European Parliament report for the Omnibus II Directive

March 2012

The publication of the approved text on Omnibus II from the European Parliament's ECON committee seeks to enshrine the provisions relating to products with long-term guarantees and paves the way for trilogue discussions to finalise the Solvency II Level 1 text

INTRODUCTION

On 28 March 2012 the European Parliament's Committee on Economic and Monetary Affairs (ECON) published its consolidated report of compromise amendments for Omnibus II. This text follows the approval of the Parliament's latest draft amendments at the ECON vote on 21 March 2012 and sets out their proposal for the Solvency II Framework Directive going into the trilogue discussions with the European Commission and the Council of the European Union.

While the report includes a significant number of proposed amendments to the Level 1 text, particularly in relation to products with long-term guarantees, in many cases it is unclear how these should be applied in practice. Furthermore, as a result of continuing political lobbying, the report appears to have been brought together at the last minute. In many areas, this has resulted in a confused and overly restrictive text which will need to be addressed during the trilogue discussions.

To assist you in digesting this report, Milliman has prepared this 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.

IMPLEMENTATION DATE AND SOLVENCY II TIMELINE

The Parliament text retains the proposed split implementation dates and phasing-in requirements for Solvency II. Member States would be required to transcribe the requirements of the Directive into national law by 1 January 2013 (brought forward by 2 months) while companies would be required to comply with the requirements from 1 January 2014.

From 1 July 2013, companies would be required to:

- Calculate estimates for the SCR, MCR, amount of own funds and the balance sheet based on a reference date of the first day of the financial year starting on or after 1 July 2012, but before 1 July 2013
- Provide supervisors with the specified information necessary for supervision, as set out in Article 35, on an annual basis in relation to the financial year ending on or after 1 July 2013

We note that the timetable set out in the report for transcription of the Solvency II directive into national law remains tight, particularly considering the recent change in the provisional date for the plenary vote to September 2012.

While companies will need to be in a position to provide estimates of the financial position under Solvency II during the phasing-in period, it is not clear whether these should be based on the standard formula or unapproved internal models. The proposals also appear to require companies to be in a position to provide full year-end reporting under Solvency II for the 2013 financial year.

The text also includes a number of revised dates by which EIOPA must submit draft regulatory and implementing technical standards to the Commission. Under this, all technical standards specified in the Directive would be required in draft form in advance of the transcription of Solvency II into national law on 1 January 2013 (other proposed versions of the text allowed EIOPA until 2016 for draft technical standards in a number of areas).

TRANSITIONAL PERIODS

In addition to the phasing-in requirements, the Parliamentary report sets out a number of transitional measures potentially allowing companies additional time to comply with specific requirements where they meet the relevant criteria.

These transitional periods are proposed for a number of key areas including:

- **Compliance with the SCR** - companies with balance sheets smaller than EUR 25 billion may be permitted an additional 2 years to comply with the SCR, subject to supervisory approval
- **Systems and structures** – a potential two years to establish appropriate systems and structures to provide the required information to Supervisors, including the Solvency and Financial Condition Report (SFCR)
- **Own funds** – any basic own funds issued prior to the official publication date of the Omnibus II text in the Official Journal, and that were eligible to cover at least 50% of the Solvency I solvency margin, may be included in Tier 1 basic own funds for up to 10 years post implementation. Items which could only be used to cover at most 25% of the Solvency I solvency margin may be included in Tier 2 basic own funds for up to 10 years
- **Repackaged loans** – where tradable securities, or other financial instruments based on repackaged loans, were issued before 1 January 2011, the requirement for the originator to retain a net economic interest of no less than 5% would only apply where new underlying exposures are added or substituted after 31 December 2014
- **Group internal models** – where an undertaking is located in the same Member state as its ultimate parent, but has a significantly different risk profile from the rest of the group, the parent may be permitted up to 7 years from 1 January 2013 to apply for the approval of an internal group model (sic) covering that undertaking

We note that many in the industry are lobbying for the possibility of further transitional arrangements in other key areas, such as reporting, to be left open at least until the implications of the final Level 2 text are known.

The specific transitional periods set out in the text cover many of the key areas where companies may have difficulty complying with the day-one requirements. As such these should help to give companies the necessary time to comply with the Solvency II requirements without causing significant market disruption.

REPORTING REQUIREMENTS

While the report retains the requirement that full reporting must be done annually, the text proposes that supervisors may restrict quarterly reporting to information that changes significantly over the year as long as the combined contribution of the company to total market share does not exceed 20% of a member state's life or non-life insurance market (i.e. the company is deemed not to play a major role in that financial market).

