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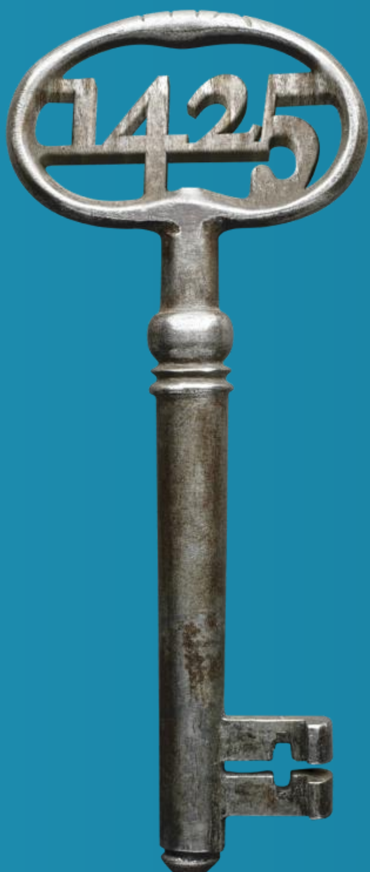

Solvency II
Change your mind and mind the change!

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Solvency II : a child is born
Is it a boy or is it a girl?

Why Solvency II?

- Solvency I as designed in the 70’s is not sufficiently risk based
- Solvency I does not encourage insurers to better manage their risks
- Solvency I does not attach sufficient importance to the qualitative aspects of supervision
- Solvency I does not include an early warning signal
- Solvency I does not attach sufficient importance to group supervision

Solvency II: a remedy or a problem

- There is a growing awareness across the globe that a risk based solvency regime is needed
- The S II project was inspired by reforms within the EU (i.e. UK & NL) and outside the EU (i.e. CH & AUS)
- Because of a lack of international pressure (contrary to Basel III) the EU project has taken a lot of time
- Many insurers have improved their risk management, but the absence of a requirement to change – and the delays - have had a negative impact on the readiness and willingness of companies to change

Solvency II: 3 pillars and a roof

Group supervision & cross-sectoral convergence

Groups are recognised as an economic entity => supervision on a consolidated basis (diversification benefits, group risks)

Pillar 1: quantitative requirements

1. Harmonised calculation of technical provisions
2. "Prudent person" approach to investments instead of current quantitative restrictions
3. Two capital requirements: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR)

Pillar 2: qualitative requirements and supervision

1. Enhanced governance, internal control, risk management and own risk and solvency assessment (ORSA)
2. Strengthened supervisory review, harmonised supervisory standards and practices

Pillar 3: prudential reporting and public disclosure

1. Common supervisory reporting
2. Public disclosure of the financial condition and solvency report

(market discipline through transparency)

Main characteristics of Solvency II

- Market consistent valuation of assets and liabilities
- Total balance sheet approach
- Two capital requirements: SCR with confidence level of 99,5% VaR over a one year time horizon and MCR with absolute floor
- Possibility to calculate the SCR using an internal model approved by the supervisor
- Three pillar approach introduced by Basel II for banks
- Extended and fully harmonised supervisory powers
- Group supervision on equal level with solo supervision

Proportionality Principle

- Applies to all three pillars, i.e. quantitative requirements, qualitative requirements and disclosure
- Applies also to the exercise of supervisory powers
- MS must ensure the application of this principle when implementing the SII legislation
- EC must ensure the application of this principle when adopting delegated acts, RTS or ITS (Omnibus II)
- EIOPA must ensure the application of this principle when developing draft RTS, draft ITS, guidelines or recommendations (Omnibus II)

Proportionality Principle: why?

- Objectives:
  - Ensure that the regime is not too burdensome for SME's by taking account of the nature, scale and complexity of their business
  - Ensure that the regime takes account of the particular nature of specific industries, such as
    - Captive insurance and captive reinsurance undertakings
    - Reinsurance undertakings

Proportionality Principle: examples

- Use of undertaking specific parameters
- Combination of governance functions (exc. Internal audit)
- Use of outside experts or outsourcing
- Application of the ORSA requirement
- Supervisory reporting (Omnibus II)
  - Exemption from quarterly reporting
  - Exemption from reporting on item-by-item-basis
- Public disclosure: Solvency and Financial Conditions Report
- Simplified methods and techniques to calculate TP

Legislative Process - **Lamfalussy**

Level 1: Framework Directive

Level 2: Implementing Measures (Commission)

Level 3: Convergent implementation assisted by close co-operation between national authorities

Level 4: Rigorous enforcement of Community legislation by the Commission

Recapitulation of the process

- Framework Directive adopted in 2009 (level 1)
- Draft implementing measures prepared by the EC during the course of 2009-2011 (level 2)
- Draft supervisory guidance prepared by EIOPA in 2011-2012 (level 3)
- Date of first time application: 1 November 2012

