Hot Topic

Solvency II requirements published

The publication of the Omnibus II text provides much needed clarity to the market on some key topics

FS Regulatory Centre of Excellence
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Summary

On 25 November 2013 the Council of the European Union published the likely final compromise text of the Omnibus II. The publication of this text follows the conclusion of the technical debate at the Trilogue meeting of 13 November 2013 and provides clarity on some of the key requirements of the Solvency II regime.

Below is a summary of some of the key areas where Omnibus II will amend Solvency II's requirements which we cover in more detail in this Hot Topic:

1. Further clarification on the Long Term Guarantee Package (see our previous Hot Topic *Agreement reached on long term guarantee package*).
2. Potential for easing the regulatory reporting requirements for smaller insurers.
3. Provisional 'equivalence' of third countries.
4. Transitional arrangements and phasing in.
5. Extension of the recovery period for a breach in the SCR and raising of the floor of the MCR

The European Parliament is currently scheduled to vote in plenary to approve the text in February 2014. Following approval by both the Parliament and Council the Directive will be published in the Official Journal (likely to be May 2014) and become part of EU law.

Omnibus II confirms that the implementation date of Solvency II will be 1 January 2016 and requires Member States to transpose the Directive's requirements into national law by 31 March 2015. National supervisors will be given the legal power to grant approvals in areas such as internal models and ancillary own funds from 1 April 2015.

The Commission and EIOPA will be producing a lot of subsidiary legislation (in the form of delegated acts and technical standards) over the course of the next two years which will specify detailed requirements on many areas of Solvency II. It is important to keep up with the oncoming avalanche of information as being prepared will be key to a successful implementation.

Long Term Guarantee (LTG) Package

The package of measures for products with long-term guarantees was the main focus of the recent trilogue discussions. Our previous Hot Topic *Agreement reached on long term guarantee package* discussed the details of the agreed approach in this area. We have therefore not covered all the details of the LTG package in this section but highlight a number of additional points of detail that were not previously known.

Risk-free curve and extrapolation

- Extrapolation will now be performed over 40 years as opposed to 30 years. This should not have a big impact for UK insurers, as sufficiently long duration gilts are available to avoid the need for extrapolation until very far into the future. However this will be significant for continental European insurers where there is no liquid market for long duration risk-free assets; in particular Omnibus II clarifies the last liquid point is expected to be 20 years for the Eurozone.
- The "ultimate forward rate" has not been specified within Omnibus II and will remain a point of debate.
- There is no clarification within Omnibus II around how EIOPA will determine the level of credit risk adjustment which is deducted from observable market rates to arrive at the risk-free curve. Further details on the methodologies, principles and techniques for determining the risk-free interest rate term structure will be set out in delegated acts.

Matching Adjustment (MA)

The application of the MA is broadly consistent with what we described in our previous Hot Topic, but with a few important changes to the detail:

- The requirement that asset cash flows cannot be changed by a third party has been slightly eased – inclusion of such an asset is now allowed provided its proceeds can be re-invested (in another asset of the same or better credit quality) to replace the expected cash flows. There has already been debate within the industry as to whether this will allow the inclusion of mortgages and infrastructure debt, and further clarification is required on this important point.
- The prescribed limit on the proportion of portfolio invested in BBB rated assets has been removed and replaced with a cap which prevents the MA earned from lower rated assets exceeding that of investment grade assets.
- The MA cannot be used alongside the discount rate transitional measure, although there is no restriction on its concurrent use with the technical provisions transitional measure.

Volatility Adjustment (VA)

- Member States may grant their supervisors the power to allow or, in exceptional circumstances, to reject the use of the VA.
- The application of the VA will be consistent with that described in our previous Hot Topic, although Omnibus II does not limit the types of business to which it may be applied (subject to supervisory approval).

