FRESHFIELDS BRUCKHAUS DERINGER

BRIEFING

SUMMARY

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# The Omnibus II directive and Solvency II

**The European Commission has proposed a directive that, if adopted, will significantly change the Solvency II project for prudential supervision of insurers. This briefing explains the proposals and their potential implications.**

## Executive summary

- Omnibus II is a new directive proposed by the European Commission that, if adopted in its present form, will make extensive changes to the Solvency II project.
- One of these changes will be to postpone implementation of Solvency II to 1 January 2013. It is unclear how far in advance of that date the regulatory structure will be fully defined.
- Omnibus II will also empower the Commission to apply more flexible transitional provisions for firms affected by Solvency II – for instance, to allow firms to rely on capital instruments that comply with Solvency I but not Solvency II.
- Notwithstanding this change, there are still some important gaps in the transitional provisions regime.
- Omnibus II will also grant extended powers to the new European Insurance and Occupational Pensions Authority (EIOPA).

## What is Omnibus II?

This briefing explains the purpose and effect on insurance of a directive proposed in January 2011 by the European Commission. It is described as the Omnibus II directive. Omnibus II also proposes amendments to the Prospectus Directive, but that aspect is not covered here.

Omnibus II, if adopted in its present form, will make extensive changes to the Solvency II project. Solvency II is the proposed new regime for the prudential supervision of insurance and reinsurance companies ('firms') and the corporate groups of which they are members. It replaces the current regime, Solvency I. The Solvency II Directive was due to come into force at the end of October 2012. One of the changes proposed by Omnibus II, however, is to change that to 1 January 2013.

We describe the main aspects of the Solvency II regime in a client guide on that subject and in an additional guide focusing on insurers outside Europe (both are available at www.freshfields.com). Solvency II is aimed at producing a more harmonised prudential regime across the European Economic Area (EEA). The regime is expected to be better aligned with market practices and more sensitive to the risks faced by firms, resulting, among other things, in a better deal for policyholders and beneficiaries.

The final calibration of the prudential requirements has yet to be set. It will be influenced by a quantitative impact study (QIS5) carried out in 2010. Over recent years the financial crisis has also significantly influenced policy development within the project.

## The European Insurance and Occupational Pensions Authority

The crisis was one of the factors leading to the creation of the European Insurance and Occupational Pensions Authority (EIOPA), based in Frankfurt, Germany. It replaces the Committee of European Occupational Pensions Supervisors (CEIOPS) and is a regulatory and supervisory authority in its own right.

EIOPA will acquire further powers to develop the details of the regime under the Omnibus II directive. For instance, it will:

- have extended powers, to be exercised in conjunction with the Commission, to develop the detailed aspects of the regime;
- be able to specify what amounts to an 'exceptional fall in financial markets', justifying national supervisors in extending the time for remedying solvency capital requirement (SCR) breaches; and
- resolve differences between national supervisors in the supervision of international insurance groups.

## Transitional provisions

The original Solvency II Directive contained very limited transitional provisions allowing firms to rely on existing Solvency I standards. One of these allows firms a year from the directive's entry into force to comply with the Solvency II minimum capital requirement (MCR) where the firm is already complying with the Solvency I required solvency margin.

Omnibus II would give the Commission powers to ease the change to the new regime by allowing it to make further transitional provisions. These powers are set out in new articles, in particular 261(4) to (6) and 308b to be inserted into the Solvency II Directive. They include, for instance, powers to apply transitional provisions over limited specified periods:

- to allow firms to rely on capital instruments that comply with Solvency I but not Solvency II;
- to phase in requirements on governance rather than making them all apply from day one;
- to specify a 'transitional SCR' to apply on a temporary basis instead of the standard formula SCR, falling within a 'corridor' between:
  - the upper limit of the standard formula SCR; and
  - the lower limit of the MCR plus half the difference between the MCR and the standard formula SCR; and
- to enable non-EEA third countries that satisfy certain conditions to be treated as 'equivalent' to the Solvency II regime for regulatory purposes pending a final determination on whether they are fully entitled to that status.

Articles 261 and 308b set out the maximum period over which transitional provisions may operate. That period is, for instance, 10 years in relation to capital instruments. But the Commission may ultimately decide to propose transitional provisions over a very much shorter period or not at all. Here Omnibus II defines the Commission's powers. It does not specify whether or how they should be exercised.

## Issues not covered by transitional provisions

It should also be noted that the transitional provisions do not apply to every aspect of the regime.

For instance, there are no provisions covering the possibility that applications for the approval of internal models to calculate the SCR may not have been fully considered and dealt with by 1 January 2013. There is therefore a risk that firms (including Lloyd's syndicates) that have invested in such models will not benefit until some time later from the lower capital requirements that the models may produce.

One way of addressing this problem may be to allow models to be approved on an interim basis, subject to later confirmation or revocation of the interim approval. This would require an amendment to Omnibus II and hence to the Solvency II Directive.

There are also no transitional arrangements for the rules on investments by firms in securitised loans under article 135 of the Solvency II Directive. Those rules are required to apply to investments made after 1 January 2011, but they have not yet been formulated. So unless any changes are made to article 135 they will apply retrospectively.

## The legislative structure

Omnibus II proposes changes to how rules and standards will be formulated under Solvency II. It is therefore worth restating what that structure will be if Omnibus II is adopted in its current form. The legislative structure, inspired by the Lamfalussy report and adjusted by Omnibus II, is as follows.

