FRESHFIELDS BRUCKHAUS DERINGER

The European insurance market and third-country insurers

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Introduction

A new regulatory regime for the European insurance market is due to come into force at the end of 2012 or the beginning of 2013. This new regime, 'Solvency II', will replace the current Solvency I regime and will apply to the whole of the European Economic Area (EEA). It will have significant implications for insurance and reinsurance companies ('firms') authorised in other parts of the world.

In this client guide we consider those implications. We focus in particular on:

- firms with head offices outside Europe that reinsure risks ceded to them by EEA firms;
- firms with head offices outside Europe but that operate in the 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.

This guide does not discuss the distinct Solvency II rules on special purpose vehicles (SPVs).

Recent news on Solvency II

The Solvency II level one Directive was formally adopted by the EU in November 2009. We have described the general features of the new regime and current progress towards its implementation in a separate client guide, Solvency II and the regulation of insurance across Europe.

In April 2010, the European Commission published a draft technical specification for its fifth series of Solvency II quantitative impact studies (QIS5). This provides further information on the detailed rules likely to apply under the new regime, although many final policy decisions may be deferred until the completion of QIS5.

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 a branch or establishment within the EEA; or
- the creation of an EEA subsidiary.

Non-admitted insurance

Most EU members allow their (re)insurance risks to be covered on a non-admitted basis (ie without requiring the insurer to have a local authorisation), if the firm in question has no presence in the state of the risk. A minority of member states do not allow this, or they may impose restrictions for some lines of business.

In France, for instance, the rule against non-admitted insurance applies to most lines apart from marine and air transport. In the UK, there is no restriction on non-admitted insurance operations, although in the retail sector financial promotion rules apply even to non-admitted insurers.

Solvency II makes no significant changes to the rules on non-admitted insurance.

EEA establishments of non-EEA firms

A non-EEA firm may wish to establish a permanent presence or establishment in an EEA state. In this case, it must apply for a 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 operations of the establishment. 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 a full authorisation in each EEA state where it operates or (to the extent that non-admitted (re)insurance is not allowed) covers or reinsures risks. Here again, Solvency II makes no significant changes.

EEA subsidiaries and participations of non-EEA groups

Firm A, authorised in EEA state B, may be a subsidiary of firm 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, E, also based outside the EEA. There may also be an EEA intermediate holding company, F.

Members of the group may be linked not only by parent/subsidiary relationships, but also through 'participations', a complex corporate concept based loosely around a holding of at least 20 per cent.

In such cases, for solo regulatory purposes, A is treated as an EEA firm. It is prudentially supervised within the EEA by reference to its worldwide activities.

Under Solvency I, as applied by the Financial Services Authority (FSA) to the UK, if group capital is in regulatory deficit at European level (ie for company F), A itself is in regulatory breach. By contrast, A is only required to *report* on group capital at ultimate world level (ie for company E). It is only required to *ensure* that group capital at that level is not in deficit if the FSA applies an individual requirement to that effect.

This will change under Solvency II as described below.

A few significant legal distinctions

Non-admitted insurance or establishment?

It is not always easy to establish whether the activities of a third-country insurer operating on a non-admitted basis remain truly offshore or whether the local presence has evolved to a degree if a European establishment can be said to exist. The European Commission has issued guidance on this question in its interpretive communication: Freedom to provide services and the general good in the insurance sector. One of the key factors is where major business decisions as to, for instance, underwriting and payment of claims, are made.

The existence or otherwise of an establishment is also an issue regarding where insurance activities should be taxed, although the concept of 'establishment' has a meaning in tax law that is different from its regulatory meaning.

Establishment or head office?

A third-country insurer that has an establishment in Europe will require a local authorisation for that establishment. Again, however, there is an important distinction between:

- non-core activities in Europe giving rise to a European establishment; and
- a more systematic migration of the main activities and management of the firm, suggesting that the head office of the firm in question has itself moved to Europe.

The latter would trigger the requirement for a full European authorisation and prudential regulation of the firm's worldwide activities.

