Newsletter

Understanding where Solvency II is heading

European Parliament supports delay in full implementation, sets out transitional measures & more ....

Solvency II Technical Team - October 2011

Summary

The Omnibus II Directive is the Directive which, once approved by the Council of the European Union ("the Council") and the European Parliament ("the Parliament"), will amend the Solvency II Directive. In particular, Omnibus II will set the implementation date, introduce transitional measures, specify the areas and the timing for further Solvency II legislation, align the Solvency II Directive to the Lisbon Treaty, incorporate new powers given to EIOPA and other technical amendments.

Over the past two months there has been significant debate about Solvency II's implementation date. On 21 June 2011 the European Council made public its proposal[1] to defer full Solvency II implementation until **1 January 2014**. However, this revealed the thinking of the Council only. Last week, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament published its ***draft*** report on the Omnibus II Directive. This document represents a step forward towards much needed clarity on not only the Solvency II implementation date but also on a number of key transitional and technical issues. However, this is just the first milestone from the Parliament's perspective: the draft report will be subject to - perhaps many - amendments prior to its adoption by ECON. It does provide a starting point for comparing the positions of the Parliament and the Council which currently diverge in a number of areas.

Over the next few months the ECON Committee and Council will first finalise their own positions before coming together to negotiate an agreement on the final Omnibus II proposals. The Parliament currently anticipates a plenary vote in January 2012[2] to adopt the final, agreed text.

For ease of reference in this paper we refer to the latest Presidency Compromise text as "Council's proposals" and the draft report of ECON Committee as "Parliament's proposals". It should be noted that both sets of proposals are draft and subject to change.

This document summarises the most relevant aspects of Parliament's proposals and compares those with current Council's proposals.

[1] The latest Presidency Compromise dated 15 July is available from http://register.consilium.europa.eu/pdf/en/11/st12/st12723.en11.pdf

[2] Per http://www.europarl.europa.eu/oeil/file.jsp?id=5895132

Implementation date

Consensus builds on Solvency II implementation timetable

Parliament proposes that the full requirements of Solvency II should not be implemented until 1 January 2014. Instead, during 2013 it is proposed that there will be a legal obligation for insurers and supervisors to take all measures necessary to ensure compliance as at 1 January 2014. Although there are some differences in the detail, this is broadly in line with Council's proposals around implementation date. Both Council and Parliament now refer to 2013 as a year of transition and preparation.

What are the proposed requirements during 2013?

There will be an obligation for insurers to submit detailed Solvency II information to their supervisors during the course of 2013. However, Parliament and Council's proposals are not aligned on this area.

While the Council proposes requiring submission of detailed implementation plans by 1 June 2013, the Parliament goes a step further and proposes that, as at 1 July 2013, insurers should have submitted their SII balance sheet, MCR, SCR, Own Funds and Regulatory Supervisory Report (RSR).The actual submission date is not specified in the proposals.

A key consideration on which the industry will want clarity is precisely what information will be required to be submitted to supervisors in 2013, as at what date it will be prepared at and what the submission deadlines will be.

Is this really good news?

This is a positive development as it brings us closer to ending the distracting debate over whether there will be a delay. Despite the delay in start date, the reality is insurers cannot afford to be complacent with their plans as they will still be required to file Solvency II information over the course of 2013 to prove their readiness. This means insurers will need to have the appropriate systems and processes in place by the end of next year.

The industry is likely to welcome Parliament and Council's consensus on pushing back the implementation date to 2014, given that a considerable amount of the technical detail is still to be finalised. The more crucial issue for the industry now is how the areas of disagreement on some of the Level 2 implementing measures are resolved but there is unlikely to be any clarity on this until Autumn 2011 and the rules will not be finalised until well into 2012.

