

Update Solvency II; Omnibus II, next steps

Baltic Actuaries' seminar Vilnius Wednesday 23 April 2014

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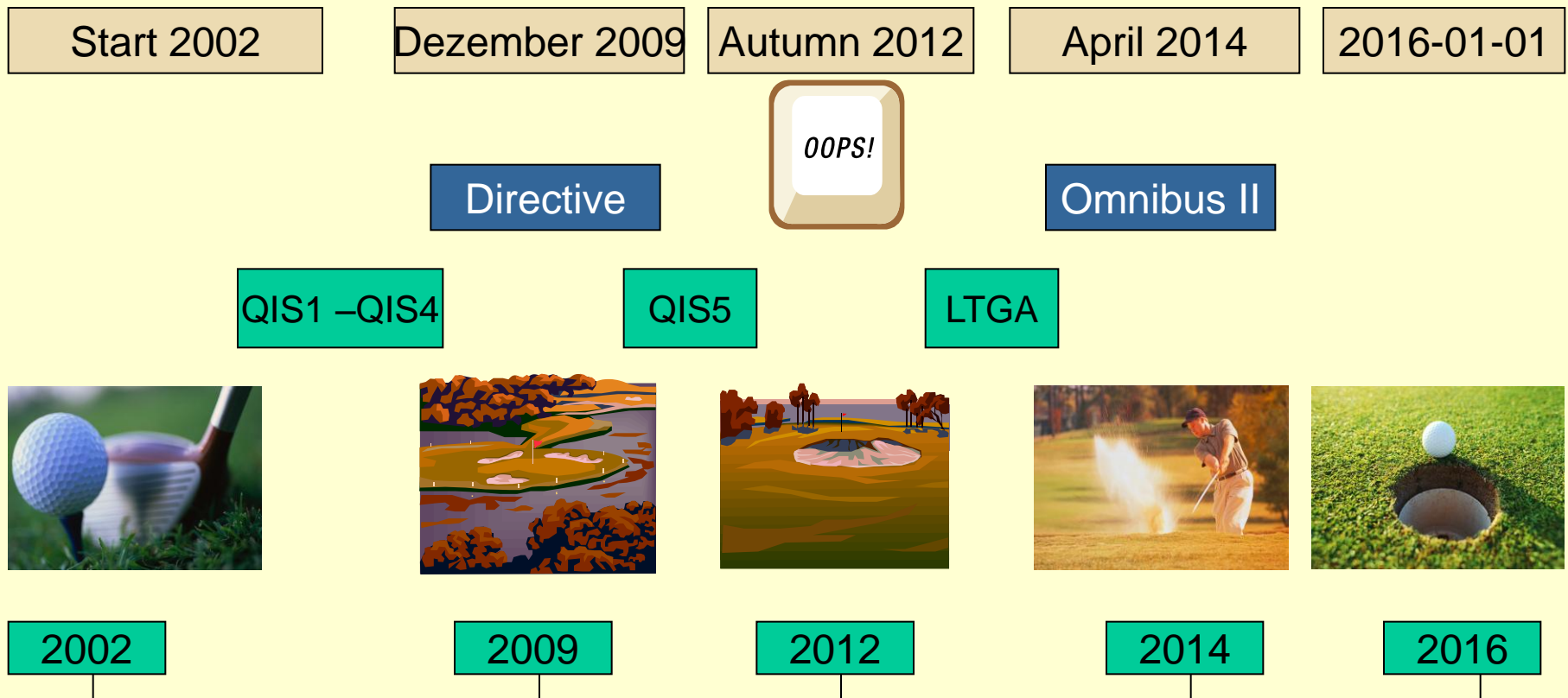
1. Status Solvency II

