising from assumed reduction in cost of capital over 10 years from 2013 (£m)				
Lower Estimate: Firms have 90% of QIS5 available capital levels	96,300	**0** [lower benefit]	290	387	581	774
Best Estimate: Firms have 100% of QIS5 available capital level	107,100	0	**323** [best estimate benefit]	430	645	860
Higher Estimate: Firms have 110% of QIS5 available capital level	117,800	0	355	**473** [higher benefit]	710	946

The Commission's impact assessment considered a range of 5 to 10bps to be plausible. To arrive at a best estimate, the HM Treasury 2008 partial impact assessment took the midpoint of this range (7.5bps), then halved it to allow for the ICAS regime already having resulted in some benefit. In line with the partial impact assessment, we have taken 3.75bps as a best estimate.

Using a 3.75bp reduction with the 'best estimate' capital scenario gives a benefit with a 2011 present value of £323m.

To allow for uncertainty, we also consider a lower and higher estimate of the benefit. The lower estimate assumes no reduction in capital cost, giving a benefit of zero, while the higher estimate is

[27] A particular area of uncertainty is the application of transitional measures to capital instruments, which will be decided as part of Omnibus II. There is also some evidence that firms were not always consistent in the reporting of their capital instruments for QIS5.
[28] A basis point is one hundredth of 1%, or 0.0001.

derived by combining the higher available capital scenario with a 5bp reduction to give a benefit of £473m.

Improved efficiency of risk and capital management

As the Commission noted in their impact assessment, Solvency II has been designed to bring about improvements to firms' risk management processes. By better managing their risk and their capital requirements, firms will be able to manipulate their risk/return profiles (for instance through diversification activity), leading to efficiency gains. The size of insurers' balance sheets means that even very small efficiency savings are likely to be substantial when considered in aggregate. However, since these efficiency gains are very difficult to quantify directly, an alternative approach is to use an improvement in investment returns as a rough proxy.

The UK insurance industry has approximately £1.6 trillion[29] of assets in aggregate. We have investigated the benefit that would result if investment returns on these assets improved by between 1 and 3.5 basis points.

For each of the scenarios modelled below, it is assumed that the additional returns persist for ten years (with the total assets remaining fixed at £1.6 trillion over that period).

Scenario	Assumed improvement in return (bps)	Resulting additional investment income per annum (£m)	Total additional investment income over 10 years (£m)	2011 present value of additional investment income over 10 years from 2013 (£m)
Very Low	1	160	1,600	1,286
Low	1.5	240	2,400	**1,928**
Low - Moderate	2	320	3,200	2,571
Best Estimate	2.5	400	4,000	**3,214**
Moderate - High	3	480	4,800	3,857
High	3.5	560	5,600	**4,500**

In line with HM Treasury's 2008 partial impact assessment, a best estimate of 2.5 basis points per annum of additional investment returns over the next 10 years has been used, giving a benefit with a present value of around £3.2bn. The size of the benefit is very sensitive to the assumption about the basis point increase in achievable returns, so lower and higher estimates have also been calculated as shown in the table above. Given this sensitivity, we would be interested in views on the quantitative estimates made in this respect.

B2. Non-monetised Benefits

Administrative benefits to industry

As part of their research for the FSA, EY asked sample firms to try to quantify the administrative benefits of complying with the Solvency II regime. Firms struggled to do so, and not enough data was gathered to undertake a quantitative analysis, but firms did describe the administrative benefits they expected:

- improved risk modelling, analysis and management;

[29] Source: ABI Key Facts September 2010

- enhanced governance processes;
- improvements in management information;
- a greater definition of risk appetite; and
- improvements to documentation and the internal control framework.

These administrative benefits are mostly attributable to Pillar 2 of the regime (which deals with risk management and governance). EY believe these benefits are likely to materialise, and will also contribute to the better management and avoidance of downside risk (or in other words to 'loss aversion'), which is in itself a significant benefit of the new regime (discussed below).

A harmonised regulatory framework across Europe should reduce ongoing compliance costs for UK firms with operations in other EU countries.

There are also likely to be some administrative synergies between Solvency II and the introduction of International Financial Reporting Standards 4 Phase II (IFRS4)[30], the new accounting standard for insurance contracts proposed by the International Accounting Standards Board (IASB). IFRS4 is expected to introduce some fundamental changes, requiring significant system and process upgrades.

Insurance Market Benefits

Solvency II will create a 'level playing field' across Europe for the provision of insurance and reinsurance services. This will create an increased opportunity for UK insurers to compete within Europe, and will also open up the UK market to increased competition from insurers in other member states. Competitive effects are considered further within the Competition Impact Test, annexed.

The risk-based nature of the new framework should make the insurance market in Europe more efficient, in the sense that if pricing and capital allocation are more closely aligned to the real risks faced, then policyholders are more likely to be charged appropriately according to the risks they choose to insure, and shareholders compensated more appropriately for the risks they assume.

Pillar 3 of the Solvency II regime concerns disclosure; in particular, it is intended to increase the level of transparency in insurers' public and regulatory reporting. This enhanced level of disclosure aims to bring greater 'market discipline' to bear. The amount and range of information that will be publicly disclosed will be greater than at present. It is hoped that this will result in market participants exerting greater supervision over, and greater competition to, other insurers. The Commission have suggested[31] that insurers following best practice might be more likely to be rewarded by a lower cost of financing.

Internal Model benefits to industry

80% of the 60 firms in Deloitte's 2011 Solvency II survey plan to implement either a full or partial internal model under Solvency II. We have already noted that the aggregate capital impact of internal models cannot be known at this stage. However, there are other benefits to firms of internal model usage[32]:

- Better understanding of the firm's business and capital requirements through identification of the true risk profile of the business;
- Improved evaluation of risk-adjusted returns on capital;

[30] In Deloitte's 2011 Solvency II survey, 43% of the 60 firms surveyed expected to integrate the implementation of IFRS 4 Phase II with Solvency II, with a further 18% of firms still undecided.

[31] See the Solvency II FAQ document previously referenced.

[32] See for example *Internal Models – A Winning Solution for Solvency II*, Guy Carpenter (2007), and *Benefits and challenges of using an internal model for Solvency II*, Milliman (2008).

- Better understanding of the relative contribution of the major categories of risk to the firm's overall risk profile;
- Improved capability to balance risk with reward, to measure performance, and to identify strengths, weaknesses and opportunities;
- Better assessment of the impact of strategic decisions on capital requirements;
- Improved quality of documentation; and as a result,
- Better communication of results to supervisors and ratings agencies, as well as for internal communications.

Increased confidence of rating agencies in a firm's risk management is one of the factors that may help to reduce a firm's cost of capital, as discussed and modelled in section B1 above.

Benefits to Consumers

The main benefit of Solvency II to consumers of insurance products will be the greater level of policyholder protection they will enjoy; that is, the greater likelihood that insurance providers will be able to meet their liabilities as they fall due.

It is very likely that Solvency II will affect the price of insurance, but without the details of the finalised requirements, it is not possible to predict the direction or magnitude of price changes for specific products at this stage.

It seems likely that as firms re-calculate their capital requirements on a Solvency II basis, and re-evaluate their business for profitability and return on capital, some products will become more expensive to provide whilst others will become cheaper. Competitive shifts in the market will also drive price changes. Consumers of products that end up with a lower price will benefit, but this benefit will be at least partially offset by consumers of products that increase in price. Pricing is considered further in section C4.

A 2007 briefing note by the Comité Européen des Assurances (CEA)[33] listed the key consumer benefits of Solvency II as being: greater consumer confidence; enhanced policyholder protection; cost-effective protection; and more innovative and competitive products.

Benefits to the financial system – averted loss

There have not been many insurer failures to date, although there have been some notable failures that have had a substantial impact on policyholders and investors. Payouts under the Financial Services Compensation Scheme in respect of insurer failure totalled £172m in the 3 years to 2011[34].

Some of the past causes of insurer failure have been:

- inadequate provision for the guarantees within policies or for policyholders' reasonable expectations;
- poor risk management processes and controls;
- under-pricing of contracts;
- overly-rapid expansion;
- difficulties within other (non-insurance) parts of an insurance group;
- multiple exposures to the same pool of risks, and opaque reinsurance structures.

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[33] *Solvency II Why It Matters to Consumers*, available from www.cea.eu

[34] This figure has been derived from annual reports of the FSCS for 2008/09, 2009/10 and 2010/11, available at www.fscs.org.uk.

In their cost-benefit analysis for the FSA, EY argue that Solvency II will reduce the probability of insurer default via the 'three-pillar' approach: Pillar 1 will align capital requirements more closely with the actual assets and liabilities held; Pillar 2 will lead to more pro-active risk management activity; and Pillar 3 will improve transparency via heightened public disclosure, leading to greater market discipline.

Solvency II also explicitly requires insurers to account for embedded options and guarantees, and to base technical provisions on policyholder expectations rather than only the contractual minimum liabilities.

It therefore seems likely that Solvency II will reduce the probability of a repeat of some of the previous causes of insurer failure, and therefore the probability of a default. However, as there is very limited data on insurer default, this benefit has not been quantified; further, part of the benefit of a reduced probability of default will already be reflected in the reduced cost of capital that has been modelled.

C. Wider Impacts

According to a July 2011 paper[35] from the Bank for International Settlements' Committee on the Global Financial System (CGFS), insurance firms may adjust their operations in several ways as a result of new regulations:

- Change the size and allocation of investment portfolios;
- Transfer risk to the financial markets using reinsurance, securitisation or hedging with derivatives;
- Streamline group structures to better capitalise on diversification benefits;
- Redesign products over time.

In this section we consider the wider impacts of Solvency II implementation. In particular we consider the investment, financial market, product/pricing and insurance market implications. Competition effects are considered in the Competition Impact Test, annexed.

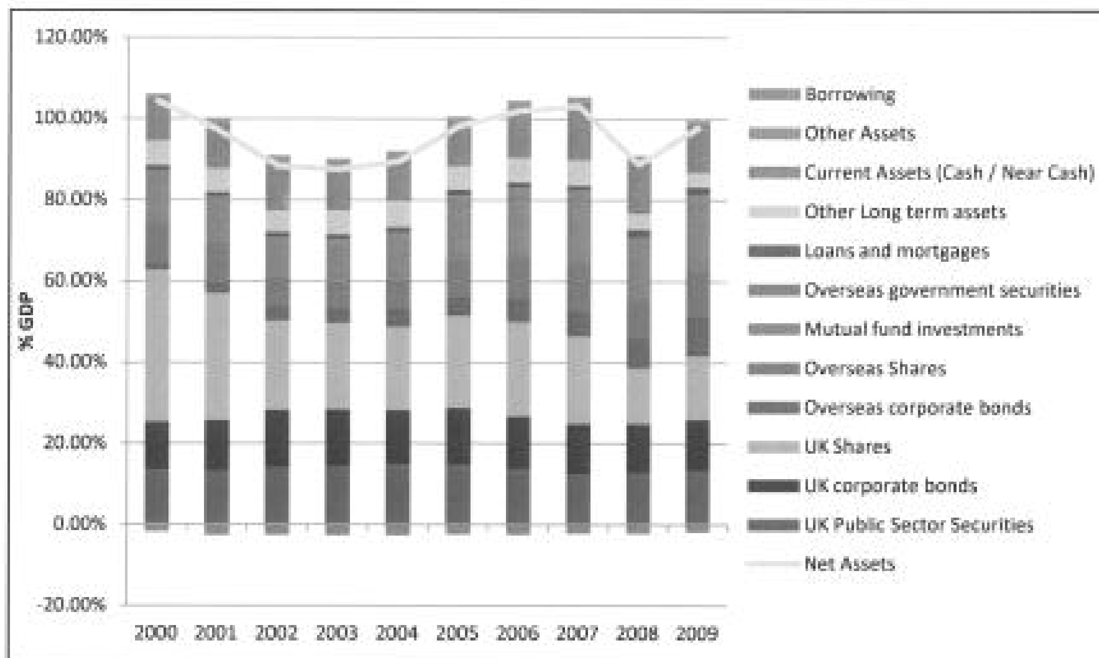
C1. Asset Allocation

Baseline

The following graph shows trends in asset allocation amongst insurers for the period from 2000 to 2009. Most notable are the shifts away from equities and into mutual funds (also known as collective investments) and overseas corporate bonds. The analysis that follows should be interpreted in the context of this shifting 'baseline', since asset allocation has clearly not been static over the period preceding the introduction of Solvency II, and some of the drivers of the changes seen in past years will still be in evidence.

