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Solvency II and U.S. Equivalence

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Activity with respect to Solvency II is increasing in the United States. The implications vary depending on how directly impacted a given U.S. company is by Solvency II.

In the United States, the companies most interested in the development of Solvency II are U.S.-domiciled subsidiaries with parent companies located in the European Union (EU). In order for the parent company to meet the requirements, its subsidiaries must comply with the various components of Solvency II regarding calculating required capital, demonstrating strong Enterprise Risk Management (ERM) and governance, and providing required disclosures to the public and the regulators. Responding adequately to these new requirements will mean a major shift in thinking for many organizations.

One unknown with respect to U.S. subsidiaries relates to the "equivalence" rules under Solvency II. These rules lay out required characteristics of local regulatory regimes in order for the capital standards of those regimes to be considered "equivalent" to Solvency II. The National Association of Insurance Commissioners (NAIC) has embarked on a Solvency Modernization Initiative (SMI) to examine current solvency requirements, review international developments, move toward a principle-based approach to solvency regulation, and ultimately improve the U.S. solvency system. The SMI Task Force is planning some significant changes to the U.S. regulatory requirements which will likely increase the chance that the U.S. gains equivalence. While U.S. insurance solvency regulation is

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NAIC Solvency Modernization Initiative Timeline (based on the latest SMI Roadmap)

Year	2010				2011				2012			
Quarter	1	2	3	4	1	2	3	4	1	2	3	4
RBC Capital Requirements												
Identify Calibration/Correlation Policy				December								
Plan to modify formulas and implement missing risk charges				December								
Industry Impact Study												December
Determine change to RBC												December
Governance and Risk Mngmt												
Legal Framework			July									
International Corporate Governance Study			September									
Outline high-level governance principles								December				
Develop ERM/ORSA Type Tool								December				
Develop model law or other implementation tool												December
Group Supervision												
Supervisory college tracking document			August									
Updated Models #440 and #450 adopted				October								
Accreditation Part B Guidelines				December								
Holding Company Best Practices				December								
Study of Holding Company Financial Reporting Requirements								December				
Study Need for Group-Wide Supervision Best Practices												December
Approach to Group-Wide Capital Assessment												December
Stat Accounting & Financial Reporting												
Policy Positioning regarding IFRS: documentation of considerations			August									
Initial Valuation Model (VM-20)				October								
Comments on IFRS Exposure Draft				11/30								
Industry Study					March							
Statistical Agent Policy Decisions					March							
Final Valuation Model (VM-20)						Summer						
IFRS Policy Position Adopted by Subgroup					March							
IFRS Policy Position Adopted by Executive/Plenary							October					
Reinsurance												
Task Force Adoption of Recommendations				October								
Task Force Adoption of Amendments to Model #785 and #786							October					

updated on a continuous basis, the Task Force will be focusing on five key areas:

- Capital requirements,
- Governance and risk management,
- Group supervision,
- Statutory accounting and financial reporting, and
- Reinsurance.

SPECIFIC TIMELINES WITH ACTIONS IN KEY AREAS ARE SUMMARIZED BELOW:

If equivalence is met in the United States, the U.S. subsidiaries with EU parent companies could base their required capital on U.S. statutory capital requirements, and use that as a basis for local decision making. The U.S. subsidiary would still need to meet certain other requirements with respect to risk management and reporting; however, the level of effort for implementation would be somewhat lower, and more importantly the required capital may be lower for certain types of business. To the extent equivalence is not achieved, competitive issues are likely to result between U.S. domiciled companies and U.S. subsidiaries of EU parents, as the former will price products with a view toward U.S. statutory capital requirements, whereas the latter will be required to consider market-consistent, Solvency II capital requirements in their pricing.

Solvency II is a reality and will impact not only those companies with operations in the EU, but also the broader U.S. industry. Solvency II is likely to raise the bar for risk management practices for all insurers, and potentially disclosures as well. This will be fueled by regulators and rating agencies as they review the detailed analysis and disclosures for those companies that do implement Solvency II. S&P has already provided commentary that those companies that are effectively following Solvency II would likely be considered to have a "strong" ERM rating.

A set of six principles are outlined underlying the regulatory review process that need to be met in order for a jurisdiction to be considered equivalent.

