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Global Corporate Insurance & Regulatory

BULLETIN

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UK – FSA Solvency II briefing, ABI's industry response and FSA's Q&A on implementation

On 3 November 2011, the FSA held an industry briefing on Solvency II. Julian Adams, Director of Insurance at the FSA gave a speech outlining what the FSA's timetable for implementing Solvency II means for internal model firms, to which Otto Thorensen of the Association of British Insurers (**"ABI"**) gave the industry response. We set out below the key points of both Mr. Adams' and Mr. Thorensen's speeches, and also discuss the FSA's questions and answers on Solvency II Directive and the internal model approval process, issued on 14 November 2011.

FSA – JULIAN ADAMS

Mr. Adams reported on the recent survey of the types of applications that firms were expecting to submit. He commented that the data received would assist the FSA immensely in planning their workloads in the run-up to implementation.

He confirmed that (whilst the issues would not be completely certain until the Omnibus II Directive is finalised, which is expected Q1 2012) the FSA now expects that Member State governments and regulators will be required to have transposed the Solvency II Directive into national law by January 2013, but that the rules will only become applicable to regulated firms from January 2014 (**"Bifurcation"**). Mr. Adams stated that this is *"emphatically not"* a wholesale delay in the implementation date, and was aimed to help solve practical implementation issues in some Member States whilst allowing more time for firms to prepare for implementation. Therefore, *"there should be no loss of momentum in firms' implementation programmes"*.

Mr. Adams went on to explain that each firm or group that has already been accepted into pre-application has been allotted a 'submission slot', during which they would be expected to submit their internal model application. The FSA has sought to group together applications from firms with similar business models or approaches, in order to ensure a reasonable degree of consistency. He also clarified that the FSA will not be allowing further firms to enter the pre-application process as a result of Bifurcation, and they do not expect to see significant changes to model scope or approach as a result either. Firms who do have such changes in mind are encouraged to discuss this with their supervisor as a matter of urgency.

Mr Adams explained what the FSA expects firms to do in the run-up to implementation, and confirmed that the FSA intends to explore with firms possible ways of avoiding the costs associated with the dual running of an ICAS and a Solvency II model, whilst also focusing on policyholder protection.

Firms were also urged to continue to develop contingency plans for what they would do if the FSA does not give model approval, or only gives approval for part of the model.

The text of Mr. Adams' speech can be found here.

INDUSTRY RESPONSE – OTTO THORENSEN

In response to Mr. Adams' speech, Otto Thorensen welcomed the briefing. He commented that ABI members do not welcome the delay in Solvency II's implementation, but do *"accept that the delay has become inevitable due to the hold up in the legislative process"*, and welcome the clarity provided on *"a previously confusing situation"*.

Mr. Thorensen stated that it was crucial that firms continue to work towards implementation with the same determination as before, although he also urged the FSA to provide a clear steer on the application windows and more clarity on the implementation process and the use of internal models for ICA purposes during 2013. The ABI are keen to work with the FSA to develop a workable solution to the potential duplication between ICAS models and Solvency II models during 2013.

He stated that some further uncertainty should be lifted by the publication of EIOPA's consultations on own risk and solvency assessment (**"ORSA"**) and reporting and disclosure (for more on which, see the article below entitled *"EIOPA publishes two consultation papers on reporting and public disclosure under Solvency II, and FSA publishes guide to the consultation paper"*).

Mr. Thorensen concluded by reaffirming that the UK industry is committed to the implementation of Solvency II as soon as it is practically possible, and that the ABI will continue to strive for sensible and workable solutions to the challenges of Solvency II.

The text of Mr. Thorensen's response can be found here.

FSA'S QUESTIONS AND ANSWERS ON SOLVENCY II DIRECTIVE AND THE INTERNAL MODEL APPROVAL PROCESS

Further to the speeches discussed above, the FSA published a set of questions and answers on the Solvency II Directive on 14 November 2011.