### Level one

The Solvency II Directive, adopted in November 2009, in theory contains the main principles of the regime, described as 'level one'. In practice, some of it is quite principles-based and other parts of it are highly detailed and prescriptive. This framework is subject to amendment from time to time by further 'level one' directives, including Omnibus II.

Omnibus II will result in many articles being entirely recast, others being amended and some, such as 308b, being inserted. Only when Omnibus II has been finally adopted through the co-decision procedure will the new proposed legislative framework become fully operative. This is not likely to happen until 2012.

### Level two

The level one directive provides for the regime to be supplemented by further rules at level two. EIOPA's predecessor, CEIOPS, provided a full set of advice to the Commission on the recommended content of the level two rules (but not their legal drafting). The Commission is not bound to follow this advice. Indeed, it has indicated an intention to depart from it in a number of areas. The QIS5 (see above) specification formulated in 2010 indicated the Commission's then thinking on the calibration of the rules. This may change significantly when the outcome of QIS5 is taken fully into account. It is also likely that there will be a QIS6, but its outcome may be too late to influence the calibration of the rules as at January 2013.

Omnibus II makes changes to the procedure for adopting level two rules and expands their coverage beyond the areas on which CEIOPS originally advised. In theory, level two rules may be either directives or regulations. Directives, such as the level one directive, would need to be transposed into the law of member states. This procedure often gives rise to considerable delays and inconsistent implementation. Regulations, by contrast, have direct effect. It seems that the Commission expects the bulk if not all of the level two rules to take the form of regulations.

Most of the powers to adopt legislation at level two are mandatory. They must be exercised before the regime comes into force. Some, on the other hand (covering, for instance, finite reinsurance and supervision of intra-group risk concentrations) are optional. EIOPA and the Commission are concentrating for the time being on the mandatory rules. So, for instance, within the UK, the Financial Services Authority (FSA)'s existing rules on finite insurance will probably carry forward for the time being and the FSA will develop its own rules on intra-group risk concentrations.

There is no requirement as such for the Commission to consult publicly on draft level two rules. Once Omnibus II has been adopted, the rules will be formally proposed, probably in late 2011 or early 2012, and then adopted, probably later in 2012, and come into force with the level one regime, unless the EU Council and/or the European Parliament object. The Council and Parliament will have less-extensive powers than they do under the procedure applicable to level one. They will in effect be able to say 'yes' or 'no' but not to debate and submit detailed amendments.

In fact, although there is no obligation to consult, informal consultations with 'key stakeholders' have taken place on a series of preliminary drafts of the level two rules. In practice, suggestions for changes to the rules are perhaps likely to prevail only if they are made through trade or professional associations.

### Level three

Level three of the Lamfalussy process envisages the development of non-binding standards and guidance supplementing the level one and two rules. In January 2010 CEIOPS consulted publicly on level three guidance covering the 'pre-application process' leading up to the approval of internal models. Subsequent level three consultations, however, have been confined for the time being to 'key stakeholders'. These cover, among other things, governance, the own risk and solvency assessment, reporting and own funds.

The formal process of consultation via the EIOPA website will not happen until after the level two rules have been finalised. It may, of course, be that by then the pre-consultation will have considerably narrowed the scope for further change.

### Level two and a half? Technical implementing standards

A new species of regulation created with EIOPA and applied within Solvency II by the Omnibus II Directive consists of 'technical implementing standards'. Unlike level three guidance these standards will be fully binding, but they must be confined to issues that are truly technical and not politically controversial.

So for instance, Omnibus II allows the Commission to make level two rules developing the concept of the 'best estimate' that is key to calculating the technical provisions under Solvency II. These rules may in turn be supplemented by implementing technical standards determining the conditions of application of the best estimate rules. The FSA has also indicated that the procedure for approval of internal models is likely to be supported by technical implementing standards.

Omnibus II requires EIOPA to develop drafts of all the proposed implementing technical standards under Solvency II by 31 December 2011. Unlike for the level two rules, a public consultation is required. The standards are then expected to be confirmed by the Commission in 2012.

### Level four

Level four of the Lamfalussy process requires the Commission to monitor member states' implementation and compliance with the new Solvency II regime and to take enforcement action if necessary. The new powers granted to EIOPA will allow it fully to support that process.

## Further delays in implementation?

Getting the Solvency II regime ready in time for 1 January 2013 is imposing serious challenges on the resources of regulated firms, of their supervisors and of EIOPA itself and the Commission. A recent speech by Hector Sants, chief executive of the FSA, expressed optimism about the FSA's ability to adapt to Solvency II, but this attitude may not prevail across Europe as a whole.

The original timetable indicated that the regulatory structure would have been defined at least a year before the regime comes into force. That is now unlikely. But the ability to adopt transitional standards will allow the regime to be introduced by stages and the 1 January 2013 date should probably therefore be regarded as one of those stages rather than a 'big bang'.

## Further information

The above is a very brief summary of an extremely complex proposal. We are happy to provide further information, explanations and comments.

For further information please contact

Ian Poynton
T +44 7832 7673
E ian.poynton@freshfields.com

Jonathan Goodliffe
T +44 20 7716 4544
E jonathan.goodliffe@freshfields.com





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