THE BASICS OF EQUIVALENCE

Until recently, the guidance on equivalence appeared to indicate that the United States would not be deemed equivalent in advance of Solvency II implementation. In particular, the Commission of European Insurance and Occupational Pensions Supervisors (CEIOPS) guidance on equivalence included the following:

A set of six principles are outlined underlying the regulatory review process that need to be met in order for a jurisdiction to be considered equivalent. They are:

1. powers and responsibilities of the supervisory authority;
2. authorization requirements to undertake (re)insurance business;
3. system of governance and its regulatory oversight;
4. business change assessment;
5. solvency assessment; and
6. supervisory cooperation, exchange of information, and professional secrecy.

The U.S. regime does not currently meet all of these principles. We believe items 3, 5, and 6 are of particular challenge.

In general, the published guidance has created a major challenge for U.S. subsidiaries of European parent companies. Without knowing whether the United States might be granted equivalence, these companies cannot do appropriate capital planning nor is there a firm basis of understanding of requirements to allow for a robust Solvency II implementation plan.

POSITIVE EVOLUTION

More recently, the Solvency II Experts Group has been working on a consolidated set of Level 2 implementing measures taking into account the feedback received on the consultation papers, which aim at providing advice on the more detailed technical implementing rules. The current proposal in the consolidated measures is that if a local regime is moving toward solvency regulation that meets the Level 2 criteria, that regime could be granted a transitional period. The Level 2 criteria are the six principles referred to above. However, based on the latest draft, they no longer appear to require a market consistent measurement basis, just an "economic" one. There are three requirements in order to get there:

- Regime is risk-based or measures being taken to get there.
- Supervisors willing to engage in equivalence discussion and exchange information.
- The supervisors in the regime are bound by obligations of professional secrecy.

If granted, the local regime would be treated as if equivalent for the three-year period.

The new guidance appears positive, in that two hurdles have been removed:

(1) the requirement to use a market consistent basis for the liabilities, which the U.S. regulators are strongly against, and

(2) the need to be assessed for equivalence before Solvency II adoption in order to use U.S. RBC as the basis for Pillar 1 (which would not have happened for the United States).

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In addition to the revisions to the Level 2 measures, a host of Solvency II developments occurred in the first month of the New Year. Some of these developments relate to equivalence for the United States:

As of Jan. 1, 2011, the Solvency II landscape was impacted by the introduction of a new regulatory body—the European Insurance and Occupational Pensions Authority (EIOPA). EIOPA is charged with carrying out activities to support policyholder protection (including pension plan participants), financial stability, and transparency of markets and financial products.

EIOPA replaces CEIOPS and will advise the European Parliament and the European Commission (EC) on issues and regulations for the insurance industry and the occupational pension plans. Some of EIOPA's responsibilities include drafting regulation and binding technical standards (BTS) for adoption by the European Commission, and will also have the power to issue guidelines and recommendations on the application of the binding technical standards. EIOPA will assist supervisors with the appropriate application of the rules of the European Union, and also assist in monitoring and reporting on compliance with those rules. The responsibilities of EIOPA and its coordination with EU member countries are in many ways similar to those of the National Association of Insurance Commissioners (NAIC) and its coordination with the states. However, it appears that EIOPA has more authority with respect to the promulgation of regulations and guidelines, as the standards are expected to be adopted by the EC largely as written and then will be applicable to the EU member countries.

One of the areas of focus for EIOPA will be third country equivalence and establishment of a transitional regime, both for third countries moving toward equivalence as well as for companies adopting the Solvency II requirements directly, to help ease the transition for companies that are struggling to meet the deadlines.

On January 19th, the "Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the Powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority," also known as Omnibus II, was issued by the European Commission. The proposed directive will now be sent to the Council and the European Parliament for consideration. The primary purpose of Omnibus II is to strengthen the supervision of the financial services industry. A specific component of this is broadening the authority of the key European Supervisory Authorities, including EIOPA. Another key component relates to transitional arrangements, including those related to equivalence.

Omnibus II specifies that the EC may adopt a transitional period, not to exceed five years, for subsidiaries in third countries in which it is unlikely that the third country will meet the requirements for equivalence by the end of 2012. It also specifies that the Commission may adopt requirements specifying conditions that must be met by the third country in order to qualify for the transitional regime. The conditions shall cover "commitments given by the supervisory authorities, their convergence to an equivalent regime over a set period of time, the existing or intended content of the regime, and matters of cooperation, exchange of information, and professional secrecy obligations."

Omnibus II also specifies that during this transitional period, the group solvency calculation may use, for the subsidiary in the third country, the Solvency Capital Requirement (SCR) and their own funds eligible to cover the SCR as required by that third country. In addition, parent company supervisors may, during the transitional period, rely on the group supervision of the third country supervisor.

