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Omnibus II effective measures in adjusting the current Solvency II framework

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Abstract

The article describes some difficulties arising in connection with implementation of Solvency II at the Member State level. The main objective of this paper is to present the problem solving of Solvency II Directive of insurance and reinsurance on long-term guarantee package with the help of the new Omnibus II Directive. For this purpose in the article were investigated the results of last impact assessment with long-term guarantees package to the current Solvency II framework to cope with artificial volatility and low interest rate environment, and to ensure both transparency and level-playing field. After the impact assessment EIOPA analyzed each measure against the objectives and recommended the inclusion of the following measures: extrapolation, classical matching adjustment, transitional measures, and extension of the recovery period, not to include the so-called extended matching adjustment on the basis that it would not provide sufficient policyholder protection.

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1. Introduction

The Omnibus II Directive will amend certain provisions of the Solvency II Directive, including the implementation date. There has been limited progress in agreeing the details of the new legislation. According to the

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Solvency II EU Directive implementation timetable, from 2014, following the entry into force of the Directive, insurance companies within the European Union with a gross premium income of more than 5 million euro will be required to establish their capital requirements in accordance with this Directive (Clipici, 2012). Omnibus II will amend the Solvency II Framework Directive, to bring it in line with the EU's Lisbon Treaty and to take account of the EU's new supervisory structure. Adoption of Omnibus II requires agreement from the European Commission, the European Parliament and the Council of the EU. Discussions on the proposals have been significantly delayed by the failure to agree provisions of the long-term guarantee package. As a result, it was decided to conduct impact assessment to decide on the final provisions.

The impact assessment took place between 28 January and 31 March 2013. The European Insurance and Occupational Pensions Authority (EIOPA) released its findings in June 2013.

2. The Solvency II implementation obstacles

The Solvency II Directive (2009/138/EC) on the financial position of insurance undertakings had to be adapted in response to: new architecture for its implementing measures introduced in the Lisbon Treaty (2009) new financial supervision measures introduced in Regulation 1094/2010 establishing the European Insurance and Occupational Pensions Authority.

In order for the ESFS to work effectively, changes to the financial services legislation would be necessary, in particular to provide an appropriate scope to the more general powers provided for in the individual regulations establishing the authorities, ensuring a more harmonized set of financial rules through the possibility to develop draft technical standards and facilitate the sharing, where necessary, of micro-prudential information.

The Commission Communication on Financial Supervision in Europe was accompanied by an impact assessment analyzing the main policy options for establishing the ESFS and ESRB. A second impact assessment accompanied the legislative proposals, examining the options in more detail and analyzed the options for the appropriate powers for the authorities to work towards achieving a single set of harmonized rules and concluded that this capacity would be rightly limited to those areas to be defined in forthcoming sectorial legislation, and identified such potential areas. Additionally, in developing the draft technical standards themselves, the authorities should undertake appropriate analysis of potential related costs and benefits and consult stakeholders before submitting them to the Commission.

These changes will be implemented through the "Omnibus II directive", currently in negotiations between Parliament and Council. The Framework Directive is principles-based, and the detailed rules of the Solvency II regime will be contained in Implementing Measures adopted by the Commission, and covering about 40 important areas in the Framework Directive. The Commission will propose implementing measures after Omnibus II directive enters into force.

The changes to be made to the Solvency II Directive aim to:

- to adjust existing level 2 empowerments to the Lisbon Treaty: existing level 2 empowerments should be transformed into empowerments for delegated acts. Also appropriate control procedures should be foreseen;
- provide for transitional requirements in relation to valuation, governance, supervisory reporting and public disclosure, the determination and classification of own funds, the standard formula for the calculation of the Solvency Capital Requirement and the choice of methods and assumptions for the calculation of technical provisions, including the determination of the relevant risk-free interest rate term structure. It is also necessary to enable level 2 measures to specify transitional arrangements in relation to the treatment of third country regimes. The transitional requirements should not result in more favorable treatment for insurance and reinsurance undertakings, or lower protection for policy holders. They should encourage undertakings to move towards compliance with the particular requirements of the new regime as soon as possible;
- amend level 2 empowerments: in order to allow for greater convergence on procedures for supervisory approvals already provided for in Solvency II (specific parameters, model change policies, special purpose vehicles and the setting and removal of capital add-ons), the Commission should be empowered to adopt measures by means of delegated acts specifying procedure in these areas;
- include the European Cooperative Society (SCE) in the list of permissible forms of insurance and reinsurance undertakings;

- introduce an amendment to reflect the adaptation to the Euro amount of the MCR floor for captive reinsurance undertakings.