Key points from these questions and answers include that:

- The FSA will make materials available to firms by February 2012 to enable them to make their applications from March 2012.
- All firms will be assessed against the same, finalised, requirements. Where there is ambiguity, the FSA will work with firms to make reasonable assumptions based on the information available. If it is not appropriate for it to make a working assumption, it will hold off on the review of that part of the model until it has greater clarity and certainty.
- The FSA will let firms know as soon as possible where it is of the belief that the firm is not likely to meet the Solvency II requirements within the scheduled timelines.

- Firms who are not in pre-application should assume that they will not get a decision for day one of the Solvency II regime. When, after the regime comes into effect, they do submit a model, the FSA will have an obligation to review it and give its decision within six months of receipt of a complete application.

The questions and answers can be accessed here.

UK – EIOPA publishes two consultation papers on reporting and public disclosure under Solvency II, and FSA publishes guides to the consultation papers

On 8 November 2011, the European Insurance and Occupational Pensions Authority (**"EIOPA"**) published two consultation papers in relation to reporting and public disclosure under Solvency II. The FSA has published guides to the consultation papers as well as, on 30 November 2011, publishing questions and answers (**"Q&A"**) on issues relating to reporting and disclosure under Solvency II.

The first EIOPA consultation paper focuses on a draft proposal on quantitative reporting templates. Alongside this paper, EIOPA has published solo reporting templates, group specific reporting templates and summary documents.

The second EIOPA consultation paper concerns own risk and solvency assessment (**"ORSA"**) and includes proposed guidelines on:

- the content of the narrative Solvency and Financial Condition Report (**"SFCR"**);
- the content of the narrative Regular Supervisory Report (**"RSR"**);
- reporting where pre-defined events have occurred; and
- processes for public disclosure and supervisory reporting.

The paper contains 27 guidelines on the content of the SFCR (which Solvency II requires firms to publish and provide to the FSA on an annual basis) and two additional guidelines on group SFCRs. There are also five guidelines on the process for reporting, two guidelines in relation to identifying pre-defined events and 16 guidelines on the content of the RSR.

The guidelines for both the SFCR and the RSR cover five broad topics: business and performance, system of governance, risk profile, valuation for solvency purposes and capital management.

The consultation papers are both open for feedback until 20 January 2012.

In response to these consultation papers, the FSA published guides summarising the content of the papers and setting out what firms should do next, as well as a set of Q&A on reporting and disclosure.

The FSA emphasised that firms should read the consultation papers in detail and respond to them via the EIOPA website, explaining which parts they like (with reasons) as well as commenting on elements that need improvement, and proposing alternatives.

It also encouraged senior management to take steps to understand the information required, to ensure they can provide the data required to complete the returns and to keep track of changes to their regulatory returns software.

In addition, it reminded firms that they can register with the EIOPA website for updates about consultations and other developments.

Please view the first EIOPA consultation paper , the second EIOPA consultation paper; the FSA's guide on reporting, the FSA's guide on ORSA and the FSA's Q&A.

UK – FSA consultation papers on 'Solvency II transposition' and 'Solvency II and linked long-term insurance business'

On 9 November 2011, the FSA published two consultation papers, one on Solvency II transposition and the other on Solvency II and linked long-term insurance business. We discuss both in this article.

CP11/22 – SOLVENCY II TRANSPOSITION

CP11/22 is the first of two proposed consultation papers which the FSA plans to release before the date by which it is envisaged that member states will be required to transpose Solvency II (1 January 2013). The second consultation paper will be released once agreement has been reached on Omnibus II and the Solvency II level 2 legislation.

CP11/22 is important for three main reasons, namely:

1. It sets out the FSA's approach to the transposition of Solvency II – the FSA is using an "intelligent copy-out" approach, meaning that it has aimed to update the FSA Handbook in a way that is useful to firms, but also keeps to the level 1 text as closely as possible. The draft Handbook text is set out in an appendix to CP11/22.
2. It details the limited areas of discretion that member states have in relation to Solvency II.
3. It explains how the fundamentals of Solvency II will be applied in the UK.