2. Next Steps

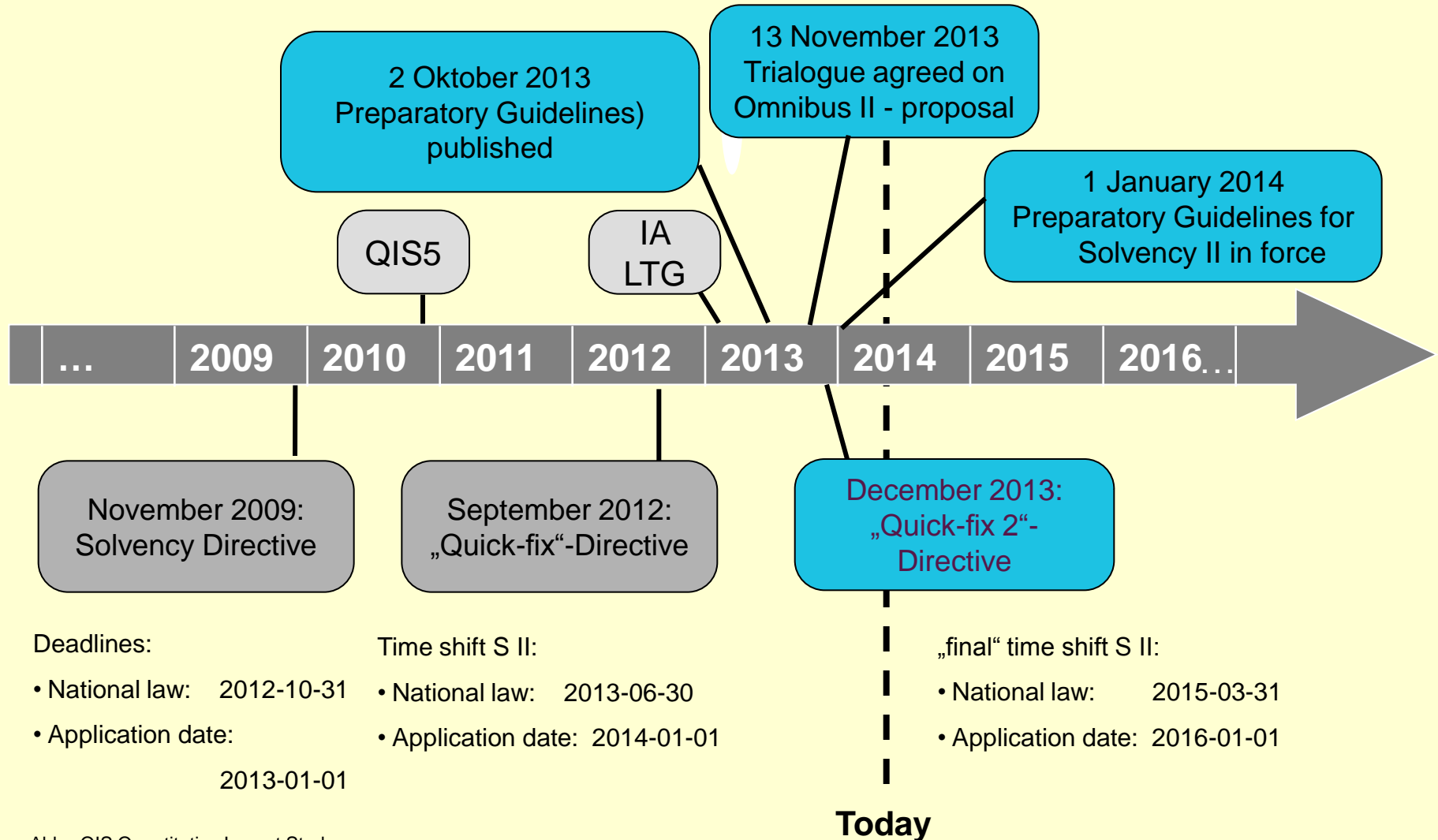
1. Status Solvency II

2. Next Steps

Only a matter of holing out?



Current Status of Solvency II activities



Deadlines:

- National law: 2012-10-31
- Application date: 2013-01-01

Time shift S II:

- National law: 2013-06-30
- Application date: 2014-01-01

„final“ time shift S II:

- National law: 2015-03-31
- Application date: 2016-01-01

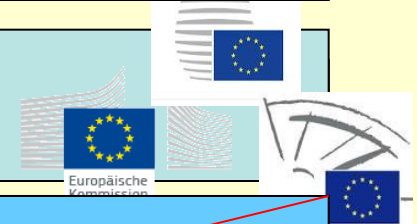
Level 1 – Directive is now adopted

11 March 2014: EU Parliament adopts Omnibus II – Directive
14 April 2014: European Council adopts Omnibus II - Directive
May 2014 (?): Publication in the Official Journal of the EU

Dezember 2013: Quick-Fix 2 Directive

Start 2016-01-01

November 2013: Trialogue – Parties agree on a
Compromise for a Omnibus II – Directive



September 2012 First Quick-Fix Directive

~~Start 2014-01-01~~

**17 December 2009: Directive 2009/138/EC of the European Parliament
of 25 November on the taking-up and pursuit
of the business of Insurance
and Reinsurance (Solvency II)**

~~Start 2013-01-01~~

Omnibus II Directive

The Solvency II Framework Directive (2009) 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
- Distortion in capital markets (EU-Crisis, Lehmann,...) showed the need for a change in technical details (e.g. risk free interest rate)

Valuation of long term business has been causal for the postponement



Directive, Article 76 **General provisions**

1. ...
2. The value of technical provisions shall correspond to the current amount insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking.
3. **The calculation of technical provisions shall make use of and be consistent with information provided by the financial markets and generally available data on underwriting risks (market consistency).**
4. Technical provisions shall be calculated in a prudent, reliable and objective manner.
5. ...

Article 77 Calculation of technical provisions

1. The value of technical provisions shall be equal to the sum of a best estimate and a risk margin as set out in paragraphs 2 and 3.
2. The best estimate shall correspond to the probability-weighted average of future cash-flows, taking account of the time value of money (expected present value of future cash-flows), using the relevant risk-free interest rate term structure.
 - The calculation of the best estimate shall be based upon up-to-date and credible information and realistic assumptions and be performed using adequate, applicable and relevant actuarial and statistical methods.
 - The cash-flow projection used in the calculation of the best estimate shall take account of all the cash in- and out-flows required to settle the insurance and reinsurance obligations over the lifetime thereof.
 - The best estimate shall be calculated gross, without deduction of the amounts recoverable from reinsurance contracts and special purpose vehicles. Those amounts shall be calculated separately, in accordance with Article 81.
3. ...

Sounds like an easy recipe for actuaries:

Calculation of technical provision:

- 1) Take up-to-date information, realistic assumptions, adequate statistical methods
- 2) Take account of all cash in- and outflows over the lifetime of the contract
- 3) Discount the cash-flow using risk-free interest rate term structure
- 4) Add a risk margin

Technical Provision

A market consistent value of an asset or liability is its market value, if it is readily traded on a market at the point in time that the valuation is struck, and, for any other asset or liability, a reasoned best estimate of what its market value would have been had it readily been traded at the relevant valuation point.
(Kemp 2009)

Market consistent value of Technical Provisions (standard procedure)

1. Identify the „space of replicating instruments“, as set of financial instruments available for valuation (traded in a deep, liquid and transparent market)
2. Replicate the resulting Cash Flows by financial instruments
3. Market consistent value of liability calculated as market price of replicating portfolio

(see GC-paper on Market Consistency 2012)

Standard procedure not (easily) applicable if

- 1) Capital Markets are incomplete
- 2) Space of replicating instruments for cash-flows is void
- 3) Liability driven asset allocation („held to maturity“,...)

