European Parliament draft report on Omnibus II Proposal

August 2011

The publication of a draft report by the European Parliament proposes a number of amendments to the Solvency II Directive including a shift in the implementation date to 2014.

INTRODUCTION

On 27 July 2011, the European Parliament's Committee on Economic and Monetary Affairs published a draft report on the proposed Omnibus II Directive (Rapporteur: Burkhard Balz).

The report has been based on the second Presidency Compromise text for Omnibus II, as released by the Presidency of the Council of the European Union on 14 April 2011. The report proposes changes to the wording of the draft Omnibus II Directive to align it to the Omnibus I Directive, adopted by both the banking sector and the securities and markets sector in October 2009. In addition, amendments to the Solvency II requirements are proposed in a number of areas, including:

- the timing and duration of transitional measures;
- the illiquidity premium;
- third country equivalence;
- reporting requirements; and
- the minimum capital requirements.

The draft report includes a proposed deferral of the full implementation date for Solvency II to 1 January 2014, while introducing a phasing-in of the requirements throughout 2013.

To assist you in digesting the draft report, Milliman has prepared this short summary of the content of this document, covering the changes, and including a brief analysis of what we expect these proposals to mean both for companies and Solvency II in general.

ALIGNMENT OF SOLVENCY II DIRECTIVE TO EIOPA

The draft report proposes several changes to align the Omnibus II text to Omnibus I wording and to help provide further clarity on where responsibility for approval lies.

Specifically, the text proposes the re-introduction of regulatory technical standards, aimed at ensuring consistent harmonisation of the regime. In a number of cases these replace existing implementing technical standards where it is felt that the topic would merit further involvement of supervisory expertise. Accompanying implementing technical standards are used to set out the procedures to be followed and formats and templates to be used.

Under the draft report, all regulatory technical standards would need to be submitted by EIOPA by 1 March 2012 with implementing technical standards to follow by 1 June 2012 and 1 July 2012, depending on the topic.

The proposed amendment to move the submission date for the draft technical standards to before the date for the full implementation of Solvency II should make compliance with the new regime less of a moving target for companies.

However, we note that regulators should avoid rushing to introduce the final guidance, to ensure that Solvency II results in a relevant and meaningful regulatory environment while removing any potential for regulatory arbitrage between member states.

Regulatory technical standards are envisaged for the majority of areas under Solvency II, including:

- Information to be provided to supervisors
- Valuation of assets and liabilities

- Calculation of best estimate liabilities and the risk margin
- Methodology and formula for the calculation of the illiquidity premium
- Assessment and eligibility of own funds
- Calculation of SCR by standard formula
- Internal models
- Calculation of the MCR
- Qualitative requirements for investments
- Exceptional falls in financial markets
- Non-compliance with the SCR
- Finite reinsurance and SPVs
- Group SCR and internal model

It is proposed that implementing technical standards will submitted by EIOPA setting out the procedures to be followed and formats and templates to be used, for the following areas:

By 1 June 2012:

- Supervisory approval of own funds
- Supervisory approval process for USPs
- Internal model approval
- Approval of major changes to internal models
- Capital add-ons
- Solvency and Financial Condition Report (SFCR), solo and group
- Procedures for updating correlation parameters
- SPVs
- Determination of the existence of an exceptional fall in financial markets.

By 1 July 2012:

- Information to be provided to supervisors
- Information to be disclosed by member states.

The need for separate regulatory and implementing technical standards has been highlighted previously in order to reduce the potential for consistency problems between sectors where different types of implementing measures are proposed for the same provisions.

We note that while the draft text specifies a number of regulatory and implementing technical standards that must be submitted by EIOPA, the door is left open for further implementing technical standards should they be required.

STREAMLINING OF EIOPA MEDIATION

The draft report extends the definition of the college of supervisors required for group supervision to include EIOPA, while setting out further details on the assistance and mediation that EIOPA may provide to other members of the college.

The report also sets out the procedure that should be followed should EIOPA's mediation decision be blocked by other members of the college of supervisors.

IMPLEMENTATION DATE AND TRANSITIONAL MEASURES

The draft report reflects an implementation date of 1 January 2014 for full compliance with Solvency II, while Solvency I requirements would remain in force until this date (and companies would be required to hold Solvency I capital in accordance with this).

Despite this, the report explains that it has no intention to postpone the implementation of Solvency II, but rather sets out the need for a smooth transition from current to the new regimes (for both companies and supervisors). As such, it is proposed that Solvency II is phased-in during 2013 with important supervisory information being provided from July 2013 and full compliance taking place from 1 January 2014. It is proposed that the transitional measures should be reduced to the strictly necessary and set out in the Solvency II Directive.