Financial crisis

- Already influenced the Framework Directive, for instance more emphasis on financial stability
- Impacted the draft level 2 measures developed by EC
- Showed very clearly in QIS 5 results (2010-2011)
  - Volatility in TP and own funds particularly in the case of long term guarantees
  - Existing contracts hit by low interest rate environment
- New EU supervisory architecture
  - CEIOPS becomes EIOPA

Omnibus II – Time out

- Adaptation of Framework Directive to include changes resulting from the transformation of CEIOPS into EIOPA
- Inclusion of new powers for EIOPA in order to deal with the problem of artificial volatility in the measurement of TP relating to LTG
- Inclusion of transitional measures to facilitate the transition from Solvency I to Solvency II
- Change of the date of first application from 1 November 2012 to 1 January 2013

Omnibus II: longer than expected

- Proposal came out later (January 2011 instead of December 2010) than expected because of delay with final adoption of Omnibus I (November 2010 instead of September 2010)
- General approach agreed in Council in September 2011
- Vote in ECON (EP) in July 2012
- Trilogue meetings from July 2012 onwards
- Quick Fix 1 Directive (September 2012) with new dates:
  - date for implementation by MS: 30 June 2013
  - date for first time application: 1 January 2014

Why the delay on Omnibus II?

- Issues relating to Omnibus II:

  - EP wants LTG package in the Framework Directive

  - EP wants to Lisbonise Solvency II

  - EP raises other issues: sovereign bonds, transitional equivalence, proportionality, correspondence table, etc.
- Issues relating to negotiation process:

  - Fierce lobbying by the insurance industry

  - Difficult Trilogue process

  - Priority given to the banking regulatory agenda

From **Lamfalussy** to **Lisbon**

Level 1: More detailed Framework Directive

Level 2: Delegated Acts : Regulation (Commission)

Level 3: RTS and ITS developed by EIOPA
Endorsed by the EC

Level 4: Guidelines and Recommendations developed by EIOPA

What is in a name? DA-RTS-ITS

- DA are prepared and adopted by the EC: scrutiny of Council & EP : 3 + 3 (amended Comitology procedure)
- RTS are prepared by EIOPA and adopted by the EC : scrutiny of Council & EP : 3 + 3 or 1 + 1 + 1
- Most RTS foreseen for level 2 will now be adopted as DA prepared by the EC but are subject to sunrise clause
- ITS are developed by EIOPA and adopted by EC as IA
- Stakeholder Group must be consulted on draft RTS/ITS
- RTS : supplement or amendment of non-essential elements of a legislative act
- ITS: uniform application – no policy choices

Long term guarantees

- Market turbulence creates artificial volatility in the calculation of TP and own funds
- Low interest rate environment makes it difficult to provide long term guarantees
- Low interest rates complicate a smooth transition from Solvency I to Solvency II
- A one size fits all solution is not possible because of the existence of different life products
- A European solution is necessary to avoid creating distortions in the internal market and to prevent a move away from a unified approach to solvency

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LTG package after Trilogue

- Matching adjustment (cannot be combined with volatility adjustment or interest rate transitional)
- Extrapolation
- Volatility adjustment (MS might require prior approval)
- Extension of recovery period (7y)
- Transitional measure on risk free interest rates (16y)
- Transitional measure on technical provisions (16y)
- Allowance for DA, RTS, ITS, annual reporting by EIOPA and reporting by EC after 5 years with possible review

Way forward

- Political Trilogue finished on 13 November 2013
- Further technical work needed before final decision
- Quick Fix 2 with 2 new dates: 31 March 2015 for implementation by MS and 1 January 2016 as start date for Solvency II
- Plenary vote in EP in March 2014 to be followed by agreement in Council
- Level 2 measures to be proposed by EC in summer 2014
- Level 3 measures (ITS) to be proposed afterwards by EIOPA, accompanied with guidelines
- Package to be concluded before end 2014 (or early 2015)

What does it mean for you?

- No more postponement of Solvency II “ad calendas graecas”
- Official start date of Solvency II: 1 January 2016
- Phasing in of Solvency II for approval processes through ITS and guidelines to be applied as of 1 April 2015:
  - Matching adjustment
  - Ancillary own funds
  - Undertaking Specific Parameters (USP)
  - Internal Models + Joint decision for group IM
  - Special Purpose Vehicles

MS must speed up implementation

- MS must ensure that supervisors have certain powers already from 1 April 2015, such as the power to require the establishment of a college of supervisors or to identify the group supervisor

- MS must ensure that supervisors have certain powers already from 1 July 2015, such as the power to determine the choice of method to calculate the group SCR or to determine the application of transitional measures

Other important issues in Omnibus II

- Flesh to the bone on proportionality (supervisory reporting)
- Notification of every authorisation or withdrawal of authorisation to EIOPA
- Avoidance of overreliance on external ratings
- Transitional period for disclosure of capital add-on or impact of specific parameters moved from 2017 to 2020
- Disclosure to EIOPA of number of undertakings or groups benefitting from exemption of quarterly reporting and reporting on an item-by-item basis

Other important issues in O II (2)