Open issue

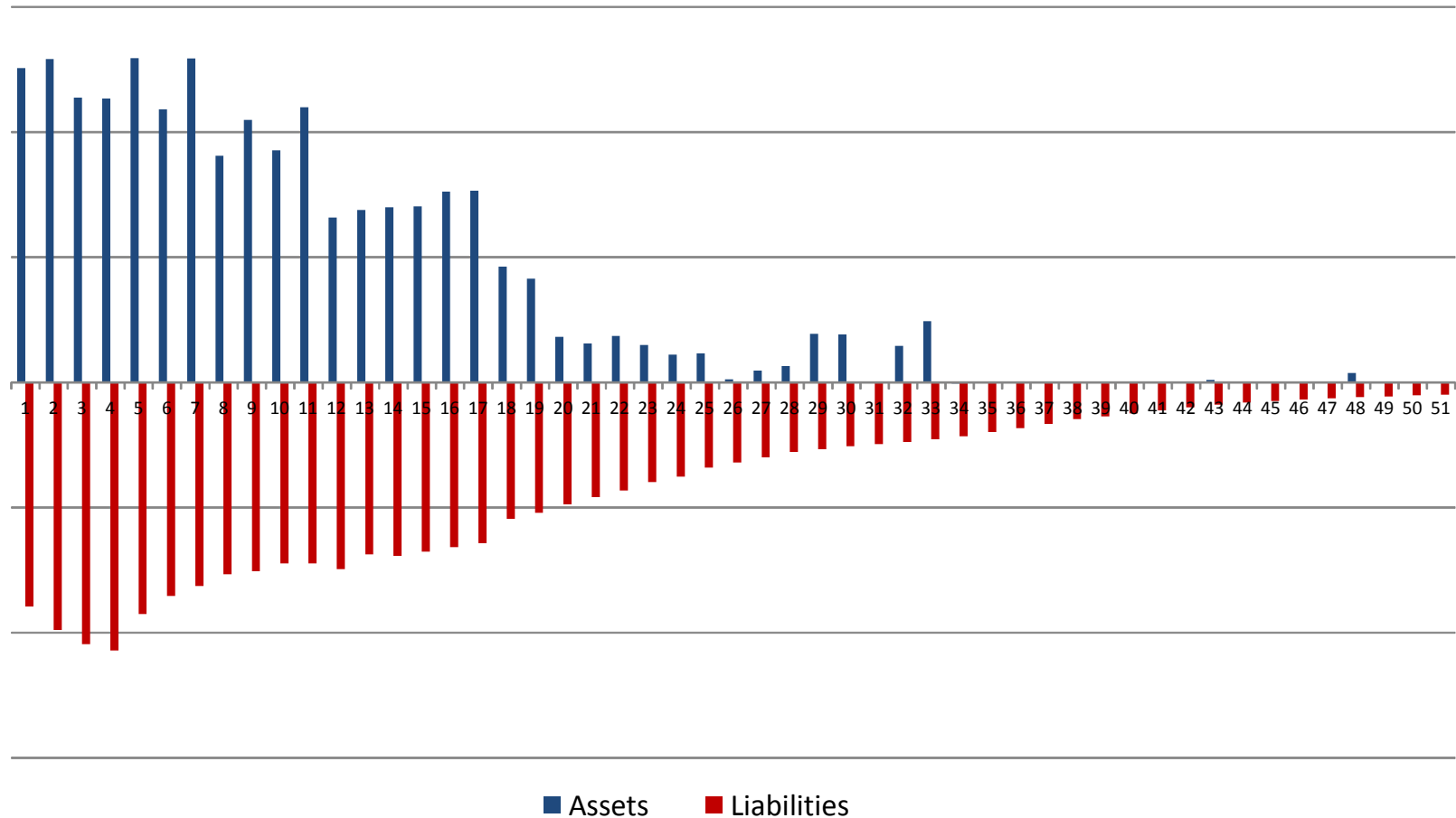
Prevailing legal framework:

- Market consistent valuation is core issue of Directive (art. 76)
- 99,5% confidence level is contained in Directive

Acknowledging this and being aware of limitations of market consistent valuation (mark-to-market) leaves an open issue !

Cash-flows resulting from liabilities are significantly longer than those from assets

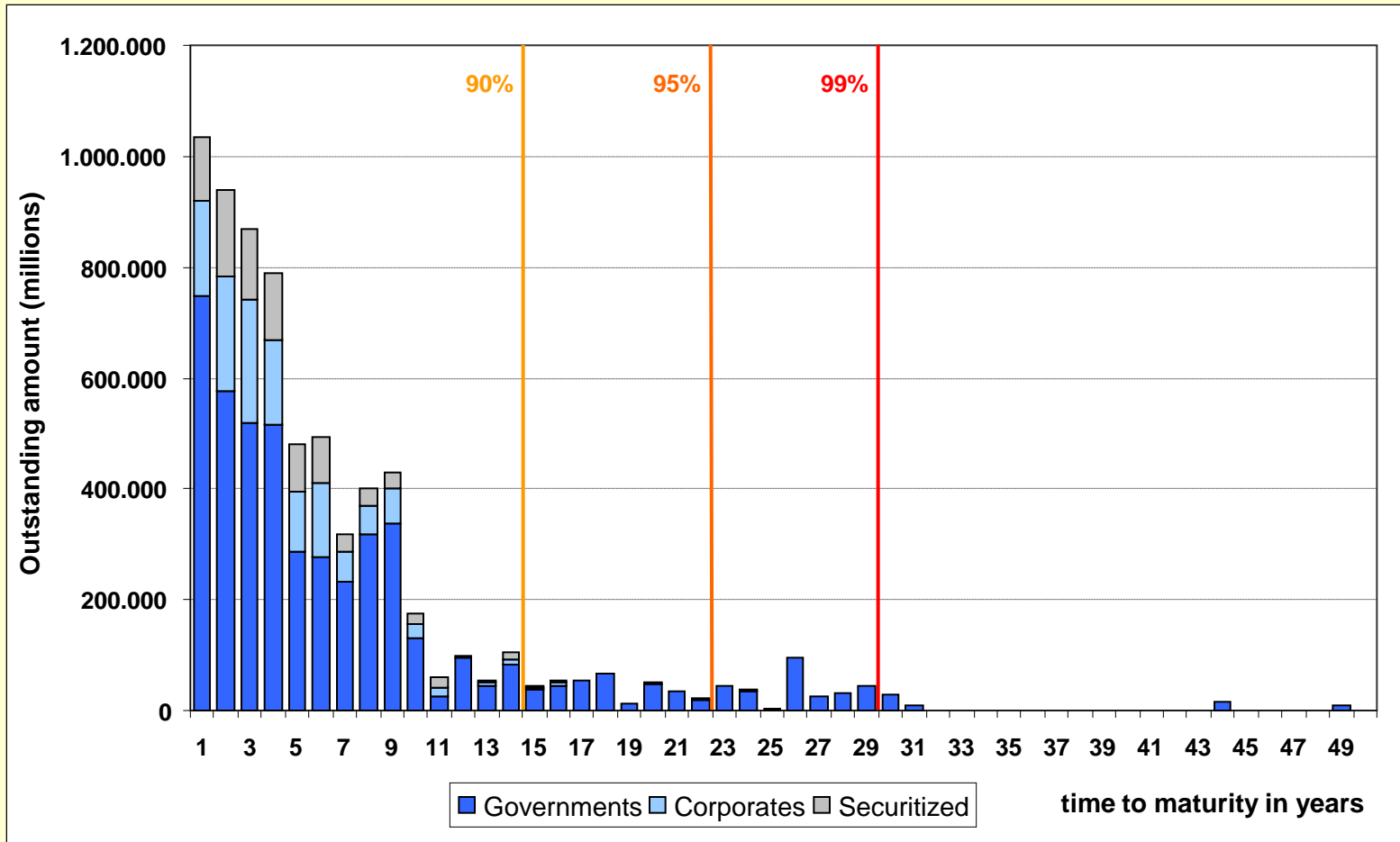
Cashflows of Assets and Liabilities



Last Liquid Point (LLP)

LLP – how liquid is the bond market in Eurozone?