The first Quick Fix Directive stated that the application date for Solvency II is 1 January 2014. However, delays to the agreement on the final text of the Omnibus II Directive have made this date unworkable. The issue under discussion was a long term guarantee (LTG) package. It was decided that an impact assessment was necessary before legislation could be finalized.

3. Long-term guarantee package and policyholder protection

Experts agreed that Solvency II should include regulatory measures to deal with the issues associated with long-term guarantees insurance products that may be affected by short term volatility (Bourdais, 2012). In this context, short-term volatility is volatility of technical provisions, capital resources (known as own funds) or capital requirements that does not reflect changes in the financial position or risk exposure of insurance or reinsurance undertakings carrying out insurance business of a long-term nature. The long-term guarantee package has been tested in the context of the Long-Term Guarantees Assessment and comprises different elements which are partially applicable for a short or medium term only. The following measures are part of the LTG package:

Table 1. Long-term guarantee package measures. *Source:* Lloyd's

No.	Measures	Content of measure
1.	Applicable only in exceptional financial market circumstances / crises	Counter-cyclical premium: national or currency-specific Pillar 1 adjustment to the risk-free rate applicable to all types of insurance business
2.	Applicable to certain long-term business for a transitional period:	Extension of the recovery period: undertaking-specific Pillar 2 measure granting more time to recover from undercapitalization for undertakings with liabilities > 12 years;
3.	Transitional LTG measure	Undertaking or portfolio-specific Pillar 1 adjustment to the risk-free rate for certain long-term guarantee products (restricted to 7 years) ;
4.	Permanently applicable to Extrapolation	Currency-specific Pillar 1 tool determining the risk-free term structure after the Last Liquid Point.
5.	Extended „Matching Adjustment“	Portfolio-specific Pillar 1 adjustment to the risk-free rate for long-term contracts with matched assets and liabilities, and without policyholder options
6.	Classical“ Matching Adjustment“	Portfolio-specific Pillar 1 adjustment to the risk-free rate for life contracts and non-life annuities

The overall aim of the LTG package is to provide more stability to the economic balance sheet of insurers and thus to the European insurance market as a whole by ensuring that Solvency II includes appropriate regulatory measures to deal with issues associated with long-term guarantee products that may be especially affected by short-term market movements. This is generally supporting policyholder protection. On the other hand, many participants raised the concern that any measure which increases the discount rate and therefore decreases technical provisions has the potential impact of reducing policyholder protection. For the most part, the tested LTG measures could result in an increase of the discount rate (apart from the extension of the recovery period), and so there is a clear potential risk to policyholder protection. The objectives of the technical impact assessment were to evaluate:

- the impact of the proposed LTG package on policy holder protection;
- whether the proposed LTG package will allow supervisory authorities to supervise insurance and reinsurance undertakings and insurance and reinsurance groups efficiently and effectively;
- whether the proposed system can be implemented efficiently and effectively by all insurance and reinsurance undertakings and the cost of implementation;
- whether the proposed system provides the right incentives for good risk management and wide risk diversification and contributes to the correct risk reflection of the undertakings;

- the impact on financial stability and whether the proposed system has the potential to create systemic risks;
- the impact of the proposed LTG package on the single market, including on crossborder business;
- the impact of the proposed LTG package on insurance and reinsurance undertakings' solvency position and also possible competition distortions in national markets and the single market;
- the impact of the proposed LTG package on long-term investments by insurance and reinsurance undertakings.

In order for the Long Term Guarantee measures to be effective in adjusting the current Solvency II framework to cope with artificial volatility and low interest rate environment, and to ensure both transparency and level-playing field, there are proposed the following changes to the Long Term Guarantee Package: 1) Extrapolation, 2) Matching adjustment, 3) Volatility adjustment, 4) Extension of recovery period, 5) Transitional measure on the risk-free interest rates, 6) Transitional measure on technical provisions.

3.1. Extrapolation

The Solvency II Extrapolation has become a central element of the Long-Term Guarantees package. An economic extrapolation is a method of using known market values to estimate, or “extrapolate”, future values for which there is no accurate market data. In Solvency II it is used to smooth market volatility at the long-end of the interest rate curve by providing a more stable regulatory risk-free rate against which insurers’ long-term liabilities can be discounted (Fulcher, 2013).

