Solvency II - the next steps

JAMES MAHER looks at the key requirements and current near term priorities for Irish (re)insurers as set out by the preparatory guidelines that were published by the Central Bank of Ireland on November 4th 2013.

With the publication of the preparatory guidelines by the Central Bank of Ireland (CBI) on 4th November 2013, Solvency II is now back at the forefront of the agenda for the insurance and reinsurance industry here in Ireland. The principal aim of the guidelines is to ensure that (re)insurance companies take active steps towards implementing elements of Solvency II in a consistent and convergent way and is prepared when Solvency II goes live on 1st January 2016.

James Maher

The preparatory guidelines issued by the CBI are in response to EIOPAs publication of their own preparatory guidelines for the implementation of Solvency II to the National Competent Authorities (NCAs) on 31 October 2013. The guidelines set 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.

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In addition, consensus on outstanding elements of the Omnibus II Directive, including the treatment of 'long term guarantees' (LTG) has been achieved between the trilogue parties (European Parliament, European Council and the European Commission) on 13th November 2013. This agreement provides welcome confidence (if not certainty) for companies and paves the way for the application of a consistent prudential framework for insurance regulation in Europe, from 1st January 2016.

OUTLOOK

So what were the key elements agreed within the trilogue? Below we summarise changes arising in respect of three important areas being progress on long term guarantees, transitional arrangements and Equivalence.

Moving forward on long term guarantees

Agreement in principle has been reached in a number of key areas that have allowed progress to be made on long term guarantees, in particular the following has been achieved:

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 per cent for corporate bonds and 30 per cent for government bonds and an extended scope of eligible liabilities (including reinsurance of eligible liabilities and business with limited mortality exposures).

Volatility adjustment: will be based on a proportion (65 per cent) 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.

Extended transition periods and optionality

To enable companies absorb the impact of transition to the new regime on the capital requirements of their inforce business a significant transition period of up to 16 years has been provided for. This is of particular interest for companies with significant existing exposure to long term guarantees.

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Rethinking 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.

In the remainder of this briefing note we focus on the core components of the preparatory guidelines.

Preparatory guidelines

The CBI published five documents as part of the guidelines pack. The documents published are as follows:

1. Introduction to CBI guidelines - sets out the general scope for the application of the guidelines, e.g. the use of the PRISM framework in the application of the guidelines, and the circumstances where a company may be out of scope.

2. Systems of governance - sets out guidelines so that all companies will look to have an effective governance and risk management system in place when Solvency II goes live.

3. Forward looking assessment of own risks - sets out guidelines for developing and implementing a forward looking assessment of the risks to which they are exposed with the first assessment expected during 2014.

4. Pre-application of internal models - sets out guidance on what firms, who are currently engaged with the CBI in the pre-application process, should consider as part of their preparation for the formal application process.

5. Submission of information to the CBI - sets out the reporting requirements that will to apply in the period prior to full implementation date.

Implications for (re)insurers

Given the increased certainty over the timing and nature of the directive and the agenda laid out by the CBI what are the current and near term priorities for (re)insurers getting ready for Solvency II?

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- Understanding the capital implications of Solvency II on balance sheets, allowing for the impact of the available transitional measures on their back-book. This will require updating methodology and models for the latest regulatory agreement, determining which transitional measures to apply, and completing 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. The CBI has also stated that this may be used as a benchmark against which compliance with existing statutory requirements is assessed, e.g. Corporate Governance Code.

- Determining an 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.

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