Figure 5: Assets held by insurers relative to GDP, 2000-2009
Source: Office for National Statistics

[35] As previously referenced.



Implications of Solvency II for asset allocation

Analyst literature[36] on the asset allocation impacts of Solvency II has to date focussed on the implications of the standard formula calibration as tested under QIS5. The broad conclusion has been that this calibration would make it more expensive to hold equity-like instruments, structured products, and long-term or low-rated corporate bonds, whilst government bonds in the issuer's domestic currency and covered bonds would appear more attractive[37]. There have been associated concerns expressed about the potential effects on insurers' provision of financing for the real economy, and possible perverse risk incentives to hold large quantities of periphery sovereign debt, which we discuss further in section C2.

However, these early conclusions must be interpreted with caution:

- the exact treatment of these items within the standard formula is still undecided, and there may yet be substantial changes to the calibration;
- the use of internal models means that there will still be heterogeneity in individual firms' assessments of market risk. Firms, particularly larger firms, are likely to use bespoke methods to accurately reflect their own specific risk profiles rather than rely on the standard formula factors;
- firms will take into account criteria other than capital requirements when making investment decisions, such as any need for cashflow matching;
- transitional arrangements may be in place which would affect the scope and timing of any impact.

There will also be other new drivers influencing insurers' investment decisions in the coming years; for example, IFRS 4 Phase II is likely to introduce additional accounting volatility into insurers' P&L statements, which may lead to some de-risking of asset holdings.

The combined effect of these uncertainties and the presence of other driving factors mean that it is too early to say whether analysts' predictions will be borne out in practice. Further, the current risk-based ICAS regime for UK insurers is likely to make the impact different in the UK than in other member states. However, it is certainly likely that on a Europe-wide basis, the move to fully market-consistent valuation

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[36] See for example Fitch Ratings' June 2011 paper *Solvency II Set to Reshape Asset Allocation and Capital Markets*, the JPMorgan/IIA paper *Solvency II: A Briefing for the CIO* or the Oliver Wyman/Morgan Stanley paper *Solvency 2: Quantitative and Strategic Impact – The Tide is Going Out*.

[37] These assessments have tended to use a 'return on capital' approach to evaluate the relative merits of different asset classes. The overall attractiveness is then a function of both the assumed returns available and the amount of capital required to support the investment.

practices, and Solvency II's focus on the risks to the asset side of the balance sheet as well as to the liability side, will cause some significant changes.

The potential impacts of asset allocation changes on individual markets are explored further in the following section[38].

C2. Financial Market Impacts

Capital Markets

Insurers as providers of capital
Insurance companies are important providers of finance to UK companies, including banks. Life insurers are particularly important providers of stable long-term finance, for example to infrastructure projects and directly to Government, usually in the form of long-term bonds.

Equity Markets
As Figure 5 above shows, over the past decade there has been a general trend amongst UK insurers to move away from equity investments. This is likely to have been driven by a combination of poor equity performance, the market crises of the early 2000s and 2008, and the new regulatory requirements of the ICAS regime putting increased focus on the asset side of the balance sheet. Despite this decline, equity backing ratios do remain high for UK life insurers versus their European counterparts.

The relatively high volatility of the market values of equity investments, combined with a likely 39%[39] capital charge under the standard formula, may mean that the equity holdings of insurers continue to decline. However, trends in equity holdings will depend in part on any trends on product provision, since some insurers may respond to Solvency II by increasing their provision of unit linked products, where investment risk is borne by the policyholder and so capital charges are substantially reduced. Insurers will also be incentivised to hold a wide range of investments in order to achieve a diversification benefit, so equities would still have an attraction for this purpose.

Corporate Bond Markets
The calibration of the capital charges for corporate bonds in QIS5 led analysts to speculate[40] that longer-term and lower-rated corporate bonds would become less attractive investments because of the relatively higher charges they would attract (even once the additional returns offered were taken into account). Based on the same criteria, bonds of three to five years' duration have been suggested as insurers' preferred habitat under Solvency II. This has led to comments about possible segmentation of the bond markets, and also a greater use of derivatives such as interest rate swaps to allow firms to match the duration of their assets and liabilities without holding longer-dated bonds.

However, this module of the standard formula is still being calibrated and it is highly likely that the final calibration will be different from that used under QIS5. Further, the desirability of exact cash-flow matching (rather than duration matching) and the limited availability of instruments such as interest rate swaps at the longest durations will retain incentives to hold physical bonds. Demand for corporate bonds will also be linked to the design of the matching premium, which is discussed in the section on Infrastructure, below.

Covered Bonds

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[38] For reasons of space and proportionality, the commentary here is relatively brief. A more comprehensive assessment of the possible market impacts is provided in the CGFS paper previously referenced.

[39] Plus or minus a 'symmetric dampener' component

[40] See the papers on asset allocation referenced earlier.

Covered bonds are seen to receive a relatively favourable capital treatment under the standard formula. If the calibration of their capital charges in the final regime is unchanged from QIS5 then this asset class could see continued growth as a result of increased interest from insurers.

Investment in Infrastructure

Much of UK infrastructure is funded by the issue of long-term debt. As mentioned above, Life insurers have traditionally been well-placed to invest in such debt because the resulting cashflows can be used to match those of long-term contracts such as annuities. The UK's current regulatory regime encourages such matching because the return offered on the matching assets can be used as the basis for the discount rate applied to the annuity liabilities.

As a market consistent regime, Solvency II will require almost all liabilities to be valued using a 'risk free' discount rate. However, the finalised implementing measures are likely to allow an addition to be made to the risk-free rate when discounting annuity liabilities, so long as the liabilities are demonstrably closely matched by appropriate backing assets and are managed separately (or 'ring fenced') from the rest of the firm's business. This addition to the discount rate is referred to as a 'matching premium'. The specifics of its design and application have only recently been proposed by the Commission. This proposal includes restrictions on assets that are rated BBB or lower that could affect the industry's appetite for investment in certain infrastructure products.

The final standard formula treatment of long-term corporate debt and the design of the matching premium are both likely to have an impact on the appetite of insurers to continue to provide investment in infrastructure. If investment by insurers declined significantly, this could raise the cost of financing for infrastructure providers, with a potential knock-on effect on consumers via higher prices.

At this point it is too early to say what the extent of this impact might be, as both of these areas of the regime are still under discussion within Europe.

Insurers as issuers of capital

As mentioned in earlier sections of this assessment, there is currently insufficient evidence to draw conclusions about the quantum of any capital-raising activity in response to Solvency II. However, since 80% of firms were able to meet the QIS5 SCR, and firms will have had time in the run up to implementation to anticipate any deficits versus their Solvency II capital positions, any new issuance is likely to be absorbable without causing significant capital market impacts, particularly if transitional measures allow any impact to be spread over time.

Government Bond Markets

The standard formula will treat investments in European sovereign debt as effectively risk free, which would seem to incentivise insurers to invest more heavily in this asset class, including in higher-yielding periphery debt. However, insurers using internal models will need to properly allow for spread and default risks on such debt which would moderate this effect. Any significant changes to the composition of insurers' government bond holdings would be likely to have a noticeable market impact given the volume of government bonds that insurers currently hold on their balance sheets.

C3. Consumer Impacts: Product Price and Quality

If the marginal costs of providing an insurance product increase as a result of Solvency II, then insurers will have several choices in how they react:

- Withdraw partially or fully from the market for that product type;
- Reduce the quality of cover provided for a given price;
- Retain the quality but increase the price of the product; or
- Some combination of the above.

These choices are likely to be influenced by:

- The extent of competition in the market, and the actions of competitors;
- Barriers to entry and exit from the market;
- Whether the product is a discretionary purchase or is mandatory (i.e. third party motor cover);
- Consumer preferences in terms of paying more or receiving a lower quality product;
- Whether the product is of strategic importance to the provider;
- The product's contribution to diversification effects.

Any changes to product design will take into account accounting and tax treatment as well as the cost of provision in capital terms.

Effect on the annuity market

If products which offer guaranteed returns to policyholders (such as annuities) become more expensive to provide, then insurers may react by raising prices to reflect the increased cost of the guarantees. However, price increases would be constrained by competitive effects, and annuity providers might alternatively (or additionally) react by offering more products that are unit- or index-linked, and so transfer some or all of the investment risk to the policyholder.

There are other drivers that would lead to annuity price increases in the absence of Solvency II, such as the general trend of increasing annuitant longevity. Persistent lower returns on the assets that are typically used to back annuity liabilities could also lead to deterioration in annuity rates offered. There may be a general change in sentiment towards providing products of this type, based on a re-evaluation of their true costs and risks. The accounting treatment of such products is another relevant factor. The need to disentangle these effects is a key difficulty of assessing the impact of Solvency II on the annuity market.

The extent of any change in the cost of provision will depend heavily on the discount rate that can be used for annuity liabilities, which has not yet been agreed (see discussion on the matching premium, above)[41]. For all of the above reasons it has not been possible to quantify the likely changes to the annuity market at this stage. However, given the importance of this market to the UK, this has been a key area of focus when engaging with other Member States and with the Commission on the design of the new regulations.

Volume of products sold

Changes to product pricing and quality are likely to affect the amounts sold (at least for product lines where purchase is not compulsory). Insurers may look to provide a more granular range of policy types within a product line in order to target different market segments and meet differing customer needs.

Conclusion

Solvency II may result in certain types of insurance product becoming more expensive to provide. The extent to which this translates into higher prices or lower quality products for consumers will depend on many factors including the level of competition in each market, the nature of the product and insurers' strategic goals.

In the long run, Solvency II should lead to increased cross-border competition, consolidation activity (allowing insurers to benefit from economies of scale and diversification), and product innovation. These changes can be expected to lead to reduced prices for certain product types and a greater variety of products offered.

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[41] The discount rate that is ultimately included in the implementing measures will certainly differ from that tested under QIS5, so an analysis based on QIS5 data would not yield meaningful results.

C4. Insurance Market Impacts

The UK insurance market is the largest in Europe and the third largest in the world, accounting for 8% of worldwide premium income. The industry is also a significant exporter; one fifth of net premiums come from overseas business[42].

Solvency II is likely to affect the structure of the UK insurance market. As discussed in the previous section, the range, quality and price of products offered may change, and firms may enter and exit certain product lines, changing the composition of market subsectors. The competitive environment is also likely to change, particularly if cross-border competition intensifies and there is consolidation activity. Competition effects are treated separately in the Competition Impact Test, annexed.

Consolidation

The UK insurance industry saw an increase in actual and attempted consolidation activity in 2010, driven by the aims of both increasing operating efficiency, and diversifying the underwriting portfolio.

Solvency II is likely to be a driver for increased consolidation activity, for two main reasons; firms will be able to spread their fixed costs (including regulatory compliance costs) over a wider base, receiving an economy of scale, and will also benefit from greater diversification, reducing capital requirements. This should lead to greater profitability for the combined entity. The extent of the diversification benefit would depend on the activities of the consolidating firms; the more differentiated their individual activities, the greater the benefit of consolidation. This would tend to suggest that merger activity would be most likely between firms operating in different markets, that are not currently well-diversified, and that are not already at the size where they cannot benefit further from economies of scale.

