PROGRESS ON SOLVENCY

New steps in Solvency II. The Omnibus II Directive

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The Omnibus II Directive clears the way for Solvency II and clarifies the regulatory scope of its application in institutional terms. It approves new reporting measures and ways of valuing assets and liabilities that mitigate the problem of cyclicality in the calculation of capital. The new date for Solvency II to come into force is 1 January 2016.

Background

The task of implementing Solvency II was taken up in 2002, in view of the weaknesses observed in Solvency I as the basic, harmonised regulation to mitigate risks in the insurance industry.The work initially drew inspiration from the directives approved in Basel II to become the new prudential regulatory framework for insurers and reinsurers in the European Union (see Alonso et al., 2013).

After exhaustive consultation and technical studies, the European Parliament and the Council accepted the general framework proposed for Solvency II in 2009 (2009/138/EC)[1]. However, the economic crisis and volatility in the international financial markets revealed certain weaknesses in the supervision of companies and in the technical mechanisms used to measure assets and liabilities, making it necessary to seek solutions.

The Omnibus II Directive IP/11/49)[2] aimed to bring Solvency II into line with the reforms contained in the Lisbon Treaty, and to improve the industry's regulatory framework. Above all, however, it was intended to mitigate the volatility and pro-cyclical nature of asset and liability measurements observed in QIS5. In order to resolve these problems, Omnibus II establishes and clarifies the areas in which EIOPA (for Solvency II) and ESMA (for the Prospectus Directive) may impose their respective technical criteria, at the same time proposing a raft of measures to mitigate the effects of volatility in the financial markets on insurance products.

The adoption of the Omnibus II Directive was finally adopted on 31 January 2013, and it was formally approved in a session of the European Parliament on 11 March 2014. The Directive is scheduled to take effect on 1 January 2016.

1 (http://eur-lex.europa.eu/legal-content/ES/TXT/PDF/?uri=CELEX:32009L0138&from=EN)
2 (http://eur-lex.europa.eu/legal-content/ES/TXT/PDF/?uri=CELEX:52011PC0008&from=EN)

The Omnibus II Directive

The Omnibus II Directive proposes a series of measures to prevent pro-cyclical effects in the measurement of liabilities, thereby avoiding unreasonable calculations of capital requirements in insurance and reinsurance firms.The main such measures are described below.

Volatility adjuster

EIOPA proposed the volatility adjuster in its technical findings on the "Long Term Guarantee Assessment (LTGA)"[3], which replaced the former counter-cyclical premium (CCP). Application of the CCP significantly increased capital requirements in certain countries, implying a negative impact on solvency ratios. Moreover, the lack of a smooth or phased application process might cause sharp increases in balance sheet volatility in the short term.

The proposed new volatility adjuster (VA) is designed to reduce the artificial volatility of own funds under stressed market conditions.

The adjuster applied to the measurement of liabilities is based on the gap between the interest rates which could be obtained based on the assets included in a benchmark portfolio denominated in the reference currency (e.g. euros) and the risk-free interest rate curve for that currency (German bond curve), less a provision for the default risk. The adjuster has a direct impact on technical provisions and therefore on own funds.

Specific country adjusters may also be applied when the gap between national interest rates exceeds the spreads inherent in the specific reference portfolio for the currency concerned by more than 100 basis points.

In the its initial LTGA report, EIOPA recommended applying only 20% of this difference (excluding the part associated with the default risk) as the volatility adjuster, although this was finally raised to 65%.

Matching Adjustments

Matching of income on assets and payments on liabilities may be used as an alternative adjustment measure to the volatility adjuster described in the preceding point. Matching adjustments are especially appropriate for the measurement of life annuity products and other products like infrastructure bonds due to their extended maturities.

Significant changes have been made to the existing regulations.

- The floor applied for the basic spread has been lowered from 35% to 75% for assets other than European Union sovereign debt.
- The matching adjustment for BBB-rated bonds will not be limited to the observed parameters for A-rated bonds.
- Limits on the proportion of BBB-rated bonds have been removed, and products rated one step below investment grade may now be held in the asset portfolio.
- The requirement for ring-fencing of assets has been removed, and replaced by the requirement that they should be identified, organised and managed separately from firms' other activities. Hence, the assets assigned to a portfolio cannot be used to cover losses incurred in another line of business conducted by an entity.
- Products subject to immaterial mortality risk are now included (e.g. life insurance combined with life annuities, a key point for Spanish insurers).

