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Briefing note

June 2015

UPDATE: Solvency II Equivalence

On 5 June 2015, the EU Commission adopted draft delegated acts on third country equivalence decisions under the Solvency II Directive.

Equivalence between third country jurisdictions and the EU can bring benefits - EU insurers can use local rules in equivalent jurisdictions to report on their operations in third countries, reinsurers based in an equivalent jurisdiction can be treated in the same way as European reinsurers and, depending on the waiver requirements of national competent authorities, EEA supervisors can rely on the group supervision of an equivalent third country.

This note discusses the recent equivalence decisions taken by the Commission and outlines some legal considerations for Solvency II group supervision where the ultimate parent undertaking of a group is located in an equivalent third country jurisdiction and where it is not.

Assessment

Equivalence under the Solvency II Directive is not a single determination in relation to a third country's solvency regime, but three separate decisions, each with its own requirements and very specific effects. Equivalence is offered in:

- Reinsurance (Article 172),
- Group solvency calculation (Article 227), and
- Group supervision (Article 260).

The Commission asked the European Insurance and Occupational Pensions Authority (EIOPA) to produce advice on whether a third country satisfies the general criteria for assessing third country equivalence under Articles 172, 227 and 260.

EIOPA's methodology in completing its report to the Commission involved assessing the supervisory system under various principles including

"The decisions taken [by the Commission] will lead to more choice and competition for European consumers and also enable European insurers to compete more effectively in overseas markets.

So this should be good for European businesses and the European economy."

Jonathan Hill

EU Commissioner for Financial Stability, Financial Services and Capital Markets Union

The case for equivalence

Solvency II is sold, by Brussels policymakers, as the legislative framework that raises supervisory and solvency standards for the insurance sectors – not just on a European level – but globally. The key aims of the regime are to:

- Ensure an adequate level of policyholder protection on a global basis,
- Reduce regulatory complexity,
- Facilitate cross-border activities of insurance and reinsurance undertakings, and
- Reinforce the global trends towards economic risk-based approaches.

The high ambitions reflected in the Solvency II equivalence regime, coupled with the promise of substantial benefits for 'third countries' that align their supervisory systems with Solvency II, go some way to explain the readiness of countries to seek equivalence.

providing sufficient policyholder and beneficiary protection, supervisory cooperation under conditions of professional secrecy and the proportionality principle.

The Commission's decisions on 5 June 2015 are based on EIOPA's final advice for the countries specified in the below analysis.

First tier

The term 'first tier' is used to describe those countries first subject to a Solvency II equivalence assessment, namely Switzerland, Bermuda and Japan (Japan sought Article 172 equivalence only).

Switzerland

The Commission, on 5 June, granted full equivalence to the solvency and prudential regime for insurance and reinsurance undertakings in Switzerland, which is set out in a draft Commission Delegated Decision.

This decision will now be considered by the European Parliament and Council. And, if the Parliament and Council are content – which seems likely – the Swiss equivalence decision will be made, published in the Official Journal of the European Union, and final.

The Commission's decision in respect of Switzerland comes as no surprise. The Swiss introduced a home regime similar to Solvency II from the start of their equivalence assessment and EIOPA found positively for the Swiss in their final advice of December 2014.

The Commission's decision, also on 5 June, in respect of another first tier country - Bermuda - is surprising. This is discussed below.

Test for equivalency

Solvency II provides three distinct areas of equivalence evaluation for countries outside the EU – so called 'third countries':

Reinsurance (Article 172 of the Solvency II Directive)

- This relates to the reinsurance activities of third country firms.
- Where the solvency regime of a third country is found to be equivalent to Solvency II, reinsurance contracts between EEA insurers and reinsurers authorised in that third country will be treated in the same manner as reinsurance contracts concluded with EEA firms.

Group solvency calculation (Article 227 of the Solvency II Directive)

- This is only relevant to EU insurance groups with insurance/reinsurance subsidiaries or branches authorised in a third country.
- A finding of equivalence for the solvency regime means that, for the group solvency calculation, the contribution of the third county insurer to the group solvency calculation, based on local rules, can be taken into account – a huge benefit for internationally active EU groups.
- This only applies if group solvency is calculated with method 2 – the 'deduction and aggregation method' detailed in Article 233 of the Solvency II Directive.

Group supervision (Article 260 of the Solvency II Directive)

- Where the ultimate parent company of a group of EEA firms is headquartered in a third country, a determination of equivalence means that the EEA supervisors can rely on the group supervision of that third country (Article 261).
- However, EIOPA guideline 5 on group solvency requires that, after consulting with other supervisory authorities concerned, the acting group supervisor should assess whether more efficient supervision is achieved this way or whether the default position at the level of the EU ultimate parent undertaking should stay in place.
- National competent authorities may, therefore, require a waiver in order to rely on the equivalent group supervision exercised by the third-country supervisory authorities.

Transitional regime

Solvency II provides two types of transitional equivalence:

- a 'temporary' regime available for reinsurance and group supervision for a period of 5 years (with a possible extension of one year)[1]; and
- a 'provisional regime' for the purposes of the group solvency calculation for an initial period of 10 years.[2]

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[1] Article172(5) and Article 260(6) of SII Directive
[2] Article 227(6) of SII Directive

On 5 June, the Commission decided that Australia, Bermuda, Brazil, Canada, Mexico and the USA are equivalent for the group solvency calculation on a 'provisional' basis i.e. for a period of 10 years, which is renewable.