Consolidation activity may result in a reduced number of players in the market; however, the need for approval from competition authorities should preclude mergers that are likely to reduce the level of competition.

Reinsurance

Any impact on the reinsurance market will depend on the relative changes in cost of providing both insurance and reinsurance. Insurers will only transfer risk to reinsurers if they could not more profitably retain it themselves. If insurers' costs increase by more than reinsurers' prices, it is likely that there will be greater transfer of risk to reinsurers.

Reinsurers' prices will be affected by the same factors as direct insurers' – that is, by capital requirements, costs of compliance, and the extent to which increased costs are passed on via higher prices. Most reinsurers are very well-diversified (geographically as well as by product line), large (and so better able to absorb any increases to fixed costs) and can access capital relatively cheaply. This would tend to suggest that the cost of supplying reinsurance will not increase as much as the cost of supplying direct insurance, which would suggest a greater use of reinsurance, particularly by undiversified or smaller direct insurers for whom reinsurance will be a cheaper substitute for additional capital.

6. Risks and Assumptions

The ultimate impact of the Solvency II Directive will be heavily reliant on the details of the accompanying implementing measures and guidance, which are yet to be finally agreed. The cost benefit analysis presented here therefore does not and cannot fully reflect the final form of the regime.

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[42] All of these statistics are from ABI Key Facts September 2010.

As stated earlier, the last complete package of proposed implementing measures to be comprehensively tested by the industry was the Technical Specification for QIS5. Firms completed the QIS5 exercise between July and October 2010, and submitted results on the basis of their positions at 31/12/2009.

Since the QIS5 results have been used, in full awareness of their limitations, to inform many of the conclusions in this analysis, we here set out the full list of associated caveats, almost all of which have already been mentioned elsewhere:

- QIS5 indicates the industry position as at year-end 2009 only.
- The results from the exercise are a point-in-time estimate, so cannot illustrate any potential volatility in the industry's solvency position.
- The industry completed the exercise on a "best-efforts" basis. This means that, although it has been subject to sense-checking and basic validation by the FSA, the data that was provided may have been incomplete, or have been based on estimates.
- The results of the exercise do not take into account management actions, such as restructuring, changing product mix, changing investment strategy et cetera, that are highly likely to occur between now and the introduction of the new regime.
- The results do not reflect the use of internal models, which are likely to have a significant effect on the aggregate industry position.
- The results are based on use of an Illiquidity Premium to supplement the risk-free discount rate for long-term liabilities. However, the Commission's latest proposal replaces this with a new Matching Premium to support highly illiquid products (such as UK annuities), and a counter-cyclical premium to increase the discount rate for all other products when markets are stressed.
- The results do not capture transitional arrangements, which may smooth the changeover to the new regime. The effect of transitional arrangements is likely to be very material.
- The results reflect the QIS5 standard formula calibration, which is likely to be significantly changed before the regime is introduced. In particular, the results reflect:
    1. The QIS5 approach to discounting technical provisions (including a liquidity premium), which is likely to be substantially changed, with material effect, before the regime is introduced.
    2. The QIS5 approach to eligibility and tiering of own funds, which may change between now and implementation.
- The aggregate results are for solo firms, many of which will be parts of a larger group. The group solvency position is unlikely to be simply the "sum" of the solo solvency positions, and complex group interactions and structures will not have been adequately captured.

Wherever these caveats have a material bearing on the conclusions that can be drawn in a particular section of the analysis, this has been highlighted.

Risks of using sample data

Other conclusions of this analysis have been based on sample data which has been extrapolated to provide an industry-level estimate. There is therefore a risk that the resulting estimates are inappropriate, whether due to sample bias, extrapolation error, or the presence of material errors or estimates in the underlying sample data, which has not been independently validated.

Firms have provided their own individual views and these views may change between the time that the data was provided and the time that the regime comes into force. The views of the sample firms may not be representative of the industry. The sample of firms used to provide the one-off and ongoing administrative cost estimates contained only two firms that planned to use the standard formula. This means that the costs of using the standard formula may not have been accurately reflected.

Wherever sample data has been used to inform a best estimate, a higher and lower estimate either side has been considered to allow for uncertainty and possible error.

External Risks

There is a risk of slips to the European timetable for agreeing the remaining components of the Solvency II regime (including a risk of delay to the agreement of the Omnibus II Directive; this amending Directive is needed to make Solvency II compliant with the Lisbon Treaty and will also set the implementation and transposition deadlines and any transitional measures). A delay to Omnibus II, and/or to the subsequent agreement of the implementing measures, could significantly affect the total implementation cost for firms, national supervisors, and EIOPA[43] in its role as the European Supervisory Authority (ESA) for insurance.

7. Rationale and evidence for the level of analysis used in the impact assessment (proportionality approach)

The proportionality approach for Government impact assessments requires that the level of analysis undertaken should be in proportion to certain factors. These factors are listed below, together with brief notes on how they apply in this case:

Level of interest and sensitivity surrounding the policy	There is a relatively high level of interest and sensitivity in the content of the Directive and implementing measures. There is less interest and sensitivity around exact method of transposition employed in the UK.
Scale, duration and distribution of expected impact	Solvency II is likely to have a significant, long-lasting and widespread impact on the insurance market in the UK. There may also be spill-over effects on financial markets.
Degree to which the policy is novel, contentious or irreversible	Regulatory policy for insurers is not new in itself, and Solvency II has been several years in development. The content of the Directive and implementing measures has been widely consulted on. There will be a statutory duty to review the policy after 5 years.
Stage of policy development	This is a consultation-stage impact assessment. Further analysis can be undertaken at later stages when there will be greater certainty about the final shape of the regime, and taking on board results of the consultation exercise.
Level of uncertainty around likely impacts	Very high level of uncertainty at this stage: implementing measures are not yet finalised and these will significantly affect impact; internal models not yet fully developed; implementation and transposition dates not yet finalised; transitional arrangements not yet finalised.
Data already available and resources required to gather further data	The QIS5 data used in this assessment only indicates the impact of one version of the implementing measures at a certain point in time, so is of limited use for projecting actual impacts. However, the QIS5 exercise was a major undertaking for UK firms, and

[43] European Insurance and Occupational Pensions Authority; see https://eiopa.europa.eu/

	collecting more data on a similar (industry-wide) scale would not be feasible or proportionate whilst the final requirements of the regime remain unknown. We have also used data gathered for the FSA by Ernst & Young concerning implementation costs. We have not attempted to supplement this data with our own research because the marginal cost would not be justified by the marginal benefit.
Time available for policy development	Delaying the Government's consultation on transposition until final implementing measures are known would be unlikely to leave enough time for the transposition process, risking infraction proceedings against the UK.

Whilst the first two factors would incline towards a highly detailed assessment with full monetisation, the other factors, particularly the level of uncertainty over the impacts, limit the extent to which this would be proportionate or feasible.

Our approach has been to perform a 'best efforts' assessment of the likely costs, benefits and wider impacts, quantifying these as far as is possible or reasonable given the data available at this time.

A full monetisation of the benefits, or of the wider impacts, has not been possible. Those costs and benefits that have been monetised must be seen as indicative only, not least because of the lack of clarity over the implementing measures; section 6 on risks and assumptions sets out the other material uncertainties.

Further cost benefit analysis of Solvency II can be found within the FSA's consultation document and the Ernst & Young reports that are annexed thereto.

The FSA intends to issue a second Solvency II Consultation Paper in 2012, at which point firms will have another opportunity to contribute views on the FSA's approach to modifying the regulatory Handbook and also on the impacts of the new regime.

Summary and Description of Implementation Plan

Summary of Monetised Cost and Benefit Estimates

In the table below, the 'pessimistic' estimate has been derived by combining all of the high estimates of the cost figures with the low estimates of the benefit figures. The 'optimistic' estimate is vice-versa. The best estimate row simply comprises the best or central estimate for each of the component costs and benefits.

	2011 PV of Costs (assuming ongoing costs spread over 10 years from 2013) (£m)					2011 PV of Benefits (assuming ongoing benefits are spread over 10 years from 2013) (£m)		
	One-off administrative cost to industry	Ongoing administrative cost to industry	One-off cost to FSA	Ongoing cost to FSA/PRA	Capital Release/ Raising	Reduced cost of capital	Efficiency Gains	2011 PV of Net Benefit (£m)
Optimistic Estimate	-1,520	-1,145	-99	-55	3,214	473	4,500	5,368
Best Estimate	-1,900	-1,527	-110	-61	0	323	3,214	-61
Pessimistic	-2,280	-1,908	-121	-67	-4,601	0	1,928	-7,050

Estimate								

Summary of Non-Monetised Impacts

The table above shows a net present value of -£61m on a best estimate basis; however, the figures in the table above only reflect the costs and benefits that have been monetised and so do not capture all of the relevant factors.

Many of the impacts of implementing Solvency II, including some of the benefits, have not been assigned a monetary value.

The non-monetised impacts discussed in this assessment were:

- **Administrative benefits** to industry (e.g. better risk management and governance, better management information, better defined risk appetite, better documentation and internal controls);
- **Internal model benefits** to industry (e.g. better understanding of the risk profile, identification of strengths weaknesses and opportunities);
- **Insurance market benefits** (greater market efficiency, competition, a level playing field, more transparency due to Pillar 3 disclosure requirements);
- **Consumer benefits** (greater consumer confidence, enhanced consumer protection, greater cost-effectiveness of insurance provision, product innovation and competition);
- **Averted loss** (lower probability of a repeat of past causes of insurer failure);
- **Asset allocation** impacts;
- **Capital market** impacts;
- **Product price and quality**;
- **Insurance market** impacts;
- **Competition** impacts;
- Impacts on **smaller and lower-risk firms**.

Implementation Plan

The implementation date set out in the Solvency II Directive is 31st October 2012. However, this date is currently being amended through the Omnibus II Directive. It looks increasingly likely that the Omnibus II Directive will amend the date by which member states are required to transpose Solvency II to 31st December 2012, with the Directive coming gradually into force over the subsequent 12 months. Omnibus II is not expected to be agreed until early 2012. The UK Government will set out its implementation plan in more detail once there is some certainty as to what will be required by the EU Directives.

Annex 1: Post Implementation Review Plan

The Statutory Instrument for the proposed legal changes will contain a clause that imposes a ministerial duty to review the changes 5 years after they are implemented.

The primary focus of this Post-Implementation Review (PIR) should be whether the legislative changes have had the intended effect. Any unintended consequences that have been observed should also be set out.

Stakeholders will need to be consulted as to the effectiveness of the implementation of the new regime. As mentioned in the Small Firms Impact Test, it will be particularly important to canvass the views of

smaller firms and to ensure that they have not been disproportionately affected by the introduction of the new regime.

In line with the guidance on conducting post-implementation reviews, the following key questions will need to be considered:

- To what extent have the legislative changes achieved their objectives?
- To what extent have there been unintended consequences?
- What are the costs and benefits, in hindsight and going forward?
- Has the market changed as a result of the policy?
- Is there any scope for simplification, improvement or deregulation?
- Do compliance levels indicate that the enforcement process is appropriate?

Data will need to be gathered to allow the post-implementation review to be performed. It is likely that supervisory data from the FSA, in particular the regulatory reports that firms will produce under Solvency II, will be used for this purpose.

Publicly available data that firms will publish in accordance with the Pillar 3 requirements of the new regime may be useful to consider, and there are also likely to be several analyst reports in the public domain considering the effects of implementation.

Annex 2: Equality Impact Test

We have assessed the Solvency II proposals against the relevant equality criteria and have concluded that there will be no impact on equality considerations as a result of implementing Solvency II in the UK.

Annex 3: Competition Impact Test

Affected markets
Insurance and reinsurance markets in EU Member States will be directly affected.