The text includes a materiality clause in relation to the requirement for asset-by-asset reporting which only requires Member States to request such reporting (both in relation to regular and ad hoc reporting) when the resulting information is necessary for the supervisor to conduct its role, particularly in relation to financial stability. Specifically, the need for asset-by-asset reporting is deemed not to be necessary for companies which do not play a major role in financial markets.

We note that many companies will welcome the inclusion of a materiality clause relaxing the requirement to report asset-by-asset information on a quarterly basis.

While this will help address concerns that the reporting requirements are overly detailed, it is not immediately clear how a company's contribution to market share will be determined. For example, is this determined in relation to assets under management or premium income?

VALUATION OF LIABILITIES

In relation to the valuation of liabilities and establishment of technical provisions, the Parliament report includes new proposed wording for articles 75 to 77 specifying that the discounting of liabilities, and specifically the risk-free interest rate term structure used to calculate the best estimate liability "*shall not take into account information concerning assets held by insurance or reinsurance undertakings*".

The Parliamentary text continues to include a counter-cyclical measure to be applied in times of temporary and exceptional stress in financial markets and where it believes companies would otherwise be likely to sell large and substantial parts of their fixed income securities. However it has reverted from calling this a counter-cyclical premium in favour of the term "illiquidity premium". Under these proposals, where these market conditions are observed, EIOPA is charged with publishing adapted risk-free rates with the inclusion of an illiquidity premium for each relevant currency.

The text specifies that this adaptation should be calculated in reference to a portion of the spread that could be earned on a representative portfolio of assets relative to risk-free. Fundamentally, the adapted rates would only apply to certain substantially illiquid liabilities, details of which will be set out in future implementing technical standards together with the *"detailed criteria for the methodology to calculate the illiquidity premium*". Where companies have made use of the adapted rates, this must be disclosed together with details of the monetary impact of the adaptation on their financial position.

> *While it is pleasing to note the inclusion of a counter-cyclical measure to reduce the need for insurers to become forced-sellers of assets in times of financial market stress, many of the requirements for this to be applied appear very subjective. We note that it is vital that such a measure is sufficiently predictable for companies to be able to rely upon it being in place when needed. This is particularly important to allow companies to incorporate such a measure into their planning process and to ensure they can make appropriate decisions in times of market stress. Without such predictability, companies may still be forced to sell assets during such periods due to uncertainty around if and when the counter-cyclical measure would be applied.*

The report also opens up the possibility that government bonds should not be viewed as zero-risk in all circumstances as this does not reflect the economic reality observed, for example, during the recent sovereign debt crisis. A new recital is proposed requiring the Commission to submit a report to the European Parliament and Council as soon as possible. This would include proposals to incorporate a capital requirement for such assets and considerations of the potential destabilising impact such measures may have during periods of market stress.

EXTRAPOLATION OF RISK-FREE INTEREST RATES

A new Recital and Article are proposed in respect of extrapolation of the risk-free interest rate term structure beyond the point where relevant markets are no longer considered deep, liquid and transparent. The proposed text specifies that, under current market conditions, the extrapolation for the Euro risk-free curve should start after 20 years and, for all currencies, should converge to the ultimate forward rate for maturities 10 years after the point at which markets can no longer be considered as deep, liquid and transparent. At this point, the extrapolated forward rates should be within 3 basis points of the ultimate forward rate.

SYMMETRIC ADJUSTMENT MECHANISM AND MATCHING ADJUSTMENT

The report proposes the concept of a symmetric adjustment mechanism to be included in the calculation of the capital requirements under the spread risk sub-module in the standard formula. This mirrors the current symmetric adjustment mechanism under the equity risk sub-module. This adjustment would be based on the current level of an appropriate fixed income securities index relative to its weighted average level and should result in the spread risk capital charge being no more than 25% higher or lower than the unadjusted (standard) spread risk capital requirement. When companies are applying the adapted risk-free rates, it is proposed that the spread adjustment mechanism should not be applied when to do so would result in a spread capital requirement lower than the standard spread capital requirement.

The European Parliament text also includes a new article in respect of a matching adjustment (previously the matching premium) for certain life insurance obligations. Under this, Member States may allow companies to apply an adjustment to the risk-free rate used to calculate the best estimate liabilities for life insurance obligations. The adjusted would be based on the spread on the matching assets less the fundamental spread in respect of the expected default and downgrade risk retained by the company (subject to a floor of 75% of the long-term average of the spread) so long as a number of conditions are met. Use of the matching adjustment is subject to prior regulatory approval.

While the proposals for the calculation of the fundamental spread appear less prescriptive than those set out in the draft Level 2 text of 31 October 2011, they retain the seemingly arbitrary floor for the fundamental spread of 75% of long term spreads. While the long term spread is no longer specified as being over the last 30 years, we would still expect this floor to apply for a significant proportion of time. We note that, as this is likely to lead to higher credit risk deductions than companies currently use, and hence higher technical provisions, it appears to introduce an element of prudence that is at odds with the basic principles upon which Solvency II is based.