The implementation timetables proposed by the Parliament and the Council are summarised below:

	Parliament	Council
Transposition of Directive into national law	31 December 2012	31 March 2013
Power for granting of supervisory approvals (e.g. use of internal models, ancillary own funds, use of undertaking specific parameters in the standard formula SCR)	1 January 2013	1 June 2013
Pre implementation reporting	As of 1 July 2013 (no submission date specified). Full Solvency II balance sheet, own funds, MCR and SCR. Regular Supervisory Report (Member States may waive this requirement for insurers without the necessary systems and structures in place).	By 1 June 2013 An implementation plan providing evidence of the progress made. The implementation plan shall contain inter alia information relating to technical provisions, eligible own funds, capital requirements, system of governance and processes and procedures in place for supervisory reporting and public disclosure.
Implementation of Directive's full requirements	1 January 2014	1 January 2014

As can be seen from this table, whilst there is agreement on the date for full implementation, there remains some work to do for Parliament and Council to align their plans for transition during 2013.

Transitional measures

Moving forward but not yet a meeting of minds

The original Omnibus II proposals set out a number of areas where transitional measures could be adopted and specified their maximum duration and the minimum standards to be met. However, both Parliament and Council are proposing that Omnibus II should set out in more detail the actual transitional measures that should apply rather than leaving this to Level 2 legislation.

The Appendix summarises the transitional measures contained in Parliament's and Council's proposals. In some areas there is close agreement, for example both Council and Parliament propose a 10 year period for the grandfathering of own funds and a five year period during which third countries may be deemed equivalent. In addition, both parties recognise the need for some relief for SCR non-compliance for an initial period after the Directive comes into effect. The length of such period and conditions of application of the transitional diverge (for more detail see the Appendix).

However, in some important areas the Council's proposals contain transitional measures that are not present in the Parliament's draft. These areas include:

- Excluding insurers in run-off from the scope of Solvency II for the first three years of its application provided the run-off is expected to complete within three years.
- Allowing life insurers which currently use discount rates based on asset yields when calculating technical provisions to move progressively to the risk-free discount rate required by Solvency II over a seven year period.
- Phased implementation of the full market risk capital charge for equities over a five year period.
- A two year period where exposures to any Member States' governments and central banks denominated in the currency of another Member State would be exempt from capital charges in respect of concentration risk and spread risk.

  Conversely the Parliament proposes transitional measures in the areas of systems and controls over Pillar 3 reporting that are not present in the Council's proposals.

  The move towards the inclusion of transitional measures in the Level 1 text is a welcome move to reduce the uncertainty in this area, as is the convergence of Council's and Parliament's proposals for transitional measures in certain key areas. However, it is to be hoped that there can be a prompt resolution of the remaining areas of difference so that the industry can properly prepare for the requirements that will come into force on **1 January 2014** in safe knowledge of which requirements will, and will not, be subject to transitional measures.

Delegated Acts and Technical Standards

Parliament's proposals make some changes to the proposed use of Delegated Acts and Implementing Acts that had been set out in the original Omnibus II proposals (Level 2).

The changes aim to align Solvency II to the Lisbon Treaty and the European Supervisory Authorities (ESA) Regulations. The ESA Regulations introduce regulatory technical standards (RTS) and implementing technical standards (ITS) previously known as 'Level 3' measures.

Parliament proposes that ITSs are developed mainly around procedural issues and adopted as Implementing Acts by the European Commission (this involves scrutiny by Parliament and Council and equates to the previously known as 'Level 2' measures). On the other hand, EIOPA has a formal role in drafting RTSs and Parliament proposes that RTSs should be adopted as Delegated Acts by the European Commission (this involves a lesser degree of Parliament and Council ongoing scrutiny). Although, this might seem a technicality at first glance it reflects an ongoing debated about the potential shift in the powers of Council, Parliament, Commission and EIOPA to develop financial legislation. As a result, insurers interested in influencing the decision making process should understand the process for developing the relevant legislation.

What is the timing for publication?

a) Regulatory Technical Standards (RTSs)

Parliament's proposals indicate that EIOPA shall submit draft RTSs to the Commission by **1 March 2012**. In practice, many of these RTSs are in areas where CEIOPS (EIOPA's predecessor body) has already submitted fully consulted on advice to the Commission. It is to be hoped that the introduction of this March 2012 deadline does not unduly delay the finalisation of these standards.

b) Implementing Technical Standards (ITSs)

Parliament is proposing that all draft ITSs should be submitted by EIOPA to the Commission by **1 June 2012**. On the other hand, the Council is proposing staggered deadlines for the submission of draft ITSs between **30 September 2012** and **31 December 2016**. There is therefore a clearly significant difference in the timescale envisaged by the Council and Parliament for the drafting of the ITSs. All those in the industry will be hopeful that Parliament's more aggressive timetable can be met as this will limit the period of uncertainty surrounding these measures.

