

CLIENT UPDATE

SOLVENCY II - THE WAY FORWARD

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On 10 October 2014, the EU Commission adopted a delegated act (the “Delegated Act”) under the Solvency II Directive (2009/138/EC as amended by Directive 2014/51/EU).

WHAT DOES THE DELEGATED ACT DO?

The Delegated Act sets out implementing rules with detailed requirements for individual insurance undertakings and groups. These rules will comprise the core of the single prudential rulebook for (re)insurance undertakings in the EU. In particular, the Delegated Act covers:

- rules for the market consistent valuation of assets and liabilities, including technical provisions. The rules set out technical details of the so called ‘long-term guarantee measures’ which were introduced by the Omnibus II Directive to smooth out artificial volatility and ensure that insurers can continue to provide long-term protection at an affordable price;
- rules for the eligibility of insurers’ own fund items, covering capital requirements to improve the risk sensitivity of the regime and allow timely supervisory intervention. The Delegated Act confirms the previous treatment of Tier 1, 2 and 3 classifications of own funds which remain largely unchanged from previous drafts circulated by the EU Commission;

- the methodology and calibration of the Minimum Capital Requirement (“MCR”) and of the standard formula for the calculation of the Solvency Capital Requirement (“SCR”); this includes the calibration of market risks on insurers’ investments, taking into account the Commission’s long-term financing agenda;
- for undertakings applying to use an internal model to calculate their SCR, the implementing rules also specify standards that must be met as a condition for authorisation;
- the organisation of insurance and reinsurance undertakings’ systems of governance. In particular, the role of the key functions defined in the Solvency II Directive (actuarial, risk management, compliance and internal audit). The implementing rules also specify aspects of the supervisory review process and the elements to consider in deciding on an extension of the recovery period for undertakings that have breached their SCR;
- reporting and disclosure requirements, both to supervisors and to the public. Increased comparability and harmonisation of information is intended to improve the efficiency of supervision and foster market discipline;
- criteria for supervisory approval of the scope of the authorisation of special purpose vehicles taking on reinsurance risk, and requirements related to their operation;
- rules related to insurance groups, such as the methods for calculating the group solvency capital requirement, the operation of branches, coordination within supervisory colleges, etc.; and
- criteria to assess whether a solvency regime in a third country is equivalent.

TIMELINE FOR IMPLEMENTING THE DELEGATED ACT

The Delegated Act takes the form of draft Regulation which, once in force, will be directly effective across the EU without the need for any national implementing legislation.

The European Parliament and the European Council have until January 2015 to object to the Delegated Act known as a “no objection” review period. The European Council and/or the European Parliament could ask for the no-objection review period to be extended until April 2015. Assuming that there are no objections, once the Delegated Act has been approved by the European Parliament and the European Council and the date confirmed, it will enter into force across the EU without further implementing legislation.

However, The Solvency II Directive, along with the Omnibus II Directive that amended it, will have to be implemented into national legislation by the Member States of the EU before 31 March 2015. On 1 April 2015, a number of early approval processes, such as the

approval process for insurers' internal models to calculate their Solvency Capital Requirement, will start. The Solvency II regime will be fully applicable on 1 January 2016. In addition to certain grandfathering provisions, insurers that are unable to meet the SCR by 2016 will have until 31 December 2017 to meet the SCR, provided that regular updates are given to the supervisor and demonstrable progress is made towards compliance.

CAPITAL CHARGES FOR SECURITISED ASSETS

Capital charges for securitised assets under the standard formula in the Delegated Act are significantly reduced from those set out in the draft published by the EU Commission in July 2014.

For senior tranches, the capital charges are now more aligned to the charges that would apply if the underlying assets were held by the insurer directly. This is intended to respond to concerns that high capital charges for securitisations would deter insurers from investing in securitised assets.

REVIEW OF THE IMPLEMENTING MEASURES SET OUT IN THE DELEGATED ACT

The methods, assumptions and standard parameters used when calculating the SCR with the standard formula will be reviewed by the EU Commission by the end of 2018. The review is intended to rely on the experience gained by (re)insurance undertakings during the first years of the application of the implementing rules and is expected to focus on the calibrations of fixed-income securities and infrastructure investments.

CONCLUSION

Once the Delegated Act is approved by the European Parliament and the European Council, insurers will be able to identify with greater precision the types of investments which best suit their risk profile and capital requirements.

It remains to be seen whether the reduced capital charges for high-quality securitisations will encourage Insurers to invest in these assets and help to promote, if not reinvigorate, the post crisis, still sluggish, securitisation markets.

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Please do not hesitate to contact us with any questions.

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