Insurance Briefing

December 2011

Solvency II - Group supervision and equivalence

In October, the FSA acknowledged that it is working towards a 1 January 2014 start date for Solvency II. As widely predicted, the original timetable for completing such a fundamental overhaul of insurance regulation has simply proved too ambitious for both firms and regulators. Even with this further delay, firms will no doubt struggle to be ready on time; it does not help that some key aspects of the new regime remain unsettled.

In the area of group supervision, challenges associated with preparing for Solvency II at a solo level are magnified by the need for coordination between group companies and, often, by the involvement of several regulators. The position is likely to be especially difficult for groups operating outside the EEA, which must try to reconcile different systems of supervision and overcome barriers (whether legal or practical) to the exchange of information.

In a speech at the ABI's Solvency II conference on 8 December 2011, Julian Adams (Director of Insurance, FSA) highlighted the importance of group supervision under Solvency II and the need for industry to engage with group issues. Otto Thoresen, ABI Director-General, has also expressed concerns about the read-across of Solvency II solo requirements to groups and the operation of colleges.

This briefing considers some of the issues for groups under the Solvency II Directive (Directive). We also refer briefly to the FSA's first consultation paper on transposition of the Directive (CP11/22), which was published on 9 November 2011, and to HM Treasury's Solvency II consultation, which was launched a couple of weeks later. Both cover group supervision. Comments on the two papers must be provided by 15 February 2012 and we intend in due course to issue a briefing looking at the points they raise.

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Insurers and reinsurers that are part of a group must, in particular:

- Gain a complete understanding of the impact of Solvency II on the group and make sure that relevant regulators agree - the legislation is not always very clear so there is considerable scope for misunderstanding;
- Prepare for all aspects of group supervision – much of the focus to date has been on capital requirements (including group internal models) but other aspects of group supervision, such as governance, cannot be ignored;
- Implement any group restructuring in good time - a Part VII FSMA transfer takes several months to complete, particularly given current constraints on FSA resources, and other restructurings are also likely to take some time to implement;
- Bear in mind that regulatory decisions concerning groups are likely to take considerably longer than decisions at the solo level, reinforcing the need to plan early.

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Group supervision – how will things change under Solvency II?

Solvency II represents a step change from group supervision under the Insurance Groups Directive (IGD). Improvements inspired by other European legislation in the financial sector include the introduction of a dedicated "group supervisor" with real powers and responsibilities and the establishment of Colleges of Supervisors to take a coordinated approach to supervision. Capital requirements are, as at the solo level, risk-based and reinforced by Pillar 2 requirements (e.g., governance; group ORSA) and by new reporting obligations.

Group supervision is triggered under Solvency II by the presence of an EEA insurer or reinsurer (together referred to as "insurers" in this briefing) within a group that satisfies one or more of four tests (see separate box). Applying those tests, it is clear that the threshold for group supervision is set at a relatively low level. Only one insurer is needed under Cases 2, 3 and 4 and only one of the insurers in a Case 1 group need be headquartered in the EEA. Group supervision under Case 4 is relatively light touch and not considered further here.

| Case 1 | EEA insurer is a participating undertaking in at least one EEA or non-EEA insurer |
| Case 2 | EEA insurer whose parent is an EEA insurance holding company* |
| Case 3 | EEA insurer whose parent is a non-EEA insurance holding company or a non-EEA insurer* |
| Case 4 | EEA insurer whose parent's primary focus lies outside the financial sector (a "mixed activity insurance holding company") |

"Participating undertaking" is established by:

- a parent/subsidiary undertaking relationship
- 20% voting rights or capital, direct or by way of control
- an Article 12(1) relationship for accounting consolidation purposes (see 7th Company Law Directive)

Subsidiaries of an "insurance holding company" must be "exclusively or mainly" insurers. This should mean that a group that is predominantly active in the non-insurance field, but which has a relatively small ancillary insurance operation, is subject to limited supervision only, under Case 4. Consistent with past FSA guidance in this area (which was removed when the FSA decided to adopt a more principles-based approach to regulation, but which there was no reason to believe was wrong), groups should assume that the "exclusively or mainly" test is not simply a matter of counting subsidiaries. If it were, groups with insurance holding companies may find it relatively easy to establish enough non-insurance subsidiaries to avoid the full rigour of the groups regime.