Essentially the Solvency II Extrapolation is comprised of three elements:

- 1) the fixed interest rate to which long-dated forwards are assumed to converge (the Ultimate Forward Rate or UFR);
- 2) the point from which market data is no longer used (the Last Liquid Point or LLP);
- 3) and the rate of convergence from market rates at the LLP to the UFR.

EIOPA advised to select a convergence period that is significantly longer than 10 years (e.g. 40 years) for the euro, as it should decrease more efficiently the volatility of own funds because it produces risk-free rates that are more market consistent, and gives also better incentives for good risk management. On the concerns whether the impact of extrapolation should not be publicly disclosed in the same way as for the matching adjustment, the volatility adjustment or the transitional measures, one can stress that the extrapolation is not a measure undertakings may choose but the prescribed method for derivation of discount rate when the risk-free interest rate can no longer be observed in financial markets. The extrapolation method used should be disclosed in the report on solvency and financial conditions together with the description of other methods used for the valuation of assets and liabilities, associated risk and sensitivities.

During the crisis, markets experienced severe falls in prices of equity and credit assets accompanied by significant falls in long-dated yields. Insurers and pension funds in Europe, particularly in the Netherlands and Scandinavia were already subject to mark-to-market and risk-based capital rules, and as a result came under solvency pressure. They were forced to reduce risk and hedge rates to protect solvency, but this further depressed long-dated rates creating a pro-cyclical effect, as shown on Fig. 1.

Fig.1 shows the difference between market forward rates at a 25 year and 15 year maturity for EUR and GBP. In the absence of supply-demand distortions, e.g. caused by regulatory-driven asset-liability hedging, one would expect this difference to be small and positive, and indeed this is the underlying assumption of Solvency II Extrapolation. Actual market rates show a different situation (Fulcher, 2013). Article 76 of the Solvency II Directive requires that technical provisions would be consistent with market prices and financial market data. Extrapolation was originally proposed only as a theoretical technique to place a market-consistent value on a non-traded item, namely ultra-long-dated cash-flows past the term of any traded instruments, for example after 50 years in Euro (EUR). Following the global financial crisis, stakeholders started to question the reliability of market data and the potential impact of market-consistent valuation on macro-economic stability. Extrapolation was identified as a possible tool to manage pro-cyclicality.

Criticism against Solvency II calibrations has been raised before, arguing, for example, that the Standard Formula is unstable with respect to distributional settings or the inappropriate choice of indices proxying specific equity classes (Mittnik, 2011).

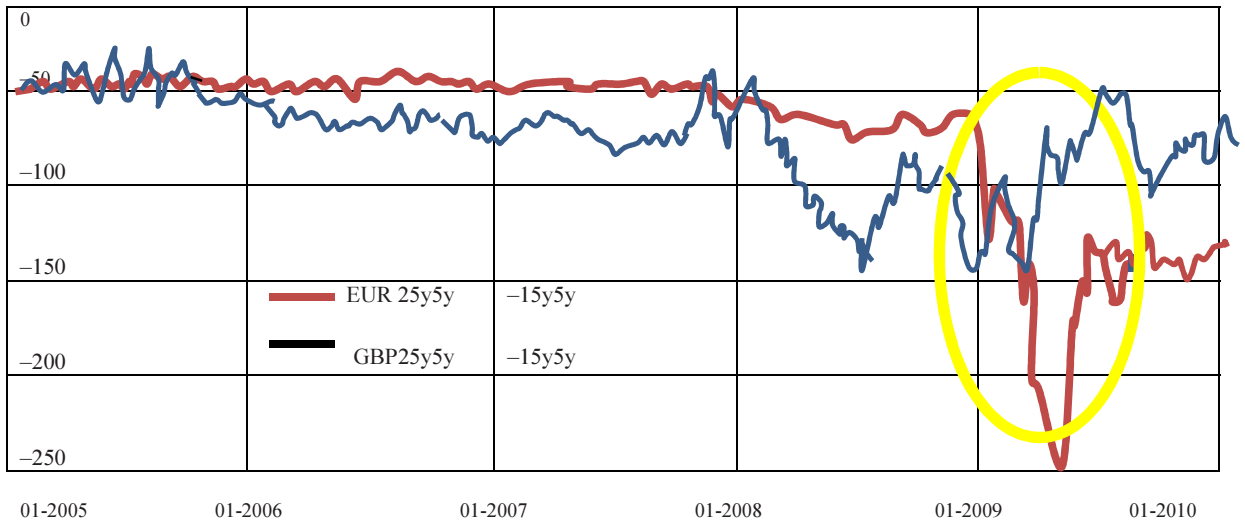


Fig. 1. Distortions in EUR and GBP curves. Source: Nomura

3.2. Matching adjustment

Strict ring-fencing is one of the fundamental conditions to use classic matching adjustment. Nevertheless, the ring-fencing requirement should be understood in an economic sense and should not hinder the use of the matching adjustment in Member States where there is no legal concept of a ring-fenced fund in national legislation.