There will also be indirect effects on insurance and reinsurance markets outside of the EU, alternative risk transfer markets (e.g. catastrophe bonds, longevity swaps, securitisations) and on distributors of insurance and reinsurance products (e.g. wholesale or retail brokers, or Independent Financial Advisors).

For this consultation-stage impact assessment, we focus on the direct effects on competition within the UK markets for insurance and reinsurance.

Aim
This competition assessment considers whether the implementation of Solvency II is likely to:

8. Directly or indirectly limit the number or range of (re)insurers operating in the UK;
9. Limit the ability of UK (re)insurers to compete;
10. Reduce UK (re)insurers' incentives to compete vigorously.

However, as there is no scope for the Government to pursue alternatives to regulation in this area, or to exercise discretion when implementing the Directive, we do not investigate any potential actions to modify or mitigate any competitive effects.

Baseline: Current competitive environment

Number and location of suppliers in the affected markets

Insurance markets tend to have a large number of competitors. Research by Ernst & Young undertaken for the FSA[44] suggests that in the UK, each sub-sector[45] has more than 20 competitors. However, in each sub-sector the top 5 firms earned at least 50% of total Net Written Premiums, suggesting that there is some concentration of market power.

Nature of competition: price-based, or product differentiation?

The nature of competition in each sub-sector will depend on factors such as whether the insurance is a discretionary purchase or is compulsory, the number of market participants, the concentration of market power, the barriers to entry and exit, and the nature of the product offered. Competition in the market for a product such as private motor third party liability insurance is likely to be based almost entirely on price because the products will be homogeneous, whereas for example travel insurance offerings are likely to be more differentiated in order to cater to the needs of different types of consumer, and so higher quality products will be able to command higher prices.

Characteristics and prices of products affected

Insurance products range from the highly standardised (e.g. term assurance) to the highly differentiated (e.g. bespoke cover provided by the Lloyd's market). Prices are similarly heterogeneous since they will be commensurate with the size of the risks insured.

Ease and degree of switching between products

This will depend on several factors, including: the standard length of contract term (e.g. monthly renewal, annual renewal, multi-year contracts for term or whole-of-life assurance); the terms offered for surrender or early termination of contracts, including any penalties imposed; the accrual of any discretionary benefits and the treatment of these if the contract is terminated; embedded options and guarantees and the way these are valued for surrender or termination purposes; the ability of consumers to compare prices and contract terms across providers; the number of alternative providers in a given market; the sales channel used to distribute the product.

Degree of invention and innovation in recent years

Insurance tends to be a relatively static market in terms of product innovation. Technological advances such as the advent of smart-phones will have seen the creation of a small number of new retail product lines in recent years, but the overall insurance market is slow to evolve and will continue to be constrained by the criteria that make a risk 'insurable'. Although drivers such as increasing annuitant longevity have created incentives for insurers to offer innovative new products for retirement provision, attempts to introduce products such as variable annuities on a large scale have been relatively unsuccessful to date.

One of the main sources of product innovation in the UK is likely to be the London Market because of the highly individual nature of some of the risks that are covered.

There have also been some attempts to create markets for 'quasi-insurance' or alternative risk transfer methods such as catastrophe bonds or weather derivatives but these have been small in number to date.

Possible effects of Solvency II on the Competitive Environment

Direct limit on the number or range of (re)insurers

The introduction of Solvency II will not place any direct limits on the number or range of suppliers. It awards no exclusive rights of supply, does not require insurance or reinsurance to be procured from a particular supplier or group of suppliers, does not create any form of licensing scheme, and does not place any fixed limit on the number of suppliers.

Indirect limit on the number or range of (re)insurers

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[44] See the Ernst & Young *Industry Level and Financial and Financial Market Impact Assessment* prepared for the FSA and annexed to the FSA's consultation document. This document contains a detailed analysis of the current state of competition in the UK.

[45] Private Motor, Commercial Motor, Household (domestic property), Commercial Property, Accident, Health, Liability, Life, Individual Pensions, Occupational Pensions, Protection, Other.

The introduction of the new regime may have an indirect impact on the number or range of (re)insurers writing certain lines of business.

Costs of new (re)insurers relative to existing (re)insurers

It is unlikely that the costs of new suppliers would generally be higher than the costs of existing suppliers (since e.g. it may actually be cheaper and more efficient to design Solvency II-compliant systems from scratch than to adapt existing systems). The costs to new entrants are therefore unlikely to create additional barriers to entry or to limit innovation and product development.

Costs of some existing (re)insurers versus other existing (re)insurers

Any increase to the cost of provision may be higher for firms that are less well-diversified (since they will generally face a higher increase in the capital required to support each pound of premium written). This may push undiversified niche providers out of certain markets, but the desire to increase the diversity of business underwritten may also mean that better-diversified players are incentivised to branch out into these niche markets.

Incremental cost increases will also be higher for firms who have to do more work to reach the minimum standards required by Solvency II (for instance firms whose data handling or reporting systems are inadequate and must be redesigned or upgraded). In this sense Solvency II will favour those (re)insurers whose businesses are already run in a way which is compatible with the new regulations (and so may favour UK insurers competing in other Member States because of the existence of the ICAS regime).

The costs associated with implementing Solvency II may make it harder for EU insurers to compete in territories outside of the EU that are not subject to the new regime. However, transitional measures are expected to apply in the years immediately following implementation, and some countries have signalled an intention to develop regulatory regimes that would be deemed 'equivalent' to Solvency II, so the extent to which this effect will materialise in practice is currently uncertain.

Costs of entry or exit

If the capital requirements for writing certain classes of business increase (because e.g. the calibration of the standard formula is more onerous than the general status quo), the cost of entering the market for that type of business will increase. However, firms already in the market will also generally experience a cost increase, so if the increased cost can be passed on, this may not translate into a higher barrier to entry than would previously have existed. If capital requirements for certain types of business were to decrease, the opposite conclusions would apply.

Limits on the ability of (re)insurers to compete

Solvency II will not place any restrictions on the prices that can be charged for (re)insurance products, or on the characteristics of the products provided (e.g. by introducing minimum quality standards). One of the long-term objectives of the new regime is to foster innovation and to increase the range of products offered.

The sales channels that can be used will be unaffected.

The geographic area in which (re)insurers can supply products will be unchanged, but the harmonisation of requirements across Member States should improve the functioning of the single market, increasing cross-border competition and reducing the costs (e.g. compliance costs) for firms operating in several territories, which would tend to increase competition.

There will be no additional restrictions on the advertising of products or on the organisational forms that can be adopted by market participants.

The rules on counterparty default risk may mean that insurers are strongly incentivised to purchase reinsurance from highly-rated reinsurers. However, there will also be an incentive to purchase from a wide range of providers in order to retain diversification, which would tend to mitigate any concentration of the reinsurance market.

Limits on the incentives for (re)insurers to compete vigorously

Solvency II will not introduce any exemptions from general competition law.

It will not impose minimum contract periods or notice periods and so will not directly affect the cost to consumers of switching between products (although it is not possible to rule out indirect effects on contract terms resulting from the Solvency II concept of contract boundaries[46] – an area of the regime which is still in development at this stage).

The new regime will require the disclosure of a greater amount of information than previously. This information may give market participants greater insight into the business of their competitors. It is difficult to say whether this would have a pro- or anti-competitive effect since, as discussed above, the markets for individual lines of business within the wider insurance market are highly divergent in terms of their competitive characteristics. Anti-competitive effects could arise as a result of tacit price collusion between market participants, but this would only really be a possibility within markets where competition is focused on price and products are highly similar. Such markets (e.g. retail motor insurance) are generally already highly competitive and price information is readily available via aggregator websites.

Annex 4: Small Firms Impact Test

This section considers the potential impact of the Solvency II regime on smaller firms, and in particular, whether this impact is likely to be disproportionate.

Scope of the regime and effect on micro-businesses

The Solvency II Directive will apply to almost all EU insurance and reinsurance firms regardless of size or complexity. Since it is a maximum harmonising Directive, the Government cannot choose to exempt certain firms from its scope, or reduce the extent to which its provisions apply to certain firms, as this would lead to infraction proceedings. However, the very smallest firms (with premium income less than €5m and technical provisions of less than €25m) will be exempted by the *de minimis* criteria laid down in the Directive. This should mean that any micro-businesses (those with fewer than 10 employees) are out of scope.

The FSA estimates that around 130 small insurance firms (mainly Friendly Societies) and a few other special cases will fall outside the scope of the Directive. For these firms, the current FSA Handbook sourcebooks, and the provisions that apply to Solvency I insurers, will remain in place. Firms that are out of scope because of the *de minimis* criteria can still apply for authorisation under Solvency II.

Rationale for including smaller firms in the scope of Solvency II

The Commission have stated[47] that "[t]o make the new rules only available to large insurers would put all other insurers at a potential competitive disadvantage. These insurers would not benefit from the possibility of using full or partial internal models and from potentially lower capital requirements and they would be seen by the market as 'second tier insurers' operating under outdated and less sound rules, with matching higher funding costs. This might further advance consolidation of small insurers in the EU rather than protect their present position."

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[46] The final rules on contract boundaries will determine the time horizon over which the cashflows arising from contracts should be modelled.

[47] See the Commission's *Solvency II Frequently Asked Questions*.

Concerns of smaller firms with respect to Solvency II

The FSA's Smaller Businesses Practitioner Panel[48] (SBPP) represents the views and interests of smaller regulated firms, and provides advice to the FSA on its policies and the strategic development of financial services regulation. The Panel's members are all senior practitioners from smaller regulated firms across the financial services industry.

The SBPP's 2010/11 annual report[49] highlights the Solvency II concerns of smaller firms that have been discussed with the FSA to date. The concerns that relate specifically to the burden of the regime on smaller firms are:

- Proportionality, in particular the regulatory uncertainty surrounding the transition to the FSA's successor bodies and how this will affect the application of the 'proportionality principle';
- The implementation costs for smaller firms;
- The burden of increased technical resource requirements for smaller insurers such as mutual insurers;
- The capacity of smaller firms to choose to use internal model approaches;
- The potential for capital increases at firm level.

For the purpose of this impact test, these concerns have been assumed to be a representative list of the concerns of smaller firms with respect to the burden of Solvency II.

We examine these concerns in turn, consider the available evidence to date for the likely impact on smaller firms, and discuss the provisions within the Directive and the forthcoming implementing measures and guidance that are intended to ensure that the requirements placed on smaller firms are not unduly burdensome.

Principle of proportionality

It is a cornerstone of the Solvency II regime that the qualitative and quantitative requirements on firms should be proportionate to the nature, scale and complexity of the risks that are faced. This concept is referred to as the 'proportionality principle', and one of its intentions is to avoid placing an undue burden on lower-risk firms. Firms will not be able to expect less burdensome treatment purely on grounds of their size (e.g. in terms of number of employees), since it is the size of a firm's risks that matter.

National supervisors, including the FSA (and later its successor bodies, the PRA and FCA), will have to ensure that the supervisory processes they develop for Solvency II fully embed this principle. Organisations such as the SBPP are actively engaged with the regulator to ensure that the needs and concerns of smaller firms are taken into account for this purpose.

The practical application of the proportionality principle by supervisors will play a crucial role in ensuring that the full flexibility and judgement allowed under the Directive is utilised to avoid placing unnecessary burdens on lower-risk firms.

Implementation costs for smaller firms

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[48] See the Smaller Businesses Practitioner Panel's website for more information: http://www.sbpp.org.uk

[49] http://www.sbpp.org.uk/publications/annual_reports/AR_2011.pdf

Initial work undertaken by the FSA in this area suggests that the implementation cost per pound of liabilities (or per pound of liabilities plus premiums in the case of non-Life insurers) may be no greater for small firms that for larger firms, although it should be noted that this analysis was based on a very small sample size, and so may not generalise to the entire population of smaller firms.