The triggers for group supervision are cumulative, which means that a particular group may be supervised at more than one level and may have more than one group supervisor (see further below for powers and responsibilities). For example, an EEA insurer which is directly owned by an EEA insurance holding company, but whose ultimate parent is outside the EEA, may be subject to group supervision at both the EEA sub-group level and at the insurance parent (worldwide group) level (see Diagram A).

A group that is headed by a non-EEA insurer or insurance holding company, but which has multiple entry points into the EEA, may have a number of EEA sub-groups, each of which is supervised separately and in addition to any supervision at worldwide group level (see Diagram B). The group in Diagram B may, in theory at least, have up to three group supervisors.
Group supervision applies to the entire group, including any companies (whether or not they are insurers) in which a participation is held (broadly, 20% or more of voting rights or capital) and including any non-EEA companies. Although the Directive states that this does not mean that a supervisory role should be played in relation to firms that are outside the scope of the Directive (such as holding companies), the requirement that Member States ensure that all persons who effectively run an insurance holding company are fit and proper is an express exception to this general rule. The Directive also seems to envisage the direct imposition of other obligations on insurance holding companies e.g., see provisions dealing with the reporting of risk concentration and intra-group transactions. It is not clear how effective such requirements would be against companies located outside the EEA.

Diagram A: Levels of Group Supervision - EEA Sub-Group and Worldwide Group

Diagram B: Levels of Group Supervision - EEA Sub-Groups and Worldwide Group.
Identity and role of the group supervisor

Coordination and decision-making powers given to the "group supervisor" under Solvency II make it important for groups that their preferred supervisory authority assumes that role. The Directive establishes criteria for determining which supervisory authority should be group supervisor, but allows those criteria to be overridden where their application would be "inappropriate". The group has an opportunity to state its preference before such a decision is taken and should seek to influence supervisors' use of this power if it is concerned about who might otherwise become group supervisor.

The group supervisor is likely to be obvious in most cases. If not, application of the Directive criteria will depend on the location and respective sizes of the EEA insurance companies and the location of any parent companies. In a particularly complex group, relevant supervisors should already have been contacted to ensure that one, and only one, expects to assume the role of group supervisor. Current proposals for a phased introduction of the Solvency II regime, involving Member State transposition of the Directive by 1 January 2013 (although it would not apply to firms for a further year), may be helpful in this area in ensuring that "Colleges of Supervisors" can be fully functioning before the new groups regime comes fully into force. Indeed, Mr Adams noted in his 8 December speech that the FSA is already working hard to coordinate its approach with that of supervisory authorities in other EEA states, with a view to ensuring that collective decisions can be made at the right time.

Whilst the group supervisor is required to consult with other members of the college, it has final decision-making powers in a number of areas, including whether to approve a group model or impose a group capital add-on. These powers are likely to be diluted, however, once EIOPA receives powers under the (currently draft) Omnibus II Directive to resolve disagreements between supervisory authorities.

Colleges of supervisors

The establishment of a "College of Supervisors" for each insurance group is expected to make group supervision considerably more effective and efficient than under the IGD. Membership of the college will always include the group supervisor and supervisory authorities of all Member States in which the head office of a subsidiary is situated, seemingly regardless of whether that subsidiary is an insurance company. This is surprising as membership might be expected to be limited to supervisory authorities of Member States in which group insurers are located rather than extending to other types of company. It may be an error.

Supervisory authorities of "significant" branches and of group companies that are not subsidiaries will also be allowed to participate in the college, but their involvement is strictly limited to achieving the objective of an efficient exchange of information. Level 2 implementing measures (which will be called "delegated acts" once Omnibus II takes effect) will define a "significant branch" for these purposes. EIOPA will also be empowered to develop technical standards dealing with the operational functioning of colleges.

Much of the detail about how the group supervisor and colleges should work together remains unresolved at this stage but it will be important for groups that the new arrangements work as smoothly as possible and without constant reference of decisions to EIOPA for review.

Groups with an EEA parent – capital requirements

EEA-headquartered groups will be required to calculate a group SCR at the level of the ultimate EEA insurance holding company or EEA insurer. As for solo supervision, the group SCR can be determined by applying the standard formula or through an approved internal model.

Thus, the requirement to calculate a group SCR rests in Diagram C at the level of the ultimate EEA insurance holding company. No group SCR is required at either the intermediate insurance holding company or mixed activity insurance holding company level.

