EUROPEAN COMMISSION
Directorate General Internal Market and Services

Solvency II prudential framework for the insurance sector

Report on the Long-term Guarantee Assessment

by the European Insurance and Occupational Pensions Authority

Introduction

The Omnibus II Directive proposed in 2011 includes several amendments to the Solvency II Directive (Directive 2009/138/EC) to adapt it to the new European System of Financial Supervision. The most controversial issue being discussed in the trilogue is the introduction of measures on the treatment of insurance products with long-term guarantees under the new Solvency II insurance regulatory regime ("Long-term guarantee package" or LTG package). Since no agreement on the LTG package could be achieved in the trilogue, negotiations were suspended in September 2012. The Council, the European Parliament and the Commission then mandated the European Insurance and Occupational Pensions Authority (EIOPA) with carrying out a technical assessment of the measures, in order to provide a technical basis for a political agreement on Omnibus II.

The Terms of Reference of the assessment, agreed by trilogue parties, envisage that the Commission transmits EIOPA's technical findings to the co-legislators with its own report. EIOPA published its technical findings on 14 June.

EIOPA's Technical Findings

The Commission services commends EIOPA for the thoroughness of its assessment and the tremendous effort that has gone into fulfilling the mandate set by trilogue parties in a relatively short timeframe. The European Commission services also commend the 427 participating EEA insurance and reinsurance undertakings for their efforts. EIOPA's assessment will equip trilogue parties with the technical information which was lacking at the time of the trilogues in 2012 which will prove crucial in bringing the discussions to a successful conclusion. The Commission services consider that EIOPA's technical findings provide a sound basis for achieving a speedy political agreement on Omnibus II.

These technical findings confirm firstly the importance of LTG measures for many Member States in periods of financial stress such as those experienced in 2011 and secondly that a package of different measures is needed to cater for the different insurance products offered in Member States. Notwithstanding this, the Commission services support a solution that deepens the integration of the Single Market and agrees with EIOPA's recommendation to remove Member State options and exclusions for cross-border business.

The objectives of the technical assessment were to evaluate:

- the impact of the proposed LTG package on policy holder protection;
- whether the proposed LTG package will allow supervisory authorities to supervise insurance and reinsurance undertakings and insurance and reinsurance groups efficiently and effectively;
- whether the proposed system can be implemented efficiently and effectively by all insurance and reinsurance undertakings and the cost of implementation;
- whether the proposed system provides the right incentives for good risk management and wide risk diversification and contributes to the correct risk reflection of the undertakings;
- the impact on financial stability and whether the proposed system has the potential to create systemic risks;
- the impact of the proposed LTG package on the single market, including on cross-border business;
- the impact of the proposed LTG package on insurance and reinsurance undertakings' solvency position and also possible competition distortions in national markets and the single market; and
- the impact of the proposed LTG package on long-term investments by insurance and reinsurance undertakings.

EIOPA analysed each measure against these objectives and recommends the inclusion of the following measures:

- Extrapolation – important for valuing insurance liabilities in the absence of reliable market information;
- Classic Matching Adjustment – important for insurance products, such as annuities, which have predictable payments to policyholders and allow for strict cash flow matching;
- Transitional Measures – important for insurance products offering high interest guarantees that were concluded in the past, in order to smooth the transition from Solvency I to Solvency II; and
- Extension of the Recovery Period – allows undertakings sufficient time to restore compliance with capital requirements in exceptional situations.

EIOPA advises not to include the so-called Extended Matching Adjustment on the basis that it would not provide sufficient policyholder protection and would be unduly difficult to supervise. In addition, the Counter-Cyclical Premium (CCP) was judged to be likely to have an adverse financial stability impact due to the way it would be triggered, as well as unintended impacts on undertakings' solvency requirements that it generated. As a consequence, EIOPA advises to replace the CCP with a permanent, more predictable measure, the Volatility Balancer, which like the CCP mitigates the impact of bond spread volatility on own funds but avoids side-effects on capital requirements.

The Way Forward

The Commission services consider that the LTG package, comprised of measures for Extrapolation, the Classic Matching Adjustment, Transitional Measures, the Volatility Balancer and the Extension of the Recovery Period, can meet all of the listed objectives. In particular, the concept of a Volatility Balancer should provide an appropriate replacement to the CCP and the Extended Matching Adjustment.

Long-term guarantees are in the interest of policyholders, and the LTG package will enable them to continue to be offered widely.

The measures by removing artificial volatility from the solvency assessment will enable insurers to hold assets for the long term and avoid forced sales of those assets in times of market downturns, thus promoting long-term investment. This is also important in ensuring that the package of measures does not increase systemic risk.

Efficiency and cost of implementation have been duly taken into account in EIOPA's analysis. The design of the measures avoid adverse risk management incentives which should also be secured with accompanying qualitative requirements on risk management (Pillar II) and requirements on supervisory reporting and market transparency (Pillar III).

The Commission services would also emphasise that the reference point for the testing carried out under the technical assessment was the end of 2011, one of the most difficult market situations experienced in several decades. Under such circumstances, it is to be expected, and completely within the logic of a risk-based prudential regime such as Solvency II, for some European insurers to find their capital position below the Solvency Capital Requirement (SCR), and therefore in need of drawing up a recovery plan, together with their supervisors. The SCR is a level of solvency which triggers intensified supervision, and it is unrealistic and undesirable to expect that no European insurers will ever fall below the SCR, although it is of course accepted that more time should be granted to restore compliance with the SCR in exceptional situations.

Against this background, all parties involved should approach the forthcoming discussions in a spirit of pragmatism and compromise. The Commission services believe that such a compromise can be found within the scope of the measures that EIOPA recommends, but acknowledges that some amendments to their design and calibration may prove necessary.

Further delays in concluding the political discussions on Omnibus and the resulting uncertainty would be disruptive and costly for the European insurance sector and detrimental to policyholder protection as Solvency I is outdated.

The Commission services stand ready to play a full role in the forthcoming discussions, and will make all efforts to achieve an agreement, on the basis of EIOPA's technical findings.

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