OTHER RECENT ACTIVITIES

In addition to the equivalence impacts mentioned above, there were several additional activities early in 2011 related to the overall Solvency II guidance.

EIOPA ISSUES ITS WORK PLAN

The newly formed EIOPA got to work right away. On January 19th, EIOPA issued its Solvency II Medium Term Work Plan. The work plan is focused on activities related to the implementation of Solvency II, versus the historical focus of the European regulators which was on the development of the regulations.

EIOPA has identified the following work streams to carry out their efforts:
- Valuation of Assets and Liabilities including Technical Provisions;
- Solvency Capital Requirements (SCR, MCR);
- Own funds;
- Governance and ORSA;
- Reporting;
- Disclosure;
- Group Supervision, Supervisory Cooperation, Coordination and Information Exchange, including Colleges of Supervisors;
- Internal Models;
- Supervisory Review Process and Risk Assessment Framework, including Supervisory Transparency and Accountability; and
- Equivalence.

As mentioned above, one of the key responsibilities of EIOPA is in the drafting of binding technical standards (BTS) for adoption by the EC, as well as drafting of non-binding guidance to assist supervisory authorities in their review and analysis of company's compliance with the standards. With respect to Solvency II, the work on the BTS is expected to run from April to December of 2011, and the work on the non-binding guidance will run through March of 2012 (drafting of this "Level 3" guidance has already started). The BTS are dependent on the finalization by the EC of the Level 2 implementing measures and the adoption by the European Parliament of the Omnibus II Directive discussed below. Adoption of Omnibus II by the European Parliament is targeted for November, 2011.

With respect to equivalence, which is clearly an area of keen interest for U.S. companies subject to Solvency II, the priority for the work stream will include the development of Level 3 guidance for supervisors to assist them in undertaking equivalence assessments of third countries. In addition, EIOPA is expected to provide the results of its equivalence assessment of the first wave of countries (Switzerland, Bermuda, and Japan) by September 2011. The second wave of assessments is planned for 2011–2012, and the third wave for 2013–2015. The timing of these assessments is being carefully coordinated with plans for a transitional regime, which is described in the section on Omnibus II below.

Solvency II Framework and Levels

Level	What is it?	What does it include?	Who develops?	Who decides?
1	Solvency II Directive	Overall Framework Principles	European Commission	European Parliament, European Council
2	Implementing Measures	Detailed Implementation Measures	European Commission	EIOPC
3	Supervisory Standards	Guidelines to enhance Supervisory Convergence	CEIOPS (now EIOPA)	
4	Evaluation	Monitoring Compliance and Enforcement	European Commission	European Commission

OMNIBUS II IMPLICATIONS

As described above, Omnibus II was issued in January. Omnibus II makes the following general amendments to the existing Directives:
- Definition of the appropriate scope of **technical standards,**
- Inclusion of mechanisms for the authorities to **settle disagreements,** and
- **General amendments** to allow the directives to operate in the context of new authorities created (such as EIOPA).

In addition to these general amendments, several additional amendments were made specific to Solvency II which fall under the following main points:

1. *Transitional Requirements—this is a significant change with implications for the U.S. industry, and is discussed in more detail below;*

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2. *Amending Level 2 empowerments—empowering the EC to adopt measures to specify procedures for supervisory approvals in specific areas and also to take into account the new Lisbon Treaty, i.e., to ensure regulatory consistency and appropriate empowerment of the regulatory bodies involved in the Solvency II guidance; and*

3. *Extension of two months to implementation date—this officially extends the implementation date of Solvency II to Jan. 1, 2013.*

The specifics regarding transitional arrangements are covered by new sections inserted into the original Solvency II Directive. These new sections essentially provide for the following:

- timeframes during which specific requirements of the Solvency II Directive would not apply in the event that the Commission adopts transitional measures instead;
- authority for the Commission to adopt requirements ("delegated acts") allowing for a transitional regime for specific components of the Solvency II Directive, up to a specified maximum length of time; and
- certain limitations apply to the acts that may be adopted, for example with respect to the allowable level of the Solvency Capital Requirement.