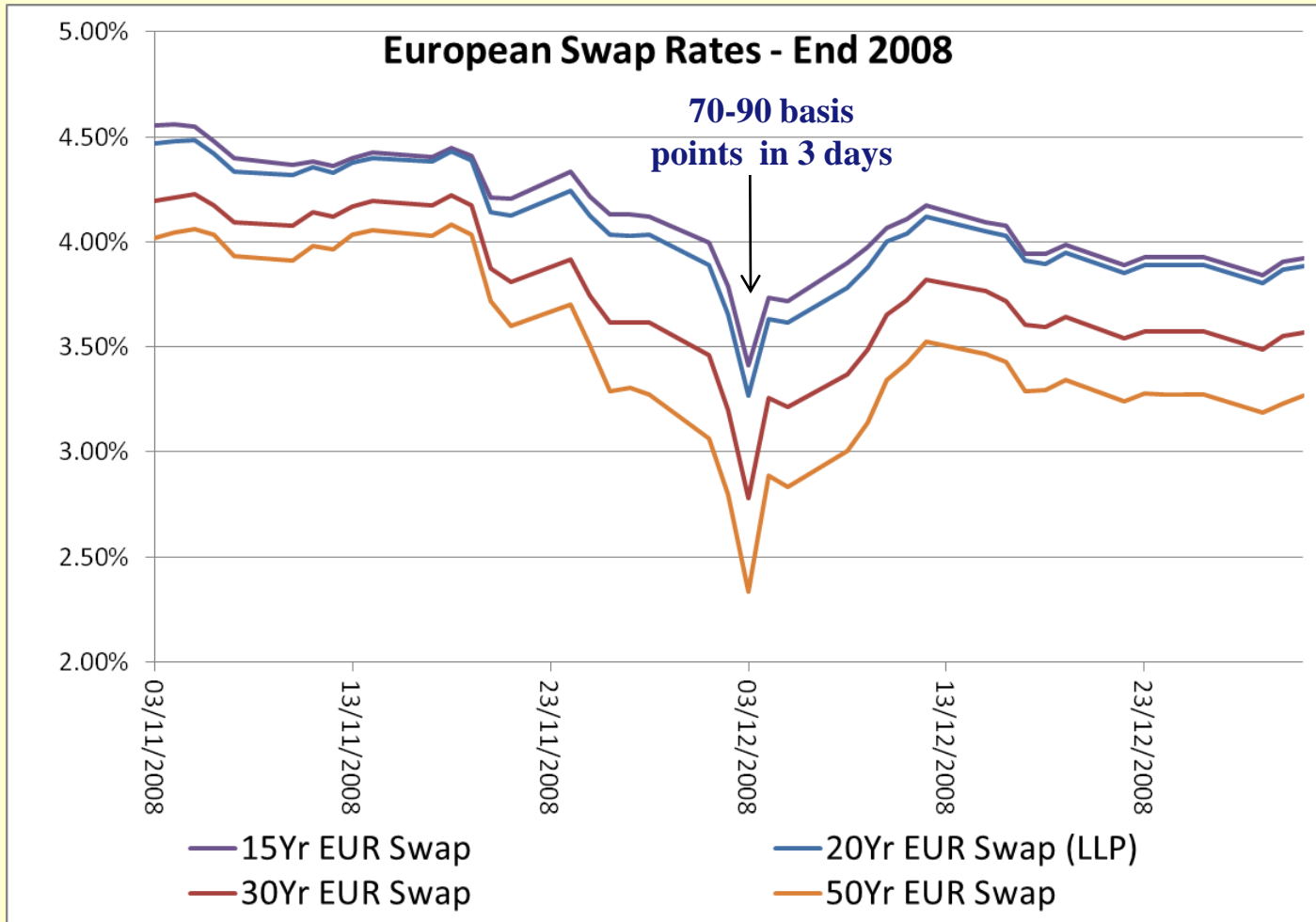
Source: Barclays Euro Aggregate Q1 2011



At very long terms a few transactions might influence the prices... but this is equally true before the LLP



Assumption: Caused by Danish pension funds; Attempt to match long term business (?)



Source: Bloomberg

Valuation in absence of an active, deep, liquid and transparent market

„Mark-to-model“ requires guidance for e.g.

- a) incomplete markets (temporarily distorted markets, ..)
- b) lack of replicating instruments (e.g. long term business)
- c) specific structure of Cash Flows („illiquidity“ of liabilities, ..)

Additional condition to be considered:

avoid artificial volatility, but provide proper information on risk inherent in business

In the QIS5 exercise adaptations of interest term structure had been tested (extrapolation, illiquidity premium, ...)

Autumn 2012: Trialogue Parties didn't come to an agreement about Omnibus II – Directive

Based on QIS5 – results there has been no consensus about the valuation of business with long-term guarantees.

EIOPA was mandated to perform a comprehensive field study to test all measures under discussion to adapt the interest rate term structure (Extrapolation, Counter Cyclical Premium, Matching Adjustment, transitional rules for backbook,...)

LTGA has been performed in 2013. Several scenarios and combinations of such adaptations have been tested.

Next steps to Omnibus II LTGA (Tested Supervisory Measures)

Extrapolation

- Extrapolation of yield curve
 - last liquid point?
 - extrapolation period?
- Ultimate forward rate UFR

Counter-Cyclical Premium (CCP)

- Shift of yield Curve to prevent from procyclical activities

CCP replaced by
„Volatility Adjustment“



LTGA Package

Matching Adjustment (MA)

- Depending on portfolio

Extended Matching
Adjustment not accepted

Transitional Measures (TM)

- No grandfathering
- Transitional period for backbook

19 June 2013: EIOPA published Final report and proposed a set of supervisory measures that were assumed to be suitable to ensure an adequate treatment of this business.

The final report contained also proposals for new supervisory measures that had not been tested within the LTGA.

Several of the proposed measures have been criticized by the industry and also by the actuaries.

Lithuanian Presidency worked out a compromise paper.

The Trialogue – Parties agreed on this paper 13 November 2013.

