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Conclusion of Omnibus II negotiations paves way for application of Solvency II in 2016

Agreement on the details of the Omnibus II Directive, including the treatment of "long term guarantees" (LTG) was finally reached on 13 November between the trilogue parties (European Parliament, European Council and the European Commission). This agreement provides welcome certainty for clients and paves the way for the application of a consistent prudential framework for insurance regulation in Europe, from 1 January 2016.

Recent negotiations between Member States in the European Council have focused on LTG and the need to achieve a solution for the treatment of the variety of products that offer these guarantees in many Member States. These discussions have been informed by the LTG assessment carried out by EIOPA earlier in 2013, which demonstrated the absolute need for a package of measures.

"EY welcomes the successful conclusion of the Omnibus II Directive negotiations, which provides clarity over the long awaited Solvency II implementation timeline," said Martin Bradley, Global Insurance Risk and Regulatory leader. Agreement permits application of Solvency II in Europe from 1 January 2016, preceded by an initial preparatory phase. The preparatory guidelines recently issued by EIOPA to the National Competent Authorities (NCAs), now assume greater importance - setting out a number of key requirements for (re)insurers to meet over the next two years as they adapt their risk management, reporting and capital management processes to the new prudential regulatory regime.

In addition to the LTG package, the agreement reached in the trilogue covers enhanced qualitative supervisory measures such as the potential for NCAs to apply capital add-ons in certain circumstance, and a requirement for liquidity plans. The allowance for a "provisional equivalence" status for third country prudential regimes, applying for a (renewable) ten year period, is also included in the agreement.

Ratification of the agreement by European Council and Parliament will take place ahead of a full plenary vote in the European Parliament scheduled for 3 February 2014. Member States will be required to transpose Solvency II into their national law by March 2015, ahead of application from 1 January 2016.

Key features of the agreement

<u>Long Term Guarantees</u>

Matching adjustment

The agreed version of Omnibus II reflects much of the feedback from Member States provided during the negotiations. Features include: flexibility of asset eligibility (e.g. inclusion of certain additional assets with fixed cashflows, relaxation of credit quality limits and some ability to trade assets), a floor to the fundamental spread of 35% for corporate bonds and 30% for government bonds and an extended scope of eligible liabilities (including reinsurance of eligible liabilities and business with limited mortality exposures).

Whilst we understand that the references to ring fencing of assets and liabilities may have been removed from the agreed text, restrictions on diversification credit in the calculation of the Solvency Capital Requirement using the Standard Formula, will still apply.

Volatility adjustment

The Volatility Adjustment will be based on a proportion (65%) of the risk-corrected currency spread with an additional allowance for a risk-corrected country spread, subject to certain conditions. We understand the Volatility Adjustment will apply under all economic conditions to all business except for unit-linked and business where the Matching Adjustment is applied. Furthermore, it will be a Member State option whether to require pre-approval of the Volatility Adjustment.

Transitional measures

The transitional measures aim to ensure a smooth transition between the old and new regulatory regimes immediately after the application of Solvency II. Furthermore, the agreement includes an interest rate adjustment as a parallel shift in the Solvency II interest rates. The transitional measures phase in the impact of Solvency II over a period of 16 years.

Equivalence

A fresh approach has been designed to judge the equivalence of third-country regulatory regimes, for which full equivalent status has not been obtained. A set of conditions will be prescribed to assess whether the regulatory system is risk-based and broadly equivalent to Solvency II. If these conditions are met, "provisional equivalence" is granted. This can last for 10 years with the additional possibility of being renewed beyond the 10 year point, leaving time for convergence between regimes to occur. This approach is intended as a pragmatic and effective solution for cases where equivalence is not possible on exact terms. It is particularly relevant for the US, due to the state based supervision not providing a basis for the standard assessment process and avoids the major European (re)insurance groups having to compete on a non-level playing field.

Implications for clients

After significant uncertainty over the last 12 months concerning the capital implications of Solvency II, and indeed whether a single prudential regime would be agreed by the European co-legislators, (re)insurers can now plan to complete their Solvency II programs with increased confidence.

Although it is already clear that there will not be complete consistency of approach by NCAs during the preparatory period (with some choosing not to apply the threshold requirements and others bringing forward Solvency II reporting), (re)insurance groups should still benefit from a significant alignment of approach by the NCAs.

Looking ahead over the next two years, priorities for (re)insurers will include:

- Understanding the capital implications of Solvency II on their balance sheets, allowing for the impact of the available transitional measures on their back-book. This will require updating their methodology and models for the latest regulatory agreement, determining which transitional measures to apply, and completing their assessment of available and required capital on these bases.

- Enhancing the components of Pillar 2. The preparatory guidelines reflect raised standards for the system of governance (including the risk management system) applying over the preparatory period, and establish requirements for firms to make a forward assessment of own risks using ORSA principles.

- Determining their approach to financial reporting. The lack of certainty over the implementation of Solvency II has delayed progress with Pillar 3 workstreams in many (re)insurers. Acceleration of activities to understand readiness for meeting the preparatory guidelines, identification of any data gaps, determining the reporting solution (e.g. whether to build or purchase a vendor package), and redesigning and optimising the reporting processes may be necessary. Performing dry runs will gauge the level of preparedness towards the extensive reporting requirements of Solvency II.

How EY can help

EY is ready to assist (re)insurance clients with their preparations for Solvency II. Following the Omnibus II agreement, particular areas where we can support you include:

- Analysing the impact of the possible long term guarantee measures, including the (combined) effect of selected measures, and the operational and business implications

- Providing technical support or review as Solvency II methodology and models are refreshed for the latest regulatory developments

- Conducting gap analyses or readiness assessments of the current capabilities and processes against all EIOPA preparatory guidelines, and local NCA requirements

- Assisting with the design and implementation of the financial reporting processes for Pillar 3

Please contact your regular EY advisor for further information.