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FINANCIAL MARKETS LAW COMMITTEE

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Discussion of legal uncertainties arising from the Solvency II Directive

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FINANCIAL MARKETS LAW COMMITTEE

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Table of abbreviations

"EIOPA"	means the European Insurance and Occupational Pensions Authority
"ISPV"	means an undertaking which fulfils the definition of "Special Purpose Vehicle" in Article 2(1)(p) of the RID (*see below*) or Article 13(26) of the Solvency II Directive (*see below*)
"Level 2 Measures"	means implementing or delegated acts to be adopted by the European Commission in accordance with Articles 290 and 291 of the Treaty on the Functioning of the European Union. The Solvency II Directive (*see below*) currently refers to "implementing measures". However, the Omnibus II Directive (*see below*) is expected to amend the Solvency II Directive to make clear that these measures are adopted in accordance with the treaty Articles referred to above
"MCR"	means Minimum Capital Requirement
"Omnibus II Directive"	means the proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority
"RID"	means Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance, otherwise known as the Reinsurance Directive
"RLD"	means Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, otherwise known as the Recast Life Directive

"SCR"	means Solvency Capital Requirement
"Solvency II Directive"	means Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast)

1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. The FMLC wishes to draw attention to a number of issues that give rise to concern regarding the interpretation of the Solvency II Directive.

2. THIRD COUNTRY BRANCHES

2.1. The provisions of the Solvency II Directive concerned with the authorisation of third-country branches (see Title I, Chapter IX) are closely based on existing European insurance legislation. This paper draws comparisons with provisions in the RLD in order to highlight uncertainties that arise from the relevant provisions of the Solvency II Directive.

2.2. First, uncertainty arises as to the way in which the criteria for the authorisation of third country branches are to be applied. Second, it is unclear whether authorisation is the subject of minimum harmonisation and, if so, how "gold-plating" of authorisation requirements by individual Member States might operate in a cross-border context.

MCR and SCR criterion

2.3. Uncertainty arises as to whether the requirement for the third-country undertaking to cover the MCR and SCR, as it appears in Article 162(2)(f), is to be met at the level of the branch or at the level of the undertaking. The Article provides as follows:

> A Member State may grant an authorisation where the undertaking fulfils at least the following conditions:
>
> [...]

> it undertakes to cover the Solvency Capital Requirement and the Minimum Capital Requirement in accordance with the requirements referred to in Articles 100 and 128;
>
> [...].

2.4. On the one hand, and indicative of the criterion needing to be met at branch level, Article 166 of the Solvency II Directive—which explains how the MCR and SCR must be calculated in the branch context—states clearly that the MCR and SCR must be calculated at the level of the branch. One can infer that Article 162 is intended to be read in accordance with Article 166.

2.5. In a similar vein, Article 162 is evocative of equivalent provisions of the RLD (Articles 151 and 155) which are clearly applicable only at the level of the branch; it can be implied that Article 162 is intended to have a similar effect to those provisions.

2.6. On the other hand, however, the fact that Article 162 cross-refers to Articles 100 and 128 may indicate that the MCR and SCR criterion is to be met at undertaking level. This is because both Articles 100 and 128 clearly apply at the level of the undertaking.

2.7. Given these conflicting interpretations, legal uncertainty exists and clarification would be of benefit.

Governance criterion

2.8. It is unclear whether the governance criterion in the Solvency II Directive (Article 162(2)(i)) is to be satisfied at the level of the branch or the undertaking. The relevant provision states as follows:

> A Member State may grant an authorisation where the undertaking fulfils at least the following conditions:
>
> [...]

it fulfils the governance requirements laid down in [Articles 41 to 50].

2.9. One interpretation is that the overall intention behind Articles 162 to 175 is the assurance that EU branches only of third-country undertakings are subject to the Solvency II Directive and that that the governance criterion should, therefore, be met at branch level.

2.10. However, Articles 41 to 50—to which Article 162(2)(i) refers—do not sit easily with this interpretation because the governance requirements therein are applicable at the level of the undertaking.

2.11. Clarification of this point would increase legal certainty.

Minimum or maximum harmonisation?

2.12. There is a lack of clarity as to the right of Member States to place additional and more onerous requirements on third country branches.

2.13. Article 162(2) of the Solvency II Directive provides that "a Member State may grant authorisation where the undertaking fulfils *at least* the following conditions" (emphasis added). This implies that additional conditions can be imposed. However, this would be unusual given that most of the Solvency II Directive harmonises maximally.

3. *MUTATIS MUTANDIS* PROVISIONS AND GROUPS

3.1. It is not always clear how rules in the Solvency II Directive which have been designed to be applied to solo undertakings should be interpreted in a group context. A number of the Directive's provisions which deal with the supervision of undertakings in groups (see Title III) apply rules for solo undertakings (see Titles I and II) at the group level "*mutatis mutandis*".

3.2. This is, for example, the case with respect to capital add-ons for groups. In this regard, it is not clear how the question of whether the group SCR appropriately reflects the risk profile of the group—a question to be answered by the relevant supervisory authority under Articles 232 and 233(6)—is to be

determined. This is because an inherent part of the test, which is to be inferred from Article 37, refers to solo undertakings. The result of this uncertainty is that the group will not be able to predict how the supervisor would calculate the need for a group capital add-on to be imposed.

