

Solvency II Consultation,
c/o The Insurance and Savings Team,
HM Treasury
Sent via email

15 February 2012

Your reference

Our reference JSW/2012/Feb/lett03 SII HMT

Dear Sirs

Response to consultation on Solvency II

We appreciate the opportunity to provide feedback on HM Treasury's consultation paper on Solvency II. This response is sent on behalf of Lloyd's.

Lloyd's is a society of members incorporated under the Lloyd's Acts 1871 – 1982 that operates as an insurance and reinsurance market. The aggregate premium income of the Lloyd's market in 2010 (the latest year for which audited figures are available) was £22.6bn. Lloyd's will be subject to Solvency II and has an intensive implementation programme to ensure compliance centrally and within the market.

We agree that full implementation of the Solvency II Framework Directive ("the Directive") requires amendments to UK legislation and we welcome the decision to press ahead with the process of transposition, notwithstanding the considerable uncertainty that remains at the present time regarding the EU's legislative processes.

HM Treasury will be aware that the Financial Services and Markets Act 2000 ("FSMA") is already a complex piece of legislation and that its amendment by the Financial Services Bill will make it more complex still. Once Solvency II is in force, a (re)insurance undertaking in the UK will find Solvency II requirements spread across the following documents:

- Solvency II Framework Directive (as amended by the Omnibus II Directive)
- Level 2 EU Delegated Acts
- Level 2 EU Regulatory Technical Standards
- Level 2 EU Implementing Technical Standards
- EIOPA Guidelines and recommendations
- FSMA (as amended)

Financial Services and Markets Act 2000 (Solvency 2) Regulations 2012
FSA Handbook (as amended; to be replaced, in due course, by separate PRA and
FCA rulebooks)

This complex network of legislation at EU and national level cannot be viewed as optimal and adds to the regulatory burden on the UK insurance sector. It is, perhaps, unfortunate that a decision has been taken to place many Solvency II provisions into a freestanding section of the Solvency II Statutory Instrument, adding to the pieces of legislation that must be consulted. Nevertheless, we can understand the reluctance to add further complexity to FSMA.

It is therefore important that UK legislation is correctly drafted, so that all necessary Directive provisions are transposed in a way that fits into the wider legislative structure, without leaving gaps or “gold-plating”. Broadly speaking we believe that your proposals achieve this and commend the efforts you have made. Our detailed responses to this consultation are set out below. We note below any areas where we think that the proposals will not align UK legislation with the Directive

Chapter 6 Conditions for Authorisation and De-authorisation

Do you agree with the way in which the Government is proposing to amend FSMA, to enable the PRA to withdraw authorisation of a (re)insurance undertaking in specified instances?

We agree that it is desirable to amend FSMA in the manner suggested, to bring it into line with the Directive. However, we think that the proposed amendments will not be sufficient to align UK legislation with the Directive.

The paper notes that Directive Article 144 specifies that a supervisory authority may withdraw authorisation in specified circumstances, including (sub-para (b)) “*the undertaking concerned no longer fulfils the conditions for authorisation*”. The conditions for authorisation are listed in Article 18: they are not the same as the “threshold conditions” in FSMA Schedule 6. FSMA s. 45(1)(a) gives the FSA powers to vary or cancel a Part IV permission if the authorised person “*is failing, or is likely to fail, to satisfy the threshold conditions*”. We understand that the Financial Services Bill will replace this section with a similar provision in FSMA s. 55J.

Neither in its current or amended form does FSMA make reference to the Directive’s conditions of authorisation or give the UK supervisory authority power to withdraw a (re)insurance undertaking’s authorisation on the grounds that it no longer fulfils these conditions, except to the extent that such non-fulfilment triggers other grounds for withdrawal. Consequently, without further change, UK legislation will not fully comply with the Directive.

Chapter 7 PRA powers to comply with Solvency II

Do you agree with the ways in which the Government is proposing to amend FSMA?

As noted in our introductory comments, our preference is that transposition of Solvency II into UK law is as straightforward as possible. We assume that HM Treasury is confident that Part 3 of the Solvency II Statutory Instrument (“Part 3”) is an essential element of transposition.

Part 3 must be read in conjunction with SOLPRU, the FSA’s draft new prudential sourcebook for insurers. SOLPRU provides full details of the regulatory powers covered by Part 3 of the Solvency II Statutory Instrument, whereas Part 3 covers certain, but not all, aspects of the powers. SOLPRU is an account of UK regulatory requirements based on Solvency II that can be read entirely independently from Part 3. For example, the requirements on undertakings to seek various supervisory approvals, from which all the other requirements stem, are set out in SOLPRU, not in Part 3. Furthermore, the FSA will exercise powers it already possesses to make SOLPRU and does not propose to rely on Part 3. If the FSA is able to make rules effectively transposing Solvency II into UK legislation without reference to Part 3, this does raise a question over the efficacy of Part 3.