The question where a head office is located may also arise with a holding company that is the ultimate parent of an insurance group. If the holding company claims to be based in a non-EEA country, but European supervisors consider that the head office is in fact in Europe, the group is most likely to be treated as a European group subject to the mandatory full Solvency II group regime. Questions of equivalence will not, therefore, arise.

Equivalence issues generally

Whether specific third countries are regarded as equivalent in the supervision of firms or groups may have a number of consequences under Solvency I and Solvency II. Similar issues arise with banking groups and financial conglomerates, but these are not directly covered in this guide.

Financial conglomerates themselves are not covered by the Solvency II project, although insurance groups within the conglomerate will be. A specific country may be equivalent under Solvency II for one aspect of insurance of financial services supervision, but not for another. The Solvency II equivalence proposals do not cover SPVs.

In this client guide we consider:

- what the consequences of equivalence or non-equivalence may be in the three insurance regulatory contexts in which it arises (see Introduction above);
- the criteria for determining equivalence; and
- the process by reference to which equivalence or non-equivalence is to be determined under Solvency II.

Equivalence issues for solo firms

If the solo solvency regime of a non-EEA country is regarded as equivalent, 'reinsurance contracts concluded with undertakings having their head office in that third country shall be treated in the same manner as reinsurance contracts concluded with an undertaking which is authorised in accordance with this Directive.'

This will prevent the supervisor of the ceding firm from, for instance:

- requiring pledging of assets to cover unearned premiums and outstanding claims provisions (no such requirement is currently imposed in, for example, the UK); or
- allowing less credit for the reinsurance to be taken than would apply if the reinsurer were authorised in the EEA.

Equivalence issues for EEA groups

Solvency I

Currently within the UK, third countries outside the EEA treated as equivalent for insurance purposes 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 Handbook Glossary definition of a '[designated state or territory]'. It was established following discussions between the FSA and supervisors in other member states.

If a firm authorised in an equivalent non-EEA country is a member of a UK insurance group, its capital may be counted towards group regulatory capital by reference to local regulatory requirements. This is a significant advantage for groups supervised by the FSA, since in the UK the group regulatory capital of insurance groups is currently calculated by reference to regulatory surplus (the aggregation/deduction method). So member firms of the group authorised in non-equivalent jurisdictions may need to have their capital written down by reference to UK requirements. This may in turn result in a lower figure for group regulatory capital.

Solvency II

Under Solvency II, the default method for calculating group regulatory capital will be the accounting consolidation method (described in the Directive as 'method one'). Method one is based on the consolidated accounts of the group in question. Most EEA member states (other than the UK) already apply this method. The UK will move over to method one when Solvency II is implemented.

When that method is applied, the fact that some members of the group are authorised in non-equivalent jurisdictions will not affect the calculation of group regulatory capital. The supervisor for the group in question may, however, decide to apply the aggregation/deduction method ('method two') instead of method one to the group as a whole or to a part of the group, in which event:

- if method two is applied to a firm in an equivalent jurisdiction, the group supervisor will have the option to apply either:
  - the local rules for calculating the capital of the firm in question; or
  - Solvency II rules; and
- if method two is applied to a firm in a non-equivalent jurisdiction, the Solvency II rules must be applied.

So in this context, a finding that the jurisdiction in question is equivalent *may* avoid the need for write-downs to the extent that Solvency II rules are stricter than local rules. However, it will not necessarily have that effect. It will depend on which method is applied and how the group supervisor exercises its discretion.

The discretion to apply method two is in principle more likely to be exercised regarding firms in non-equivalent countries. Capital items particularly likely to be written down or excluded from group regulatory capital will include items that are not regarded as 'fungible', ie available to support the group as opposed to the solo firm that issues them.

Equivalence issues for non-EEA groups

Solvency I

As noted above under Solvency I as applied in the UK, a firm merely reports on the regulatory capital of its ultimate world parent. So the question of equivalence does not directly arise for non-EEA groups, although it may possibly indirectly influence how the FSA will react to the group capital report.

Solvency II

Under Solvency II, the treatment of insurance groups whose ultimate parent has its head office outside the EEA is brought into line with the treatment of banking groups and financial conglomerates. If group supervision in the jurisdiction in question is recognised as equivalent, EEA member states are required by the directive to 'rely on' that supervision.