Under the proposed amendments, member states may allow companies a maximum of 2 years from 1 January 2014 to:

- comply with their SCR (provided their balance sheet total is less than EUR 500 billion (sic))
- have in place appropriate systems and structures to meet their reporting requirements

- have in place appropriate systems and structures to provide information for group supervision.

The phased introduction of the Solvency II requirements set out in this draft report is likely to be welcomed by many companies, particularly those that have invested significant resources in internal model developments (although those companies that have been hoping for an extended, wide ranging transition may find these amendments less welcome).

As the draft report is based on the second version of the Omnibus II Presidency Compromise text, it is not clear whether the full implementation date of 1 January 2014 has been included in response to changes set out by the Council of the European Union in the fourth iteration of the Presidency Compromise text or whether this has been developed independently.

Furthermore as the second version of the Omnibus II Presidency Compromise text did not include details of the proposed transitional arrangements for the risk-free rate (amongst other things), it is currently unclear whether these would be considered strictly necessary under the proposals set out in this draft report.

We note that the FSA has commented on its website that the next iteration of the Presidency Compromise text for Omnibus II is expected to be released in September and that it will provide clarity on both this draft report and the compromise text once this has been made public.

Proposed amendments simplify the aims for transitional periods, with the relevant recitals stating only that such periods should aim at "avoiding market disruption" and "encourage undertakings to move towards compliance with the particular requirements of the new regime as soon as possible". These aims appear to be less focused on reducing the impact of the requirements on policyholders and products, and instead look to return the emphasis of the transitional periods to encouraging compliance with the new regime.

Specifically, from 1 January 2013, supervisors will have the power to decide on a number of items, including:

- the approval of USPs
- the approval of own funds classifications
- the approval of ancillary own funds, including those of an intermediate insurance holding company
- the approval of full or partial internal models (solo and group)
- the choice of method for the calculation of group solvency
- determine equivalence and temporary equivalence for third countries
- establish colleges for group supervision.

From 1 July 2013, companies will have to:

- calculate their SCR, MCR, amount of own funds and determine the balance sheet and profit and loss account under Solvency II and provide this information to supervisors
- provide supervisors with the information set out in Article 35 as required for supervisory purposes.

Basic own fund items issued before 1 January 2014 will be included as Tier 1 basic own funds for up to 10 years so long as they meet the following criteria:

- the item ranks after the claims of all policyholders and beneficiaries and non-subordinated creditors
- the item is only repayable or redeemable at the option of the company
- the item is free from encumbrances
- the item is fully paid in, undated and able to absorb losses on a going-concern basis.

We note that companies will be required to provide information on their SCR and own funds to supervisors from 1 July 2013 (a more onerous requirement than under previous Presidency Compromise texts). This requirement appears in contrast with earlier statements in the draft report aimed at reducing the level of information that would be required from companies on a more frequent than annual basis. As a result, it is not clear whether companies would be expected to carry out a full run of their systems in order to provide this.

Furthermore, as the full implementation of Solvency II would not be live until 2014, it is not clear what companies which are not yet in a position to provide this information, either due to delays in approval or otherwise, would be expected to provide.

Under this draft report, the final implementing technical standards relating to the supervisory approval of own funds and the approval process for internal models are due to be submitted by EIOPA up to one year in advance of this date. While this should give companies greater confidence that they will be able to adapt their systems and processes as required to meet the approval criteria, we note that many companies are already well advanced in these areas and may need to invest additional time and resources should the final guidance deviate from expectations.

ILLIQUIDITY PREMIUM

The text proposes a number of amendments to the Articles in relation to the illiquidity premium. While it acknowledges the proposed replacement of the illiquidity premium with a countercyclical premium and matching premium, the paper comments that these have not been formally addressed to the European Parliament and as such focuses on the illiquidity premium. Despite this, we may expect similar proposals to be carried forward to the development and publication of the countercyclical and matching premia, should these be adopted.

The text proposes that EIOPA should publish the relevant risk-free interest rate term structure for each relevant currency on a quarterly basis, as well as the equivalent term structure including an illiquidity premium where this is observed in the market. Significantly, text proposes that the illiquidity premium should be derived from a formula specified in Article 86 of the Level 1 Directive (with a threshold to prevent small values due to market anomalies or measurement errors) in order to provide more certainty and predictability in the market.

While the paper retains the criterion that the illiquidity premium should only be applied during periods of stressed market conditions, it proposes that member states, rather than EIOPA, should be able to determine when these periods occur. Where used, companies must publicly disclose the use of the premium and the monetary effect on their financial position.