By default, groups will be required to calculate their group SCR on an accounting consolidation basis, unless they can demonstrate to their group supervisor that the exclusive application of the default method is "inappropriate", in which case they may apply the alternative (aggregate and deduction) method or a combination of the two methods. There is no guidance as to how this test should be applied in the Directive itself, although Level 2 measures are expected to specify relevant criteria.
Groups with a non-EEA parent – equivalence

Under Solvency II, all groups that contain an EEA insurer are, in principle, subject to group supervision at the worldwide level, notwithstanding any issues of extra-territoriality. We have no doubt that many difficult cases will arise in this context.

Equivalence

The first question for a group which has a non-EEA parent company will be whether a finding of "equivalence" has been made in relation to group supervision carried out in the relevant non-EEA jurisdiction. Subject to the availability of transitional provisions (see further below), determination of "equivalence" is a matter in the first instance for the Commission, failing which, individual supervisory authorities can take a decision (see Diagram D). There is clearly a risk under this second scenario that Member States will reach different views about whether a particular third country regime satisfies equivalence criteria. This could leave some insurers at a relative disadvantage to others depending on their home state regulator, although EIOPA is expected to try to limit the extent to which this happens in practice, with the help of Level 3 guidance.

If the relevant third country has been determined to be equivalent, Member States must rely on the regulatory authority in that jurisdiction to carry out group supervision and cannot also supervise the group at the non-EEA holding company level (although group supervision would still take place separately at the level of any EEA sub-group – Diagram A provides an example of this).

The wording of the Directive suggests that the relevant third-country supervisor will also be group supervisor although it seems at least arguable that this can be overridden by agreement between the relevant supervisory authorities. It remains to be seen how the Directive is applied, for example, where the only group presence in a non-EEA jurisdiction is an insurance holding company and all insurance and reinsurance operations are carried on through EEA subsidiaries.
Insurers whose parent is an insurance holding company having its head office outside the EEA OR a non-EEA insurer (“Parent”)

Has the Commission made a decision on the equivalence of the third country involved?

NO

Has the Commission concluded that the third country regime is equivalent?

NO

Group supervisor has concluded that regime is equivalent OR regime is deemed equivalent under transitional relief?

YES

Member States apply Solvency II at the level of the Parent (worldwide level); OR “other methods”, which may include requiring the establishment of a new EEA insurance holding company.

YES

Diagram D: Parent undertakings outside the EEA and verification of equivalence

Non-Equivalence

Groups that are headed by a non-EEA insurance holding company established in a jurisdiction that has not been found to be equivalent will be supervised by applying either Solvency II at the worldwide group level (as with EEA groups, supervision is not required at the level of intermediate companies) or by applying "other measures". The Directive does not specify what "other measures" should comprise, although they must:

- "ensure appropriate supervision" of insurers and reinsurers within the group; and
- "allow the objectives of group supervision" under Solvency II to be achieved.

The Directive specifically provides that "other measures" may include requiring a group to establish an insurance holding company within the EEA but it would be a mistake to assume that this alone will be enough to meet the requirements of the Directive. If it were, supervision at the worldwide level of non-EEA headquartered groups which already have an EEA sub-group would not be needed, notwithstanding that this is clearly contemplated by the Directive (Case 3 in Diagram A).

For non-EEA groups that find themselves headquartered in a jurisdiction that does not obtain "equivalent" status, the disadvantage of the Directive is the lack of certainty it gives groups about how they will be supervised, including the extent to which they will be required to meet Solvency II capital requirements on a worldwide level.

On the other hand, in these circumstances Member State supervisory authorities have a fairly broad discretion to decide on appropriate "other measures". This leaves it open to groups to try to agree the basis on which they will be supervised in the lead-up to implementation and they may be well-advised to consider carefully how they would prefer to be supervised before any discussions begin. A well thought-out proposal that can be put to the supervisors at an early stage may pay dividends in terms of influencing the course of such discussions.
Weighing up the options – how should groups respond to Solvency II?

All groups should already have considered how to optimise their Solvency II position, both in the period between now and the new regime taking effect and, in due course, before the benefit of any transitional relief is lost. This is despite the considerable uncertainty that still surrounds the final shape of the regime.

Groups should already have decided whether to apply for approval of a group model. Other possible strategies for the group include:

- Following the failure of "group support" proposals, there may be capital benefits for EEA groups in moving all of their insurance business into one group company and passporting their activities into other Member States.

- Disposing of interests where the burden of Solvency II is disproportionate to any benefit obtained from those interests - some groups that are predominantly based outside the EEA, but which have a smaller EEA presence that brings Solvency II into play, may feel that their best option is to pull out of Europe altogether.