Bermuda

In respect of Bermuda, the Commission decided that it was equivalent in respect of commercial insurers only with the exclusion of captives, which are subject to a different Bermudian regulatory regime.

As a first tier country, Bermuda was expected to achieve equivalence for all three areas, not just for the group solvency calculation. However, it is possible that the Commission is still deciding on the two remaining areas and will publish its decision alongside that for the other remaining first tier country – Japan.

USA

The Commission's decision in respect of the USA is surprising especially because, until 5 June, there was little public indication that the USA would be granted any kind of equivalence in time, not least due to its state regulation system.

With respect to US reinsurance equivalence under Article 172, the Council issued mandate of 21 April 2015 appears to be the latest position in respect of the EU-US dialogue on reinsurance. The mandate authorises the Commission to negotiate an agreement with the United States on reinsurance.

Documents published in relation to this dialogue process allude to an end date in 2017. In particular, a Steering Committee (set up in light of a report comparing the EU-US insurance supervisory and regulatory regimes) agreed a 'Way Forward' plan in December 2012 which outlined a "*detailed project plan…that will be updated periodically as the following common objectives and initiatives are pursued over the next five years*". This would, therefore, take us through to at least 2017.

It is likely that the Memorandum of Understanding ('MoU') resulting from the EU-US dialogue would permit the exchange of information, and so this could meet the Article175 of the Solvency II Directive 'agreement with third countries' requirements.

The MoU could therefore assist the US, if it wishes, to seek equivalence under Article172 and/or Article 260 but it does not de facto mean that equivalence will be attained. This is because of the hurdles involved in attaining equivalence including assessment of 'principles of equivalence' underpinning EIOPA's methodology.

Should the US wish to seek equivalence under Article172 and/or Article 260 it could be achieved - in theory - on a 'fast track' approach, using data submitted by NAIC (National Association of Insurance Commissioners) during the EU-US dialogue process. However difficulties would remain even if this data were used, for example, the evaluation process of US state-based regulation.

Legal impact

Group capital equivalence

Such equivalence is beneficial as it reduces the likelihood of operations in the non-EEA jurisdiction in question requiring extra regulatory capital. This is a real possibility when the European group supervisor requires the group's capital to be calculated using the deduction and aggregation method. In such cases, equivalence allows the group supervisor to apply local rules if it so chooses and so reduce the regulatory burden and compliance costs.

The majority of countries, which were the subject of the Commission decisions on 5 June, attained group solvency calculation equivalence under Article 227 under the provisional basis.

Of note is that provisional equivalence under Article 227(5) **can be granted without the third country concerned fulfilling the full required criteria for equivalence.** This provision also appears to be used as the basis for granting equivalence to a country which hasn't even applied for equivalence in the first place.

Instead equivalence can be attained where a mere subset of conditions is met, including that a solvency regime capable of being assessed equivalent is in place or may be adopted and applied by the third country.

The decision of provisional equivalence for these countries in relation to group capital is, of course, a real benefit to European (re)insurance groups who have a wide international presence.

Structuring

Equivalence is an important consideration in group structuring decisions. As we are seeing, larger (re)insurance groups are considering the benefits of restructuring and the move to a more streamlined branch structure which facilitates an easier movement of capital.

Some groups are also reviewing their domicile, including considering the implications of where their 'head office' is based for Solvency II purposes. The key consideration is to seek a base where regulation is aligned to (re)insurers business and investment strategy and one which avoid the potential traps from non-equivalence.

Group supervision

The Commission has only found full equivalence for Switzerland so far, so the implications for group supervision, where the ultimate group undertaking is in a non-equivalent jurisdiction, remain for other non-EEA countries.

For such non-equivalent countries, the directive provides either for group supervision using Solvency II rules or for supervisory authorities to be permitted to use 'other methods' [3] which ensure appropriate supervision of the insurance undertakings in the group, including requiring the establishment of EEA holding company and execution of supervision at that level. This is supported by EIOPA guideline 5 on group solvency which envisages an alternative method of supervision to be the establishment of an EEA holding company so supervision can be exercised at that level.

However, in the UK, the PRA has taken the view that supervision at the level of the ultimate third country parent is the default option and is requiring firms to apply for a waiver to be supervised at the level of the ultimate EEA parent. Specifically, firms will need to apply for a waiver of Chapter 20 of the PRA Rulebook, Rules 20.1 to 20.4 respectively, the requirements for 'Third countries'.

We would argue that the application of a waiver is purely a technicality resulting from the rule drafting and the group, for Solvency II purposes, should apply at the EEA level, by application of Rule 3.1 of the PRA Rulebook.

This has meant that, following supervisory statement 9/15 'Group supervision' , the PRA, when applying 'other methods' to ensure appropriate supervision to the group, places the onus on firms to justify supervision at the EEA level. This overlooks Article 262(2) of the Solvency II Directive which allows for the establishment of an entity with its head office in the EEA in order to establish supervision at that level. If an EEA entity is already established, the PRA could accept supervision of the group at the EEA level would be adequate.

[3] Article 262(2) of the Solvency II Directive

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