The proposed use of a published formula for the calculation of the illiquidity premium will be welcomed by the industry, which has long been pushing for such an amendment.

In particular, this proposal will give companies greater certainty around the valuation of their liabilities, allowing such premia to be incorporated in pricing and capital management processes.

While the proposal retains the criterion that the illiquidity premium can only be applied during periods of market stress, the proposal to allow member states to determine when this occurs should help make the application less subjective and reduce any delay that may have resulted from its application.

THIRD COUNTRY EQUIVALENCE

The draft report sets out the definition of the proposed criteria necessary for a 5 year period of temporary equivalence if an equivalence decision is not approved, including:

- the third country has made a written commitment to adopt and apply an equivalent regime
- a convergence plan has been established to meet this commitment
- sufficient resources have been allocated to meet the commitment
- the present regime is risk-based and based on market valuation of assets and liabilities
- agreements are in place to exchange confidential supervisory information
- progress reports will be submitted by the third country every 6 months.

A list of countries which are assessed equivalent and those assigned temporary equivalence should be published by EIOPA on its website.

REPORTING

To help limit the burden on small and medium sized undertakings, which may be forced to introduce systems and structures purely for the purpose of quarterly reporting, new text is proposed for Article 35 restricting the information that should be required from undertakings by the supervisors more frequently than annual. This aims to limit such reporting to information that changes significantly

over the year. Furthermore, new text is proposed that would remove any requirement for companies to report assets on an item-by-item basis to supervisors, further reducing the burden of supervisory reporting.

In order to harmonise the reporting approach, regulatory technical standards should be submitted by EIOPA covering the information to be provided for supervisory purposes and the timing of this information by 1 March 2012.

While the timing of this technical standard should give companies time to adjust their reporting procedures before the first information is due to be submitted to supervisors in 2013, we note that many companies are already well advanced in designing their reporting systems using the draft Quantitative Reporting Templates (QRTs), released as part of the Level 3 pre-consultation, as a template. As such, any significant changes in the granularity or outputs required for final reporting purposes would represent a material amount of work for many companies, which would not be welcomed at this stage.

While it is not clear how the final QRTs will differ from those released in January 2011, comments at the time raised concerns that the templates were overly complicated and were not fully in line with the draft Level 2 requirements. Particular concerns were raised over the quarterly reporting requirements (for example the need to report the risk margin on a quarterly basis), and, while we are pleased to note the proposed amendments in this draft report, the extent to which these concerns are taken on board will not be clear until March of next year.

MINIMUM CAPITAL REQUIREMENTS

The draft report proposes increases in the absolute floor of the MCR, as set out in Article 129(1) of the Solvency II Directive, in order to bring the starting amounts in line with the revisions set out in Article 300 of the Directive.

Under this, the MCR floor for life and non-life insurance undertakings would increase to EUR 3.5 million and EUR 2.3 million respectively (up from EUR 3.2 million and EUR 2.2 million), while for reinsurance undertakings the MCR floor would be EUR 3.5 million (up from EUR 3.2 million).

SUMMARY AND ANALYSIS

While the draft report published by the European Parliament's Committee on Economic and Monetary Affairs is not the most user-friendly of documents, it proposes extensive changes to the text of the draft Omnibus II Directive and its proposed amendments to the existing Solvency II Directive.

The amendments include a number of changes to the text and format of the Directive in order to bring it into line with the Lisbon Treaty and both the banking sector and the securities and markets sector. These include the introduction of regulatory technical standards to ensure harmonisation of the rules while the procedures to be followed and formats and templates to be used would be set out in implementing technical standards.

The text proposes a number of further changes to the requirements themselves, including echoing the call for the full implementation date for Solvency II to be moved to 1 January 2014 (with submission of information to supervisors from 1 July 2013), enshrining the use of a formula for the calculation of the illiquidity premium in the Level 1 text, providing further guidance on the role of EIOPA in group supervision and expanding the roles for supervisors in their local markets.

While we expect the aims behind most of the proposed amendments in the draft report to be welcomed by companies, the draft report appears to further complicate the already confusing array of documents currently circulating on Solvency II. As a result, it remains unclear how these proposals fit within the numerous iterations of the Presidency Compromise texts for Omnibus II and how the amendments will be considered going forwards.

We note that the FSA has commented on its website that the next iteration of the Presidency Compromise text for Omnibus II is expected to be released in September 2011 and that it will provide clarity on both this draft report and the compromise text once this has been made public.

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