

European Commission Issues Summary of Responses to the Consultation of Level 2 Implementing Measures



May 2011

The responses to the recent consultation on the Level 2 Implementing Measures show significant issues with the proposed methodologies, whilst highlighting large social and economic impacts that could result from the current text.

INTRODUCTION

On 5 May 2011, the European Commission published its summary of responses to the consultation on the Level 2 Implementing Measures for Solvency II.

The summary pulls together responses from 68 parties following a two month public consultation on the latest text for the Level 2 consolidated Implementing Measures, held from November 2010 to January 2011.

The Commission has commented that while feedback was received on all policy areas, stakeholders' concerns largely relate to a small number of key issues, and it is on these areas that the Commission will focus its impact assessment.

These areas include:

- the impact on long-term products;
- volatility and pro-cyclicality;
- proportionality, especially around reporting; and
- the need for transitional measures in certain areas.

To assist you in digesting this report, Milliman has prepared this short summary of the content of the document, covering the key issues and including a brief analysis of the key concerns and the potential impact of these on the future state of Solvency II.

IMPACT ON LONG-TERM PRODUCTS

The report highlights significant concerns surrounding the impact of the current Level 2 Implementing Measures on products with long-term guarantees or with long-term exposures. This includes the potential social and economic impact should it no longer be viable for insurers to continue to offer these products. Particular issues arise from the proposed methodology for deriving the risk-free curve to be used in the calculation of technical provisions and the additional volatility this

methodology introduces into the valuation of assets and liabilities. Other concerns relate to the application of, and uncertainty surrounding, the illiquidity premium as well as the capital requirements resulting from the current SCR calculations, which a considered by respondents to be excessive in some cases.

We note that the several responses, in particular those of accountants, mention that the use of a fixed Cost-of-Capital rate is not compatible with the draft international accounting standards for insurance contracts, potentially paving the way for this parameter being subject to review within the finalised text.

Given the significance of these products for retirement provision, we are pleased to note that a working party has been set up by the Commission to look into the specific issues surrounding products with long-term guarantees.

The Commission has committed to ensuring that the characteristics and risks specific to these products will be adequately reflected in the implementing measures, as a sign that it is taking these concerns seriously.

VOLATILITY AND PRO-CYCLICALITY

There are significant concerns around the effectiveness of the Pillar 1 equity dampener as a method for reducing pro-cyclicality and for limiting the need for fire sales of assets during market downturns. While the current proposed methodology goes some way to achieving this aim, the design of the symmetric adjustment has been questioned by a number of respondents.

The Commission notes that respondents have also highlighted the potential counter-cyclical effects of the illiquidity premium, if applied correctly, and

proposed that an additional dampener is included for the artificial widening of Government bond spreads.

We note that while the application of an illiquidity premium during times of market stress should also act as a counter-cyclical measure, by adjusting illiquid liability values in response to the shift in asset values due to a change in illiquidity, the effectiveness of this relies on matching the asset and liability movements during times of market stress.

The current proposal of applying the illiquidity premium as an on/off mechanism over a fixed time period coupled with the powers given to EIOPA in the current draft Omnibus II text to determine when individual markets are in stress seems unlikely to provide the matched asset and liability movements required for an effective counter-cyclical mechanism.

REPORTING PROPORTIONALITY

The report highlights the need for the proportionality principle to be applied more consistently across all of the three pillars of Solvency II and in particular to the Pillar 3 reporting requirements. Specifically, respondents have proposed excluding certain undertakings from quarterly reporting based on the size, nature and complexity of the risks inherent in their business. Furthermore, it was suggested that approximations should be permitted for quarterly forms, in order to reduce the reporting burden, and that, as such, these quarterly forms should not be publicly disclosed.

TRANSITIONAL MEASURES

The Commission notes that transitional measures are likely to be needed in certain areas to ensure a smooth transition to the Solvency II regime and to avoid market disruption. Areas particularly highlighted by respondents as requiring transitional measures include:

- own funds
- reporting requirements
- third party equivalence

IMPACT ON INSURANCE MARKETS AND PRODUCTS

The report notes that many respondents have highlighted the potential impact of the current Solvency II requirements on product development and on pricing for existing products. Under the current proposals it is expected that capital costs would result in lower prices for products such as simple term assurance, while the potential impact for products with long-term guarantees may be significant price increases or withdrawal from the market altogether. Given the significant dependence of private pensions on such long-term guarantees, this would likely see a shift towards products which transfer more risk to policyholders (contrary to the aims of Solvency II). In the extreme, this may result in a greater reliance on state run pension provision.

The potential impact on companies' investment strategies has been highlighted by a number of respondents, in particular the high capital charges for corporate bonds and equities which could prompt a move to lower risk assets such as government bonds, with a resulting impact on expected investment returns. It is noted by the report that insurers provide vital liquidity and stability to investment markets through regular injections of premium income and long-term investment horizons. The current Level 2 requirements may provide an incentive for companies to reduce their long-term investment strategies in favour of opportunistic investments, threatening their role in reducing market volatility.

SUMMARY AND ANALYSIS

The summary report from the European Commission shows a high level of engagement from stakeholders across the industry. Concerns raised mainly focus around a few specific areas, primarily those affecting products with long-term guarantees. Given the important role that such products play in retirement planning across Europe, the potential social and economic impact of the current Level 2 text could be significant and it is pleasing to note that the Commission has set up a working party to address these concerns directly.

The need for transitional arrangements has been highlighted by many respondents to help smooth the introduction of Solvency II for companies and to prevent disruption to markets. While the report states that respondents have specifically requested these in areas including own funds, reporting and equivalence, we note that the latest proposed Omnibus II text contains the scope for transitional arrangements to be applied across most, if not all, of the major areas of Solvency II.

The Level 2 text cannot be finalised until Omnibus II is passed into European law, currently expected to be in the first quarter of 2012. As such, it may be expected that further iterations of the draft Level 2 text will be released as the Commission aims to reduce complexity in the guidance and address the remaining areas of concern.

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