The conditions for application include the following:

- The company should assign a portfolio of assets made up of bonds and other assets with similar cash-flows to cover the best estimate liabilities such that the asset cashflows replicate the liability cashflows
- The company should maintain this asset portfolio over the lifetime of the life insurance obligation
- The liabilities and assigned assets should be ring-fenced, managed and organised separately from the rest of the business
- There should be no future premiums arising from the liabilities
- The liabilities should only be exposed to longevity, expense and revision risk
- There should be no policyholder options, or only a surrender option where the surrender value does not exceed the value of the covering assets
- The asset cashflows should be fixed, except for any dependency on inflation, and should not be changeable by the issuers of the assets or any third party
- The activities of the company to which a matching adjustment can apply are restricted to those carried out in the country where the company is authorised

While there are no specific details of the credit quality of the assigned assets, the proposed text requires EIOPA to develop draft regulatory technical standards to specify this. The text states that the assets should be higher than the minimum quality generally considered to be investment grade and, where relevant, should include appropriate limits to guarantee an overall adequate credit quality for the entire company. The report proposes that these draft technical standards should be submitted to the Commission by 1 September 2012.

The inclusion of a matching adjustment in the report will give comfort to many insurance companies, particularly those offering long-term annuity products, that they will be able to continue providing affordable products to consumers and to take a long-term view of investments under Solvency II.

Despite this, many of the conditions around the application of the adjustment appear unduly restrictive, contrary to good risk management practices, and look likely to make the adjustment unworkable for many companies.

In particular, the requirement that the credit quality of the assigned assets is higher than the minimum investment grade quality may be interpreted as being more severe than the previous criteria restricting the assigned assets to BBB or higher, that industry has already been lobbying against. These appear superfluous in light of the prudent person principle enshrined in Solvency II.

Finally, we note that the proposal that the matching adjustment can only apply to insurance activities in the country of authorisation would place restrictions on cross border business. This is seemingly at odds with the Solvency II aims of promoting wider harmonisation across the European insurance market.

Where companies are applying a matching adjustment, the text specifies that they cannot apply any other adjustment to the risk-free rate, including the use of the adapted relevant risk-free rate and the spread adjustment mechanism. While a company cannot actively switch between applying and not applying the matching adjustment, it may be prevented from applying the adjustment if it is unable to comply with the conditions for application, and is unable to return to compliance within two months. This restriction would apply for a period of two years following non-compliance.

We note that preventing a company from applying the matching adjustment for a period of two years when it is unable to meet the criteria for application will force companies to reflect any previously unrealised losses or gains, resulting from spread movements, on their balance sheet.

Where companies are unable to meet these criteria due to significant falls in the credit quality of their assets, such a move may serve to further penalise companies already in financial difficulties.

Furthermore, the proposed restriction preventing companies from applying other adjustments to the risk-free rate within the company if a matching adjustment is used for one class of business may lead insurers to reconsider the impact of holding annuity business within a standalone company or within a company with wider business exposure.

By its nature, the matching adjustment can be a positive or negative adjustment to best estimate liabilities. In situations where the matching adjustment applied by companies is positive, the following information must be submitted in writing to supervisors:

- A description of the impact of reducing the matching adjustment to zero
- Where zeroisation of the matching adjustment would leave the company unable to cover its SCR, plans to either restore eligible own funds to a level that would cover the SCR or to reduce the risk profile to ensure compliance with the SCR
- The amount of technical provisions to which the matching adjustment is applied

Under the proposed Parliament text, the application of the adapted relevant risk-free rate, extrapolation, symmetrical adjustment mechanism and matching adjustment will be reviewed 5 years after the full Solvency II implementation date (or 3 years for the matching adjustment) on the basis of an assessment and public consultation conducted by EIOPA.

Should the review conclude that the matching adjustment is not appropriate, provision for a transitional measure is included in the proposed text. Under this transitional measure, the risk-free interest rate applied to the insurance liabilities meeting the specific criteria would move linearly from one including a matching adjustment to one without a matching adjustment within 7 years of the Solvency II implementation date.

We note that the current proposal in the Parliamentary text effectively moves the requirements surrounding the calculation and application of the matching adjustment from Level 2 (as per the draft Level 2 implementing measures as at October 2011) into Level 1. While this would act to enshrine the matching adjustment within the Solvency II framework, it would also make it more difficult to adjust the requirements if necessary. Indeed, should the proposals prove unworkable, the only alternative appears to be based on EIOPA's review and the option to phase-out the adjustment over a period of seven years from the Solvency II implementation date.