The finally agreed measures became part of the Omnibus II – Directive.

Besides the changes caused by the Lisbon – Treaty several supervisory measures related to the valuation of long term business are now part of the Omnibus II Directive

- a) Extrapolation of interest rate term structure (Art. 77a)
- b) Matching Adjustment (Art. 77b, c)
- c) Volatility Adjustment (Art. 77d)
- d) Transitional rules for backbook (16 years)
 - i. dynamic (Art. 308c)
 - ii. static (Art. 308d)
- e) Recovery Period extended to 7 years (Art. 138)

Status Omnibus II Directive

Adopted by European Commission: 11 March 2014 ✓

Adopted by European Council: 14 April 2014 ✓

Publication in the Official Journal: ?? May 2014

Article 77a

Extrapolation of the relevant risk-free interest rate term structure

The determination of the relevant risk-free interest rate term structure referred to in Article 77(2) shall make use of, and be consistent with, information derived from relevant financial instruments. That determination shall take into account relevant financial instruments of those maturities where the markets for those financial instruments as well as for bonds are deep, liquid and transparent. For maturities where the markets for the relevant financial instruments or for bonds are no longer deep, liquid and transparent, the relevant risk-free interest rate term structure shall be extrapolated.

Article 77b

Matching adjustment to the relevant risk-free interest term structure

1. Insurance and reinsurance undertakings may apply a matching adjustment to the relevant risk-free interest rate term structure to calculate the best estimate of a portfolio of life insurance or reinsurance obligations, including annuities stemming from non-life insurance or reinsurance contracts subject to prior approval by the supervisory authorities where the following conditions are met:

...

- (c) the expected cash flows of the assigned portfolio of assets **replicate each of the expected cash flows** of the portfolio of insurance or reinsurance obligations in the same currency and any mismatch does not give rise to risks which are material in relation to the risks inherent in the insurance or reinsurance business to which the matching adjustment is applied;*
- (d) the contracts underlying the portfolio of insurance or reinsurance obligations **do not give rise to future premium payments**;*

...

Article 77d

Volatility adjustment to the relevant risk-free interest rate term structure

1. ...
2. *For each relevant currency, the volatility adjustment to the relevant risk-free interest rate term structure shall be based on the spread between the interest rate that could be earned from assets included in a reference portfolio for that currency and the rates of the relevant basic risk-free interest rate term structure for that currency.*

The reference portfolio for a currency shall be representative for the assets which are denominated in that currency and which insurance and reinsurance undertakings are invested in to cover the best estimate for insurance and reinsurance obligations denominated in that currency.

3. *The amount of the volatility adjustment to risk-free interest rates shall correspond to 65 % of the risk-corrected currency spread.*

Article 77f Review of long-term guarantees measures and measures on equity risk

- 1. EIOPA shall, on an annual basis and until 1 January 2021, report to the European Parliament, the Council and the Commission about the impact of the application of Articles 77a to 77e and 106, Article 138(4) and Articles 304, 308c and 308d, including the delegated or implementing acts adopted pursuant thereto.*

Article 308c

Transitional measure on the risk-free interest rates

- 1. Insurance and reinsurance undertakings may, subject to prior approval by their supervisory authority, apply a transitional adjustment to the relevant risk-free interest rate term structure with respect to admissible insurance and reinsurance obligations.*

...

Article 308d

Transitional measure on technical provisions

- 1. Insurance and reinsurance undertakings may, subject to prior approval by their supervisory authority, apply a transitional deduction to technical provisions. That deduction may be applied at the level of homogeneous risk groups referred to in Article 80.*

...

in Article 45, the following paragraph is inserted:

"2a. Where the insurance or reinsurance undertaking applies the matching adjustment referred to in Article 77b, the volatility adjustment referred to in Article 77d or the transitional measures referred to in Article 308c and 308d, they shall perform the assessment of compliance with the capital requirements referred to in paragraph 1(b) with and without taking into account those adjustments and transitional measures.";

in Article 138, paragraph 4 is replaced by the following:

"4. In the event of exceptional *adverse situations affecting insurance and reinsurance undertakings representing a significant share of the market or of the affected lines of business*, as declared by EIOPA, and where appropriate after consulting the ESRB, the supervisory authority may extend, for affected undertakings, the period set out in the second *subparagraph* of paragraph 3 by a *maximum period of seven years*, taking into account all relevant factors *including the average duration of the technical provisions*.

Remarks from an actuary's perspective:

Some Supervisory Measures are obviously the result of negotiations and have clearly the character of compromises

There is still no satisfying definition of market consistency that takes account of the specifics of long term insurance business and its consequences for the resulting cash flows

The credit risk adjustment (35 bp in the LTGA) of the swap curve seems to be much too high. What is risk free?

Some settings (65% of spread for volatility adjustment) are a result of long discussions and are clearly compromises. Open questions are also related to the reference portfolio. Further analysis might help to come to better results in a next revision.

- 1. Status Solvency II**
- 2. Next Steps**

1. Status Solvency II

2. Next Steps

Michel Barnier, European Commissioner for Internal Market and Services (11 March 2014)

The Commission is now preparing the next stage of implementation of Solvency II, which will be the adoption of a Commission Delegated Act containing a large number of detailed implementing rules planned for the summer of this year. EIOPA is also working on a package of Implementing Technical Standards that will ensure that everything will be ready for the application of Solvency II on 1 January 2016."

Article 290

1. A legislative act may **delegate to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act.**

The objectives, content, scope and duration of the delegation of power shall be explicitly defined in the legislative acts. The essential elements of an area shall be reserved for the legislative act and accordingly shall not be the subject of a delegation of power.

2. Legislative acts shall explicitly lay down the conditions to which the delegation is subject; these conditions may be as follows:
 - (a) the European Parliament or the Council may decide to revoke the delegation;
 - (b) the delegated act may enter into force only if no objection has been expressed by the European Parliament or the Council within a period set by the legislative act.

For the purposes of (a) and (b), the European Parliament shall act by a majority of its component members, and the Council by a qualified majority.

