



Insurance and reinsurance news

THIRD-COUNTRY ISSUES UNDER SOLVENCY II

This newsletter considers regulatory issues concerning:

- insurance and reinsurance companies ('firms') with head offices outside Europe but that operate in the European Economic Area (EEA) or are members of an EEA insurance group; and
- firms with head offices in the EEA but that are part of a third-country (ie non-EEA) insurance group.

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Introduction

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Recent news on Solvency II

Agreement was reached on the Solvency II level-one directive in April 2009. We have described the general features of the new regime in a separate client guide called [Solvency II and the regulation of insurance across Europe](#).

Third-country insurers operating in the EEA

There are three main business models for third-country firms operating in the EEA:

- (re)insuring EEA risks without a presence or authorisation within the EEA (often referred to as 'non-admitted insurance');
- the creation of an establishment within the EEA; or
- the creation of a European subsidiary.

Non-admitted insurance

Most European jurisdictions, including the UK, allow their (re)insurance risks to be covered on a non-admitted basis. A minority do not, or require that they should at least be written through local intermediaries. At least five EEA member states require all reinsurers involved in a co-reinsurance either to be authorised in the EEA or to have a branch in the state of the risk.

Non-admitted insurance is not an issue directly addressed within the Solvency II project. A recent report by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) describes the different approaches of EEA member states on this issue, although it does not identify which state adopts which approach.

The Reinsurance Directive (RID) is to be consolidated within the Solvency II regime. Under the RID, member states are required not to treat third-country reinsurers more favourably than EEA firms. Arguably this principle should also be regarded as applying to direct insurers. CEIOPS may ultimately develop guidance on how the principle applies to non-admitted (re)insurance.

Even in states where non-admitted reinsurance is possible, unless the reinsurer is authorised in an 'approved' jurisdiction, there may be problems for the cedant. Currently, technical provisions for direct insurance risks situated in the EEA must be covered by assets localised in the EEA. This requirement will no longer apply when Solvency II comes into force, although assets covering technical provisions must be prudently

invested. The localisation of those assets must be such as to ensure their availability. On the other hand, member states may now and under Solvency II require assets representing reinsurance recoveries to be localised in the EEA unless the reinsurer is authorised in another EEA jurisdiction or in a jurisdiction deemed to be 'equivalent'.

Equivalence under current UK rules

Currently in the UK, equivalent jurisdictions include the US, Switzerland, Hong Kong and Australia. Mainland China, Japan, Bermuda and New Zealand are not yet treated as equivalent. The full list is contained in the FSA's definition of 'designated state or territory'. The CEIOPS report shows that EEA member states adopt a variety of approaches to the recognition of third-country equivalence.

The process of establishing 'equivalence' under Solvency II is discussed further below.

EEA establishments of non-EEA firms

A non-EEA firm may wish to establish a permanent presence or establishment in an EEA state. If it does, it must apply for full local authorisation. This may or may not be granted at the discretion of the supervisor in the state in question. The supervisor may, for instance, require the non-EEA group to create a European subsidiary rather than a branch.

The non-EEA firm must also adhere to European prudential standards on the establishment's operations. Unlike firms with EEA head offices, however, the non-EEA firm's EEA branch has no right to passport into other EEA jurisdictions. It requires full authorisation in each EEA state where it operates or (if non-admitted (re)insurance is not allowed) covers or reinsures risks.

The prudential regimes of some EEA member states, including the UK's, anticipate some of the Solvency II reforms. These include the right of the supervisor to apply pillar-two 'capital add-ons' if the capital adequacy requirements at pillar one are not considered adequate to provide for the firm's full risk exposure. This will cover risks arising from the non-EEA operations of a non-EEA firm operating through an establishment in the EEA. Firms authorised in non-equivalent jurisdictions will come under special focus.

Under Solvency II, every European supervisor has the power to apply these add-ons to firms authorised in the state in question. The existing Solvency II text contemplates capital add-ons being applied only in 'exceptional circumstances', although the meaning of that expression is somewhat watered down in recital 17a.

EEA subsidiaries and participations of non-EEA groups

A (re)insurer A, authorised in an EEA state B, may be a subsidiary of a (re)insurer C, authorised outside the EEA in state D. Alternatively both A and C may be members of the same corporate group headquartered in state D and mainly operating outside the EEA. The group will usually have a non-operating holding company, also based outside the EEA.

In that event, for solo regulatory purposes, A is treated as an EEA firm. Under Solvency II, unless the group supervision regime in state D is treated as equivalent to Solvency II standards, A may be subject to group capital adequacy standards in state B implementing the group capital adequacy requirements in Title III of the Solvency II Directive. These requirements may apply by reference to the non-EEA group as a whole and to any European sub-groups.

Most EEA states currently have no special national provisions that exempt A from the requirement that reinsurance recoveries from C should be covered by local assets if D is not an approved state. Under Solvency II no such national provisions will, in any event, be possible.

CEIOPS is currently consulting on the rules for establishing which entities are to be treated as group members and which are not.

Non-EEA members of EEA insurance groups

Under both Solvency I and Solvency II, capital adequacy must be maintained at group as well as at solo level. We cover this issue in our general Solvency II client guide. Group capital adequacy requirements may be greater or less than the sum of the solo capital requirements of the firms within the group. Diversification benefits across the group, which can be established through capital modelling and otherwise, may reduce the total group regulatory capital requirements.

On the other hand capital within non-EEA group members may have to be significantly written down for the purpose of calculating group solvency because:

- the member is authorised in a non-equivalent jurisdiction and its regulatory capital position must be redetermined according to Solvency II rather than local standards; or
- capital in excess of the non-EEA firm's regulatory requirements cannot in practical terms be transferred into Europe (if for instance the local supervisor is likely to object) and cannot accordingly count towards group capital.

How equivalence will be determined under Solvency II

A non-EEA jurisdiction may be regarded as equivalent to Solvency II in regard to its solo requirements, its group requirements or both. The fact that a country is regarded as equivalent under Solvency I does not mean that it will necessarily be equivalent under Solvency II. Federal jurisdictions such as the US may require a distinct determination for each constituent state.

The Solvency II implementation timetable provides for consultation by CEIOPS (starting in December 2009) on the level-two criteria to assess third-country equivalence. CEIOPS will then consult on individual assessments of third-country equivalence in March 2011. These will be followed by discussions with the third countries concerned, leading to a final decision on the issue by the Commission itself in June 2012.

There are concerns that this may leave little time for international insurance groups to prepare before Solvency II comes into force the following October. It is possible that these concerns may be met to some degree by transitional and grandfathering arrangements, although no proposals to that effect have yet been published either by CEIOPS or by the Commission.

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