Third Presidency compromise text for the Omnibus II Directive

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The publication of the third Presidency compromise text for Omnibus II provides a link to existing Solvency I regimes through transitional provisions

INTRODUCTION

On 7 June 2011, the Council of the European Union published its third 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.

The updated text retains substantially all of the text of the previous Presidency compromise, including the significant changes proposed to the timescale for introducing all elements of Solvency II. However, further changes are now proposed to both the scope of Solvency II and to some of the areas for which transitional arrangements should be in place.

Significantly, the proposed text sets out a number of details of the arrangements that may be adopted by companies during the transitional periods, based on weighted averages of interim and final requirements. These arrangements aim to provide a link between current Solvency I regimes and the Solvency II requirements.

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.

SCOPE OF SOLVENCY II

The latest Presidency compromise text proposes a number of new paragraphs to be included in Article 3 of the Solvency II Directive to exclude the following classes of companies from the scope of the Solvency II Directive:

- closed fund companies that intend to terminate their business within 3 years of the implementation of Solvency II, or
- closed fund companies which are subject to reorganisation with an administrator already appointed (as at 1 January 2013).

Such companies must cease to conduct new insurance or reinsurance contracts before the implementation date of Solvency II.

Under the new text, companies planning to terminate their activity will be considered out of scope for up to 3 years after the Solvency II implementation date, while those looking to reorganise will only become subject to Solvency II requirements 5 years after the implementation date.

For companies looking to pursue this route, annual reports must be provided to the supervisor setting out progress and, in both cases, companies may be brought into scope earlier if the supervisor is not satisfied that sufficient progress has been made.

For groups of companies, all parts of the group must cease to conduct new business in order for these transitional measures to apply.

We note that while these changes are likely to be limited in application, particularly for life insurance companies, they will introduce a welcome relief for the companies to which they apply, and which otherwise would have had to incur significant costs to implement Solvency II requirements for a relatively short time period.

It is not clear from the current text what requirements will actually have to be satisfied by companies exempted in this way.

TRANSITIONAL ARRANGEMENTS

The latest text sets out draft proposals for the treatment of certain items during transitional periods, including:

- the risk-free interest rate term structure to be used in the calculation of best estimate liabilities relating to paid-in premiums
- own fund items that may be included in Tier 1 or Tier 2 basic own funds

- the standard parameters to be used when calculating the concentration risk sub-module, spread risk sub-module and equity risk sub-module.

During the relevant transitional period, the rates of the risk-free interest rate term structure will be calculated as the weighted average of:

(i) the interest rate used for Solvency I, as required under the consolidated directive on life assurance (2002/83/EC), based on the yield on the corresponding assets held at implementation date less a prudential margin, and

(ii) the Solvency II risk-free interest rate.

The text specifies that the weight applied to the second component should increase at least linearly from 0% during the first year of application to 100% after 7 years.

For the equity risk sub-module, the proposed text specifies that the parameters to be used for equities purchased before the implementation of Solvency II may be calculated as the weighted averages of the company-specific parameters calibrated in accordance with the duration-based equity risk sub-module and the parameters as set out in the standard equity risk sub-module as calibrated using a Value-at-Risk measure, with a 99.5 % confidence level, over a one-year period. The weights applied to the second component should increase at least linearly from 0% during the first year of Solvency II to 100% after 5 years.

For all areas, the text states that delegated acts will be adopted specifying the criteria for application of these transitional provisions.

These proposals have emerged with apparently no warning or advance comment and it will be interesting to see how they are finally translated into transitional rules whilst retaining the market consistent principles of Solvency II.

At first sight, the proposals for the risk-free interest rate appear to be a somewhat crude attempt to provide a transition to the Solvency II requirements from the risk-adjusted rates calculated under Solvency I. It is unclear how this would be applied in practice, and how it would achieve effective integration with a market consistent approach including the counter-cyclical allowances referred to below.

We note that, while this proposal does not appear to be in line with the principle of market consistency, a weighted allowance will reduce the impact over time. However, the proposal to allow companies to base their starting rates on assets held at a particular point in time potentially provides scope for firms to effectively lock into the yield on assets held on the implementation date. The detailed transitional rules will need to incorporate a holistic approach if they are to encourage sound risk management and minimise arbitrage opportunities.

The proposals in respect of the equity risk sub-module seem quite arbitrary and will be somewhat cumbersome for firms to apply given the need to classify individual equities based on date of purchase.

THIRD COUNTRY EQUIVALENCE

In addition to the above, the revised Omnibus II Directive includes some additional text surrounding the transitional period for third country equivalence which is to be set out in the Level 1 Directive. Under this, the transitional period would be set to end on the date by which the solvency regime of third country is deemed to be equivalent with Solvency II.

For groups where the parent company is based outside the European Community, group supervision by the third country may be relied on for a transitional period of 5 years, or until the third country regime is deemed equivalent if earlier.

We note that, for groups where the balance sheet total of a company based in a Member State exceeds that of the parent company situated in a third country, it is proposed that the supervisory authority of the Member State must perform the role of group supervisor under Solvency II.

COUNTER-CYCLICAL PREMIUM

The revised draft text includes a number of changes to the wording of Article 77a in order to provide for the inclusion of a counter-cyclical premium in place of the illiquidity premium that has been included in previous iterations of the Omnibus II Directive, and in the draft Level 2 text. As for the illiquidity premium, this would be included as an additional component of the risk-free interest rate term structure, aimed at reducing the impact of stressed market conditions on liability valuations.

It appears likely from the inclusion of the counter-cyclical premium in this text that this will replace the application of the illiquidity premium in the final wording of the Level 2 guidance.

While no further details on the structure or application of the counter-cyclical premium are included in the draft Omnibus II text, it is expected that this will extend the scope of the illiquidity premium to cover not just illiquidity of the market but also other market distortions resulting from periods of market stress.

SUMMARY AND ANALYSIS

The third 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 Directive.

The inclusion of text surrounding the counter-cyclical premium looks set to confirm the replacement of the illiquidity premium as a mechanism for reducing the short-term volatility of asset and liability values during times of market stress. However, it remains to be seen how this will be developed in the Level 2 guidance.

While the latest text does not make any further adjustments to the time frame of Solvency II, additional text is included describing the arrangements that may be adopted during transitional periods in moving from current regimes. It is perhaps surprising, given the tone of the recent QIS5 report, that such extended transitional arrangements are considered necessary. Moreover, the approach proposed to determining “risk-free” interest rates represents an uncomfortable blend of traditional and market-consistent regimes, and seems likely to create inbuilt future valuation strains. The detailed implementing measures which combine the transitional arrangements with the counter-cyclical premium will be awaited with interest.

Link to the full text of the Presidency compromise proposal for the Omnibus II Directive published on 7 June 2011:

http://register.consilium.europa.eu/pdf/en/11/st11/st11090.en11.pdf

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