3. The adjective "delegated" shall be inserted in the title of delegated acts.

Article 291

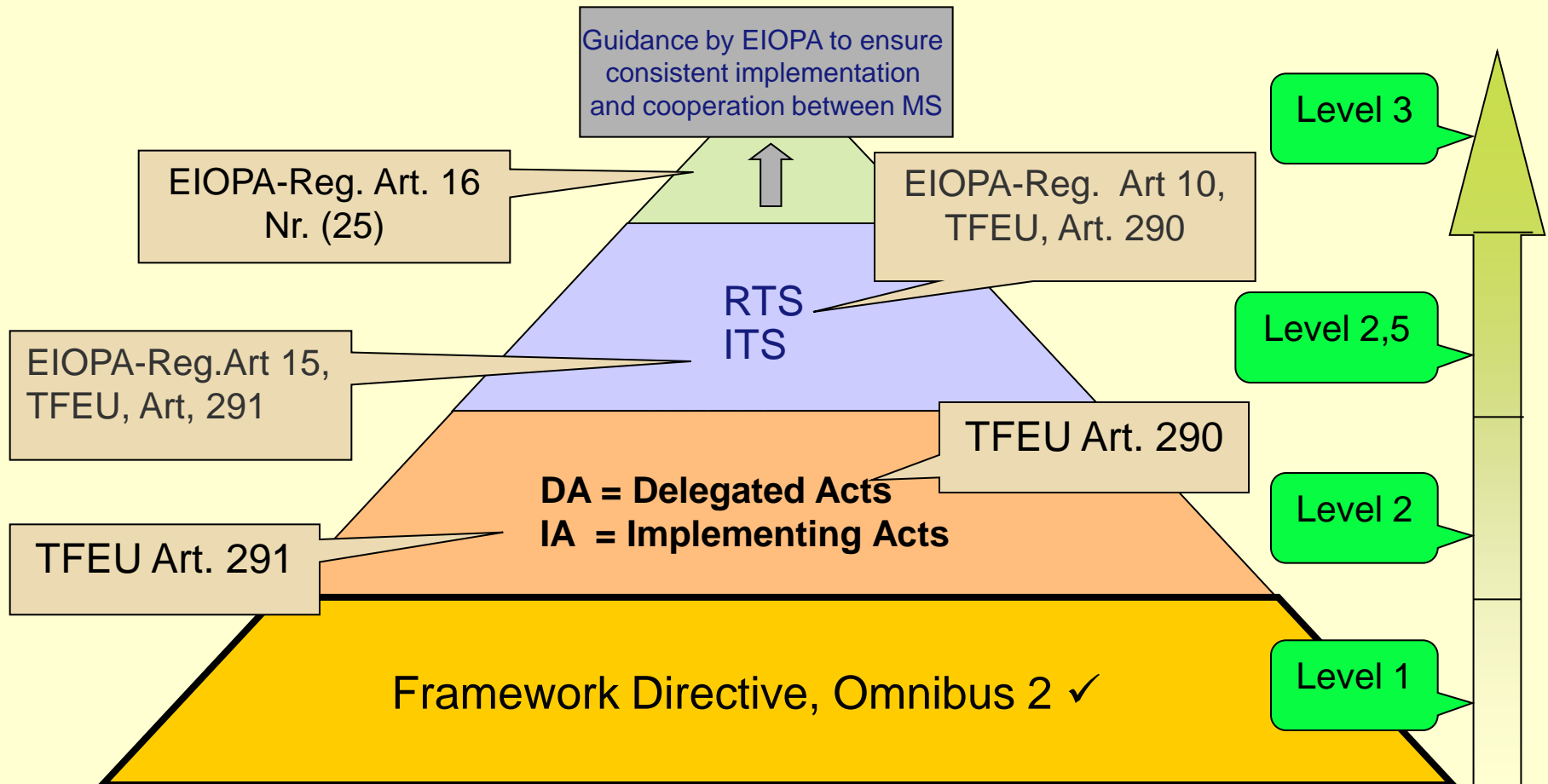
1. Member States shall adopt all measures of national law necessary to implement legally binding Union acts.
2. Where uniform conditions for implementing legally binding Union acts are needed, those **acts shall confer implementing powers on the Commission**, or, in duly justified specific cases and in the cases provided for in Articles 24 and 26 of the Treaty on European Union, on the Council.
3. For the purposes of paragraph 2, the European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, shall lay down in advance the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers.
4. The word "implementing" shall be inserted in the title of implementing acts.

REGULATION (EU) No 1094/2010 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 24 November 2010

**establishing a European Supervisory Authority (European
Insurance and Occupational Pensions Authority), amending
Decision No 716/2009/EC and repealing Commission Decision
2009/79/EC**

Further proceeding according to TFEU and EIOPA regulation



RTS = Regulatory Technical Standard
ITS = Implementing Technical Standard

Regulatory Technical Standards (RTS)

These are standards for the consistent harmonisation of rules in EU legislative acts.

Implementing Technical Standards (ITS)

These are standards for the uniform application of legally binding EU acts.

Areas to be covered, as proposed in the Omnibus II Directive, are:

- uniform reporting templates
- harmonised technical input to the standard formula
- harmonised procedures and templates for cooperation
- the exchange of information between supervisory authorities

Guidelines

The European Insurance and Occupational Pensions Authority (EIOPA) can issue guidelines to supervisors and undertakings which are not legally binding, but companies or supervisors not complying will have to explain their reasons.

Key products

The key products of this project will be the **Implementing Technical Standards (ITS)** and the **Guidelines for Solvency II**.

EIOPA is going to prepare

- **two sets of ITS:**

- Set 1: “Approval processes”;

- Set 2: “Pillar 1 (quantitative basis), Pillar 2 (qualitative requirements), Pillar 3 (enhanced reporting and disclosure) and supervisory transparency”.

- **two sets of Guidelines:**

- Set 1: “Guidelines relevant for approval processes, including Pillar 1 (quantitative basis) and internal models”;

- Set 2: “Guidelines relevant for Pillar 2 (qualitative requirements) and Pillar 3 (enhanced reporting and disclosure)”.