3.3. Similarly, it is unclear how the application at the level of the group of governance requirements for solo undertakings (see Articles 41 to 50) is to be implemented, as is required under Article 246. For example, one of the governance requirements picked up by Article 246 is the obligation for an actuarial function to be provided (Article 48). The nature of this function, as described in Article 48, is complex and intricate. A requirement for an insurance holding company to provide an actuarial function which operates consistently with the detailed provisions of Article 48 appears highly burdensome and may not be within the legislative intent of Article 246. The intent behind the Article may be to place a less prescriptive obligation on groups to provide an actuarial function—for example, one may infer that it is intended that an insurance holding company be required to employ an actuary to consider group-wide actuarial issues and to report those to the insurance holding company and regulated entities. However, because the provision relies on the concept of "*mutatis mutandis*", this is not clear.[1]

3.4. Legal certainty would be increased if, rather than relying on the application of rules "*mutatis mutandis*" to groups, the relevant rules were to be set out explicitly—adapted as necessary to the group context—in Title III.

4. TREATMENT OF EXISTING ISPVs

4.1. The concept of a "new activity" is the Solvency II Directive's threshold concept for the application of regulation establishing a line beyond which an existing ISPV—an ISPV authorised before 31 October 2012—becomes subject to Level 2 Measures under Article 211(3) of the Directive. It appears that the commencing of a "new activity" will trigger a requirement for all of

[1] It is acknowledged that "*mutatis mutandis*" provisions can provide flexibility for supervisors in the enforcement of rules and for groups as regards their structure. Nevertheless, because such provisions afford less legal certainty, they tend to be more difficult to interpret and their operation is less easily predicted by market participants.

an ISPV's ongoing programmes to close or otherwise be compliant with the Solvency II Directive's Level 2 Measures.

4.2. It is unclear what constitutes a "new activity". It may be that "new activity" is only intended to refer to substantially new engagements or the acceptance of new obligations (ie. the issuance of a new note or the writing of a new contract). A different interpretation is that "new activity" refers to any activity of a legal or financial nature, including an amendment to an existing arrangement which passes *de minimis*.

4.3. Clarity could be brought to bear on this point by introducing a (possibly exclusive) description or definition of "new activity" into Article 211(3) or through the provision of guidance by EIOPA.

5. RISK RETENTION RULES

5.1. Legal uncertainty may arise from the risk retention provisions, which restrict investment in securitisations,[2] found in Article 135(2) of the Solvency II Directive. This is because they are inconsistent with equivalent rules found in other pieces of EU legislation.[3] For example, the restriction under Article 135(2) of the Solvency II Directive applies to "securities or instruments", whilst the rules in some equivalent legislation are concerned with "securitisation positions". Similarly, Article 135(2) mandates the Commission to make rules implementing its risk retention provisions which include a requirement that the *originator* retain a 5 per cent interest. By contrast,

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[2] The EU risk retention regime requires, first, that certain entities responsible for bringing financial instruments to market assume exposure to those same instruments and, second, that other specified entities invest exclusively in financial instruments which comply with the first requirement.

[3] Rules for credit institutions can be found in Article 122a of Directive 2006/48/EC as amended by Directive 2009/111/EC ("CRD II"). Article 122a of CRD II will shortly be replaced by provisions in the proposed Capital Requirements Regulation, which will also extend to investment firms. Political agreement was reached on the proposed Regulation in March 2013. Rules for alternative investment fund managers are found in the AIFMD (Directive 2011/61/EU) and a delegated Regulation pursuant to it (Regulation 2013/231/EU). Rules for UCITS are found in the UCITS Directive (Directive 2009/65/EC), as amended by the AIFMD.

Further comments on inconsistencies between these provisions can be found in the response of the FMLC to the consultation on enhancing the coherence of EU financial services legislation of the Committee on Economic and Monetary Affairs of the European Parliament. This paper can be accessed on the FMLC's website at http://www.fmlc.org/Pages/papers.aspx.

equivalent provisions mandate the making of rules which include a requirement that the *originator, the sponsor or the original lender* retain a 5 per cent interest.

5.2. There is no clear rationale for these inconsistencies but they may result in uncertainty as to the intended effect of the rules in the Solvency II Directive. Legal certainty would be increased if these provisions were to be harmonised with equivalent rules found elsewhere in EU legislation.

5.3. Further, it is not clear whether the description of a financial instrument in Article 135(2) includes instruments issued by an ISPV. The description in Article 135(2) refers to loans which have been repackaged into tradable securities and other financial instruments.

5.4. An argument of legal construction can be made, by reference to the risk retention provisions for credit institutions,[4] which suggests that the description does not include instruments issued by an ISPV. The rules for credit institutions apply to a "securitisation" which is defined as "a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched...".[5]

5.5. Given that ISPVs repackage insurance risk rather than credit risk, an instrument issued by an ISPV would not appear to fall within the description of definition of a "securitisation" and nor, by extension, would it fall within the meaning of loans which have been repackaged into tradable securities and other financial instruments in the Solvency II Directive.

5.6. However, given that risk retention provisions have been introduced to Solvency II as a result of strong policy commitments, and in view of the fact that legislators have in mind the need to avoid the circumventing of regulatory requirements, it seems important to ensure clarity on this point.

4 *Ibid.*

5 Article 4(36) of Directive 2009/111/EC.

6. CONCLUSION

The FMLC believes that consideration and clarification of the points raised above is important for the creation of a more robust and predictable regime for the insurance and reinsurance industry and for the provision of legal certainty across the wholesale financial markets.

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[6] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.