Responses to CP11/22 should be made by 15 February 2012, and the FSA plans to report back in the second quarter of 2012. A copy of CP11/22 can be viewed here, and the FSA's summary can be viewed here.

CP11/23 – SOLVENCY II AND LINKED LONG-TERM INSURANCE

CP11/23 sets out the FSA's proposals to change its rules and guidance relating to the operation of unit-linked and index-linked insurance business. These changes aim to maintain policyholder protection whilst also ensuring that the requirements are consistent with Solvency II.

Responses to CP11/23 should be made by 15 February 2012, and the FSA plans to report back in the second quarter of 2012. A copy of CP11/23 can be viewed here.

UK – HM Treasury publishes consultation paper on Solvency II

On 23 November 2011, HM Treasury published a consultation paper on the Government's proposed changes to UK legislation to bring it in line with the requirements of Solvency II.

There are four broad categories of required changes:

- amendments to the conditions for authorisation and de-authorisation of insurance and reinsurance undertakings;
- new powers enabling the Prudential Regulatory Authority (the **"PRA"**) (currently the FSA) to approve the instruments insurance and reinsurance undertakings need to calculate their position under Solvency II;
- new duties requiring the PRA to participate in the new European supervisory framework; and
- amendments to UK terms and definitions to ensure they are aligned with those in the Solvency II directive.

The consultation paper includes a partial draft of the proposed Financial Services and Markets Act 2000 (Solvency 2) Regulations 2012 (the **"Draft Regulations"**), which is intended to affect the above changes. Part 2 of the Draft Regulations sets out amendments to the Financial Services and Markets Act 2000, while part 3 sets out freestanding provisions relating to insurance and reinsurance undertakings, including provisions for group supervision and group solvency. Amendments to secondary legislation will ultimately be provided in part 4, but these are yet to be drafted.

The deadline for responses is 15 February 2012, and respondents are requested to address any questions where they feel they can make a contribution as well as offering any further comments they may have.

UK - Cease and Desist – severe new restrictions on dealing with Iranian banks

You may have seen reports of the latest round of financial sanctions imposed by the UK Government against Iran, which were announced, and became effective, on 21 November 2011. The new measures are contained in The Financial Restrictions (Iran) Order 2011 (the **"Order"**), made pursuant to the Counter-Terrorism Act 2008. Insurers should not be deceived by the brevity of the Order (it is only two pages long), as the potential implications for the insurance market are significant.

The Order arises out of concerns regarding Iran's development of a nuclear and ballistic missile capability, and Iran's failure to address the risk of terrorist financing which, it is said, poses a serious threat to the integrity of the international financial system. It is reported that other countries are taking similar actions against Iran.

ISOLATION OF THE IRANIAN BANKING SYSTEM

The Order applies to all persons operating in the UK financial sector as financial or credit institutions (including (re)insurers) and all branches of such persons, wherever those branches are located (**"Relevant Persons"**). The Order does not, however, apply to subsidiaries of UK financial or credit institutions incorporated outside the UK or any subsidiaries of UK financial or credit institutions, wherever located, where those subsidiaries are not themselves financial or credit institutions.

The Order directs that Relevant Persons must not enter into, or continue to participate in, any transaction or business relationship with: (i) any credit institution incorporated in Iran; (ii) any subsidiary or branch of a credit institution incorporated in Iran, wherever that subsidiary or branch is located; or (iii) the Central Bank of Iran.

In practice, this means that Relevant Persons are prohibited from performing any existing transaction or undertaking any activity pursuant to an existing business relationship with Iranian credit institutions, unless licensed to do so by HM Treasury. This includes making payments to, or receiving payments from, Iranian credit institutions either directly or indirectly via one or more intermediaries.