If Part 3 is retained, we suggest that it could be simplified by replacing references to “the appropriate regulator” with references to “the PRA”. Chapter 7 of the consultation is sub-headed “Amendments to give PRA powers...” and the effect of the amendments to which it refers is to give powers to the PRA. However, Part 3 does this by granting powers to “the appropriate regulator”, which an Interpretative Paragraph then explains is the PRA for PRA-authorised persons and the FCA in any other case. All the (re)insurance undertakings subject to these provisions will be PRA-authorised persons, so it would be more straightforward simply to specify the PRA as the body to whom the powers are granted.

Composite firms authorised to carry out life and non-life insurance business: We think that this misinterprets what is admittedly an obscurely worded Directive provision. Directive Article 74(7) says:

“If the amount of eligible basic own-fund items with respect to one of the activities is insufficient to cover the minimum financial obligations referred to in first subparagraph of paragraph 3, the supervisory authorities shall apply to the deficient activity the measures provided for in this Directive, whatever the results in the other activity.”

We view this as an instruction to supervisory authorities that if a composite firm has a deficit on either the life or non-life side of its business, it is to be considered as in breach of its solvency requirement, even if, due to the position on the other side of the business, the firm is solvent overall. Part 3 implies that the PRA must, in these circumstances apply Solvency II requirements only to the part of the firm in deficit, whereas it is very likely that, in these circumstances, action will be taken in relation to the firm overall. We do not consider that it is necessary for this provision to appear in Part 3, rather than in the FSA’s Handbook (and its PRA replacement) and suggest that it is removed.

Verification of the Basic Solvency Requirement: This paragraph refers to “supervisory approval of the basic Solvency Capital Requirement”. Directive Article 104 on which it is based requires supervisory approval of Undertaking Specific Provisions only. The paragraph should be amended to reflect this.

Chapter 9 Mandating the PRA to perform other supervisory functions

Financial stability and pro-cyclicality: sub-para (b) does not, as drafted, exactly reflect the Directive. It should be re-drafted to read:

“consider the potential impact of its decisions on the stability of the financial systems in the EEA, in particular in emergency situations, taking into account the information available at the relevant time”.

Chapter 10 Terminology consistent with Solvency II

Meaning of United Kingdom Solvency 1 and 2 firm: This section defines in detail the terms “United Kingdom Solvency 2 firm” and “United Kingdom Solvency 1 firm”, although there are no other references to these terms either in Part 3 or any other part of the Solvency II Statutory Instrument.

The terms are used in SOLPRU, which also contains definitions of these terms. The definitions in Part 3 and in SOLPRU have the same meaning but are worded differently. We consider that the definitions in SOLPRU are preferable, being more straightforward. We query whether, if SOLPRU is able to define and use the terms without any reference to Part 3, and Part 3 does not use the terms, it is necessary for Part 3 to contain these definitions.

There is a subtle difference in the terms: Part 3 refers to “Solvency 2” and SOLPRU to “Solvency II”. If the two are intended to refer to the same firms, it is preferable for the terms as well as the definitions to be identical.

A Impact Assessment

We understand the Government’s position, that essentially it is no choice but to transpose Solvency II into UK law. Lloyd’s continues to support Solvency II in principle and believes that, so long as its detailed provisions are adjusted so that they properly reflect Solvency II’s objectives, it will provide long-term benefits to the EU’s insurance industry and to the insurance industry and wider economy of the UK.

Nevertheless, we note the estimates of the costs of Solvency II implementation, in particular the total figure for implementation in the UK of £1.93bn. This is an extraordinarily large expense for the insurance industry to bear, particularly at a time of economic difficulties. HM Treasury should bear in mind this significant cost burden arising from regulatory change into which it has had an input and consider what lessons can be learnt from the process. We suggest that HM Treasury will want to avoid imposing heavy levels of expense on the UK

insurance industry (or other financial sectors) through other programmes of regulatory change, such as the re-structuring of the UK's financial supervisory system.

Please let me know if you have any questions arising from this response.

Yours sincerely

A handwritten signature in black ink that reads "James Walmsley". The signature is written in a cursive style and is set against a light grey rectangular background.

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