European Commission Issues Omnibus II Directive and EIOPA Sets Out Revised Timetable

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Solvency II implementation takes two steps forward and one step back with the publication of the draft Omnibus II text and the European Insurance and Occupational Pensions Authority ("EIOPA") medium-term work plan.

INTRODUCTION

On 19 January 2011 the European Commission published the draft text of the Omnibus II Directive. EIOPA also published its Solvency II medium-term work plan.

The Omnibus II text makes a number of proposed adjustments to the existing Solvency II directive in light of the Lisbon Treaty, which recently came into force, provides details of areas where transitional measures may be applied, and proposes a two month extension to the Solvency II implementation date. The main areas of change proposed relate to:

- The introduction of EIOPA to replace CEIOPS and to address the wider responsibilities envisaged for it;
- The introduction of a procedural device called a "delegated act" to manage the required implementing measures;
- The establishment of a structural timetable for the introduction of Solvency II and the management of transitional arrangements.

The new text also corrects a few errors which slipped through in the Level 1 text.

The EIOPA work plan reflects the increased powers and responsibility of this new Europe-wide body, focusing on how the implementation of Solvency II will be progressed in order to ensure a smooth transition to the new framework.

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

EIOPA AND ITS ROLE IN THE SOLVENCY II FRAMEWORK

The Omnibus II text makes a number of changes to the Solvency II Level 1 directive, not least in the replacement of CEIOPS by EIOPA. The draft text proposes a range of amendments to the authority and responsibilities under the current Solvency II Level 1 Directive following public consultations and an impact study carried out during 2009.

Some new articles have been proposed which extend or clarify the way that certain features of Solvency II will be managed:

- EIOPA may specify how values for assets and liabilities may be established where there is no reference market value or where there is either a temporary or a permanent divergence between Solvency II and IFRS requirements;
- The requirement for EIOPA to publish information on the relevant risk-free interest rate term structure and information on the illiquidity premium "in periods of stressed liquidity";
- The role of EIOPA in harmonising inputs to the standard formula, including:
  - Assessing the eligibility of external credit assessment institutions;
  - Publishing lists of regional governments and local authorities to be treated as central government exposures;
  - Specifying the equity index to be used for the calibration of the equity risk sub-module and providing information on the symmetric adjustment; and
  - Specifying the adjustments to be made for currencies pegged to the euro.
- The supervisory requirements in approving major changes to the internal model, changes to the policy governing changes to the internal

model, or for approaches to be adopted for integrating the results of a partial model within the standard model; and,

- EIOPA can define when a "market event" has occurred and may do so in relation to an individual market.

DELEGATED ACTS

"Delegated acts" are introduced as a new power granted to the Commission which will apply to many aspects of the functioning of the Level 2 rules for setting the "implementing measures". The widespread use of this procedural device appears to be intended to allow the Commission (through EIOPA) to be more sensitive to the evolving experience of Solvency II in practice. The use of the delegated acts procedure by the Commission will be subject to specified governance requirements.

IMPLEMENTATION TIMETABLE AND TRANSITIONAL PROVISIONS

As long anticipated, the draft Omnibus II text proposes a two month delay in the implementation date for Solvency II. Solvency II will now come into force on 1 January 2013. All of the original timetable dates set out in the Level 1 Directive have similarly moved back by 2 months.

While it is not explicitly referred to, this change in implementation date feels to be reflected in the EIOPA work plan which aims to have final adopted Level 3 guidelines in place by March 2012 in order to allow time for implementation and training in preparation for the new regime.

Omnibus II sets out a number of areas where the European Commission may adopt transitional measures, in order to ensure a "smooth transition to the new regime" and avoid market disruption, as well as details of the maximum period for which these measures may be applied.

The paper highlights that during any transition period, the requirements should be at least equivalent to existing requirements and as such should not result in favourable treatment to companies, nor provide a lower level of protection to policyholders than currently applies under the Solvency 1 requirements.

The specific areas where the text proposes transitional measures may apply are set out below:

- **Article 35 (5)** - Information provided for supervisory purposes: the requirement for companies to have appropriate systems and structures in place to provide information on their system of governance, solvency, capital structure, etc. and written policies covering this - ***can be transitioned over a maximum of 5 years*** (although the text is confusing on this point and it may only be 3 years)
- **Articles 37(1)(a) and 37(2)** - Imposing a capital add-on calibrated to a 99.5% Value at Risk ("VaR') when the standard formula does not adequately capture the company's risk profile - ***can be transitioned over a maximum of 10 years***
- **Articles 41(1) and 41(3)** – the requirement for companies to have a sound system of governance, and written policies covering at least risk management, internal control, internal audit and outsourcing - ***can be delayed by a maximum of 3 years***
- **Article 51(1)** – the requirement to prepare and submit a Solvency and Financial Condition Report ("SFCR") - ***can be transitioned over a maximum of 3 years***
- **Article 75(1)** – the requirement for companies to perform a valuation of assets and liabilities at fair value - ***can be transitioned over a maximum of 10 years***
- **Articles 76(2), 76(3) and 76(5)** - general provisions covering the calculation of technical provisions using market consistent data and method of calculation (as best estimate plus risk margin) - ***can be transitioned over a maximum of 10 years***
- **Article 94** - classification of tiers for own funds - ***can be transitioned over a maximum of 10 years***
- **Articles 100, 101(3), 102 and 104** – the requirements covering the need to hold own funds to cover the SCR, the calculation of the Solvency Capital Requirement ("SCR") (including the need to cover all quantifiable risks, calibration to a 99.5% VaR over a one-year time horizon, breakdown of risk modules, and the frequency of calculation), and the structure of the Basic SCR ("BSCR") - ***can be transitioned over a maximum of 10 years***
- **Article 218 (2) and 218(3)** – the requirement for groups to maintain sufficient own funds to cover the group SCR - ***can be transitioned over a maximum of 10 years***

However, the text gives little clue as to what the transitional arrangement requirements are likely to be although, most notably, it does state that if the transitional arrangements under Articles 100, 101(3), 102 and 104 apply, the relevant transitional SCR should be no greater than the target SCR and

with a minimum of the average of the MCR and SCR.

In addition to the above, the text sets out the need for Level 2 measures to include transitional arrangements for third country regimes in order to provide them with sufficient time to adopt and implement an equivalent solvency regime.

The paper stresses that the transitional periods specified in the Omnibus II text are intended as maximum periods and as such the actual transitional periods adopted may be shorter. While the final periods will be applied at a Europe-wide level by the Commission, it is unclear whether individual countries may choose to transition faster if they so wish. The regulatory requirements applied during these transitional periods should encourage companies to move towards full compliance with the full Solvency II regime as soon as possible.

SUMMARY AND ANALYSIS

Omnibus II is a key step in the path to Solvency II but we believe that yet again Solvency II stands at a major crossroads.

In our view, the draft Omnibus II text sets out a number of worthwhile amendments and clarifications to the Solvency II Level 1 directive. In particular, we welcome the implementation date for Solvency II being delayed to 1 January 2013, many of the new powers ascribed to the Commission or EIOPA, and the new approach to managing implementing measures implied by the delegated acts procedures.

The delay in the implementation date is likely to mean that companies will not be required to apply the Solvency II requirements in the 2012 year end, although the exact prior year reporting requirements for 2013 remain to be finalised. However, this means that the first "live" run of most companies' Solvency II valuation systems will be a quarterly valuation as at March 2013. While this will give companies the opportunity to perform three live runs before the first published valuation, it remains to be seen whether an initial full run will be required at this stage. If a full run is not required, consideration should be given by companies as to how they will reconcile and justify any approximations they make in their capital calculations at this stage without the boundaries of a full capital calculation.

On the other hand, the proposed transitional arrangements for major aspects of Solvency II appear completely at odds with the aims and ideals of this ambitious project. It appears to us that the scope and the timescale of the transitional powers to be granted may risk making a mockery of Solvency II. These transitional terms appear to give the Commission the power to switch off or radically weaken many fundamental aspects of Solvency II, and indeed promote the continuation of Solvency I. Third countries may well ask why they should seek equivalence to this vision of Solvency II.

The triggering of the transitional arrangements will be in the gift of the Commission, although there is bound to be much lobbying by countries whose industry or regulators may be unable to deal with the full requirements of Solvency II from 2013. While any minimum transitional arrangements would be applied uniformly across Europe, it seems to us that there remains the possibility of different member states working to different timetables within the transitional periods to reflect their current state of readiness and work plans for the next couple of years. While some states may doubtless wish to push ahead with full compliance by the implementation date, others may see the opportunity to "take their foot off the pedal". If this were the case, it could cause confusion and present the opportunity for regulatory arbitrage across territories as companies search out the most lenient regulatory requirements. In particular, for groups operating throughout Europe, significant difficulties could arise in reconciling solo capital calculations performed under a mixture of Solvency I and Solvency II to the group reporting requirements.

In addition to the difficulties outline above, the proposed time scales for the transition periods appear far longer than is necessary to achieve an orderly implementation of Solvency II. Questions should be asked about the underlying drivers behind these time scales, and in particular the proposed 10 year maximum transition for solvency capital requirements.

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