Notwithstanding the above, provided that all reasonable steps are taken and all due diligence exercised to ensure that the requirements of the Order are complied with, it is a defence to show that Relevant Persons did not know or have reasonable cause to suspect that their participation in a transaction was prohibited by the Order.

INTERRELATIONSHIP WITH EXISTING FINANCIAL SANCTIONS

Several Iranian banks are already subject to asset freezes under the existing sanctions regime. The Order goes further and prevents all transactions and business relationships with all Iranian banks, not just making available funds or economic resources to those subject to an asset freeze.

The pre-existing sanctions regime that applies already to certain Iranian banks contained some exemptions to the prohibition on making funds available to designated persons. Previously, UK financial or credit institutions were permitted to:

1. credit frozen accounts where they receive funds transferred into the account of a designated person;
2. add interest or other earnings to frozen accounts; or
3. add to frozen accounts payments due under contracts, agreements or obligations that were concluded or arose before the date on which the person was designated, provided that such additions to frozen accounts were themselves frozen.

It is not the intention that the Order should prevent transfers of funds permitted under the exemptions described above. Accordingly HM Treasury has issued a general licence, exempting such payments.

In addition to the above, Article 21 of EU Regulation 961/2010 (the **"Regulation"**) put in place certain requirements in relation to notification of transfers of funds to or from Iranian persons, entities or bodies (broadly, that: payments of €10,000 or less

can be made without notification; payments between €10,000 and €40,000 can be made without authorisation, on condition that they are notified prior to being made; and payments greater than €40,000 must be authorised before being made). These requirements continue to apply; however, transfers of funds to or from Iranian credit institutions that would previously have been possible if made in accordance with the above notification requirements, are now prohibited.

PROVISION OF INSURANCE AND REINSURANCE

The pre-existing sanctions regime, as set out in the Regulation, prohibits specifically the provision of (re)insurance to an Iranian person, entity or body, including Iran, the Government of Iran and its public bodies, corporations and agencies. Additionally, it is prohibited to provide (re)insurance to any person acting on behalf of any of the above. The Order goes further than the Regulation and prohibits the provision of (re)insurance to Iranian credit institutions.

The Regulation includes certain exemptions to the general prohibition on the provision of (re)insurance, including: (i) the provision of compulsory or third party insurance to Iranian persons based in the EU; (ii) the provision of insurance to non-designated individuals acting in their private capacity (and reinsurance relating thereto); and (iii) the provision of (re)insurance to the owner of a vessel, aircraft or vehicle chartered by a non-designated Iranian person.

Because the Order goes further than the Regulation in certain respects, e.g. in prohibiting payment in relation to a contract of (re)insurance that would otherwise be permitted under one of the above exemptions, in order to preserve these exemptions, HM Treasury has issued a general licence (General Licence 3), allowing transactions related to these exemptions to be made (including in relation to the provision of exempt contracts of (re)insurance to Iranian credit institutions).

CONSEQUENCES FOR EXPORTERS

The Order is not intended to serve as a trade ban with Iranian companies (although the UK government does not encourage such trade). However, in the absence of a licence from HM Treasury, exporters will no longer be able to use UK credit or financial institutions to make or receive payments to or from Iranian credit institutions or to provide services where so doing would involve the UK institution in a business relationship with an Iranian credit institution. This may have implications for (re)insurers.

LICENSING

In total, HM Treasury has issued six general licences. In addition, it will still be possible to apply to HM Treasury for specific licences in respect of particular transactions. However, given the purpose of the Order (the prevention of nuclear proliferation) HM Treasury have stated that *"...it is unlikely that the Treasury will issue licences for business with Iranian banks on an ongoing basis under new contracts."*

OFFENCES

It is an offence not to comply with the requirements of the Order or to participate intentionally in activities knowing that the object or effect of them is to circumvent the requirements of the Order. Penalties for a failure to comply with the Order include: (i) a civil penalty of such amount as is considered appropriate; or (ii) a term of imprisonment of up to two years and/or a fine. In addition, civil (but not criminal) penalties may be imposed for failure to comply with the terms of a licence issued by HM Treasury.