Risk management and reporting obligations under the LTG package

- As part of the risk management system, undertakings will need to regularly assess the sensitivity of their technical provisions and eligible own funds to the assumptions underlying extrapolation, MA and VA.
- Furthermore, (re)insurers who use the MA and the VA will be required to publicly disclose the impact of applying and not applying these adjustments on their financial position.
- Where (re)insurers use the MA and VA, as part of their risk management system they will need to develop a liquidity plan projecting the incoming and outgoing cash flows in relation to the assets and liabilities subject to these adjustments.
- There are several other requirements for undertakings who use a MA or VA, including performing sensitivity analysis on the composition of the matching portfolio and quantifying the impact of a reduction of the MA or VA to zero. These assessments will need to be submitted annually to the supervisor.
- If the reduction of the MA or VA to zero results in a breach of the SCR, the (re)insurer must submit an analysis of the measures it could apply to remedy the situation.
- When a VA is used, (re)insurers must update their written policy on risk management reflecting the use of the VA.

Finally, it is important to note that the supervisor will now have the ability to ***apply capital add-ons*** if it feels the risk profile of the insurer deviates from the underlying assumptions used in applying the MA or VA. This introduces uncertainty and insurers may be concerned about this possibly introducing an uneven playing field, if approaches differ between supervisors.

Role of EIOPA and national supervisors

There are certain tasks associated with the LTG package that EIOPA and national authorities must undertake, most notably:

- EIOPA will publish each quarter risk-free interest rate term structures for each currency; fundamental spreads for each asset class, duration and rating, which will be used by insurers to calculate the MA; and VAs for each currency and country.
- EIOPA will each year provide a report to the Trilogue parties on the impact of the LTG package (until 2021). In order for them to do this, national supervisors will need to submit detailed information on the application of the various adjustment measures in their markets.
- After a public consultation, EIOPA will be required to provide the Commission with an opinion on the assessment of the application of the LTG package.

Changes to the SCR and the MCR

SCR – extension to recovery period

The maximum extension to the period an undertaking may be given to restore non compliance with the SCR in "exceptional adverse situations" has been set at seven years. Adverse situations are described as: a fall in the financial markets, a persistent low interest rate environment and a high impact catastrophic event, and will be declared by EIOPA. The extension may be withdrawn where the insurer is not demonstrating movement towards compliance.

MCR – increase in absolute floor

The article dealing with the MCR has also been amended to raise the absolute floor of the MCR to:

- €2,500,000 - €3,700,000 for non life insurers (including captives)
- €3,700,000 for life insurers (including captives)
- €3,600,000 for reinsurers
- €1,200,000 for captive reinsurers

Supervisory powers

Dates set

Omnibus II sets out the dates by which supervisors are to receive power from Member States for granting various supervisory approvals. From 1 April 2015 supervisors will have power to approve a range of issues, such as group internal models, use of duration base equity risk sub module and use of the components in the LTG package. Full details of these powers are in Appendix A.

Whilst not as far in advance of implementation as Parliament originally proposed, firms now have certainty as to the date from which they might receive various approvals or decisions.

Transitional measures

Greater clarity

The original Omnibus II proposals set out a number of areas where transitional measures could be adopted and specified their maximum duration and the minimum standards to be met. As anticipated Omnibus II now defines the actual transitional measures that will apply which will provide clarity to the industry as to whether requirements will or will not be subject to transitional measures and the extent of those measures .

More detail of the transitional measures, requirements and their duration are contained in Appendices B and C. However there are some key areas of note set out below:

Equivalence - Omnibus II sets out the transitional measures that will apply in relation to the deemed equivalence of solvency regimes of third countries.

However, regardless of whether those criteria are met, the Commission, assisted by EIOPA, may decide that a solvency regime is temporarily or provisionally equivalent provided the solvency regime meets certain conditions (see Appendix C).

For third country subsidiaries of EU Groups there is the potential to grant "provisional equivalence" for a period of up to ten years (which may be extended for further periods of ten years). In her press release following the agreement on Omnibus II Sharon Bowles commented as follows 'In order to ensure that European insurance companies are not at a disadvantage if based abroad, particularly in the USA, the Parliament's innovative proposal on provisional equivalence for a renewable ten year period was accepted by Council'. It is clear that EU policy makers were conscious of the damage a non equivalent tag would cause for EU operations in the US market if they were to hold additional regulatory capital compared to their domestic peers in the US.

For non EEA reinsurers and Groups operating in the EEA there is a potential for "temporary equivalence to be granted". However, temporary equivalence can only be granted for a maximum of six years where a third country has made a commitment to adopt, by 1 January 2021, a regime that is capable of being assessed as equivalent.