- Establishment of an EEA insurance holding company – groups headquartered outside the EEA in a non-equivalent jurisdiction may consider whether setting up an EEA holding company would facilitate discussions with supervisors about how supervision of the worldwide group should be conducted.

- Making any necessary applications in relation to group supervision in good time to ensure that they are in place once the new regime takes effect – other than internal model applications, these could include applications to leave certain group companies out of group supervision or arguing that the consolidated approach to calculating the group SCR should be replaced by deduction and aggregation.

"Equivalence"

The concept of equivalence appears under three heads, the first of which is not specific to groups and is not considered further here (see Diagram E).

Diagram E: Three aspects of equivalence

(1) Reinsurance ceded to a non-EEA Reinsurer (Article 172 of the Directive)

Contracts between an EEA cedant and a reinsurer located in an equivalent non-EEA jurisdiction must be treated in the same manner as those concluded with EEA reinsurers.

(2) Group supervision (Article 227 of the Directive)

Where the non-EEA subsidiary's regulatory regime is found to be equivalent, the group may apply to use local rules in SCR calculations carried out under the deduction and aggregation method.

(3) Group supervision (Article 260 of the Directive)

Where a group is headquartered in an equivalent non-EEA jurisdiction, the EEA supervisor must rely on group supervision exercised by the third-country supervisor.
Political equivalence or economic equivalence – which will succeed?

Equivalence assessments remain a key area of concern under Solvency II; the FSA's April 2011 paper "Delivering Solvency II" noted their importance in particular for many London market insurers and EIOPA has recognised reliance on certain non-EEA countries as crucial too. This is despite the fact that it is now clear that transitional relief will be given in each of the three areas of equivalence – the effect of the transitionals will be to treat relevant third countries as equivalent notwithstanding that no assessment will by then have been made of whether they meet the necessary criteria. This is particularly welcome given the Commission's confirmation that only Bermuda and Switzerland will be assessed under Articles 227 and 260 before Solvency II takes effect, leaving certain key jurisdictions (the US in particular) out of the first wave.

Carrying out an assessment of whether the US regime is "equivalent" is clearly difficult because day to day regulation of the insurance industry is conducted at individual state level. CEIOPS (now replaced by EIOPA) reasoned that the National Association of Insurance Commissioners (NAIC) does not qualify as a "competent authority" capable of assessment under Solvency II because it does not have supervisory authority in its own right. Perhaps not surprisingly, the NAIC argued that the US should be included in the assessments. As a concept, the NAIC pointed to ongoing regulatory reform, including the establishment of the Federal Insurance Office, as evidence of enhanced group supervision.

Debate about the US in the context of equivalence is politically charged. Thomas B Leonard, Connecticut Insurance Commissioner, has noted that "equivalence" should depend on achieving required regulatory objectives and not on the methods by which those objectives were achieved (echoing the FSA's stated philosophy on regulation). It was, therefore, "unfortunate" that the focus of much of the debate on equivalence to date has been on worldwide adoption of Solvency II and not on regulatory convergence through securing agreed objectives.

The concept of "equivalence" has also caused a great deal of concern for third countries, like the US, whose insurers potentially face being at a competitive disadvantage if they can only trade effectively in Europe by setting up European operations to write their business.

For at least some of the third countries seeking equivalence, Solvency II highlights a need for local regulatory reform, although naturally many remain reluctant to make radical changes to their existing legal and regulatory frameworks simply to obtain equivalence status. Reform can be particularly difficult to achieve where it is motivated or perceived to be motivated by external drivers (such as the implementation of the Solvency II regime in Europe). Some have commented that the standards introduced by Solvency II are disproportionate, especially to the captive insurance market. Because of this, the Guernsey financial regulator, who sees Guernsey and Jersey as a "high quality alternative to the EU and other mainstream business environments", has announced that it has no plans to seek equivalence under Solvency II. Similarly, the Jersey Financial Services Commission has confirmed that, whilst it will continue to monitor the development of Solvency II, it will predominantly focus on changes to international standards set by the International Association of Insurance Supervisors, which were released in October 2011.

The economic environment and political climate in other countries are, however, conducive to change, which may ease the path to equivalence for at least some third countries.

Issues raised by equivalence assessments

"Equivalence" opens up a number of questions about how the new regime is expected to apply, many of which remain unanswered. For example:

- How will conflicts be resolved if one Member State takes a different view from another on the equivalence of a particular third country's regime?

