

# Solvency II: Globalisation of insurance regulation



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It is a time of interesting changes in both the European and US insurance regulatory frameworks.

As is well known, in Europe, Solvency II promises a fundamental review of solvency and risk management standards across the European insurance and reinsurance industry, replacing 14 existing EU insurance directives which make up the ‘Solvency I’ regime with a single one, aimed at achieving a high degree of regulatory convergence across Europe.

At the same time, similar changes are afoot in the United States.

This article provides a short summary of some of the potential effects of these changes.

## Solvency II

The overriding objective of Solvency II is, of course, better protection for policyholders. Other objectives include promoting financial and market stability and improving the competitiveness of the industry in Europe. It aims to achieve these objectives by establishing sophisticated, risk-based prudential standards designed to take account of all *risks faced* by insurers, *not just insurance risks*.

Despite the wealth of documentation and edicts concerning it, the continuing development of Solvency II is not just a regulatory process; it is also a political one. There has been considerable public commentary by the European insurance industry regarding elements of the Solvency II package, and aside from European negotiations, the European Insurance and Occupational Pensions Authority (EIOPA) is also actively debating the impact of Solvency II and “equivalence” with US regulators.

The process is moving fast towards the expected implementation date of 31 December 2012, but much uncertainty remains, particularly as the detailed implementing measures and guidance are still in development. Solvency II cannot be ignored by those doing, or wishing to do insurance business in Europe or from it. However, the continuing uncertainties make planning difficult, not least because not all European countries are at the same point in

the development of regulatory responses to the new regime. The basic tenets of the new regime and some commercial consequences that flow from them are set forth below.

## Pillar 1: Capital

As the industry reflects on the likely capital requirements, their reactions have included a number of protests that the Pillar 1 capital requirements, particularly in relation to general insurers, are excessively prudent. In anticipation of the new capital regime, insurers have been looking at which lines of business, notably run-off and legacy business, that are tying up capital resources without producing corresponding future benefits. These capital requirements have led to a number of sales of run-off business to external acquirers. They have also re-invigorated interest in the use of the English scheme of arrangement procedure, not least in the form of the ‘Option Scheme’ by which policyholders wishing to do so can retain their cover. Another major issue is the extent to which transitional measures will be introduced to allow current hybrid and subordinated debt instruments to be recognised for a transitional period – with lack of recognition potentially causing many insurers being unable to meet capital requirements.

## Pillar 2: Risk management

There has been a great deal of emphasis on the new risk assessment and management regime under Solvency II. Interestingly, this has also fuelled the trend towards consolidation of previously multiple organisations in insurance groups, not least in the often widely dispersed handling of legacy business. Reducing the number of group companies helps alleviate operational risk by streamlining the corporate structure, while also delivering the economic benefits of increased efficiency. Taken alongside the extensive legislation on related areas such as data protection and bribery in the UK and elsewhere, these are going to be busy times for compliance teams and their advisers.

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**Pillar 3: Disclosure obligations**

In the context of the “equivalence” debate, one issue the EU has identified in agreeing equivalence with the US is the extensive use of Freedom of Information (FOI) legislation in the US. Difficulty arises because guarantees of professional secrecy are required under the Solvency II Directive (Article 66) before information can be exchanged. FOI legislation forces extensive disclosure beyond that with which EIOPA is comfortable. In Europe, the impact of fuller disclosure is awaited with some discomfort, as not only rating agencies, but also competitors may get a new and fuller insight into business models and economic effectiveness.

**Group supervision**

Solvency II establishes a comprehensive regime for the supervision of insurance groups, intended to enhance understanding of group risks and cooperation between supervisors. The group regime encompasses not only group solvency requirements, but also governance, risk management, disclosure and reporting requirements.

A college of supervisors is to be established for each group, consisting of national supervisors of group entities, and headed by a designated group supervisor.

Group supervision requirements are triggered by the presence of an EEA authorised (re)insurance company within a bigger insurance group (regardless of where the parent company is located). For groups with their ultimate parent in a third country, group supervision *potentially* applies at worldwide group level – however there is some flexibility in approach which enables EEA supervisors to choose to supervise group using “other methods,” for example, by having an *EEA insurance group holding company*.