Other technical amendments

Parliament's proposals also include other amendments to the Solvency II Directive. The amendments include:

- **Illiquidity premium – who, when and how determines it?** EIOPA would play an important role developing a method to identify illiquid liabilities and a formula to calculate the illiquidity premium to be applied during a period of stressed liquidity in the financial markets. The premium should be subject to a minimum threshold of application to avoid capturing very small market anomalies or measurement errors. Member States would then have the power **not** to allow insurers in their jurisdictions to use the illiquidity premium in the calculation of technical provisions.

  In contrast, Council's proposals replaced the illiquidity premium with a countercyclical premium and a matching premium. Parliament decided to concentrate on the original proposal for an illiquidity premium since this had already been tested in QIS5. In addition, Parliament is not proposing to include transitional measures allowing life insurers which currently use asset-backed discount rates to move progressively to the risk-free discount rate required by Solvency II over a seven year period. The lack of a matching premium together with the exclusion of transitional measures for moving from asset-backed rates to risk-free rates if crystallised in Omnibus II would be a concerning development to life insurers.

  Overall, Parliament's proposals provide more certainty to the industry about the method of calculation of the illiquidity premium. However, leaving the decision to allow application of illiquidity premium in periods of stressed liquidity to each Member State seems to add one more layer of uncertainty to this area.

- **Exceptional fall in financial markets** – During an exceptional fall in financial markets the recovery period for insurers not complying with SCR may be extended. Parliament proposes that EIOPA determines and announces when an exceptional fall in financial markets occurs in consultation with the European Systemic Risk Board.

- **Granularity of reporting** – Parliament is proposing that Member States should not require insurers to submit detailed lists of assets on an item-by-item basis to the supervisors, explaining it would be "inappropriate" to require this type of reporting on a regular basis. If this proposal is adopted it will be a very welcome change to the industry. Reporting requirements received very strong push back during consultation and it seems Parliament is inclined to tone the requirements down slightly. It remains to be seen whether it survives during negotiations over the next few months.

- **The role of EIOPA in group supervision** – Parliament's proposals include a number of more formalised binding mediation roles for EIOPA in the context of group supervision and third country equivalence. The proposals also align EIOPA's role in the college of supervisors with the EIOPA Regulation. In this role EIOPA is expected to take the lead in "ensuring a consistent and coherent functioning of the college".

- **Group reporting** – Parliament proposes including a requirement for insurers to publicly disclose at group level on an annual basis:
  - Legal, governance and organisational structure,
  - Including all regulated and non-regulated entities and material branches belonging to the group.

What happens next?

In the coming months Council and the ECON Committee will enter a period of discussion and debate to arrive at a common approach to Omnibus II. With a plenary vote anticipated in the European Parliament in January 2012, the Directive should be adopted shortly thereafter. Its publication in the Official Journal of the European Union will leave the way open for the speedy finalisation and adoption by the European Commission of the "Level 2 measures".

However, if the views of the Council and Parliament diverge significantly, reaching a compromise may prove difficult and far from optimal. There are still a number of areas hotly debated such as: illiquidity premium; third country equivalence; transitional measures; and what precisely happens and is required of insurers during 2013. It was initially envisaged that the Directive would be adopted in "first reading" but, if the negotiations were to prove difficult, it is now possible that a second reading approach could be followed (without derailing the process overall), given the apparent consensus on postponing the effective start date by one year. This would, of course, mean additional delay in finalisation of the rules and in getting complete clarity in the requirements.

What do I need to do?

Despite the delay in start date, the reality is insurers cannot afford to be complacent with their plans as they will still be required to file Solvency II information over the course of 2013 to prove their readiness. This means insurers will need to have the appropriate systems and processes in place by the end of next year.