EIOPA (31. 1. 2014) : Timeline for outstanding regulations



Timeline:

April – June 2014

Public consultation on the Set 1 of the ITS

June – September 2014

Public consultation on the Set 1 of the Guidelines

31 October 2014

Submission to the EC of the Set 1 of the ITS

December 2014 – March 2015

Public consultation on the Set 2 of the ITS

December 2014 – March 2015

Public consultation on the Set 2 of the Guidelines

February 2015

Publication of the Set 1 of the Guidelines in all the official EU languages

30 June 2015

Submission to the EC of the Set 2 of the ITS

July 2015

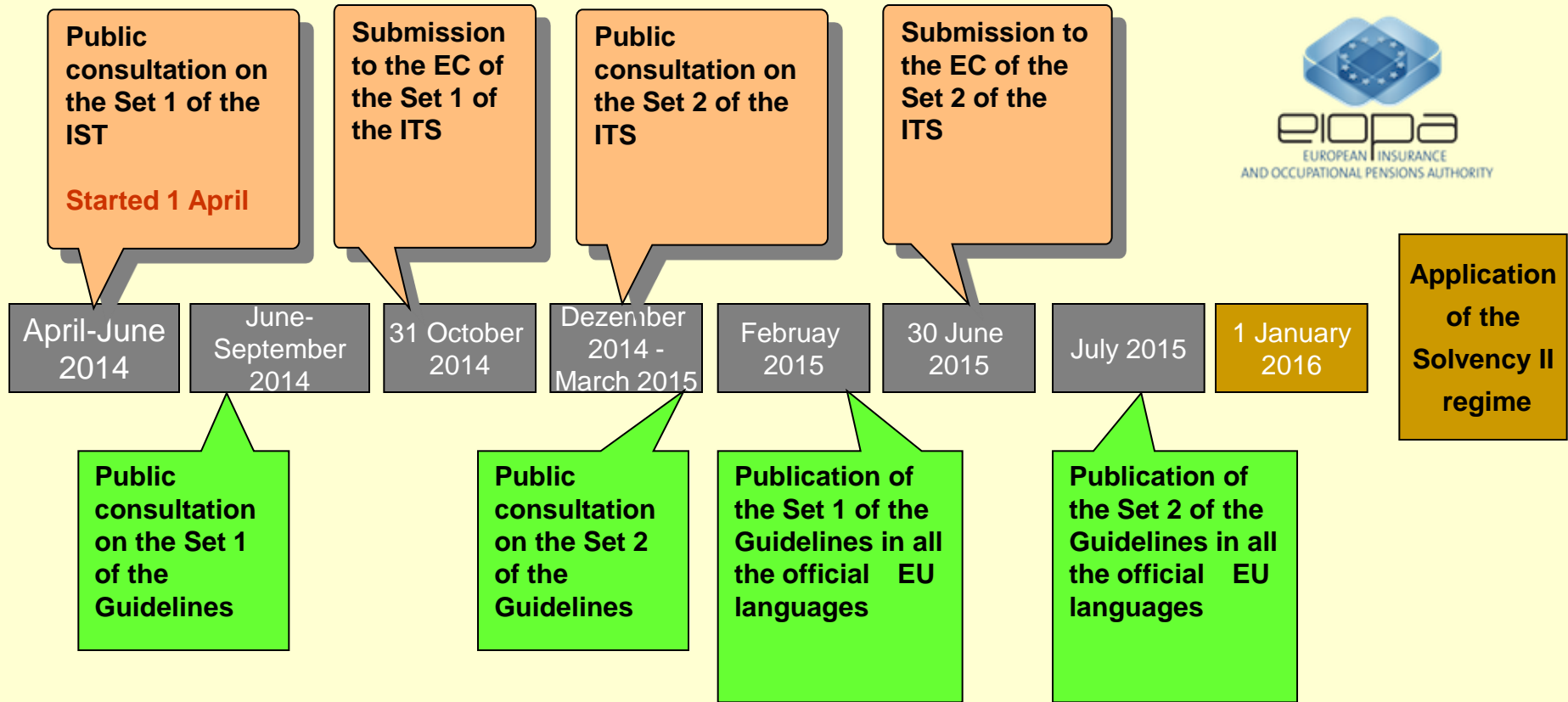
Publication of the Set 2 of the Guidelines in all the official EU languages

1 January 2016

Application of the Solvency II regime



Next steps



CP-14/004 CP on the proposal for ITS with regard to the procedures to be used for granting supervisory approval for the use of **ancillary own-fund** items

CP-14/005 CP on the proposal for ITS on **Internal Models approval processes**

CP-14/006 CP on the proposal for ITS on the process to reach a **joint decision for group internal models**

CP-14/007 CP on the proposal for ITS on the procedures to be followed for the approval of the application of a **matching adjustment**

CP-14/008 CP on the proposal for ITS on **special purpose vehicles**

CP-14/009 CP on the proposal for ITS with regard to the supervisory approval procedure to use **undertaking-specific parameters**

The period for providing comments will end on 30 June 2014

Set 1 of the Guidelines

Expected topics (some examples)



- **Pillar 1 topics:**
 - Contract Boundaries,
 - Valuation of TP,
 - Ancillary Own funds (AOF),
 - Classification of OF,
 - Ring fenced funds,
 - Biometric risk for life and health SLT risk modules,
 - USP Approval processes and Quality of data,
 - Application of the market risk module
 - ...

Set 1 of the Guidelines

Expected topics (some examples)