A possible reason for this is the tendency of larger firms to pursue internal model development (leading to higher costs), partially offsetting any economies of scale they may otherwise enjoy from having a wider base over which to spread their fixed costs.

Application of the proportionality principle will also mean that smaller firms will have less onerous requirements in some areas; for example, a smaller insurer conducting simple business will not have to have the same systems and controls as a larger insurer that has multiple business lines in multiple countries.

Anecdotal evidence from conversation with practitioners at smaller firms suggests that there may also be some pooling of technical and modelling resources amongst smaller firms in order to reduce costs.

Technical resource requirements for smaller insurers, and capacity to use internal model approaches

Insurers with relatively straightforward operations will be able to take advantage of certain simplifications to the standard formula and the calculation of technical provisions (e.g. in the areas of counterparty default risk, or the risk margin), which would reduce the technical burden in these instances.

If the standard formula is not appropriate, but a full internal model would be overly complex and expensive to implement, there are other options that firms can pursue:

- Undertaking Specific Parameters (USPs) may present a solution for firms for whom certain standard factors in the formula are inappropriate, providing they have adequate data to set their own parameters, and can satisfy the regulator that their use is justified;
- Partial internal models are likely to be an attractive option for smaller firms, since they will allow the idiosyncrasies of a firm's business to be modelled according to the firm's own methods, whilst other more generic parts of the business are modelled using the standard fomula. However, partial internal models will be subject to supervisory approval, and firms will still have to demonstrate their compliance with a subset of the criteria for use of a full internal model. Aggregation of the internally-modelled and standard formula-derived parts of the capital model will also present a technical challenge.

Use of a full internal model will require significant investment in the technical aspects of model development, and probably also investment in IT and data capability. However, the build of the model is only part of the overall requirement; firms must also demonstrate that the model is used for business decisions, and show extensive documentation and control procedures relating to the use of (and any changes to) the model. These requirements may be a very high hurdle for smaller firms to overcome, and as mentioned above, it seems likely that partial internal models will be a more realistic and cost-effective solution in this case.

To some extent, smaller firms' ability to benefit from internal model usage will depend on the FSA (and subsequently the PRA/FCA) and the regulatory approach taken to the model approval process. 78 firms were accepted into the FSA's 'pre-application' process, which concerns only those firms that are seeking approval to use their internal models from 'day one' of the new regime. In terms of allocating the FSA's resources, a decision was made to prioritise a sub-population of these firms that represent a significant market share and have the highest potential impact on the FSA's objectives. These 'top tier' firms will be

the focus of the majority of the FSA's resources prior to the implementation date, whilst the other firms will receive a reduced level of engagement.

Capital increases at firm level

The capital impact section of the evidence base showed that *on average*, smaller firms saw a 22% increase in capital surplus versus ICAS when using the standard formula under QIS5, suggesting that the use of the standard formula is not in general unduly burdensome for smaller firms. However, beneath this average there will be variation at the level of individual firms. The intention of Solvency II is not to preserve the status quo, and some smaller firms may see an increased capital requirement if this is more reflective of their real risks. This does not constitute a disproportionate burden on a firm.

Other effects on smaller firms

Small firms may be particularly likely to be the targets of consolidation activity, since they are generally likely to have the most to gain from any resulting economies of scale and greater diversification. Larger firms may want to acquire smaller insurers writing niche lines of business in order to gain diversification, whilst smaller firms may want or need access to the capital base and modelling expertise contained within larger firms in order to remain viable under the new regime.

Need for Further Work

Any assessment of the likely impact of Solvency II on smaller firms is subject to the same difficulties as a more general assessment. In particular, there is not sufficient evidence at this stage to say whether implementation and/or ongoing costs will be proportionately greater for smaller firms, whether the application of the proportionality principle will have all of its intended effects, or whether the new regime will disadvantage smaller firms in other ways versus the current regime.

The impact of the regime on smaller firms is an area we would identify for further work and scrutiny. In particular, the impact on smaller firms should be considered explicitly as part of the post-implementation review.

B Statutory Instruments

B.1 The following pages contain the Statutory Instruments.

STATUTORY INSTRUMENTS

2012 No. xxxx

FINANCIAL SERVICES AND MARKETS

The Financial Services and Markets Act 2000 (Solvency 2) Regulations 2012

Made - - - -	***
Laid before Parliament	***
Coming into force - -	***

The Treasury are a government department designated(**a**) for the purposes of section 2(2) of the European Communities Act 1972(**b**) in relation to authorisation of the carrying on of insurance business and the regulation of such business and its conduct.

The Treasury, in exercise of the powers conferred upon them by section 2(2) of the European Communities Act 1972, make the following Regulations:

PART 1

Citation and Commencement

Citation and commencement

1. These Regulations may be cited as the Financial Services and Markets Act 2000 (Solvency 2) Regulations 2012 and, except as provided in regulation 2, come into force on [1 January 2013].

2.Regulations 16 to 19 come into force on [1 June 2012].

(**a**) S.I. 1997/2781, article 6.
(**b**) 1972 c.68; section 2(2) was amended by section 27 of the Legislative and Regulatory Reform Act 2006 (c. 51) and by section 3 of, and the Schedule to, the European Union (Amendment) Act 2008 (c. 7). By virtue of the amendment of section 1(2) made by section 1 of the European Economic Act 1993 (c. 51) regulations may be made under section 2(2) to implement obligations of the United Kingdom created by or arising under the Agreement on the European Economic Area signed at Oporto on 2nd May 1992 (Cm 2073, OJ No L1, 3.11.1994, p.3) and the Protocol adjusting that Agreement signed at Brussels on 17th March 1993 (Cm 2183, OJ No L1, 3.1.1994, p.572). For the decision of the EEA Joint Committee in relation to Directive 2009/138/EC, see Decision No 078/2001 of 1st July 2011 [OJ reference]

PART 2

Amendments to the Financial Services and Markets Act 2000

Amendment to the Financial Services and Markets Act 2000

3.The Financial Services and Markets Act 2000(**a**) is amended as follows.

4.—(1) In section 55J, after subsection (7), insert—

“(7A) Without prejudice to the generality of subsections (1) to (3), in relation to an insurance or reinsurance undertaking to which the provisions of the solvency 2 directive apply, the appropriate regulator—

(a) may exercise its power under this section to cancel the Part 4A permission if it appears to it that the condition in section 55KA(1) is met;

(b) shall exercise its power under this section to cancel the Part 4A permission as soon as practicable, having regard to policy holders’ interests, if it appears to it that that the authorised person has not complied with the Minimum Capital Requirement and one of the conditions in section 55KA(2) is met.”

(7B) In subsection (7A) “the appropriate regulator” means—

(a) in the case of a PRA authorised person, the PRA, and

(b) in any other case, the FCA.”.

(2) After section 55K, insert—

“**55KA. Insurance and reinsurance undertakings: particular conditions that enable cancellation**

(1) The condition referred to in section 55J(7A)(a) is that the insurance or reinsurance undertaking has failed seriously in its obligations under the rules made for the purpose of implementing the solvency 2 directive to which it is subject;

(2) The conditions referred to in section 55J(7A)(b) are that the undertaking—

(a) has failed to submit a finance scheme pursuant to rules made for the purpose of implementing Article 139(2) of the solvency 2 directive; or

(b) has submitted a finance scheme as described in paragraph (a) to the appropriate regulator and—

(i) the appropriate regulator considers that the finance scheme is manifestly inadequate; or

(ii) the appropriate regulator has approved the finance scheme but the undertaking concerned has failed to comply with it within three months from the date it informed the appropriate regulator that it was not complying with the Minimum Capital Requirement.”.

(3) After section 55P, insert—

“**55PA. Assets requirements imposed on insurance or reinsurance undertakings**

(1) Where the appropriate regulator—

(a) intends to impose an assets requirement on an authorised person who is an insurance or reinsurance undertaking because that undertaking has not complied with the appropriate regulator’s rules implementing Chapter VI, Section 2 of the solvency 2 directive; or

(b) has imposed an assets requirement on an undertaking because it is of the opinion that its financial situation will deteriorate further, and—

(**a**) 2000 c. 8.

(i) the undertaking has breached rules made for the purpose of implementing Article 100 of the directive with regard to Solvency Capital Requirement, or

(ii) is at risk of non-compliance with those rules within three months,

it must inform the supervisory authorities of the host Member States.".

(2) In this section, "assets requirement" has the same meaning as in section 55P(2).

(3) In this section "appropriate regulator" has the same meaning as in section 55J(7B).

(4) In section 105(3)(Case 2)(aa), for "(within the meaning of Article 2.1(c) of the reinsurance directive)" substitute "(within the meaning of Article 13(4) of the solvency 2 directive)".

(5) In subsection (2) of section 116, for paragraphs (a),(b) and (c) substitute—

"(a) an undertaking authorised in an EEA State other than the United Kingdom under Article 162 of the solvency 2 directive;

(b) an undertaking whose head office is not in an EEA State and which is authorised under the law of an EEA State other than the United Kingdom to carry out reinsurance activities in its territory (as mentioned in Article 164 of the solvency 2 directive).".

(6) For subsection (5) of section 116, substitute—

"(5) "Authorised transfer" means—

(a) in subsection (1), a transfer authorised in the home State of the EEA firm in accordance with Article 39 of the solvency 2 directive;

(b) in subsection (2), a transfer authorised in an EEA State other than the United Kingdom in accordance with Article 164 of the solvency 2 directive."

(7) In section 165(7), after paragraph (d), insert—

"(e) by either regulator, to impose requirements on a person who provides any service to an authorised person who is subject to rules made for the purpose of implementing the solvency 2 directive.".

(8) In section 167(2), after paragraph (a) delete "or" and after paragraph (b) insert—

"or;

(c) where A is an insurance undertaking or reinsurance undertaking, a person who provides services to A.".

(9) After section 167(3), insert—

"(3A) If a person appointed under subsection (1) decides to investigate the business of any person under paragraph (2)(c) he must inform the appropriate authority of the Member State of the service provider prior to conducting the on-site inspection."

(10) In subsection (4) of section 190, for subsection (b) substitute—

"(b) is not subject to supervision under—

(i) the UCITS directive;

(ii) the solvency 2 directive;

(iii) the markets in financial instruments directive; or

(iv) the banking consolidation directive.".

(11) In section 198 for subsection (1) substitute—

"(1) This section applies if the PRA has received a request made in respect of an incoming EEA firm in accordance with Article 37 of the solvency 2 directive.".

(12) In section 316, in subsection (4)(b)(i), for "any of the insurance directives" substitute "the solvency 2 directive".

(13) In section 367(3) before (a) insert—

"(aa) in the case of a body to which the provisions of the solvency 2 directive apply, a regulator has cancelled its Part 4A permission in pursuance of section 55J(7A)(b);".

(14) In section 405, subsection (5), omit paragraphs (c) and (d).

(15) In section 417, subsection (1), insert at the appropriate place in each case—

"insurance undertaking" has the meaning given in Article 13 of the solvency 2 directive;

"Minimum Capital Requirement" in relation to an insurance undertaking or reinsurance undertaking has the meaning given in rules made for the purpose of implementing Articles 128 and 129 of the solvency 2 directive and directly applicable Union legislation made under Article 130 of the solvency 2 directive;

"reinsurance undertaking" has the meaning given in Article 13 of the solvency 2 directive;

"Solvency Capital Requirement" in relation to an insurance undertaking or reinsurance undertaking has the meaning given in rules and directly applicable Union legislation made for the purpose of implementing Chapter VI, Section 4 of the solvency 2 directive;".

(16) In section 425(1)(a)—

"(a) omit ""life assurance consolidation directive"", ""first non-life directive"", "insurance directives" and "reinsurance directive", and

(b) after ""single markets directive"" insert and ""solvency 2 directive"".