Insurers should consider the implication of the various Parliament's proposals to their Solvency II programme and efforts bearing in mind some of the most controversial matters will be subject of intense debate and as a consequence the final outcome cannot yet be predicted with any certainty. The more crucial piece for the industry now is how the areas of disagreement on some of the Level 2 implementing measures are resolved – such as transitional measures, illiquidity premium, and 2013 specific requirements. There is unlikely to be any clarity provided on this until autumn and the rules will not be finalised until well into 2012.

Appendix: Comparison of Council's and Parliament's proposed transitional measures

Area	Council		Parliament	
	Transitional measure	**Duration**	**Transitional measure**	**Duration**
Insurers in run-off[4]	Insurers in run-off at the date of implementation of Solvency II will not be subject to its requirements (except for Title IV in respect of reorganisation and winding-up) provided they have satisfied their supervisor that activities will be terminated within three years of Solvency II's implementation. If still in existence, such insurers will become subject to Solvency II's requirements after three years (or earlier where the supervisor is not satisfied with the progress that has been made towards terminating its activities).	3 years	None	N/A
	Insurers in run-off that are subject to reorganisation measures and where an administrator has been appointed are not subject to Solvency II's requirements (except for Title IV in respect of reorganisation and winding-up) for five years (or earlier where the supervisor is not satisfied with the progress that has been made towards terminating its activities).	5 years		
	Insurers utilising this transitional measure must submit an annual report to their supervisor setting out what progress has been made in terminating activities.			
	These provisions do not apply to insurers that are members of a group containing any other insurers not in run-off.			

[4] Reinsurers that were placed in run-off on or prior to 10 December 2007 are not subject to Solvency II by virtue of Article 12 and so will not be subject to the conditions set out in this new proposed transitional measure.

Area	Council		Parliament	
	Transitional measure	*Duration*	*Transitional measure*	*Duration*
Systems and controls for production of RSR and SFCR	None	N/A	Member States may allow insurers a period of up to two years to develop the systems and structures necessary to produce the Regular Supervisory Report (RSR) and the Solvency and Financial Condition Report (SFCR). During this period insurers only have to publish in their SFCR that information which their implemented systems and structures are able to provide.	2 years
Non-compliance with SCR	Where insurers comply with their required solvency margin under the Solvency I rules (as implemented in national law) at the date Solvency II becomes effective then, if they fail to comply with SCR during the first year of application of Solvency II they will have 12 months to achieve compliance. In these circumstances progress reports shall be submitted to the supervisor every three months.	1 year	Member States may allow insurers with balance sheet totals of less than 500bn euros a period of two years to comply with SCR provided those insurers have submitted plans for compliance.	2 years
Equivalence of third countries	Third countries which are unlikely, by the date of implementation of Solvency II, to meet the criteria for equivalence in respect of: • the solvency regime of a third country applied to reinsurance activities only; • the solvency regime of a third country applied to both insurance and reinsurance activities; or • the group supervisory regime of a third country; may be treated as though they were equivalent for a period of five years provided the Commission has made a decision that specified conditions have been met. All decisions made shall be reviewed regularly. Delegated acts may be adopted setting out the specified conditions which shall cover: • commitments given by third countries; • their convergence to an equivalent regime over a set period of time; • the existing or intended content of the regime (including, in respect of group supervisory regimes, the extent to which a third country's prudential regime exercises group supervision); and	5 years	Provided specified conditions are met, the Commission (assisted by EIOPA) may decide that third countries may temporarily be deemed equivalent in respect of: • the solvency regime of a third country applied to reinsurance activities only; • the solvency regime of a third country applied to both insurance and reinsurance activities; or • the group supervisory regime of a third country. All decisions made shall be reviewed regularly based on six monthly progress reports. As a minimum the conditions which must be met for deemed equivalence to be granted are: • the third country has given written commitments to adopt and apply a solvency regime that is capable of being assessed equivalent within the 5 year transitional period; • the third country has established a convergence programme to fulfil this commitment; • sufficient resources have been allocated to fulfil this commitment;	5 Years