Internal models: Use test,

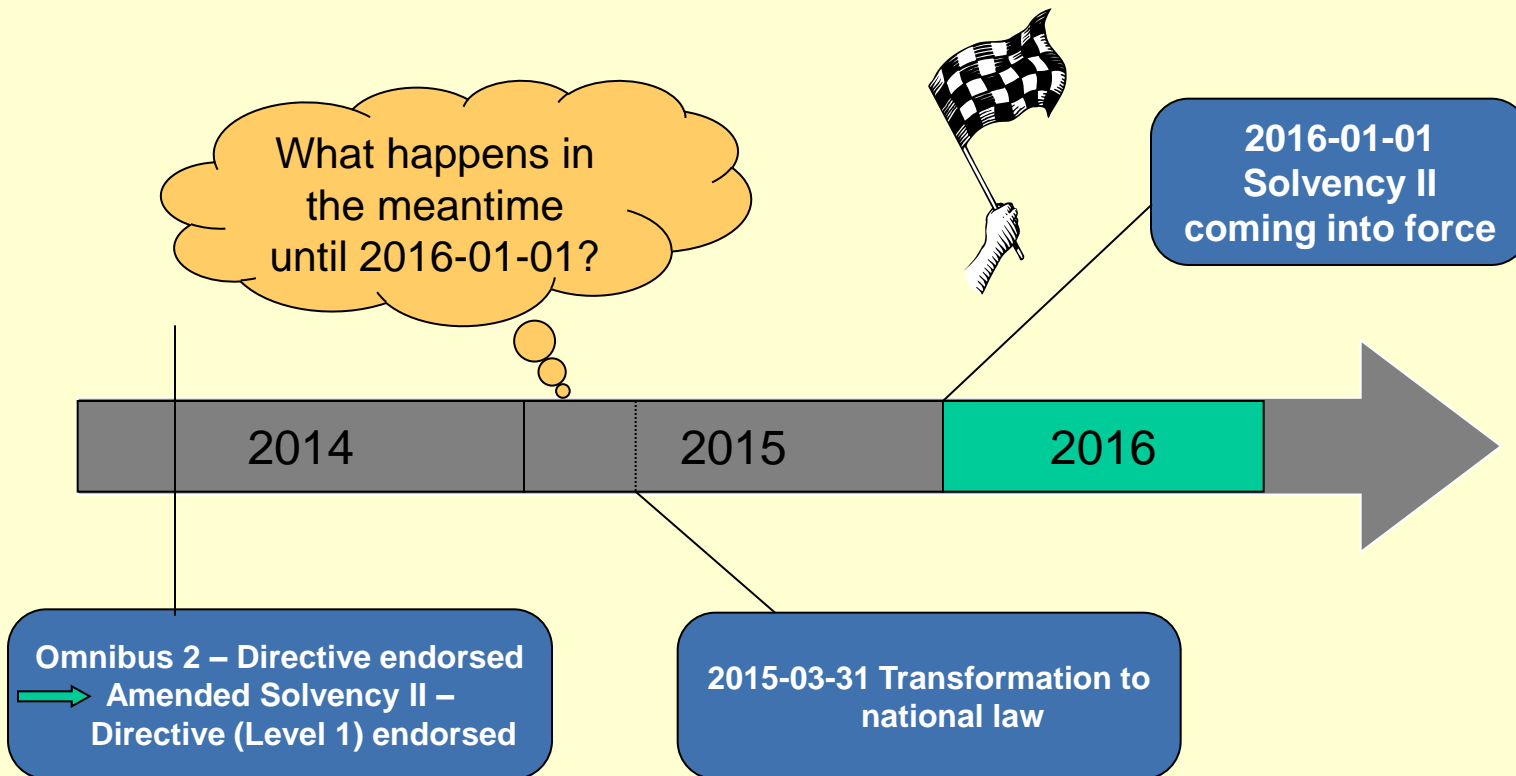
- exert judgment ,
- Probability Distribution Forecasts,
- Methodological Consistency,
- calibration – approximations,
- Profit and loss attribution ,
- Validation,
- Documentation,
- External models ,
- Colleges internal models issues

Group solvency calculation

Governance

ORSA

Preparation for Solvency II





Press Release

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EIOPA PUBLISHES THE FINAL GUIDELINES FOR THE PREPARATION OF SOLVENCY II

EIOPA received over 4000 comments while publicly consulting on the Guidelines on the preparation for Solvency II;

Guidelines allow for gradual and proportionate preparation for Solvency II by both national supervisors and industry through the “phasing-in” and threshold provision;

National supervisors are expected to ensure that insurance companies and groups take active steps towards implementing the Guidelines;

EIOPA intends to issue the Guidelines in all the official EU languages on 31 October 2013 with the application date of 1 January 2014;

EIOPA Guidelines cover a number of key areas of Solvency II

EIOPA-CP-13/09	Guidelines on Forward Looking assessment of own risks (based on the ORSA principles)
EIOPA-CP-13/011	Guidelines on PreApplication of Internal Models
EIOPA-CP-14/072	Guidelines on Submission of Information to National Competent Authorities
EIOPA-CP-13/08	Guidelines on System of Governance

„The Guidelines foresee a gradual application through “phasing-in” provisions (i.e. different expectations for 2014 and 2015).“

„The NCAs will report to EIOPA about their compliance or intention to comply within 2 months after the Guidelines’ issuance. The NCAs are required to submit a progress report to EIOPA on the Guidelines’ implementation in February 2015.“

To comply with the requirements of the Guidelines on FLAOR and Submission of Information undertakings have to perform calculations or to report according to legal requirements that are not yet endorsed.

To close this regulatory gap EIOPA will issue Technical specifications by 30 April to ensure a consistent proceeding.

The „Technical Specifications for the Preparatory Phase“

Purpose:

Technical standards aim at helping undertakings in their preparation for the application of the Solvency II requirements during the preparatory period.

This is the basis for Undertakings and National Competent Authorities to prepare the implementation of the Solvency II reporting in 2015.“

Article 45 Own risk and solvency assessment

1. As part of its risk-management system every insurance undertaking and reinsurance undertaking shall conduct its own risk and solvency assessment.

That assessment shall include at least the following:

- (a) the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;
- (b) ...
- (c) **the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement as laid down in Article 101(3), calculated with the standard formula in accordance with Chapter VI, Section 4, Subsection 2 or with its partial or full internal model in accordance with Chapter VI, Section 4, Subsection 3.**

According to Art. 45 (c) it is required to assess if the assumptions underlying the SCR – calculation deviate from the risk profile of the undertaking.

An assessment of the significance of the observed deviation is required. Undertakings are supposed to start this assessment from 2015. Support will be provided by the EIOPA- paper:

“The underlying assumptions in the standard formula for the Solvency Capital Requirement calculation”

Publication is expected in the middle of May.

Objective of Stress Tests

Support assessing the resilience of the insurance sector to adverse situations and to

Extract valid conclusions to support the stability of the financial system.

The aim of the exercise in 2014 is to

- test the resilience of insurers regarding market risk under a combination of historical and hypothetical scenarios and
- test insurance risk and,
- include a low yield element („as a follow-up to its Opinion on Supervisory Response to a Prolonged Low Interest Rate Environment“)

Timeline

30 April 2014	Launch of a Europe-wide stress test for the insurance sector;
May 2014	Workshop with industry participants;
20 June 2014	Collection and validation of undertakings' data by the national supervisory authorities (NSAs);
21 July 2014	Centralized validation of all the submissions by EIOPA;
November 2014	Disclosure of the results of the stress test analysis.

Working process

The exercise will be run in close cooperation with the national supervisory authorities: the NSAs will identify and contact prospective participants in the test.

As of now, EIOPA will provide industry participants with the regular updates on the status and all the upcoming steps of the stress test.

On 31 March, EIOPA invited insurance and actuarial associations (Insurance Europe, CRO Forum, AMICE, Actuarial Association of Europe, CFO Forum) to provide useful comments on stress test reporting templates.

The objective of this consultation is to improve the usability of the templates and to allow for early understanding of the stress test shape and requirements.