Amendments to Schedule 3 to the Act

5. In Schedule 3—

(1) In paragraph 1, for sub-paragraphs (c) and (ca) substitute—

"(c) The solvency 2 directive;"

(2) For paragraphs 3 and 3A substitute —

"*The solvency 2 directive*

3. "The solvency 2 directive" means Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (**a**) [as amended by Omnibus 2 and FICOD].".

(3) In paragraph 5, for sub-paragraphs (d) and (da) substitute—

"(d) an undertaking pursuing the activity of direct insurance (within the meaning of Article 2 of the solvency 2 directive) which has received authorisation under Article 14 of that directive from its home state regulator;

(da) an undertaking pursuing the activity of reinsurance (within the meaning of Article 2 of the solvency 2 directive) which has received authorisation under Article 14 from its home state regulator;".

(4) In paragraph 15, for sub-paragraph (6) substitute:

"(6) The permission is to be treated as being on terms equivalent to those appearing in the authorisation granted to the firm under Article 14 of the solvency 2 directive by its home state regulator ("its home authorisation").".

(5) In paragraph 19—

(i) in sub-paragraphs (5)(b)(i), (7) and (9), for "any of the insurance directives" substitute "the solvency 2 directive".

(ii) in sub-paragraph (5ZA), for "is subject to the conditions of the reinsurance directive" substitute "falls within the second sub-paragraph of Article 2(1) of the solvency 2 directive".

(**a**) OJ L335, 17.12.2009, p.1.

(6) In paragraph 20—

(i) in sub-paragraphs (3A) and (4B) for "any of the insurance directives" substitute "the solvency 2 directive".

(ii) in sub-paragraph (4D), for "the reinsurance directive" substitute "the solvency 2 directive".

Amendments to Schedule 12 to the Act

6. In Schedule 12—

(1) In paragraph 1—

(a) for sub-paragraph (2)(a) substitute—

"(a) the authorised person concerned is a UK authorised person which has received authorisation under Article 14 of the solvency 2 directive from the appropriate regulator;",

(b) for sub-paragraph (3)(a) substitute—

"(a) the authorised person concerned has received authorisation under Article 14 or 162 of the solvency 2 directive from the appropriate regulator;",

(c) for sub-paragraph (4)(a) substitute—

"(a) the authorised person concerned has received authorisation under Article 14 or 162 of the solvency 2 directive from the appropriate regulator;"

(d) for sub-paragraph (5)(a) substitute—

"(a) the authorised person concerned has received authorisation under Article 162 of the solvency 2 directive from the appropriate regulator;" and

(e) after sub-paragraph (5) add—

(6) In this paragraph "the appropriate regulator" means—

(a) in the case of a PRA authorised person, the PRA, and

(b) in any other case, the FCA.".

(2) In paragraph 2—

(i) for sub-paragraph (6)(aa) substitute—

"(aa) if the transferee is a non-EEA branch, the supervisory authorities of the EEA State in which the transferee is situated or, where appropriate, the supervisory authorities of an EEA State which supervises the state of solvency of the entire business of the transferee's agencies and branches within the EEA in accordance with Article 167 of the solvency 2 directive;",

(ii) for sub-paragraph (7A), substitute—

"(7A) "Supervisory authorities" has the same meaning as in the solvency 2 directive.", and

(iii) for sub-paragraph (9), substitute—

"(9) "Non-EEA branch" means a branch or agency which has received authorisation under Article 162 of the solvency 2 directive.".

(3) For paragraph 3 substitute—

"**3.**—(1) A certificate under this paragraph is one given by the Authority and certifying that it has consulted the host state regulator, the authorities in the Member State where the portfolio of contracts were concluded (either under the right of establishment or the freedom to provide services) and, in the case of the transferee being a branch, the Member State where the branch is situated, about the proposed scheme and that each authority has consented to the transfer in accordance with sub-paragraph (2).

(2) Each authority shall be deemed to have consented to the transfer when—

(a) it agrees the transfer of portfolio; or

(b) it does not respond but the period of three months beginning with the date where the authority received a request for consultation has elapsed.

(3) In this paragraph "host state regulator" means the competent authority (within the meaning of the solvency 2 directive) of an EEA State (other than the United Kingdom) in relation to a UK firm's exercise of EEA rights there.".

(4) In paragraph 5A, for sub-paragraph (4), substitute—

"(4) "Relevant authority" means the supervisory authorities (within the meaning of the solvency 2 directive) of the EEA State in which the transferee is set up.".

(5) In paragraph 10—

(a) for sub-paragraph (3) substitute—

"(3) The transferor is a company authorised in an EEA State other than the United Kingdom under Article 162 of the solvency 2 directive and the transferee is a UK authorised person which has received authorisation under Article 14 of the solvency 2 directive.", and

(b) for sub-paragraph (4) substitute—

"(4) The transferor is a Swiss general insurer and the transferee is a UK authorised person which has received authorisation under Article 14 of the solvency 2 directive.".

Amendment to schedule 21 to the Act

7. After paragraph 2 add—

"Solvency 2 directive and withdrawal of authorisation

3. Section 55J(7A) shall not apply until [31 October 2014] with regards to those insurance and reinsurance undertakings which comply with the Required Solvency Margin referred to in Article 28 of Directive 2002/83/EC, Article 16a of Directive 73/239/EEC or Articles 37, 38 or 39 of Directive 2005/68/EC respectively on [31 October 2013] but do not hold sufficient eligible basic own funds to cover the Minimum Capital Requirement.".

PART 3

Provisions relating to insurance and reinsurance undertakings

Interpretation

8.—(1) In this Part—

"the Act" means the Financial Services and Markets Act 2000(**a**);

"the appropriate regulator" means—

(a) in the case of a PRA authorised person, the PRA, and

(b) in any other case, the FCA;

"capital add-on" means any increase to the Solvency Capital Requirement of an insurance or reinsurance undertaking, or an insurance group, made by the appropriate regulator pursuant to sections 55L or 55M of the Act;

"the directive" means Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)(**b**) [as amended by FiCOD/Omnibus 2];

(**a**) 2000 c.8
(**b**) OJ L335, 17.12.2009, p.1.

"EIOPA" means the European Insurance and Occupational Pensions Appropriate regulator established under Regulation (EU) No 1094/2010 of the European Parliament and the Council establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority);

"group supervisor" means the competent authority responsible, under Article 247 of the Directive for the exercise of group supervision in accordance with Title 3 of the Directive;

["Level 2 measures" [word to be replaced and defined when clear the form in which level 2 measures will appear]]; and

"United Kingdom Solvency 2 firm" has the meaning in regulation 9;

(2) Save as provided by paragraph (1)—

(a) any expression used in this Part which is used in the directive has the meaning given by that directive; and

(b) any other expression used in these Regulations which is defined for the purpose of the Act has the meaning given by the Act.

Meaning of United Kingdom Solvency 1 and 2 firm

9.—(1) A United Kingdom Solvency 2 firm is—

(a) an insurance undertaking and either paragraph (2), (3) or (4) applies; or

(b) a reinsurance undertaking, and

it has its head office in the United Kingdom.

(2) This paragraph applies where the undertaking is a United Kingdom Solvency 1 firm and has not been verified to be excluded pursuant to regulation 10.

(3) This paragraph applies where the undertaking is not a United Kingdom Solvency 1 firm and—

(a) it is excluded from the directive pursuant to rules made to implement Articles 4(1) to 4(3) of the directive but it has opted to be authorised pursuant to rules made to implement article 4(5) of the directive; or

(b) it is not excluded pursuant to rules made to implement Articles 4(1) to 4(3) of the directive.

(4) This paragraph applies where the undertaking is neither a United Kingdom Solvency 1 firm nor a non-United Kingdom Solvency 1 firm and—

(a) it is excluded pursuant to rules made to implement Articles 4(1) to 4(3) of the directive but it has opted to be authorised pursuant to rules made to implement article 4(5) of the directive; or

(b) it is not excluded pursuant to rules made to implement Articles 4(1) to 4(3) of the directive.

(5) In this regulation "United Kingdom Solvency 1 firm" means a firm that immediately before the date provided in regulation 1 was an insurance or reinsurance undertaking that fell within the scope of the Solvency 1 Directive.

(6) In this regulation "non United Kingdom Solvency 1 firm" means an firm that immediately before the date provided in regulation 1 was not an insurance or reinsurance undertaking that fell within the scope of the Solvency 1 Directive.

(7) In this regulation "Solvency 1 Directive" means each of—

(a) First Council Directive 73/239/EEC of 24 July 1972 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance(**a**);

(**a**) OJ L238, 16.8.1973, p.3.

(b) Second Council Directive 88/357/EEC of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services(**a**);

(c) Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance (third non-life insurance Directive)(**b**);

(d) Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance(**c**);

(e) Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance(**d**).

Application of Solvency 2 (Verification that the directive does not apply)

10. Where an undertaking has applied for verification that the directive should cease to apply pursuant to rules made to implement Article 4(4) of the directive, the appropriate regulator shall verify whether an insurance undertaking satisfies those rules.

Financial stability and pro-cyclicality (Articles 28 and 71(1))

11. The appropriate regulator shall in the exercise of its duties under the directive—

(a) take into account, in an appropriate way, an EEA dimension;

(b) consider the potential impact of its decisions on the stability of the financial systems in other EEA States, such consideration, in particular in emergency situations, to be based on information available at the relevant time; and

(c) in times of exceptional movements in the financial markets, take into account the potential pro-cyclical effects of its actions.

The scope of the appropriate regulator's supervision for passporting firms (Article 30(3))

12. Where the appropriate regulator has reason to consider that the activities of an insurance or reinsurance undertaking might affect its financial soundness and—

(a) in the case of insurance the United Kingdom is not the home Member State but is either—

(i) the Member State in which the risk is situated; or

(ii) the Member State of the commitment; or

(b) in the case of reinsurance, the United Kingdom is the host member state

it shall inform the supervisory authority of the undertaking's home member state.

Capital add-on (Article 37)

13.—(1) Where the appropriate regulator has imposed a capital add-on pursuant to section 55L or 55M of the Act, it shall review the capital add-on of the insurance or reinsurance undertaking at least once a year.

(2) The capital add-on shall be cancelled when the undertaking has remedied the deficiencies which led to its imposition.

(**a**) OJ L172, 4.7.1988, p.1.
(**b**) OJ L228, 11.8.1992, p.1.
(**c**) OJ L345, 19.12.2002, p.1.
(**d**) OJ L 323, 9.12.2005, p.1.

Information for and reports by EIOPA (Article 52) [subject to Omnibus 2]

14. The appropriate regulator shall provide the following information to EIOPA on an annual basis:

(a) the average capital add-on per undertaking and the distribution of capital add-ons imposed by the appropriate regulator during the previous year, measured as a percentage of the Solvency Capital Requirement, shown separately as follows;

(i) for all insurance and reinsurance undertakings;

(ii) for life insurance undertakings;

(iii) for non-life insurance undertakings;

(iv) for insurance undertakings pursuing both life and non-life activities;

(v) for reinsurance undertakings;

(b) for each of the disclosures set out in paragraph (a), the proportion of capital add-ons imposed under rules made for the purpose of implementing Article 37(1)(a), (b) and (c) respectively.

Composite firms authorised to carry out life and non life insurance business (Article 74(7))

15. Where an insurance undertaking is authorised to carry out both life and non-life business pursuant to the rules made for the purpose of implementing Articles 73 and 74 of the directive, the appropriate regulator shall ensure that it applies its rules made for the purpose of implementing the directive only to the relevant part of the firm operating the deficient activity, whatever the results in the other activity.