Area	Council		Parliament	
	Transitional measure	Duration	Transitional measure	Duration
	• matters of cooperation, exchange of information and professional secrecy obligations. In each case, within three years of the implementation of Solvency II, the Commission shall review the progress on convergence to an equivalent regime.		• the present third country's solvency regime is risk-based and based on market valuation of assets and liabilities; • agreements have been concluded to exchange confidential supervisory information; and • the third country is assessed to comply with the core principles, principles and standards adopted by the International Association of Insurance Supervisors.	
Technical provisions - Risk-free interest rate term structure	Subject to supervisory approval, liabilities which, prior to the implementation of Solvency II, were valued using a discount rate based on asset yields (as permitted by the Consolidated Life Directive) can be discounted using a weighted average of that asset backed discount rate and the risk free rate that would be otherwise be required under Solvency II. The rate used will initially be the asset backed discount rate and will move to the Solvency II rate on a straight line basis over seven years.	7 years	None	N/A
Own funds	Basic own fund items that meet criteria to be set out in a delegated act shall be included in Tier 1 or Tier 2 basic own funds. The criteria that must be met have not yet been specified but, as a minimum, the insurer will need to meet the requirements of the Solvency I Directives.	10 years	Basic own fund items in issuance at 31 December 2012 that meet specified criteria shall be included in Tier 1 or Tier 2 basic own funds. For inclusion in Tier 1 the conditions include: • Ranking after all policyholders beneficiaries and non-subordinated creditors; • Item only repayable or redeemable at option of insurer subject to prior supervisory approval. No incentives to repay within 10 years of issuance; • Free from encumbrances and not connected with any other transaction that would lead to the item not satisfying the requirements for an item of Tier 2 basic own funds as set out in Article 94(2); • Fully paid in, undated and absorb losses on a going-concern basis; • Cancellation or deferral of the payment of interest or dividends in relation to that item in the event of financial stress.	10 years

Area	Council		Parliament	
	Transitional measure	Duration	Transitional measure	Duration
			For inclusion in Tier 2 the conditions include: • Ranking after all policyholders beneficiaries and non-subordinated creditors; • Original maturity of at least 5 years; • Item only repayable or redeemable at option of insurer subject to prior supervisory approval. No incentives to repay within 10 years of issuance; • Free from encumbrances and not connected with any other transaction that would lead to the item not satisfying the requirements for an item of Tier 2 basic own funds as set out in Article 94(2); • Fully paid in.	
Standard formula SCR - Exposures to Member States' central governments or central banks	For the purpose of the concentration risk sub-module and the spread risk sub-module of the SCR standard formula, exposures to Member States' central governments or central banks denominated and funded in the currency of any Member State should be treated in the same way as exposures funded in the domestic currency (and will not therefore attract a capital charge during the transitional period)	2 years	None	N/A
Standard formula SCR - Market risk charge for equities	Within the SCR standard formula, the capital charge that applies to equities not otherwise subject to the duration based approach shall move on a straight line basis over five years from initially being the charge that would apply under the duration based approach (22% at QIS5) to the charge that would otherwise apply (being, at QIS5, either 39% or 49% plus or minus the up to 10% effect of the equity dampener).	5 years	None	N/A

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To gain deeper understandings of how the new regulatory framework impacts your business please contact:

Thierry Flamand Insurance Leader	+352 49 48 48 4170	thierry.flamand@lu.pwc.com
Alexandre Heluin Pillar 1 Life insurance	+352 49 48 48 4196	alexandre.heluin@lu.pwc.com
Alexandre Moreau Pillar 1 Non-life insurance	+352 49 48 48 4119	alexandre.moreau@lu.pwc.com
Afaf Hounka Pillar 2 : Insurance risk	+352 49 48 48 2426	afaf.hounka@lu.pwc.com
Jean-Philippe Maes Pillar 2 : Financial risk	+352 49 48 48 2874	jean-philippe.maes@lu.pwc.com
Christophe Crochet Pillar 3 and Internal model	+352 49 48 48 4201	christophe.crochet@lu.pwc.com
Frédéric Wersand VAT	+352 49 48 48 3111	frederic.wersand@lu.pwc.com
Géraud de Borman Corporate tax	+352 49 48 48 3161	geraud.de.borman@lu.pwc.com