Based on the specifics of Omnibus II, below are the proposed maximum transitional periods that the Commission may grant by way of delegated acts for specific requirements of the SII Directive. The delegated acts would provide details of what would be provided in lieu of the requirements of the Directive during the transitional period, and any phasing-in of requirements:

- A three-year maximum transitional period for
  - An effective system of governance
  - Submission to EIOPA information about the level of capital add-ons
- A five-year maximum transitional period for
  - Companies to provide the supervisor with information to enable an assessment of the system of governance, the business they are carrying on, the valuation principles applied for solvency purposes, the risks faced and the risk management systems, and their capital structure, needs and management
- A 10-year maximum transitional period for
  - Relief from the supervisor to assess a capital add-on because the risk profile of the insurance or reinsurance undertaking deviates significantly from the assumptions underlying the SCR, as calculated using the standard formula. The transitional provisions to be adopted would instead specify requirements for the transitional SCR standard formula, and capital add-ons could be added based on deviation from those
  - The establishment of technical provisions. Any transitional requirements adopted with respect to technical provisions must require at a minimum that the insurer meet the regulations in place in their location of domicile as of the end of 2012
  - Having to specify an approach for calculating technical provisions
  - Having to specify the tiering requirements for own funds
  - Having to specify the standard formula approach for the SCR and that eligible own funds exceed the SCR
  - Having to specify the methodology to be used for calculating the group solvency capital requirement

WHAT IT ALL MEANS FOR THE U.S. INDUSTRY

We believe that the official adoption of Omnibus II has a significant implication for U.S. companies that are subject, through their parent, to the requirements of Solvency II. To the extent the U.S. companies meet the applicable conditions (which are yet to be specified by the Commission) for a transitional regime, up to five additional years will be added to the timeline for Solvency II adoption, during which the U.S. companies may be assessed for equivalence. It appeared that a positive outcome of an equivalence assessment prior to the planned Solvency II adoption date of Jan. 1, 2013 was near impossible; however, such assessment by Jan. 1, 2018 (in the event the transitional period is set at five years) appears feasible, assuming positive progress in certain key areas by the U.S. regulatory bodies.

We also believe there are several key implications of the United States obtaining a transitional and ultimate equivalence decision by the European regulators:

- There will be continued pressure on the NAIC and the SMI Task Force to enact solvency regulations for U.S. insurers that contain most of the key principles of the Solvency II requirements. This will require some effort by U.S. companies to comply, in particular:
  - Implementation of a more robust and transparent ERM structure (including an Own Risk and Solvency Assessment process, which is currently being proposed by the SMI Task Force);
  - Significant revisions to determination of required capital in order to better reflect the underlying risks inherent in the business;
  - Greater linkage of Risk-Based Capital results to business decisions; and
  - Increased levels of disclosure regarding governance, risk exposures, risk management, and capital position.
- The playing field in the United States and globally will be more "leveled," in that the key gaps between the capital requirements for U.S.-based companies and those of European based companies will be closed.
- The management of required capital for U.S. companies with non-U.S. affiliates should be easier, as it will be on a more common basis across legal entities (in other words, the current need to manage capital on multiple and very different bases will be eliminated or at least reduced).
- Use of a more robust regulatory capital framework will influence company strategy, and create further incentives for diversification of portfolios and use of a wide range of risk management strategies (such as reinsurance and hedging) that are understood across the organization, to the board level.

In addition to the potentially positive implications on equivalence, the transitional requirements of Omnibus II will likely ease the pain on the global insurance industry, including U.S. subsidiaries, of being able to meet the very significant requirements of Solvency II by Jan. 1, 2013. It appears that Omnibus II, and the resulting guidance that will be developed by EIOPA, will likely/is expected to bring a welcome sigh of relief from the global insurance industry.

The next several years will be a period of significant regulatory change for the insurance industry globally, with some particular challenges for the U.S. industry depending on the exact outcomes of the NAIC's proposed changes. Close monitoring of global solvency requirements as well as the specificities of the U.S. regime can be beneficial in the long run to manage the steep learning curve and plan in advance for the sweeping changes to strategy, organization, operations, and infrastructure.

LINKS:

SMI Roadmap:
http://www.naic.org/documents/committees_ex_isftf_summer_ntlmtg_meeting_smi_roadmap.pdf

EIOPAs medium term work plan:
https://eiopa.europa.eu/fileadmin/tx_dam/files/about-ceiops/WorkinProgress/SolvencyII-Medium-Term-Work-Plan-2011-2014.pdf

Omnibus II:
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/omnibus2/com2011_en.pdf

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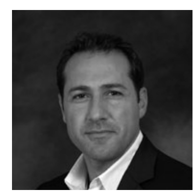

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