The road to reform

The EU's Solvency II Framework Directive — "Level 1" — was agreed in 2009. Since then, work has focused on the "Level 2" implementing measures, which put the detail on to the framework. However, another Directive, Omnibus II, needs to be passed before the Level 2 implementing measures of Solvency II are agreed. This is because Omnibus II makes changes to Level 1, reflecting developments such as the EU reforms in the Lisbon Treaty.

There have been delays in the timetable for the adoption of the Omnibus II Directive. The vote in the European Parliament's Economic and Monetary Affairs (ECON) Committee on Omnibus II is now scheduled for late March instead of January and the European Parliament's plenary vote is not expected before July.

It is unclear yet what the effect of the delays in the adoption of Omnibus II will be to the overall Solvency II timetable. The European Parliament is already starting to look in detail at the Level 2 implementing measures of Solvency II. This should make it possible to shorten the subsequent Level 2 consultation.

Officially the current timetable for a "split" implementation of Solvency II remains, with transposition into national law scheduled for 1 January 2013, followed by entry into force on 1 January 2014. Insurance Europe supports this, but has stressed the need for insurers to have at least 18 months between the point at which the reporting requirements — "Level 3" — are finalised and the point at which they are to be used.

It has been over a decade since work first began on Solvency II, the new regulatory regime for insurers. The world has changed dramatically since this new, more sophisticated regulatory scheme started to be developed. The financial crisis has highlighted starkly just how important it is to have effective regulation that is appropriate for each financial sector.

Insurance Europe, the European insurance and reinsurance federation, has always supported the development of this risk-based, prudential regime to ensure that policyholder protection is robust, to strengthen the insurance sector's attractiveness and to increase its transparency.

Key outstanding issues

The development of Solvency II is currently at a crucial phase and there are some significant issues that still need to be addressed to ensure that the regime provides the right incentives for the industry to continue to provide long-term products, in particular those that enable customers to plan their retirement provision, and to fund long-term investment for economic growth.

The significant market movements during the second half of 2011 and the associated volatility of insurers' solvency ratios under the current Solvency II proposals have shown that calculations relating to long-term guarantees and the related impact on insurers' ability to hold long-term investments are not yet appropriately designed. If left unchanged they could increase levels of capital far above those needed to cover the real risk.

The effect of this could be to increase the overall cost of such products for consumers or even to drive the industry to move away from providing long-term products and investing in long-term assets.

Insurance Europe therefore supports a package of measures that have been developed to address these issues. These measures are:

- **A counter-cyclical premium**

This would only be applied when the markets are distressed and no longer price assets rationally. It would prevent temporary and unjustified falls in solvency ratios to avoid unnecessary pro-cyclicality (i.e. forced sales at the worst time).

- **A matching premium (spread adjustment mechanism)**

This would apply at all times but only to specific products which, because of the way their product features are combined with an appropriate investment strategy, are not exposed to the volatility of the asset price beyond the risk of default. This would prevent artificial volatility that would make long-term guarantee products either more expensive than necessary or simply unavailable.

- **An extrapolation methodology**

The aim is to avoid creating volatility in long-term liabilities. Liabilities are valued by discounting at the risk-free rate. However, for very long-term liabilities there is simply no reliable risk-free rate information due to a lack of liquidity of longer duration assets, so a method has to be designed to extend the available data. If this is not done carefully, the method itself can create artificial volatility, making holding these liabilities unnecessarily expensive or impractical.

The introduction of a matching premium and counter-cyclical premium would reflect — in a mark to market environment — the fact that cash flows are matched and that losses resulting from spread movements are unlikely to materialise. This has been magnified for insurers despite the fact that the nature of insurance business means that insurers' own funds are not exposed to such volatility. Unless appropriate measures are in place to help deal with "artificial" market volatility and procylicality, it will be a significant challenge for insurers to provide long-term guarantees for policyholders and to maintain their role as long-term investors in the economy.

There are still some differences of opinion over the detail of how the package of measures should be implemented and Insurance Europe is contributing to the work to develop appropriate solutions. The insurance industry has recently been exploring technical details related to:

- the refinement of the matching premium for EU-wide application, taking into account insurers' exposure to spread movements;
- Identifying objective trigger points for the application of the counter-cyclical premium to give predictability in its application.

The insurance industry is not alone in voicing concerns over the Solvency II calculations related to long-term guarantees.

Bodies such as the International Monetary Fund (IMF) have also drawn attention to the issue. In its Global Financial Stability Report of September 2011, "Grappling with Crisis Legacies" it stated that "In touching on the potential effect of regulation on the asset allocation of institutional investors, the chapter suggests that initiatives like Solvency II for European insurance companies may push these institutions away from their traditional role of taking on longer-term risky assets, potentially dampening the positive impact of one class of 'deep pocket' investors."

The taskforce on long-term guarantees that was set up by the European Commission confirmed that this issue needed addressing and that a package of measures was required to solve it. The taskforce was made up of representatives from the Commission, the European Insurance and Occupational Pensions Authority, national finance ministry experts, the Group Consultatif of actuarial associations and the insurance industry.

EU Commissioner Barnier has made clear that a solution must be found that enables insurers to continue to offer long-term guarantee products. The Commission is therefore reconvening its taskforce.

MEPs are also keen to ensure that consumers still have access to these products and they recognise the vital role the insurance industry plays in providing stability in the markets and funding long-term growth in Europe. While Insurance Europe is therefore hopeful that they will recognise the strengths of the package of measures identified by the working group, it is still too early to predict the outcome of the negotiations.

Other issues

Addressing volatility is not the only Solvency II issue still under discussion. Among other items, Insurance Europe is still calling for an appropriate definition for contract boundaries and for changes in the treatment of own funds.

Likewise there are elements of Omnibus II that we are currently raising with key members of the European Parliament's Economic and Monetary Affairs Committee ahead of the vote that is scheduled late March. These relate to issues such as third-country equivalence, the arrangements for a "soft" launch of Solvency II and transitional provisions.

Recognising other regulatory regimes as equivalent is a key component of the new regime. It is important that well advanced countries achieve equivalence in order to avoid multiple reporting requirements under different capital regimes, since this could be costly, affecting competitiveness and leading to inefficient risk allocation.

Transitional measures are vital in the lead up to equivalence. Under Omnibus II, Insurance Europe is calling for a potential five-year extension to the original five-year transition period.