Solvency II's Long Reach – Beyond Europe

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Introduction

Solvency II, the imminent new European Union (EU) capital and regulatory regime for insurance and reinsurance, will have many and varied impacts outside the EU. This brochure presents you with an overview of these impacts and attempts to place them in an understandable and practical context.

RGA summarizes the extra-territorial impacts of Solvency II into these four categories:

1. Non-EU subsidiaries of EU groups
2. EU subsidiaries of non-EU groups
3. Recognition by EU insurers of reinsurance purchased from non-EU reinsurers
4. Non-EU countries that will eventually adopt a new capital and regulatory regime like Solvency II

Non-EU Subsidiaries of EU groups

This is the category with the greatest potential impact. EU groups are required to calculate consolidated Solvency II results covering their global insurance business, including their overseas operations. This requires either (i) the application of all Solvency II-detailed calculations to that non-EU business or (ii) that the subsidiary be in a jurisdiction whose own regulatory regime has been certified by the EU to be equivalent to Solvency II. In the latter case, the EU group will be able to use the subsidiary's local capital position.

Where the local regime has been judged equivalent for the purposes of the consolidation this means little extra work or worry for that subsidiary. Where that equivalence is not deemed to be present, the local subsidiary will have material extra work to perform

Equivalence to Solvency II

The notion of "equivalence to Solvency II" is used in three distinct areas in the Solvency II regulations. All three areas have the basic goal of ensuring that "third-country equivalent regimes" provide a similar level of policyholder and beneficiary protection to the one provided under Solvency II. Depending on the relevant area, however, this equivalence has subtle, but important, differences. The three equivalences are:

1. Equivalence of reinsurance supervision (§172 of the Solvency II Framework Directive from 2009)
2. Consolidating non-EU subsidiaries into EU group Solvency II (§227)
3. Reliance on group supervision from outside the EU (§260)

Note that countries and not companies are assessed for equivalence. A country assessed with respect to equivalence need not 'go for' all three, and the verdict may indeed be different across the three for a single country.

for its European parent. It will effectively have an additional reporting basis, on top of its local statutory, IFRS or US GAAP, tax and internal bases like embedded value (EV).

The subsidiary may find itself in the position where the Solvency II assessment of its business will be less positive than the local basis or other bases. This could require the EU group to hold additional capital (not necessarily in the non-EU country, but somewhere in the group). In extreme cases this could cause the EU group to force its subsidiary to change the business it sells or it might even, in the most extreme case, be motivated to sell its overseas subsidiary.

One example in which Solvency II would present a less rosy picture of business than other accounting and capital regimes around the world is that of business with a large savings element with fixed return rates above risk-free rates. Solvency II is based on market-consistent principles and it thereby gives no current credit for anticipated future credit spreads. Other systems, on the contrary, allow these anticipated credit spreads to be included in the rate used to discount those liabilities, giving a lower liability and thereby a lower total asset requirement (i.e., reserves plus capital).

Other examples of potential negative divergences are of business that contains material investment guarantees or which gives policyholders material options (e.g., book value surrender). Because many companies already use internal reporting or measurement systems based on market consistent principles (e.g., Market Consistent Embedded Value {MCEV}), manifestations of these divergences should not be completely unforeseen, but they may now become more high-profile by being related to the group's primary capital measure.

There will also be cases where foreign business appears much more valuable – and over-capitalised – under Solvency II than under its local basis. The typical business in this category would be most unit-linked business and some participating/with-profits business, where the policyholder bears most of the risk and the insurer receives its fees or profits in all plausible scenarios.

EU subsidiaries of non-EU groups

The nightmare scenario here was averted. EU regulators recognize that the strength and viability of an insurer

Fungibility and Transferability

Every insurance entity in the EU must meet Solvency II (including the Solvency Capital Requirement {SCR}) on a stand-alone ("solo") basis. As a result, issues of allowing for diversification between separate legal entities and questions of whether capital in one entity would truly be available to another entity are of limited practical importance within the EU. For non-EU subsidiaries, however, these issues and questions become very important. It would not be uncommon that an EU group with subsidiaries in both Asia and the US could have fundamental challenges here. The Asian business could be over-capitalised according to Solvency II and the US annuity business could be under-capitalised. In order for the group to count the excess Asian capital to cover the US deficiency, however, it must demonstrate that that excess Asian capital would be "fungible and transferable" within a nine-month period. This is no easy task.

is partly determined by the strength and support of its parent and wider group. In the earlier stages of Solvency II 'negotiation', before pragmatism started to occasionally win out over theoretical correctness, an idea was proposed to require EU companies belonging to non-EU groups to report the position of their whole global group under Solvency II. This 'tail wagging the dog' approach was eventually dropped. EU subsidiaries of non-EU groups are therefore not required to submit global group solvency figures on a Solvency II basis. For an EU subsidiary that is not the largest part of its own global group this would have created significant work outside the EU.

EU operations of non-EU groups are required to submit Solvency II filings in the same way as if they were an EU group headed by the top EU company. This means each entity must submit and satisfy stand-alone ("solo") Solvency II requirements and the group must submit a consolidated filing. When multiple EU entities exist – especially each owned directly from overseas – this requirement can motivate the group to consolidate its EU operations into one EU group, if not one EU legal entity. This is essentially the same motivation faced by EU groups, many of whom are consolidating their legal structures into as few distinct legal entities as possible.