Valuation of assets: supervisory approval of ancillary own funds (Article 90)

16.—(1) Where an insurance or reinsurance undertaking applies for supervisory approval of the amounts of ancillary own-fund items to be taken into account when determining own funds (in accordance with rules made for the purpose of implementing Article 90 of the directive), the appropriate regulator shall approve either of the following:

(a) A monetary amount for each ancillary own-fund item; or

(b) A method by which to determine the amount of such ancillary own-fund item, in which case supervisory approval of the amount determined in accordance with that method shall be granted for a specific period of time.

(2) For each ancillary own-fund item, the appropriate regulator shall base its approval on an assessment of the following:

(a) the status of the counterparties concerned, in relation to their ability and willingness to pay;

(b) the recoverability of the funds, taking account of the legal form of the item, as well as any conditions which would prevent the item from being successfully paid in or called up; and

(c) any information on the outcome of past calls which insurance and reinsurance undertakings have made for each ancillary own funds, to the extent that information can be reliably used to assess the expected outcome of future calls.

(3) If the authorised person wishes to challenge the decision in relation to the approval, they may refer the matter to the Tribunal.

Classification of funds (Article 95)

17.—(1) Where own fund items do not appear in the implementing technical standards made pursuant to Article 97 of the directive, the appropriate regulator shall consider the assessment and classification of those items made by insurance and reinsurance undertakings and may approve them accordingly.

(2) If the applicant wishes to challenge the decision in relation to the approval, they may refer the matter to the Tribunal.

Verification of the Basic Solvency Capital Requirement (Article 104)

18.—(1) When granting supervisory approval of the basic Solvency Capital Requirement, the appropriate regulator shall verify the completeness, accuracy and appropriateness of the data used.

(2) If the authorised person wishes to challenge the approval, they may refer the matter to the Tribunal.

Approval of full and partial internal models under Solvency 2 (Articles 112-127)

19.—(1) Where an undertaking has applied for the approval of a full or partial internal model pursuant to rules made for the purpose of implementing Article 112 of the directive and [level 2 measures] made pursuant to Article 114, the appropriate regulator shall approve that model only if it is satisfied that—

(a) the internal model fulfils the requirements set out in those rules and [level 2 measures]; and

(b) the systems of the undertaking for identifying, measuring, monitoring, managing and reporting risk are adequate; and

(c) in the case of a partial model, it fulfils the requirements set out in the rules made for the purpose of implementing Article 113 of the directive.

(2) The appropriate regulator must notify the applicant of its decision on an application for approval before the end of the period of six months beginning with the date on which the complete application is received.

(3) Where an undertaking applies for approval of —

(a) major changes to the internal model; or

(b) the policy for changing the internal model;

it shall apply to the appropriate regulator in accordance with paragraph (1).

(4) A decision by the appropriate regulator to refuse to approve an application under paragraphs (1) or (3) shall state the reasons on which it is based.

(5) After having received approval in accordance with this regulation, insurance and reinsurance undertakings shall not revert to calculating the whole or any part of the Solvency Capital Requirement in accordance with the standard formula as set out in the rules and [level 2 measures] made for the purpose of implementing Articles 103-111 of the directive unless paragraph (7) applies, except where the appropriate regulator has approved that it may revert to the standard formula.

(6) If the appropriate regulator refuses the application, the applicant may refer the matter to the Tribunal.

Special purpose vehicles (Article 211)

20.[to be confirmed – await Level 2 measures]

Group Supervision

Cases of application of group supervision (Article 213)

21.—(1) Paragraph 2 applies where—

(a) supervision is exercised at the level of the group in accordance with the rules made for the purpose of implementing Article 213(2)(a) and (b) of the directive, and

(b) the participating insurance or reinsurance undertaking or the insurance holding company [or the mixed financial holding company] which has its head office in the Union is a related undertaking of a regulated entity [or a mixed financial holding company] which is subject to supplementary supervision in accordance with Article 5(2) of Directive 2002/87/EC; and

(c) the appropriate regulator is the group supervisor.

(2) Subject to paragraph (3), the appropriate regulator may decide not to carry cout at the level of the undertaking either or both of the following—

(a) the supervision of risk concentration as provided for in rules made for the purpose of implementing Article 244 of the directive; or

(b) the supervision of intra-group transactions referred to in rules made for the purpose of implementing Article 245 of the directive.

(3) Before taking the decision provided for in paragraph (2), the appropriate regulator shall consult the other supervisory authorities concerned.

Scope of group supervision (Article 214)

22. Where the appropriate regulator is the group supervisor and is of the opinion that an insurance or reinsurance undertaking should not be included in the group supervision because—

(a) the undertaking which should otherwise be included under the rules made for the purpose of implementing Article 214 is of negligible interest with respect to the objectives of group supervision; or

(b) the inclusion of the undertaking would be inappropriate or misleading with respect to the objectives of group supervision

it shall consult the other supervisory authorities concerned before taking a decision.

Group supervision of ultimate parent undertaking at Union level (Article 215)

23. Where—

(a) a participating insurance undertaking;

(b) a reinsurance undertaking; or

(c) an insurance holding company

referred to in rules made for the purpose of implementing points (a) and (b) of Article 213(2) is a subsidiary undertaking of an undertaking which is subject to supplementary supervision in accordance with Article 5(2) of Directive 2002/87/EC(**a**), the appropriate regulator may, after consulting the other supervisory authorities concerned, decide not to carry out at the level of that ultimate parent undertaking the supervision of risk concentration referred to in rules made for the purpose of implementing Article 244 of the directive, nor the supervision of intra-group transactions referred to in rules made for the purpose of implementing Article 245 of the directive, or both.

Group supervision of ultimate parent undertaking at national level (Article 216)

24.—(1) Where—

(a) a participating insurance or reinsurance undertaking or an insurance holding company has its head office in the EEA States outside the United Kingdom; and

(b) the ultimate parent undertaking in the EEA States of the participating insurance or reinsurance undertaking or insurance holding company has its head office in the United Kingdom; and

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(**a**) [reference this]

(c) the appropriate regulator considers that the ultimate parent undertaking should be subject to group supervision at national level; and

(d) the appropriate regulator is not the group supervisor,

the appropriate regulator may decide to subject the ultimate parent undertaking to group supervision at a national level, subject to paragraph (2).

(2) Before the appropriate regulator seeks to exercise its power under section 55L or 55M of the Act to subject the ultimate parent undertaking to group supervision at a national level it shall consult the group supervisor and the ultimate parent undertaking.

(3) Where the appropriate regulator has exercised its power in accordance with paragraph (2) it shall explain its decision to both the group supervisor and the ultimate parent undertaking in the EEA States.

(4) The choice of method of calculation of solvency made by the group supervisor in respect of the ultimate parent undertaking in the EEA States shall be recognised by the appropriate regulator as determinative.

Group Solvency

Frequency of calculation (Article 219)

25.—(1) Where the appropriate regulator is the group supervisor, it shall ensure that the calculation referred to in the rules made for the purpose of implementing Article 218(2) and (3) are carried out at least annually.

(2) Where the group is not headed by an insurance or reinsurance undertaking, the group supervisor shall consult other supervisory authorities concerned and the group itself as to which undertaking in the group should submit the relevant data.

(3) The group supervisor shall identify which undertaking in the group shall submit the data.

Group supervision: choice of method (Article 220)

26.—(1) In this regulation—

(a) 'method 1' is the method set out in rules made for the purpose of implementing Articles 230 – 233 of the directive;

(b) 'method 2' is the method set out in rules made for the purpose of implementing Articles 233 and 234 of the directive.

(2) Where the appropriate regulator is the group supervisor and is considering exercising its power under section 55L or 55M of the Act to require a group to use method 2 for calculating its solvency, or a combination of method 1 and method 2, it shall consult the other supervisory authorities concerned and the group itself, before exercising its power

Inclusion of the proportional share (Article 221)

27.—(1) Where the appropriate regulator is the group supervisor, subject to paragraph (2), it shall determine the proportional share held by the participating undertaking in its related undertakings which shall be taken into account in the following cases—

(a) where there are no capital ties between some of the undertakings in a group;

(b) where a supervisory authority has determined that the holding, directly or indirectly, of voting rights or capital in an undertaking qualifies as a participation because, in its opinion, a significant influence is effectively exercised over that undertaking;

(c) where a supervisory authority has determined that an undertaking is a parent undertaking of another because, in the opinion of that supervisory authority, it effectively exercises a dominant influence over that other undertaking.

(2) Before determining that share, the appropriate regulator shall consult the other supervisory authorities and the group itself.

Exercise of functions under section 148 of the Act for the purpose of applying a decision in relation to the group solvency calculation. (Articles 225 and 227)

28.—(1) The appropriate regulator may exercise the powers conferred by section 138A of the Act (modification or waiver of the rules) where there is a significant change to the third country regime and it appears desirable to do so in order to ensure that the insurance or reinsurance undertaking carries out its calculation in accordance with the rules made for the purpose of implementing the directive.

(2) In such a case the requirements contained in subsections (1) and (6)(b) of section 138A for the appropriate regulator's powers to be exercisable only on the application or with the consent of an authorised person shall not apply.

Eligible own funds of an intermediate insurance holding companies (Article 226)

29.—(1) Paragraph (2) apples where an insurance or reinsurance undertaking holds, through an insurance holding company [or a mixed financial holding company], a participation in—

(a) a related insurance undertaking;

(b) a related reinsurance undertaking; or

(c) a third-country insurance undertaking.

(2) Where an undertaking applies for supervisory approval to take into account, for the purposes of group solvency, own funds of an intermediate holding company (referred to in paragraph 1) which would require prior authorisation pursuant to regulation 16 if they were held by an insurance or reinsurance undertaking, the appropriate regulator shall base its approval on an assessment of those conditions in regulation 16(2).

(3) If the applicant wishes to challenge the decision in relation to the approval, they may refer the matter to the Tribunal.

Related third-country insurance and reinsurance undertakings (Article 227) [subject to Omnibus 2]

30.—(1) Where the appropriate regulator is the group supervisor and —

(a) a participating undertaking in a third country insurance or reinsurance undertaking so requests; or

(b) on the appropriate regulator's own initiative

subject to paragraph (2), it shall verify whether the third country has a solvency regime which is at least equivalent to that set out in Title 1, Chapter VI of the directive.

(2) Before making verification, the appropriate regulator shall consult the other supervisory authorities concerned and EIOPA.

The appropriate regulator's power as group supervisor to approve group internal models (Article 231)

31.—(1) This regulation applies where the appropriate regulator is the group supervisor and has received an application for permission to calculate the consolidated group Solvency Capital Requirement and the Solvency Capital Requirement of insurance and reinsurance undertakings in the group on the basis of an internal model.

(2) The application referred to in paragraph (1) must be made by an insurance or reinsurance undertaking in the group to the appropriate regulator in such a manner, and accompanied by such information as required by rules made for the purpose of implementing Article 231 of the directive and level 2 measures.

(3) Following an application made in accordance with paragraph (1), the appropriate regulator shall—

(a) inform EIOPA and the other supervisory authorities concerned that an application has been received without delay;

(b) forward the completed application to EIOPA and the other supervisory authorities concerned without delay and initiate discussions with a view to reaching a joint decision on the application;

(c) provide the other supervisory authorities concerned with a document setting out its proposal within five months from the date of receipt of the complete application by the group supervisor; and

(d) cooperate with other supervisory authorities to do everything within their power to reach a joint decision on the application within six months from the date of receipt of the complete application by the group supervisor.

(4) The appropriate regulator shall provide the applicant and the other supervisory authorities concerned with a document setting out the fully reasoned joint decision referred to in paragraph 3.

(5) In the absence of a joint decision within six months from the date of receipt of the complete application by the group supervisor, the group supervisor shall make its own decision on the application. In making its decision the group supervisor shall duly take into account any views and reservations of the other supervisory authorities concerned expressed during the applicable period.

(6) The appropriate regulator shall provide the applicant and the other supervisory authorities concerned with a document setting out its reasoned decision referred to in paragraph (5).