Despite this, it is important to note that, following the publication of this report, all three parties in the trilogue discussions now appear to recognise the importance of the inclusion of a matching adjustment of some description to address the issues surrounding products with long-term guarantees. We believe it is now important that the discussions move forward to find a solution in these areas that is workable for the insurance industry, ensures insurers continue to be able to take a long term view of investments and, critically, ensures that policyholders are adequately protected and are given access to products that meet their needs at an affordable price.

It is not clear how the requirement to submit a restoration plan if a company cannot meet its SCR with a zero matching adjustment should be interpreted. As drafted, this simply requires companies to produce a plan. However, if companies are required to then implement this plan, it would appear to act to undermine the benefits of the matching adjustment.

EQUIVALENCE

The draft report makes a number of proposals relating to the requirements for equivalence of regulatory regimes. These include the allowance of temporary equivalence for a period of up to 5 years (with a possible extension of 1 year) for third countries that do not currently fulfil the equivalence criteria but do satisfy the following:

- The third country has given written commitments that it will adopt and apply an equivalent regime before the end of the period
- A convergence program and sufficient resources have been allocated to fulfil this commitment

- The current solvency regime is risk-based and based on an economic valuation of assets and liabilities
- Agreements have been concluded to exchange confidential supervisory information
- It has an independent system of supervision based upon the principles and standards adopted by the International Association of Insurance Supervisors (IAIS)
- Obligations of professional secrecy have been established for all persons acting on behalf of the third country's supervisory authorities

The text specifies that reinsurance contracts concluded with undertakings with their head office in a third country which is assigned either full or temporary equivalence should be treated in the same way as contracts taken out with companies falling under the Solvency II regime.

SUMMARY

The approval and publication of the consolidated report of compromise amendments for Omnibus II by the European Parliament's ECON committee sets out the Parliament's proposal for the Solvency II Framework Directive going into the trilogue discussions with the European Commission and the Council of the European Union.

While there a number of inclusions that are likely to be welcomed by industry, the report feels less coherent than it might have been, and is perhaps a reflection of a desire to incorporate last minute political discussions while meeting the deadline for the ECON vote of 21 March 2012. As such, there are a number of areas where the proposals are either open to interpretation or appear unworkable for many companies.

In particular, while many companies may be relieved that a matching adjustment has been included in the text following months of uncertainty, it appears that many of the restrictions and criteria surrounding the application of the measure may negate much of this relief.

Specifically, under these proposals, the use of the matching adjustment is not automatic and must be approved by both member states and individual supervisors, potentially limiting its application across the wider industry. Many of the restrictions applied to companies wishing to take advantage of the matching adjustment appear likely to discourage its application by individual firms.

Despite this, we note that it was important for the ECON committee to ensure this report was produced in time for approval at the March vote in order to maintain confidence in Solvency II and to ensure that companies retain the focus and momentum in their Solvency II projects.

The approval of this report allows the trilogue discussions to move forward to determine a final version of the Omnibus II text that is both workable for companies and provides the appropriate level of protection to policyholders.

ABOUT MILLIMAN

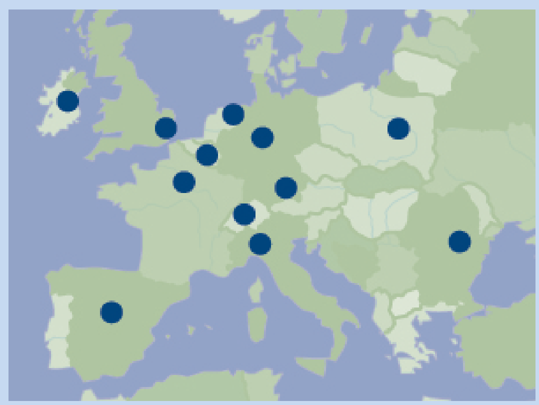
Milliman is among the world's largest independent actuarial and consulting firms. Founded in 1947, the company currently has 53 offices in key locations worldwide employing more than 2,500 people.

www.milliman.com

MILLIMAN IN EUROPE

Milliman maintains a strong and growing presence in Europe with 250 professional consultants serving clients from offices in Amsterdam, Brussels, Bucharest, Dublin, Dusseldorf, London, Madrid, Milan, Munich, Paris, Warsaw, and Zurich.

www.milliman.ie



CONTACT

If you have any questions or comments on this briefing paper or any other aspect of Solvency II, please contact any of the consultants below or your usual Milliman consultant.

Aisling Barrett
aisling.barrett@milliman.com
+353 1 647 5511

Mike Claffey
mike.claffey@milliman.com
+353 1 647 5902