- **Technical provisions** – There are two transitional provisions which have been introduced as part of the long-term guarantee package and which will affect technical provisions; one in respect of the discount rate used in the valuation and the second a "catch all" covering technical provisions. Both of these will allow insurers to gradually move from their current solvency regime to Solvency II measurement requirements over a period of 16 years, with the weighting applied to Solvency II increasing linearly during the period.

  These transitional measures cannot be used together on the same block of business, and the use of either will require approval from the Supervisor.

- **Other transitional measures -** The transitional provisions for reporting deadlines are unchanged with annual submissions reducing from 20 weeks to ultimately 14 and quarterly deadlines reducing from eight weeks to five over the course of four years. Groups have an additional six weeks.
- The ten year period for the grandfathering of own funds remains unchanged.
- Insurers in run-off may be excluded from the scope of Solvency II for the first three years of its application provided the run-off is expected to complete within three years.
- Relief for SCR non-compliance for an initial period of two years after the Directive comes into effect is afforded.
- There will be phased implementation of the full market risk capital charge for equities over a seven year period.
- The two year period where exposures to any Member States' governments and central banks denominated in the currency of another Member State would be exempt from capital charges in respect of concentration risk and spread risk will be followed by two years where the charge progressively increases before reaching full rates.

No transitional measures have been included in the areas of systems and controls over Pillar 3 reporting.

Other technical amendments

Potential reporting relief for small insurers

National supervisors may exempt insurers from elements of regular supervisory reporting under article 35. Supervisors may allow annual reporting of information that would otherwise be reported more frequently (e.g. quarterly QRTs) and may allow less frequent or ad hoc reporting of information that would otherwise be reported annually.

These exemptions may be granted where the standard reporting requirements would be overly burdensome and are restricted to not more than 20% of that Member State's life and non-life insurance and reinsurance markets respectively with priority being given to the smallest undertakings. The exemptions do not extend to items required to be reported publicly as part of the SFCR.

If an insurer is part of a group, this provision will not apply unless the insurer can demonstrate reporting with the prescribed frequency would be inappropriate given the nature, scale and complexity of the risks inherent in the business of the group.

Delegated acts and technical standards

Omnibus II sets out which criteria or requirements will be covered by delegated acts and which will be covered by technical standards. In many (but not all) instances the date by which technical standards will be submitted is specified; these dates range throughout 2014 and 2015. Insurers can therefore expect a series of additional requirements to be published over the next two years.

Contacts

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What do I need to do?

After a lengthy delay to Solvency II, we can now safely say it is back. The finalisation of Omnibus II provides helpful certainty on the requirements in many areas. However, further detail will emerge with the publication of delegated acts, technical standards and EIOPA guidelines in the period leading up to implementation.

Insurers will benefit from re-engaging their Solvency II programmes to ensure they are well placed to address the elements of the new regime that are now known with more certainty and to ensure they keep up to speed with all the information due to come out over the next two years ahead of implementation.

It is also important for insurers to maximise the opportunity during 2014 and 2015 to ensure they can transfer Solvency II compliance to business as usual. This interim period is an opportunity to trial certain aspects of the new regime.

The LTG package provides insurers with optionality in the choice of discount rate. Firms should perform an impact assessment to understand all of the options available to them, and to identify which is most beneficial for their business under a range of economic conditions. Following this, firms should begin to transition their businesses to ensure readiness for Solvency II, including optimising asset portfolios and enhancing processes and systems.

Appendix A: Supervisory Power to decide certain key topics

From 1 April 2015 supervisors will have power to decide on the approval of:-

- Ancillary own funds.
- Classification of own funds.
- Undertaking specific parameters.
- Full or partial internal models.
- Special purpose vehicles.
- Ancillary own funds of intermediate holding companies.
- Group internal models.
- Use of duration base equity risk sub module.
- Use of matching adjustment to relevant risk-free interest term structure.
- Use of volatility adjustment to relevant risk-free interest term structure.
- Use of transitional measure on the risk-free interest rates.
- Use of transitional measure on technical provisions.

Supervisors will also have the power from that date to:-

- Determine the level and scope of group supervision.
- Identify the group supervisor.
- Establish a college of supervisors.