Applications forwarded to the appropriate regulator as relevant supervisory authority by group supervisor (Article 231)

32.—(1) This regulation applies where the appropriate regulator is a relevant supervisory authority and has been forwarded a complete application for permission to calculate the consolidated group Solvency Capital Requirement and the Solvency Capital Requirements of insurance and reinsurance undertakings in the group on the basis of internal model by the group supervisor.

(2) The appropriate regulator must work together, in full consultation with the group supervisor and the other supervisory authorities concerned to reach a decision within six months from the date on which the group supervisor received the completed application.

(3) Where the group supervisor has taken a decision regarding the calculation of the group Solvency Capital Requirement and that of insurance and reinsurance undertakings in the group on the basis of an internal model, that decision shall be recognised as determinative and applied by the appropriate regulator.

(4) Where the appropriate regulator imposes a capital add-on in accordance with the rules made by the appropriate regulator to implement Article 231(7) of the directive, the appropriate regulator shall explain any decision to both the insurance or reinsurance undertaking and the group supervisor.

Group capital add-on (Article 232)

33. Where the appropriate authority is the group supervisor, in determining whether the consolidated group Solvency Capital Requirement appropriately reflects the risk profile of the group, it shall pay particular attention to any case where the circumstances which would give rise to the appropriate regulator using its powers under section 55L and 55M of the Act to set a capital add-on at undertaking level, may arise at group level, in particular where:

(a) a specific risk existing at group level would not be sufficiently covered by the standard formula or the internal model used, because it is difficult to quantify;

(b) a capital add-on to the Solvency Capital Requirement of the related insurance or reinsurance undertakings is imposed by the supervisory authorities concerned.

Subsidiaries of an insurance or reinsurance undertaking: Solvency Capital Requirement (Articles 237, 238, 239 and 240)

34.—(1) Where—

(a) an application is made for permission to be subject to the rules made for the purpose of implementing Articles 238 and 239 of the Directive, and

(b) the appropriate regulator is one of the supervisory authorities concerned;

it shall work together with the other supervisory authorities concerned and shall do everything within its power to reach a joint decision within three months from the date of receipt of the complete application by all the supervisory authorities within the college of supervisors as to whether or not to grant the permission sought and to determine the other terms and conditions, if any, to which the permission should be subject.

(2) [Omnibus 2 changes to Article 237(3,4,5,6)

(3) [Omnibus 2 changes to Article 238)

(4) [Omnibus 2 changes to Article 239)

(5) Where the appropriate regulator is the group supervisor it shall—

(a) verify at least annually, on its own initiative, that the conditions referred to in the rules made for the purpose of implementing Articles 236(b),(c) and (d) continue to be complied with; and

(b) perform such verification upon request from the supervisory authority concerned, where the latter has significant concerns related to the ongoing compliance with those conditions; and

(c) require the parent undertaking to present a plan to restore compliance within an appropriate time where the verification performed has identified weaknesses; and

(d) after consulting the college of supervisors, deem the rules made for the purpose of implementing Articles 236(b), (c) and (d) to be no longer complied with where it has determined that the plan referred to in sub-paragraph (c) is inefficient or not implemented within the agreed time frame; and

(e) immediately inform the supervisory authority concerned where it has made a decision that the rules are no longer complied with under sub-paragraph (d).

Supervision of risk concentration and intra-group transactions (Articles 244 and 245)

35.—(1) With regards to the type of risks or intra-group transactions insurance and reinsurance undertakings in a particular group should be obliged to report, where—

(a) the appropriate regulator is group supervisor it shall act in accordance with paragraph (2), subparagraphs (a) to (e) below; or

(b) the appropriate regulator is consulted by the group supervisor as a supervisory authority concerned it shall act in accordance with paragraph (2), subparagraph (b) below.

(2) In accordance with paragraph (1), the appropriate regulator shall—

(a) consult the other supervisory authorities concerned and the group; and

(b) take into account the specific group and risk management structure of the group; and

(c) following consultation as provided for in subparagraph (a), identify the type of risks and intra-group transactions insurance and reinsurance undertakings in a particular group shall report; and

(d) impose appropriate thresholds based on solvency capital requirements, technical provisions or both; and

(e) when reviewing the risk concentrations and intra-group transactions, monitor the possible risk of contagion in the group, the risk of a conflict of interests and the level or volume of risks.

Supervision of system of governance (Article 246)

36. Where the appropriate regulator is the group supervisor and has received a request from a participating insurance or reinsurance undertaking to undertake the own risk and solvency assessment at the level of the group and at the level of any subsidiary within the group at the same time and to produce a single document covering all such assessment, before exercising its power under section 55L or 55M of the Act it shall—

(a) consult the members of the college of supervisors (as provided for in Article 248(3) of the directive; and

(b) take into account their views or reservations.

The group supervisor (Article 247(2))

37.—(1) Subject to regulation [38]—

(i) the appropriate regulator shall be group supervisor where it is the supervisory authority where paragraph (2) applies; or

(ii) where paragraph (2) applies to another supervisory authority, the appropriate regulator shall recognise that supervisor as the group supervisor.

(2) The task of group supervisor shall be exercised—

(a) by the supervisory authority which is competent for all insurance and reinsurance undertakings in a group;

(b) where a group is headed by an insurance or reinsurance undertaking, by the supervisory authority which has authorised that undertaking; or

(c) where the group is not headed by an insurance or reinsurance undertaking, by the supervisory authority—

(i) which authorised the insurance or reinsurance undertaking, the parent of which is an insurance holding company;

(ii) which authorised the undertaking or undertakings in the same EEA State as the insurance holding company where more than one insurance or reinsurance undertaking with a head office in the EEA States have as their parent the same insurance holding company which has a head office in an EEA State;

(iii) which authorised the insurance or reinsurance undertaking with the largest balance sheet total where the group is headed by more than one insurance holding company with a head office in different EEA States and there is an insurance or reinsurance undertaking in each of those EEA States;

(iv) which authorised the insurance or reinsurance undertaking with the largest balance sheet total where more than one insurance or reinsurance undertaking with a head office in the EEA States have as their parent the same insurance holding company and none of these undertakings has been authorised in the EEA State in which the insurance holding company has its head office;

(v) which authorised the insurance or reinsurance undertaking with the largest balance sheet total where the group is a group without a parent undertaking, or in any circumstance not referred to in sub-paragraphs (i) – (iv),

Derogation from the rules determining the appropriate authority to be group supervisor (subject to O2)

38.—(1) Where the appropriate regulator is a supervisor concerned and considers that a derogation from the criteria set out in regulation 37 which determine which authority should be group supervisor should be considered it shall—

(a) no more than annually request a discussion with the other supervisory authorities concerned; and

(b) do everything within its power to reach a joint decision on the choice of group supervisor within three months from the date of request; and

(c) ensure that the group has an opportunity to state its opinion.

(2) Where the appropriate regulator is a supervisory authority concerned and receives a request for a discussion from another supervisory authority concerned regarding a derogation from the criteria in regulation [37] which determines which authority should be group supervisor, it shall comply with sub-paragraphs (b and (c)) of paragraph (1) above.

Cooperation and exchange of information between supervisory authorities (Article 249* O2)

39.—(1) In this regulation 'responsible authority' means an authority responsible for the supervision of an individual insurance or reinsurance undertaking in a group.

(2) Where the appropriate regulator is the group supervisor it shall cooperate closely with the responsible authorities, in particular in cases where an insurance or reinsurance undertaking encounters financial difficulties.

(3) Where the appropriate regulator is one of the responsible authorities it shall cooperate closely with the other responsible authorities in the group and the group supervisor, in particular in cases where an insurance or reinsurance undertaking encounters financial difficulties.

(4) Where the appropriate regulator is the group supervisor or a responsible authority, it shall—

(a) provide other authorities with such information so as to allow and facilitate the exercise of the supervisory tasks concerned under the directive;

(b) communicate all relevant information to the other authorities without delay; and

(c) call immediately for a meeting where—

(i) it becomes aware of a significant breach of the Solvency Capital Requirement or a breach of the Minimum Capital Requirement of an individual insurance or reinsurance undertaking;

(ii) it becomes aware of a significant breach of the Solvency Capital Requirement at group level calculated on the basis of consolidated data or the aggregated group Solvency Capital Requirement, in accordance with which ever calculation method is used pursuant to the rules made for the purpose of implementing Title III, Chapter II, Section 1, subsection 4; or

(iii) other exceptional circumstances are occurring or have occurred.

Consultation between supervisory authorities (Article 250)

40.—(1) Without prejudice to regulation [39] and the rules made for the purpose of implementing Article 248, the appropriate regulator shall, where a decision is of importance for the supervisory tasks of another supervisory authority, prior to taking any decision, consult the other supervisory authorities in the college of supervisors with regard to the following:

(a) changes to the shareholder structure, organisational or management structure of insurance or reinsurance undertakings in a group, which require the approval or authorisation of supervisory authorities; and

(b) major sanctions or exceptional measures taken by supervisory authorities, including the imposition of a capital add-on to the Solvency Capital Requirement under section 55L or 55M of the Act and the imposition of any limitation on the use of an internal model for

the calculation of the Solvency Capital Requirement under the rules made for the purpose of implementing Title 1, Chapter VI, Section 4, Subsection 3.

(2) Where sub-paragraph (1)(b) applies and the appropriate regulator is not the group supervisor, the group supervisor shall always be consulted.

(3) Where the appropriate authority is considering a decision on information received from another supervisory authority, it shall consult the other supervisory authorities concerned before taking that decision.

(4) Without prejudice to the rules made for the purpose of implementing Article 248 of the directive, the appropriate regulator may decide not to consult in cases of urgency or where such consultation may jeopardise the effectiveness of its decision.

(5) Where paragraph (4) applies, the appropriate regulator shall, without delay, inform the other supervisory authorities concerned.

Access to information (Article 251)

41. Where the appropriate regulator is the group supervisor and needs information from an undertaking pursuant to rules made for the purpose of implementing Article 254(2) of the directive, but that information has already been given to another supervisory authority, the appropriate regulator shall contact that authority wherever possible to avoid duplication of reporting to the various authorities involved in supervision.

Verification of equivalence (Article 260 * O2)

42.—(1) Where —

(a) insurance or reinsurance undertakings have a parent undertaking which is—

  (i) an insurance holding company with a head office outside the EEA; or

  (ii) a third country insurance or reinsurance undertaking; and

(b) the appropriate regulator would be the group supervisor if the criteria set out in regulation [37] were to be applied, and

(c) the Commission has not concluded previously in respect of the equivalence of the third country concerned,

the appropriate regulator shall, subject to paragraphs (3) and (4), verify whether the undertakings are subject to supervision by a third-country supervisory authority, which is equivalent to that provided for by rules made for the purpose of implementing Title III on the supervision at the level of the group of insurance or reinsurance undertakings referred to in the rules made for the purpose of implementing Article 213(2)(a) and (b) of the directive.

(2) The verification shall be carried out at the request of the parent undertaking or of any of the insurance or reinsurance undertakings authorised in the EEA, or on its own initiative.

(3) Before taking a decision, the appropriate regulator shall consult the other supervisory authorities and EIOPA.

(4) Where the parent undertaking referred to in paragraph (1)(a)(i) and (ii) is itself a subsidiary of an insurance holding company having its head office outside the EEA or a third country insurance or reinsurance undertaking, paragraph (5) shall apply.

(5) Where paragraph (4) applies and the appropriate regulator would be the group supervisor if the criteria set out in regulation 37 were to be applied, it shall explain its decision on equivalence to the group.

Intragroup transactions [Article 265]

43.—(1) [to follow]

PART 4

[Amendments to secondary legislation]

[Amendments to secondary legislation to follow]

PART 5

44.—(1) [review clause to follow]

EXPLANATORY NOTE

(This note is not part of the Order)

[Explanatory note to follow]

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