Ring-fencing requires that the undertaking organizes and manages the portfolio of assets and obligations separately from other parts of the business and therefore is not able to meet risks arising elsewhere in the business using ring-fenced assets. This should not hinder an efficient portfolio management as recommended by EIOPA. However the reduced transferability and scope for diversification between the ring-fenced portfolio and the remainder of the undertaking needs to be reflected in calculation of own funds and the Solvency Capital Requirement.

As there is no objective reason for the different floor to the fundamental spread, the exposures in corporate debt should be treated equally to exposures in sovereign debt. It would not favor investments in sovereign debt but should encourage long term investments in corporate bonds and thereby promote economic growth (Eling, Pankoke, 2013).

Where no reliable credit spread can be derived from default statistics, as it might be for government bonds, the fundamental spread should be equal to the floor of the fundamental spread, calculated as a portion of the long term average of the spread over the risk-free interest rate of assets of the same duration, credit quality and asset class, as observed in financial markets.

For exposures to sovereign debt, the 'asset class' should capture the differences between individual Member States, as tested in the LTGA.

It should be noted that there are other elements of the matching adjustment framework that should enable to ensure its prudence and transparency. The matching adjustment may be applied subject to prior approval by the supervisory authority. Undertakings applying the matching adjustment should regularly perform sensitivity analysis to the assumptions underlying the calculation of the matching adjustment and assess compliance with the eligibility criteria for application of the matching adjustment on a continuous basis through Own Risk and Solvency Assessment.

In addition, the matching adjustment will be accompanied by the public disclosure of the application of this measure together with the full impact on the undertakings' financial position, in the same way as other Long Term Guarantee measures, in order to ensure transparency, comparability and a level-playing field. Public disclosure of the impact of the measure on the undertaking's financial position should not lead to wrong conclusions nor create

confusion amongst the public. If undertaking explains that through sound risk management the matching adjustment enables to offer to policyholders more attractive insurance products, thus increasing the value of the undertaking, ensuring the future sustainability of the business and consumer protection, stakeholders will reward such behavior, particularly in the current low interest rate environment. Table 2 shows that under the current regime, insurers across Europe have typically regarded particular assets as a good match for long-term liabilities. In practice, this has meant holding corporate bonds in the UK and Spain, while French and Portuguese insurers prefer equities. Italian insurers have favored domestic government bonds.

Table 2. Countercyclical measures & LT package by region. Source: Nomura

Country	Long-term liabilities	Corporate bonds	Equities	Domestic government bonds
United Kingdom		x		
Spain		x		
French			x	
Portuguese			x	
Italy				X

3.3. Volatility adjustment

The spread on the reference portfolio for the volatility adjustment should be determined in a transparent manner using relevant indices where available. As the volatility adjustment would be a predictable adjustment, calculated on a permanent basis, the determination of the spread on the reference portfolio should be simple and based on indices where available.

The volatility adjustment is designed to mitigate the effect of exaggerations of bond on undertaking's own funds. It allows the inclusion in the discount rate of a portion of the spread observed on a representative portfolio of sovereign and corporate bonds held by European insurers. This portion of spread should not be attributable to a realistic assessment of expected losses, unexpected credit risk or any other risk of the assets, and it should reflect only "artificial volatility". In addition, the use of the portfolio of assets held by the market at EU or level, instead of the actual portfolio of assets held by each undertaking, should prevent undertakings' incentives to invest in riskier assets.

The volatility adjustment would apply to all types of insurance obligations, life and non-life, without any eligibility conditions (except unit-linked liabilities) however the effect of application on major part of non-life insurance obligations would be limited because of the short duration of non-life insurance contracts.

The volatility adjustment was proposed to substitute the counter-cyclical, which raised financial stability issues in relation to its activation/deactivation and the benefit of which was partially offset by additional capital requirements. The volatility adjustment should not have these drawbacks.