From 1 July 2015 supervisors will have power to:-

- Decide to deduct any participation in credit institutions, investment firms and financial institutions from group own funds.
- Determine the choice of method to calculate group solvency.
- Make determinations on equivalence in relation to third country insurance and reinsurance undertakings that are part of a group and group solvency regimes (where no determination has been made by the Commission).
- Permit insurance and reinsurance undertakings to be subject to group supervision with centralised risk management.
- Decide the scope and level of group supervision to be applied to groups headquartered in third countries whose regime is not found to be equivalent.
- Determine, where appropriate, the application of transitional measures.

Appendix B: Transitional measures

Area	Transitional measure	Duration
Insurers in run-off[1]	Insurers in run-off at 1 January 2016 will not be subject to its requirements (except for Title IV in respect of reorganisation and winding-up) provided they have satisfied their supervisor that activities will be terminated before 1 January 2019. If still in existence, such insurers will become subject to Solvency II's requirements after three years (or earlier where the supervisor is not satisfied with the progress that has been made towards terminating its activities).	Three years
	Insurers in run-off that are subject to reorganisation measures and where an administrator has been appointed are not subject to Solvency II's requirements (except for Title IV in respect of reorganisation and winding-up) for five years i.e. until 1 January 2021 (or earlier where the supervisor is not satisfied with the progress that has been made towards terminating its activities).	Five years
	Insurers utilising this transitional measure must notify its supervisory authority that it is applying the transitional measures and submit an annual report to their supervisor setting out what progress has been made in terminating activities.	
	These provisions do not apply to insurers that are members of a group containing any other insurers not in run-off.	
Reporting deadlines	The deadlines for the submission of information are extended when Solvency II is implemented but over a period of four years starting on 1 January 2016, the deadline will decrease each year.	4 years
	Where information is required to be submitted annually or on a less frequent basis (annual QRTs and SFCR), the initial deadline is 20 weeks after the financial year-end decreasing by 2 weeks each financial year to 14 weeks.	
	Where information is required to be submitted quarterly (quarterly QRTs), the initial deadline is 8 weeks after the quarter-end decreasing by 1 week each financial year to 5 weeks.	
	For groups, the deadlines are extended by six weeks respectively.	
Own funds	Basic own fund items that meet the requirements of the Solvency I Directives on 31 December 2015 shall be included in Tier 1 or Tier 2 basic own funds (dependent on their classification under the Solvency I Directives). The own fund item must have been issued prior to 1 January 2016 or the date of entry into force of the delegated act referred to in Article 97 whichever is the earliest.	10 years
	These provisions will also apply at group level.	

[1] Reinsurers that were placed in run off on or prior to 10 December 2007 are not subject to Solvency II by virtue of Article 12 and so will not be subject to the conditions set out in this proposed transitional measure

Area	Transitional measure	Duration
Repackaged loans	Where insurers have invested in tradable securities or other financial instruments based on repackaged loans that were issued before 1 January 2011, the requirements to be met for such investments will apply only in circumstances where new underlying exposures were added or substituted after 31 December 2014. This provision will also apply at group level.	N/A
Standard formula SCR - Exposures to Member States' central governments or central banks	Until 31 December 2017, for the purpose of the concentration risk sub-module and the spread risk sub-module of the SCR standard formula, exposures to Member States' central governments or central banks denominated and funded in the currency of any Member State should be treated in the same way as exposures funded in the domestic currency (and will not therefore attract a capital charge during the transitional period). In 2018 and 2019, the standard parameter to be used when calculating the concentration risk sub-module and the spread risk sub-module of the SCR standard formula shall be reduced by 80% and 50% respectively. In 2020 there will be no reduction. This provision will also apply at group level.	Four years
Standard formula SCR - Market risk charge for equities	Within the SCR standard formula, the capital charge that applies to equities (purchased on or before 1 January 2016) not otherwise subject to the duration based approach shall move on a straight line basis over seven years from initially being the charge that would apply under the duration based approach to the charge that would otherwise apply. The criteria to be met for equities to qualify for this transitional provision will be specified in a delegated act. This provision will also apply at group level.	Seven years
Non-compliance with SCR	Where insurers comply with their required solvency margin under the Solvency I rules (as implemented in national law) on 1 January 2016, if they fail to comply with SCR during the first year of application of Solvency II they will have until 31 December 2017 to achieve compliance. In these circumstances progress reports shall be submitted to the supervisor every three months. The extension may be withdrawn if insufficient progress is being made. This provision will also apply at group level where the group complied with the adjusted solo solvency requirement under the Insurance Groups Directive.	Two years
Occupational pension schemes	Where Member States applied ring fencing provisions, they may continue to do so until 31 December 2019. This provision will also apply at group level.	Four years
Partial internal group model	For seven years after 31 March 2015, application will be permitted for approval of internal models for a part of a group where an undertaking and ultimate parent are situated in the same Member State and where the part of the group forms a distinct part having a significantly different risk profile from the rest of the group.	Seven years
Technical provisions - Risk-free interest rate	Subject to supervisory approval, insurers can gradually introduce the impact of moving from their current discount rate to a Solvency II discount rate over a	16 years

