Fourth Presidency compromise text for the Omnibus II Directive

June 2011

The publication of the fourth Presidency compromise text for Omnibus II proposes a one year delay in the implementation of Solvency II

INTRODUCTION

On 21 June 2011, the Council of the European Union published its fourth version of the proposed Presidency compromise text for the Omnibus II Directive. This text further develops the amendments to the existing Solvency II Directive proposed in the original Omnibus II released in January of this year.

Significantly, the updated text proposes a further one year delay in the Solvency II timeframe, in addition to the two month delay already proposed in an earlier draft, moving the date of implementation for Solvency II to 1 January 2014.

The latest text retains the proposed transitional arrangements as set out in the previous draft released earlier this month, but further details are provided on the scope of the transitional arrangements relating to: own funds; business written under Article 4 of the Pensions Directive (2003/41/EC); and additional requirements for companies that are unable to cover their Solvency Capital Requirements under Solvency II.

To assist you in digesting the draft directive, 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.

SOLVENCY II TIMEFRAME

The latest Presidency compromise text proposes a further one year delay to the timeframe of Solvency II. The implementation date for Solvency II across Europe would therefore be set at 1 January 2014. A corresponding shift is also seen in the timings of the proposed transitional arrangements with a number of these now stretching until the end of 2018.

In order to prepare for implementation, the latest draft text requires member states to transpose the Solvency II Directive into national law by 31 March 2013. A selection of requirements would be implemented by 1 July 2013 for the purposes of assessment only, including: the classification and approval of own funds; approval of partial and full internal models; use of undertaking specific parameters; SPVs; and calculation of group solvency requirements.

The continuing shift in the Solvency II timeframe is likely to be met with mixed responses from across the various stakeholders.

A number of companies will doubtless welcome the extended timeframe, both in allowing additional time to develop and implement their Solvency II plans and in helping to reduce the pressure on scarce Solvency II resources. However, the proposed timeframe appears to imply that the start of both the internal model approval process (IMAP) and the process for supervisory approval of own funds will now be postponed until 1 July 2013 - a delay which will likely be met with concern from companies already progressing down this path.

Furthermore, the proposed delay should allow more time for key issues in the current Solvency II requirements, as highlighted in the recent responses to the draft Level 2 text, to be addressed and hopefully move Solvency II towards a more appropriate and consistent regime.

We note the statement from the FSA on 20 June 2011, preceding this draft text, stating that UK companies should continue to target an implementation date of 2013, and EIOPA's comments that Solvency II would not be pushed back from the 2013 implementation date. Due to the timing of these releases, it is unclear whether they were written with this text in mind.

To help ensure that companies are fully prepared for the application of Solvency II in a timely and consistent manner, the latest draft of the Omnibus II text provides for supervisory authorities to have the power to require companies to provide them with an implementation plan, against which they will monitor progress. It is proposed that this will need to be provided to supervisors by 1 July 2013 and should include information relating to: technical provisions; eligible own funds; capital requirements; system of governance; and the processes and procedures in place for both supervisory reporting and public disclosure.

TRANSITIONAL ARRANGEMENTS

The latest iteration of the draft directive includes new text concerning the scope of the transitional arrangements relating to the classification of own funds. This confirms that transitional arrangements should relate to basic own-fund items issued prior to Solvency II implementation including:

- Subordinated mutual member accounts;
- Preference shares; and,
- Subordinated liabilities.

The need for transitional arrangements surrounding existing basic own fund items, and in particular hybrid instruments, issued before the implementation of Solvency II has long been highlighted by companies and industry groups. As such, the confirmation of this scope will come as a welcome inclusion for many.

Despite this, there is currently no further information on what grandfathering arrangements will be in place and whether the length of the transitional periods will be sufficient to allow companies adequate time to redeem, or restructure, their debt and to do so without causing significant market disruption.

In addition to the above, the proposed text provides an allowance for occupational retirement provision business written in accordance with Article 4 of the Pensions Directive. Where this Article has been applied by member states, companies can continue to apply Solvency I requirements, except those relating to technical provisions, to this business until 31 December 2015.

It is unclear how this arrangement would work in practice as it appears to mix best estimate technical provisions under Solvency II with Solvency I capital requirements (which assume prudent technical provisions). Furthermore, it appears that a final comparison to Solvency II capital requirements may be required, obliging companies to maintain parallel systems for both regimes.

SOLVENCY CAPITAL REQUIREMENT

The revised text proposes an addition to article 138 setting out the requirement for companies which are unable to comply with their Solvency Capital Requirements (SCR). It is proposed that companies complying with the Required Solvency Margin on the day prior to implementation of Solvency II, but which are unable to cover their SCR during the first year for which Solvency II is in force, will be permitted a period of 12 months to either raise sufficient own funds to cover their SCR, or to reduce the risk profile of their business and thereby reduce their SCR to achieve compliance.

Companies affected by this will be required to submit quarterly progress reports to the supervisory authority setting out the measures taken and progress made.

SUMMARY AND ANALYSIS

The fourth Presidency compromise text for the Omnibus II Directive proposes some further alterations to the original Omnibus II text, which set out a range of changes to the Solvency II Level 1 Directive.

While the latest draft text sets out additional proposals covering areas such as the scope of the transitional arrangements for own fund items and the requirements for companies unable to comply with the SCR, the most significant change is the proposal to delay the implementation of Solvency II until 1 January 2014 with corresponding shifts applied to the dates of the transitional periods.

While the change in timeframe may give both companies and supervisors welcome breathing space to design and implement their Solvency II plans, we note any resulting delay to the IMAP process may be a cause for concern amongst companies already well advanced in this area.

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