Such reliance, however, will not prevent the EEA member states from continuing to take an interest in group issues as they affect the solo firms for which they are responsible. Moreover, the third-country group supervisor will be expected to follow European practice in convening a college of supervisors to discuss and agree issues affecting the group. The college will represent all supervisors responsible for solo firms in the group as well as supervisors in whose jurisdiction 'significant branches' of group members have been established.

If group supervision in the jurisdiction in question is not regarded as equivalent, the group is likely either to be supervised by an EEA supervisor or to be required to establish a European holding company.

Criteria for determining equivalence under Solvency II

The Solvency II implementation timetable provides for consultation by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) on the level two criteria to assess third-country equivalence. This consultation was completed in April 2010. In its Consultation Paper 78, CEIOPS proposed a series of high-level objectives and principles by reference to which equivalence should be determined for:

- third-country solo firms in respect of business ceded by EEA firms;
- third-country members of EEA insurance groups; and
- third-country insurance groups.

These objectives and principles were supplemented by more prescriptive 'indicators' derived from the main outlines of the Solvency II regime. CEIOPS originally proposed that the indicators should be treated as 'factors which provide guidance in determining whether the relevant principles and objectives are achieved.' In its final advice, however, it made clear that 'when assessing a particular principle and objective, every indicator does not

necessarily need to be fulfilled in order for principle and objective to be considered observed.'

There is considerable overlap in the requirements for equivalence as between the three points above.

The result of CEIOPS' advice to the Commission is that it is not entirely clear what is expected of third countries seeking equivalence recognition. More clarity may emerge if and when CEIOPS publishes level three guidance.

Some Solvency II proposals reflected in the indicators go beyond internationally accepted regulatory practice (as recorded, for instance, in standards published by the International Association of Insurance Supervisors). It may be unreasonable to expect third countries to adhere to them. Some of them, such as the one-in-200 confidence level applied within the solvency capital requirement, may, however, be viewed as more fundamental.

Other key issues in determination of equivalence will be:

- whether the third-country regulatory and supervisory regimes provide a similar level of policyholder/beneficiary protection to the one provided under the Solvency II Directive;
- how those regimes apply the proportionality principle to, for instance, smaller firms;
- the requirement for strict adherence to confidentiality rules and practice for information supplied by firms to supervisors and by one national supervisor to another national supervisor; and
- whether third-country supervisors have the resources and independence required to act effectively.

Although CEIOPS has now published its final advice to the Commission on equivalence criteria, it remains open to the Commission to depart from that advice when it publishes its own proposals for level two measures in October and November 2010.

The process for determining equivalence

CEIOPS is due to consult on individual assessments of third-country equivalence in March 2011 and to provide final advice to the Commission on that issue by the end of July 2011. It will also be developing level three guidance on the methodology to be applied in assessing third-country equivalence. This will be followed by discussions with the third countries concerned, leading to the Commission's own proposals on individual assessments by December 2011 and a final decision by February 2012.

It is possible that this timetable may slip.

There are concerns that this may leave little time for international insurance groups to prepare before the Solvency II regime comes into force the following October or January. CEIOPS has addressed these concerns by:

- pointing out that its Consultation Paper 52 proposes a mechanism for determining how reinsurance transactions with non-EEA firms in non-equivalent jurisdictions should be treated;
- pointing out that national supervisors acting as group supervisors for specific groups may make equivalence determinations if the Commission has not already done so, although any determination of equivalence by a group supervisor may be reversed at a subsequent date by the Commission;
- indicating that 'the Commission may wish to consider the need for a transitional period in order to integrate the international operation of groups into the Solvency II regime and to allow for the development of a harmonised approach across Europe to internationally active groups.' In this connection it should be noted that the QIS5 technical specification accepts that transitional arrangements may be required on a number of aspects of the Solvency II regime; and
- suggesting that the Commission should consider in appropriate cases making findings of 'qualified equivalence' if, for instance, the non-EEA supervisor meets the criteria for supervising some, but not all, insurance groups.

Freshfields Bruckhaus Deringer will be monitoring the equivalence agenda within Solvency II as the implementation date approaches and will from time to time publish updated versions of this client guide.

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