Area	Transitional measure	Duration
term structure	period of 16 years. Liabilities which prior to the implementation of Solvency II were valued using a discount rate based on asset yields (as permitted by the Consolidated Life Directive) can be valued using a weighted average of the asset backed discount rate and the discount rate which would be otherwise be required under Solvency II. The rate used will initially be the asset backed discount rate and will move to the Solvency II rate on a straight line basis over 16 years. An important clarification within Omnibus II is that it is the current calculation method which is fixed at the date of implementation, rather than the current discount rate. This transitional measure is not available for blocks of business which has a matching adjustment, nor can it be used alongside the second technical provisions transitional measure (as described below). It is also only available for business in force on the date of implementation (and so cannot be applied to new business). If a firm observes that they would not comply with the SCR without the application of this measure, it shall inform the supervisory authority immediately. It will be required to take necessary measures to ensure compliance with the SCR at the end of the transitional period; submit a phasing in plan within two months; and annually report on progress. If the report shows it is unrealistic that the firm will comply with the SCR at the end of the period, the transitional measure may be revoked. Firms will also need to publically that they apply this transitional measure and quantify the impact of doing so.	
Technical provisions	Subject to receiving supervisor approval, firms may apply a transitional in respect of technical provisions which allows gradual introduction of Solvency II measurement requirements over a period of 16 years. The impact of this transitional would appear as a deduction to Solvency II technical provisions. The deduction would be based on portion of the difference between Solvency II technical provisions and technical provisions calculated under the current Solvency regime. The weighting applied to Solvency II technical provisions would increase linearly over a period of 16 years. The difference between the two regimes will be determined at date of implementation and will remain static thereafter, although firms will have the option to recalculate this every two years or more frequently following a large change in risk profile – helping to partly avoid balance sheet volatility. This transitional cannot be applied alongside the discount rate transitional, and firms will have to publically disclose the impact of this measure on their financial position. In addition, if a firm observes that they would not comply with the SCR without the application of this measure, it shall inform the supervisory authority immediately. It will be required to take necessary measures to ensure compliance with the SCR at the end of the transitional period; submit a phasing in plan within two months; and annually report on progress. If the report shows it is unrealistic that the firm will comply with the SCR at the end of the period, the transitional measure may be revoked.	16 years

Appendix C: Comparison of temporary / provisional equivalence conditions

	Article 172: Reinsurance / Article 260: Groups headed in third countries	Article 227: Third country (re)insurers
Equivalence Type	Temporary Equivalence	Provisional Equivalence
Conditions	Given commitment to the EU to adopt and apply a prudential regime before the end of the assessment period	Can be demonstrated that a Solvency regime capable of being assessed equivalent is currently in place, or may be adopted
	An established work programme to fulfil the above commitment	N/A
	Allocated sufficient resources to fulfil the above commitment	N/A
	Solvency regime is risk based and established quantitative and qualitative requirements and requirements relating to reporting and transparency [and to the supervision of groups]	Solvency regime is risk based and established quantitative and qualitative requirements and requirements relating to reporting and transparency
	Has entered into written arrangements to cooperate and exchange confidential information with EIOPA	Legislation in place that allows for cooperation and exchange of confidential information with EIOPA
	Has an independent system of supervision	Has an independent system of supervision
	Has established obligations on professional secrecy for all persons acting on its behalf	Has established obligations on professional secrecy for all persons acting on its behalf
Period	Initial period of five years plus maximum extension of one year where necessary for performing the assessment of equivalence.	Initial period of ten years which may be extended by further periods of ten years