Group supervision requirements include:

- a group Own Risk and Solvency Assessment (ORSA);
- group disclosure and supervisory reporting;
- reporting of group risk concentrations and intra group transactions; and
- requirements relating to group governance and risk management.

The calculation of the group’s solvency capital requirement (SCR) and capital (“own funds”) must also be done.

For purposes of group supervision:

- If a third country regime *is* equivalent, EEA supervisors will rely on group supervision exercised by the third country supervisor, and form a college of supervisors led by the third country supervisor.
- If *not* equivalent, Solvency II rules on group supervision may be applied – the Directive allows some flexibility as to whether they will be applied at whole group level or at EEA holding company level.
- If applied at whole group level, Solvency II group solvency will be calculated at the level of the ultimate third country parent, and governance, risk management, disclosure and reporting requirements could also apply to the whole group, including the third country parent. This issue is causing concern to international groups, notably those headquartered in the US (and other countries not in the first wave for recognition of equivalence), and has resulted in considerable discussions between US state regulators and EIOPA.

**United States developments**

In the US, the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, adopted in July 2010, creates, among other things, a new Federal Insurance Office (FIO). The Director of the FIO is required to report on issues concerning how to modernise and improve insurance regulation by January 21, 2012. Some market observers have noted that this report is likely to set the tone for the

next steps of a possible intrusion of the federal government into the current regulation of insurance by the individual 50 states. In addition, the FIO is responsible for negotiating international agreements with other countries.

Separately, in June 2008, the National Association of Insurance Commissioners (NAIC) announced a coordinated effort to analyse the solvency regulatory framework of insurance in the US. The NAIC Solvency Modernization Initiative is reviewing 5 key areas:

- Capital requirements;
- Corporate governance and risk management;
- Group supervision;
- Accounting and financial reporting; and
- Reinsurance.

The first 3 areas are similar to Solvency II’s Pillars 1-3. The accounting and financial reporting area deals with investigating the adoption of International Financial Reporting Standards (IFRS) used in Europe. In the US, insurance companies use Statutory Accounting Principles (SAP) while their corporate parents use Generally Accepted Accounting Principles (GAAP). One could observe that the NAIC appears to be positioning the 50 states as being “equivalent” with the Solvency II regime. It remains to be seen, however, whether the states, through the NAIC, or the federal government, through the FIO, will be the body to which EIOPA looks for equivalence. It is interesting to note that the FIO is also charged with negotiating and entering into international agreements.

Thus, in the United States, both convergence and globalisation of insurance regulation is occurring. The unknown is how the potential tug-of-war between the FIO and NAIC will evolve and the satisfaction of “equivalence” under Solvency II will occur.

The NAIC Solvency Modernization Initiative’s fifth area of focus is reinsurance. After a 15-year debate on the need for 100% security to be posted by unlicensed reinsurers of US ceding companies, the NAIC adopted, in December 2008, a new Reinsurance Regulatory Modernization Framework (Framework). The Framework establishes a sliding scale of relaxed security for highly-rated unlicensed reinsurers, based on their ratings and not simply being unlicensed. The Framework was incorporated into a proposed federal law drafted by the NAIC, but did not become part of Dodd-Frank. The Framework may be one of the items the FIO incorporates into the international agreements it negotiates with other countries. Separately, the NAIC, through its accreditation process, and several states individually (at this time, Florida, New York and New Jersey) have adopted versions of the Framework. This process could take years.

This is a time to consider opportunities, whether you are a buyer or, prospectively, a seller of insurance business. Even more importantly, whatever else an insurance company may be doing in relation to its European and US presence, this is clearly a time to stay very closely focused on events – both in the US and in Europe. In Europe, this applies particularly to EIOPA’s response to recent intense public commentary, notably in connection to Technical Provisions and transitional flexibility over capital, but also to the different attitudes to the standard model across Europe. ●

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