Solvency II will defer responsibility for some of its group supervision activities to a non-EU parent if the EU entity belongs to a group that is ultimately domiciled in a jurisdiction whose regulatory regime has been deemed equivalent. These activities include, for example, assessing EU group solvency, risk management practices and intra-group transactions.

A lot of discussion around Solvency II focuses on the quantitative results. These are primarily the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR) that are calculated under Solvency II's 1st Pillar. The 2nd and 3rd Pillars, covering qualitative supervision and disclosures, respectively, actually contain the more revolutionary and demanding developments. Companies must demonstrate that they have incorporated risk management into their daily management decision-making processes. They must actively share and discuss their risk management results with their regulator and they must disclose materially new and potentially difficult-to-understand information to the general public. Equivalence with respect to these latter Pillars may be the most difficult to achieve or to demonstrate.

Solvency II isn't just a capital requirement

Even if you confine your consideration of Solvency II to just the quantitative elements (1st Pillar), it is important to recognize that Solvency II is not just a determination of a capital requirement like the prior regime or most other regimes around the world. Solvency II is actually a complete stand-alone balance sheet system, unlike other systems where the capital requirement is then compared to actual capital on a separate balance sheet (e.g., local statutory accounting). You cannot simply compare the Solvency II SCR to the prior regime's capital requirement. Instead, you look at the sum of that SCR with the technical provisions calculated per Solvency II and compare that to the total value of assets, again assessed per Solvency II rules. A product could, for example, have reserves of 100 and required capital of 10 under the prior regime and have reserves of 50 and SCR of 25 under Solvency II. The total new asset requirement (75=50+25) is much lower than the prior (110=100+10) and just comparing the capital requirement (10 vs. 25) would give you a false impression. The intention is that the Solvency II balance sheet will converge with the IFRS balance sheet, but this is still only an aspiration.

Recognition of reinsurance from non-EU reinsurers

One of the key refinements in Solvency II versus the prior regime is that the impact of reinsurance and other risk mitigation techniques is now given full consideration. The prior regime had an oversimplified and an 'insensitive' treatment of reinsurance, but now companies will face no arbitrary limitations in the benefit resulting from their reinsurance.

To be eligible to be reflected as a reduction in capital requirements, reinsurance must be with an EU-domiciled reinsurance company, one based in a regime deemed equivalent or at least with a reinsurer that is capitalized to a certain level. For reinsurance with companies under the last category (i.e., strong reinsurer in a non-EU non-equivalent jurisdiction), Solvency II permits, but does not require, EU insurance regulators to impose additional requirements on the ceding insurer related to that reinsurance. For example, an EU regulator could impose collateral requirements for credit for such reinsurance. EU regulators are not permitted to treat such reinsurers/reinsurance more favourably than they treat EU reinsurers and equivalent jurisdiction reinsurers.

There are no distinctions in Solvency II between related party reinsurance and third-party reinsurance.

As well as allowing EU insurers to reflect the benefit of their reinsurance in the above circumstances, Solvency II also requires insurers to hold some capital and reserves to reflect the fact that there is a risk that the reinsurer (regardless of jurisdiction, rating

or capital level) could be unable to deliver on its promises when the need arises. The amount of this capital and reserve, however, does vary by the rating of the entity and whether collateral is present.

Even in cases where no credit is allowed for reinsurance, cedants still must reflect in their capital requirements any risks to them that arise via that reinsurance contract. One potential influence of Solvency II on reinsurance structures is that swapping of risks might become an alternative to traditional 'one-way' reinsurance transactions. Under such a 'two-way' agreement, the lack of credit for the 'outward' leg does not mean that the 'inward' leg gets ignored.

Future adoption by non-EU jurisdictions of a regime like Solvency II

Many countries outside the EU are already talking about "adopting Solvency II". This is clearly an oversimplification of matters since Solvency II is tailored to match the products and history of the 27 EU states, and another country would need to similarly tailor its 'Solvency II'. In addition, recall that the final EU Solvency II regime is the result of extensive debate, compromise and choices, and those same processes in other countries are not certain to come to the same conclusions, even if they start with the same principles.

Nonetheless, many countries will be inspired by Solvency II and will adopt new insurance and capital requirements reflecting Solvency II principles. Some observations and lessons from Europe are certainly relevant, including the following:

1. Applying short-term Value at Risk (VaR) methods and principles to long-term life insurance liabilities is not straightforward.
2. Participating and with-profits business, where management action can be used to reduce policyholder benefits in an adverse scenario, is challenging to realistically project but is of profound importance to the solvency assessment.
3. The 2008 financial crisis highlighted the relative illiquidity of insurance liabilities. Policyholders do not buy and sell/surrender their policies as often or as optimally as they make other financial decisions. The protective value of this to insurers is something that should be reflected in the capital framework. Solvency II's abandonment of historically common surrender value or zero floors in liability calculations is one example of how to reflect this view.

While other countries should be able to avoid some of the detours and dead-end paths that the EU followed during its journey of more than 10 years from formal project launch to implementation, they should not underestimate the time, energy and professional judgement required to "adopt Solvency II".

Conclusion

Though Solvency II is a European Union initiative, it will have many very significant effects far outside the EU. Like many other aspects of Solvency II, this aspect becomes increasingly complicated as you delve further into the details. This brochure provides an initial overview, but each of the paragraphs here begs as many questions as it answers. RGA, with 27 offices around the world, including eight in Europe, is well-positioned to explore these issues with you further.

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