The volatility adjustment would be a predictable adjustment, reflecting the situation of financial markets on a permanent basis, thus it would not be a permanently positive addition to the discount rate but would be close to zero under normal circumstances and could even turn, when markets are excessively optimistic (when the observed spread is lower than the fundamental spread), thus giving some symmetry to the measure.

3.4. Extension of recovery period

The conditions for the application of the extension of the recovery period needs to be clarified in order to make sure that this measure is applicable when exceptional adverse situations affect insurance and reinsurance undertakings representing a significant share of the market or affected lines of business.

There are also further changes made to the first Presidency compromise text, in order to clarify the roles of both national supervisory authority and EIOPA for the declaration of exceptional circumstances and when those

circumstances cease to apply, as well as for assessing if the conditions for applying the measure still persist. This should ensure a harmonized application of this measure.

Concerns have been expressed that the 7 years length of the extension of recovery period is very long, but it should be noted that the Directive prescribes the maximum length of the extension and it is expected that national supervisory authority will not make use of that maximum extension in many cases.

3.5. Transitional measure on the risk-free interest rates

Where Member States have adopted laws, regulations and administrative provisions pursuant to Article 20 of Directive 2002/83/EC, the Solvency I interest rates for the calculation of transitional interest rates should be determined using the methods used by the insurance or reinsurance undertaking at the last date of the application of Directive 2002/83/EC. This should allow Member States that have a variable rate under Solvency I to apply the method rather than simply the rate applicable at the transposition date.

There are other features of this measure that should ensure right incentives. The transitional measure on the risk-free interest rates may be applied subject to prior approval by the supervisory authority. As well as for other Long Term Guarantee measures, the application of the transitional measure on the risk-free interest rates should be publicly disclosed together with the calculated transitional interest rate and the impact of this on undertaking's financial position. In addition, undertakings should regularly assess whether they would comply with the Solvency Capital Requirement without application of the transitional interest rate and, if not, inform supervisory authority about actions taken and progress made to restore the compliance with the Solvency Capital Requirement at the end of the transitional period.

3.6. Transitional measures on technical provisions

The Solvency I technical provisions effectively being calculated in Member States should be used for the calculation of the transitional adjustment for technical provisions

The transitional measure on technical provisions is calculated as a difference between the values of technical provisions under Solvency I and Solvency II, then gradually amortizing this amount to zero over the transitional period. Technical provisions should be calculated net of reinsurance, in order to evaluate reinsurance assets as well, following a total balance sheet approach.

This measure may be used not only in markets where the difference in technical provisions is due to different discount rates, but in markets where the difference in technical provisions stems from other features than the discount rate (e.g. because of the risk margin or different contract boundaries). This broader transitional measure would be applicable to all obligations, life and non-life.

For the same reasons as in the case of the transitional measure on the risk-free interest rates (having Solvency II balance sheet adjusted to show allowance for transition) was proposed that this transitional measure should impact the technical provisions and the Solvency Capital Requirement rather than being only an adjustment to own funds.

The length of the period of the transitional measure on technical provisions still needs to be discussed.

It should be noted that the additional requirements for supervisory approval, public disclosure and solvency without application of transitional measure should enable to ensure adequate prudence, transparency and give the right incentives for the application of this measure.

4. Conclusions

After the impact assessment EIOPA analyzed each measure and recommended the inclusion of the following measures:

- Extrapolation – important for valuing insurance liabilities in the absence of reliable market information;
- Classic Matching Adjustment – important for insurance products, such as annuities, which have predictable payments to policyholders and allow for strict cash flow matching;

- Transitional Measures – important for insurance products offering high interest guarantees that were concluded in the past, in order to smooth the transition from Solvency I to Solvency II; and
- Extension of the Recovery Period – allows undertakings sufficient time to restore compliance with capital requirements in exceptional situations.

EIOPA advises not to include the so-called Extended Matching Adjustment on the basis that it would not provide sufficient policyholder protection and would be unduly difficult to supervise. In addition, the Counter-Cyclical Premium (CCP) was judged to be likely to have an adverse financial stability impact due to the way it would be triggered, as well as unintended impacts on undertakings' solvency requirements that it generated. As a consequence, EIOPA advises to replace the CCP with a permanent, more predictable measure, the Volatility Balancer, which like the CCP mitigates the impact of bond spread volatility on own funds but avoids side-effects on capital requirements.

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