Solvency II – still challenges to overcome

Large parts of Solvency II are in place, but there are still challenges to overcome. The postponed implementation until 2015 – or later, will give more time for adjustments.

Solvency II represents a fundamental overhaul of European insurance supervision. The aim of the new solvency regime is to increase protection for policyholders and increase the stability of financial markets. Finance Norway is working to ensure that Solvency II is adapted appropriately to the Norwegian insurance industry.

Background

One of the greatest weaknesses of the current regime, Solvency I, is that it is simple and factor-based, and a number of key risks – such as market risk, credit risk and operational risk – are not adequately captured. The lack of risk sensitivity in Solvency I means that companies do not have incentives to improve their risk management, and does not promote optimal allocation of capital.

Solvency II brings a more risk-based, market-consistent approach to insurance supervision. The aim is to build a more proportional solvency framework where all risks are identified in such a way that the solvency capital requirements reflect the actual risk to which insurers are exposed.

Structure

The final version of the Solvency II Directive (also known as Level I) was formally adopted on 25 November 2009, replacing the 14 existing insurance and reinsurance directives in the EU. It is a framework directive, and therefore requires a series of implementing measures (Level 2) elaborating on many of the 300-plus articles in the directive. These will be adopted directly by the various member states without the possibility of national adjustments.

The European Insurance and Occupational Pensions Authority (EIOPA) is responsible for drawing up further guidance on the Solvency II Directive (Level 3). Some of the guidelines will be binding technical standards that must be followed by insurers and supervisors, while others will not have to be fully implemented.

The new solvency rules have a three-pillar structure corresponding to the Basel II rules for the banking sector:

- ✓ Pillar 1: Quantitative requirements, including solvency capital requirements, requirements for calculating technical provisions and minimum capital requirements
- ✓ Pillar 2: Qualitative requirements regarding corporate governance and risk management of insurers, as well as the supervision of insurers. Permits more individual capital requirements tailored to the individual insurer’s risk. Also includes rules on internal control and self-assessment of risk and solvency

- ✓ Pillar 3: Rules on market discipline and transparency, including regulatory and public disclosure

Challenges

Robust pension system under Solvency II

The fundamental Solvency II principle of measure both assets and liabilities at market value, means that the present value of technical provisions will need to be calculated using the current risk-free interest rate curve rather than the guaranteed interest rate, as is the case in Norway today. The value of technical provisions will therefore fluctuate with changes in market interest rates, and differences in interest rate sensitivity (duration) between the two sides of the balance sheet will trigger a capital requirement for interest rate risk.

For life insurers with long-term pension liabilities, a logical adjustment to the capital requirements under Solvency II would be to invest in fixed-income securities with the same maturity as these liabilities, so that the value of the latter moves in line with the former.

However, long-term investments of this kind are not compatible with current Norwegian life insurance rules, where the required annual guarantee means that companies must invest in low-duration assets to avoid large fluctuations in annual returns. There is therefore a need to adapt the current product and operating rules to Solvency II to obtain a pension system that is appropriate for all parties. Finance Norway is working on finding good solutions.

Long-term investment opportunities

For companies to be able to adjust their investments in line with their long-term pension liabilities, they must also be able to invest in interest-sensitive assets with a sufficiently long duration. These assets must be denominated in Norwegian kroner to avoid a further capital requirement due to currency risk. Norway has only a small market in fixed-income securities issued by the public sector, so Norwegian insurers have limited scope to close the duration gap by investing in assets with low risk and high duration. Steps need to be taken to correct this imbalance.

It is also important for Solvency II to be adapted so that investments in infrastructure do not trigger excessive capital requirements. Solvency II does not contain any explicit regulation of infrastructure investments, but as the rules stand, these investments will not be a viable alternative to long-term bonds. This is because they result in a disproportionately high capital requirement (on a par with private equity), without the duration needed to match long-term liabilities.

Interest rate curve adjusted to Norwegian conditions

The methodology for calculating the risk-free interest rate curve used to value future insurance liabilities will be the same for all currencies, but the parameters will vary from currency to currency due to differences in the breadth and depth of bond markets. It is important that the parameters for Norway take as much account as possible of the limitations of the Norwegian market for long-term fixed-income instruments, and Finance Norway has been actively working for this over a number of years.

National flexibility

The scope for national adjustments to Solvency II for contracts entered into under the existing life insurance and solvency regime is currently uncertain. Although Solvency II is, in principle, to be fully harmonised, it is important for the Norwegian authorities to explore whether there is still some room for manoeuvre, and to what extent this should be exploited to ease the challenges faced by the country’s insurers.

Credit rating

One further challenge presented by Solvency II is its potential impact on the supply of funding in the Norwegian capital market. The capital requirement for insurers’ investments in bonds, structured credit products and credit derivatives will depend partly on how the credit rating agencies rate the issuer’s creditworthiness. Unlike what is common elsewhere in Europe most Norwegian savings banks do not have such a rating.

The absence of a rating means that bonds issued by these banks will trigger a higher solvency capital requirement for insurers, making them a less attractive investment. This, in turn, could give Norwegian savings banks problems with their funding.

Unrated bonds issued by Norwegian local government bodies are also treated the same as other unrated investments under Solvency II and will similarly trigger a high solvency capital requirement. Finance Norway believes that one possible solution would be for bonds issued by unrated financial institutions (including Norwegian savings banks) to be assigned a national rating.

Progress

The European Commission has been working on implementing measures for the Solvency II Directive since 2009. The timing of a decision on these measures is uncertain, as it will depend on when the Omnibus II Directive is approved. Omnibus II was presented by the European Commission in connection with the restructuring of the supervisory bodies in the EU in late 2010, early 2011, and entails changes to existing directives, including Solvency II.

Delays

The European Commission, the Council of the European Union and the European Parliament have for some time been discussing the provisions of Omnibus II that particularly affect products with long-term guarantees. The debate has centred mainly on various proposals for adjusting the interest rate curve for discounting liabilities with the aim of reducing fluctuations in companies' capital and capital requirements.

On 12 July 2012 the decision was taken to perform an impact assessment of the proposals. This was carried out between 28 January and 2 April 2013, and four Norwegian life insurance companies took part. The results of the assessment were released 14 June, and will be part of the negotiations on the Omnibus II Directive when these continue this September. An agreement on Omnibus II is not expected until the end of 2013, which means that the publication of the final draft Level 2 implementing measures for Solvency II cannot be expected before the first quarter of 2014. Consequently, a public consultation on the Level 3 guidelines and technical standards is delayed accordingly.

In its letter sent out on 4 February 2013, the Norwegian financial supervisory authority "Finanstilsynet" stated that the delays to Omnibus II probably mean that full implementation of Solvency II will not take place any earlier than 1 January 2015, and that further delays cannot be ruled out.

Interim measures

In order to ensure continued preparation for Solvency II in spite of the delayed implementation of the directive, EIOPA launched a public consultation on Guidelines for the preparation for Solvency II in March 2013. Covering requirements for companies' system of governance, forward looking assessment of the undertaking's own risk (based on the principles for ORSA – own risk and solvency assessment), reporting to supervisors, and pre-application of internal models, the guidelines will enter into force on 1 January 2014. Annual information to supervisors is to be submitted once before Solvency II is applicable, in May 2015 based on year-end data for 2014. This approach is based on the assumption that Solvency II does not enter into force before 1 January 2016.

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