CONCLUSION

The scope of the prohibitions introduced by the Order is wide-ranging and the penalties that can be imposed are severe. In essence, UK (re)insurers are prohibited from providing (re)insurance to Iranian credit institutions. In addition, the Order prohibits all payments to/from Iranian credit institutions (wherever located), whether made or received directly or indirectly. Regardless of the identity of the insured or reinsured any step in relation to any policy of (re)insurance that involves making a payment to, or receiving a payment from, an Iranian credit institution will be caught by the terms of the Order.

In such circumstances, insurers will need to determine whether any proposed course of action is permitted under the terms of one of the general licences issued by HM Treasury. If not, then a specific license application will need to be made, although the chances of such an application being looked upon favourably would, in the light of the comments from HM Treasury, appear to be doubtful.

US – New sanctions on Iran

Recently, the United States took action to pressure Iran into complying with certain international obligations and standards. On 19 November 2011, President Obama signed Executive Order 13590, which authorizes sanctions on entities that engage in transactions with Iran in excess of certain threshold amounts regarding goods, services, technology or support for the development of petroleum resources or the maintenance or expansion of the petrochemical sector. Under Executive Order 13590, if a person is found to have provided a good, service, technology, or support to Iran, the Secretary of State, in consultation with other agencies, may impose sanctions and may prohibit persons from engaging in certain activity, including, foreign exchange transactions, banking transactions, property transactions in the United States, U.S. Export-Import Bank financing, U.S. export licenses, imports into the United States, loans of more than $10 million from U.S. financial institutions, U.S. government procurement contracts, and, for financial institutions, designation as a primary dealer or repository of U.S. government funds. On 21 November 2011, the U.S. Department of State, under Executive Order 13382, designated certain specific Iranian entities that support Iran's nuclear procurement-related activities. U.S. persons may not transact business with such designees and the U.S. held assets of the designees have been frozen. Also on 21 November 2011, the U.S. Department of Treasury, through the Financial Crimes Enforcement Network, released a finding that the Islamic Republic of Iran is a jurisdiction of primary laundering concern under Section 311 of the Uniting and Strengthening America by Providing

Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001. The finding is noteworthy for stating that the Central Bank of Iran and other state-controlled entities willingly engage in deceptive financial practices in order to avoid potential sanctions. Finally, the Financial Crimes Enforcement Network released a Notice of Proposed Rule Making to impose a special measure against Iran in parallel with its finding that Iran is a jurisdiction of primary money laundering. The special measure authorizes a prohibition against the opening or maintaining of correspondent accounts-those accounts established to receive deposits from, or make payments or other disbursements on behalf of, a foreign bank, or handle other financial transactions related to the foreign bank-by any domestic financial institution or agency for or on behalf of a foreign banking institution, if the correspondent account involves Iran. Under the proposed rule, covered financial institutions would be required to apply special due diligence on correspondent accounts to prevent improper indirect use by Iranian banking institutions. Written comments on the notice of proposed rulemaking must be submitted within 60 days after the date of publication of the proposed rule in the federal register.

US – NY Implements Deregulation of Large Commercial Insurance Products

15 November 2011 was the effective date for the amendments to Article 63 of the New York Insurance Law that were enacted into law by New York Senate Bill 5811 on 17 August 2011. The amendments (and implementing regulations that also became effective on 15 November 2011) provide an exemption from rate and policy form filing and approval requirements when issuing certain policies to entities that qualify as "large commercial insureds." Prior to the amendments, the exemption was available only for risks producing a minimum annual premium in excess of $100,000 and risks that were of an unusual nature, a high loss hazard, or difficult to place pursuant to a list promulgated or amended by the Superintendent of Financial Services. The amendments have extended the exemption to include policies issued to a "large commercial insured" that employs or retains a special risk manager. An insurer utilizing the new exemption must file a certificate of insurance documenting the terms of the policy with the Superintendent within one business day of binding the insurance coverage, a supplemental checklist and New York State Department of Financial Services certification form within thirty days of policy inception, and any policy forms not previously filed with the Superintendent within sixty days of the inception date of the policy.