3 (https://eiopa.europa.eu/consultations/qis/insurance/long-term-guarantees-assessment/index.html)

- The assets contained in a portfolio associated with a liability may not be exchanged for others, leaving them “frozen”. This is a limitation, given that it significantly restricts flexibility in the management of portfolios in the face of unforeseen events.
- A series of assets (e.g. subordinated debt) are not considered eligible for matching with liabilities. The problem arises where companies currently hold a high proportion of such assets.

Extrapolation of the interest rate curve

Omnibus II describes the high-level principles for the extrapolation of the yield curve, establishing that the last liquid point utilised for the euro is 20 years, while the convergence period will be 40 years after that point.

Transitional measures

1. **Transitional measures in the risk-free interest rate curve**

   The transition from application of the interest rate curve applied to discount liabilities under Solvency I to the curve applicable under Solvency II will take place over a period of 16 years, commencing as of 1 January 2016. The transition from adjustment to the interest rate curve applicable under Solvency II will be made by applying a weighted moving measure of the difference between both interest rate curves.

   The volatility adjuster may be applied to the Solvency II component of the transition rate calculated, but matching adjustments may not be applied.

2. **Transitional measures in technical provisions**

   Transition from the reserves calculated under Solvency I to the requirements under Solvency II (in both cases net of reinsurance) will be made over a period of 16 years. The transitional nature of technical provisions may be determined separately for each segment of obligations (or “homogeneous risk groups”). The length of the transition period (16 years) is intended to allow insurers sufficient time to adapt to the new regulations and, therefore, to prevent financial instability in the short run.

Criteria for assessing equivalence with third countries

The main changes established in Omnibus II for equivalence with third countries are related with assessments of the solvency of business groups registered in the EU but with affiliates outside the EU. In such cases, groups with their head offices in the EU may apply the regulatory rules established by equivalent regimes (in the country of origin of affiliates) and consolidate capital with the group. Omnibus II now establishes that such temporary equivalence with third countries may continue for a period of 10 years, renewable for further 10-year periods.

New reporting requirements

The additional reports envisaged in Omnibus II must include the results of applying or not applying the volatility adjuster, portfolio matching and the transitional measures. Supervisory reports should include periodic assessments of the sensitivity of technical provisions and admissible own funds based on the following:

- The assumptions underlying the extrapolation of the structure and timing of interest rate risks.
- The assumptions applied in the calculation of adjustments, changes in the composition of the portfolio assigned to assets and reduction in the matching adjustment to zero.
- Assumptions applied in the calculation of the volatility adjustment and reduction of the volatility adjustment to zero.

As part of the insurer's risk management process, when an entity applies the matching adjustment or the volatility adjustment it will be required to establish a liquidity plan and to project cash inflows and outflows associated with the assets and liabilities subject to adjustment.

Supervisory powers

The supervisory authorities will approve ancillary own funds, undertaking specific parameters, general and partial internal models, the use of matching and volatility adjustments and the application of the transitional measures as of 1 April 2015.

Evaluation

In general, the design of Omnibus II has been well-received by the industry, because it will foreseeably reduce volatility in the calculation of own funds. However, some concerns remain and will need to be addressed in the second and third level texts, including for example the precise make-up of the portfolio to be used as a benchmark and the methodology applied to calculate the reduction in the spread attributable to risk in assets not referred to in Omnibus II.

A further outstanding issue which is not addressed in Omnibus II is the level of swap curve deduction in respect of credit risk and base risk. We will need to wait for the (second and third level) application measures to understand how this deduction will be calculated.

In short, a significant number of implementing documents for the Omnibus II Directive remain to be issued (second and third level documents). These implementing measures will need to provide further detail on various points under discussion, which will delay finalisation of the Omnibus II Directive for several months. In particular, these issues include:

- **Long-term guarantees**: Further detail on long-term guarantees, including the matching adjustment, is expected in the draft of the level 2 Regulations.
- **Equivalence**: The European Commission will confirm the countries considered equivalent. For example, EIPOA recommended that the regimes of Bermuda and Switzerland should be treated as equivalent, but not that of Japan, which is considered to be equivalent only for reinsurance.
- **Transitional measures**: Omnibus II has established a number of additional transitional measures, including a transitional adjustment to the risk-free interest rate and to technical provisions over a period of 16 years. It is possible that additional transitional measures will be taken before the effective date in order to ensure that the implementation of SII is not delayed again.

References

Alonso, T. Javier Alonso, Santiago Fernández de Lis, Cristina Rohde and David Tuesta (2013) "Global Financial Regulatory Trends and Challenges for Insurance & Pensions" Working Paper 13/21. June 2013.

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