- Increase of powers for EIOPA to develop ITS (common procedures, forms and templates) or RTS
- Possibility for supervisory authorities to transmit information to central banks (including the ECB), monetary authorities, payment systems overseers and the ESRB
- Review by the EC of the SCR standard formula by 31 December 2020
- Increase in the absolute floor of the MCR
- Temporary equivalence for reinsurance (5 + 1)
- Provisional equivalence for subsidiaries in third countries (10 + 10)

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Other important issues in O II (3)

- Binding mediation through EIOPA (on-site verifications and inspections, approval of group internal model, centralised risk management, supervision of intra-group transactions, membership of college of supervisors, information concerning group undertakings)
- Annual disclosure of the legal structure, the governance and the organisational structure of groups
- Temporary equivalence in the case of a parent undertaking outside the EU (5 + 1)
- No technical change before two years after entry into force of the amended Solvency II Directive (= standstill)

Transitional measures in Omnibus II

- Specific regime for companies in run-off until 1 January 2019
- Non-qualifying capital instruments issued prior to 1 January 2016: ten years (Tier 1 or Tier 2)
- Gradual shortening of period for supervisory disclosure
  - From 20 weeks to 14 weeks for disclosure on an annual or less frequent basis
  - From 20 weeks to 14 weeks for the Solvency and Financial Conditions Report
  - From 8 weeks to 5 weeks for quarterly information

EIOPA GL - Interim measures (1)

- On 27 September 2013, EIOPA published the final Guidelines for the preparation of Solvency II after a consultation process with over 4000 comments
- The Guidelines are applicable from 1 January 2014
- The Guidelines are addressed to national supervisors (NCAs) who must decide how best to incorporate them into their national regulatory or supervisory framework
- The Guidelines introduce a phased-in preparation for SII and a consistent and convergent approach to the preparation across the EU

EIOPA GL - Interim measures (2)

- The Guidelines cover almost 400 pages and deal with four main areas
  - System of governance
  - Forward looking assessment of own risks
  - Submission of information to NCAs
  - Pre-application of Internal Models
- Each of these areas contains a number of individual Guidelines: governance (52 guidelines); forward looking assessment (25 guidelines); reporting (39 guidelines) and pre-application of internal models (70 guidelines)

EIOPA GL - Interim measures (3)

- NCA's were given until 31 December 2013 to tell EIOPA their intentions with respect to the Guidelines on a comply or explain basis
- NCA's of 31 EAA countries had to respond for each Guideline in one of 4 ways: 'comply', 'intend to comply', 'do not comply' or 'not applicable'
- In case of non-compliance or intention to comply, NCAs were asked to explain their action
- Results show that there is broad acceptance of the Guidelines and a strong intention to apply them

2014 : election year – tight deadlines

- EC will try to avoid renegotiation of draft level 2 measures (DA) and wants to concentrate on a few issues, such as calibration and LTG
- Scrutiny period for Council & EP: 3 + 3
- EIOPA 2014 Work Program provides for 22 ITS and 38 Guidelines
- EIOPA Stakeholder groups need to be consulted on ITS
- All texts need to be translated into 24 official languages and published in the Official Journal

What is going on now?

- Omnibus II text is being finalised in all official languages by jurists-linguists
- EC has sent an updated version of draft implementing measures on 10 January 2014 to MS which was discussed in a meeting of the Expert Group on Banking, Payments and Insurance (dedicated to insurance) on 28 January 2014 (follow-up meeting in March)
- EIOPA has coordinated with EC the timeline for the development of ITS and Guidelines
- No text can be tabled by the EC or EIOPA before official publication of Omnibus II

From CEIOPS to EIOPA

- EIOPA as technical adviser to the EC and to EP
- Leadership role for technical issues concerning insurance supervision (RTS)
- Representation in all (92) colleges of supervisors as supervisory authority
- Binding mediation, peer reviews
- Cooperation with ESRB
- Clear mandate to further develop market conduct rules
- Supervisor for cross-border insurance groups?

Change your mind

- Solvency II puts more emphasis on the responsibility of each individual undertaking
  - Investment strategy (prudent person)
  - Asset-Liability management
  - Governance functions
  - Own risk and solvency assessment
- Be prepared for a principle based approach
  - Don’t expect everything to be regulated
- Be prepared for regular meetings
  - With your friend: the supervisor!

Mind the change

- Solvency II is a complex regime because it better corresponds to the way insurers do their business
- The increased transparency requirements will bring about important changes in data collection - need to put in place appropriate IT system
- The introduction of a risk based solvency regime has consequences for
  - Internal organisation of the business
  - Product design and innovation
  - Distribution channels

Concluding remarks

- Solvency debate often too much focused on capital
- Need to concentrate on risk management and governance
- Finalisation of Solvency II at regulatory level is just the end of the beginning
- Role of EIOPA will become more important, i.e. national supervisors are no longer “omnipotent”
- Look for opportunities, regardless of the size of the business
- Decide for yourself what business you want to be
- Be pro-active and strategic rather than re-active and defensive

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