As amended, New York Insurance Law § 6303(b)(1) defines a "large commercial insured" as an entity that generates annual commercial risk insurance premium in excess of $25,000 and meets one of the following requirements:

- Has a net worth of at least $7.5 million as of the insured's fiscal year end immediately preceding the policy effective date,
- Has gross assets exceeding $10 million and a net worth of at least $1.5 million as of the insured's fiscal year end immediately preceding the policy effective date,
- Is a for-profit business entity that generates annual gross revenues exceeding $15 million and has a net worth of at least $1.5 million as of the insured's fiscal year

end immediately preceding the policy effective date,

- Is a for-profit business entity that has gross assets exceeding $10 million and generates annual gross revenues exceeding $15 million as of the insured's fiscal year end immediately preceding the policy effective date,
- Is a not-for-profit organization or public entity with an annual budget exceeding $20 million for each of its three fiscal years immediately preceding the policy effective date,
- Has fifty employees or, together with its parent, subsidiaries and affiliates, one hundred employees as of the insured's fiscal year end immediately preceding the policy effective date, or
- Is a municipality with a population of 50,000 or more persons.

The exemption does not apply to workers' compensation, medical malpractice and certain other kinds of property casualty/insurance, and does not exempt insurers from statutory or regulatory provisions other than rate and form filing and approval requirements. In addition, the exemption for policies issued to "large commercial insureds" has a "sunset date," i.e., it will expire on 30 June 2013, unless extended by the legislature.

New York Superintendent of Financial Services, Benjamin M. Lawsky, said in a press release: "The new law and regulation enhance the ability of insurers to underwrite large commercial insureds in New York, increase speed to market for certain insurance products not currently exempted and eliminate barriers to economic development in New York."

US – New York continues legislative process regarding the treatment of qualified financial contracts under insurance insolvencies

On 30 November 2011, New York Senate Bill 2713A was delivered to the desk of Governor Andrew Cuomo for signature. If signed by the Governor, the bill will add provisions to the New York Insurance Law regarding the treatment of qualified financial contracts in an insurance insolvency proceeding. "Qualified financial contracts" include derivatives, securities lending, repurchase agreements, futures contracts and other financial instruments. These contracts are typically documented under master agreements providing for netting of obligations between the parties. The agreements also establish a right of the non-defaulting party to close out, liquidate and terminate the agreements immediately upon the insolvency of the other party and provide for collateralization of obligations on a net, rather than gross, basis. While both the U.S. Bankruptcy Code, which governs the insolvency of most U.S. companies, and the Federal Deposit Insurance Act, which governs the insolvency of U.S. banks, contain provisions exempting qualified financial contracts and netting agreements from the automatic stay mechanism, most state insurance codes governing the insolvency of insurance companies have historically not included such provisions, creating significant uncertainty for counterparties of insurance companies. This uncertainty has led to reluctance on the part of banks and other financial institutions to enter into swap agreements with insurance companies out of concern that they may be unable to exercise termination, netting and collateral realization rights under the agreements if the insurer becomes insolvent.

New York will join an increasing number of states that have passed or have considered similar laws regarding the treatment of qualified financial contracts under insurance insolvencies, especially in the last two years in the wake of the financial crisis. Such laws are largely based on the Insurance Receivership Model Act of the National Association of Insurance Commissioners, which was adopted in 2005. Unless Senate Bill 2713A is vetoed by the Governor, it will become law within ten business days or less from the time of delivery to the Governor's desk for signature.

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