- Will all Member State supervisory authorities have the expertise and resources they need to assess whether a third country regime is equivalent? Will they be willing to attempt such an assessment?

- When does a finding of non-equivalence by the Commission become open to review by an individual supervisory authority?

- How will ongoing equivalence of an approved third country regime be assured and how long will firms have to adapt to removal of a jurisdiction's equivalence status, should the need arise?
Transitional provisions under Omnibus II

It is not yet clear how many jurisdictions will qualify for transitional relief, although in a letter published on 5 December 2011 (dated 22 November 2011) the Commission suggested that there is a shortlist of 16 countries. Relief will, however, be restricted to jurisdictions that satisfy criteria that will in due course be specified by the Commission in Level 2 delegated acts. A commitment to converging towards a solvency regime capable of being regarded as equivalent by the end of the transitional period will also be required. Transitional relief in this area is undoubtedly important for firms in the absence of full assessments of equivalence before Solvency II's introduction. It does, though, leave a number of questions, including:

- What incentive is there for jurisdictions to seek a determination of full equivalence before the end of the transitional period?
- Will EIOPA have the resources and expertise needed to carry out full equivalence assessments of jurisdictions afforded transitional relief before that relief comes to an end?
- Will firms be given adequate time to adapt to finding at the end of the transitional period that a jurisdiction will not be recognised as equivalent?
- What role will Member State supervisory authorities play in relation to equivalence assessments during the transitional period?

Equivalence – next steps and timeline

Latest indications are that the timetable for reaching final decisions on equivalence has already slipped as a consequence of Solvency II's delay. Final advice from EIOPA on whether Bermuda and Switzerland should be regarded as equivalent has now been delivered to the Commission, but the Commission indicated in its 22 November letter (see above) that it will only take final decisions in the first half of 2013. Decisions on third countries that will qualify for transitional relief will come in "mid-2013".

FSA and HMT consultations on Solvency II transposition

On 9 November 2011, the FSA published CP 11/22 "Transposition of Solvency II – Part 1", the first of its planned consultations on transposition of the Directive into the FSA's Handbook of Rules and Guidance. The paper explains the FSA's general approach to transposition (which will be "intelligent copy-out") and includes draft rules on group supervision.

"Intelligent copy-out" means that the FSA will match the wording of its rules as closely as it can to the text of the Directive. It will only change the wording to the extent necessary to clarify the meaning of a requirement or where the FSA is required to make a discretionary decision. This approach inevitably limits the scope for comments on the draft text as it is difficult to argue that the FSA's proposed wording is not consistent with the Directive. There is a danger, though, that it merely delays arguments about the meaning of the rules until firms are put in the position of having to comply with the new requirements.

On 23 November 2011, HM Treasury published its proposals for transposing the Directive into UK law, including proposed amendments to the Financial Services and Markets Act 2000 (FSMA). Like CP 11/22, the draft legislation covers group supervision. However, because the proposals are based on FSMA and the regulatory framework post break-up of the FSA, there is an added layer of complexity to any review. Provisions relating to groups relate, in particular, to the role of the Prudential Regulatory Authority (as the FSA's successor) within the new European supervisory framework, including requirements around cooperation between supervisory authorities and decision-making processes. The importance of colleges to group supervision was highlighted by Julian Adams in his 8 December speech, when he also urged firms to engage with the supervisory college activity to the extent possible.

We intend to publish a briefing in due course that considers HM Treasury's proposed legislative changes and the FSA's proposed draft rules in CP11/22 and the issues that they raise for firms. In both cases, however, because only the Directive itself is being transposed into UK law (as Level 2 delegated acts and binding technical standards will have direct effect and Level 3 guidance is not legally binding), there is relatively little to review.
Final remarks

There is no one-size-fits all approach to group supervision under Solvency II and groups need to evaluate the efficiency of their current structure in light of the new regime carefully.

Opportunities to simplify complex group structures are of course already available to groups, through use of relevant business transfer rules (under existing European insurance directives) or under the European company and cross-border merger directives. These options, coupled with single market “passporting” rights, enable a group to change its group structure significantly, if this is an attractive option.

Delays in equivalence determinations or a failure to achieve equivalence can raise significant capital, structural and strategic issues for insurance groups. Groups with non-EEA subsidiaries or parents are advised to keep issues surrounding equivalence determinations under review so that they can plan properly for Solvency II. Groups should approach the issue with caution and should not be complacent. Assuming that an assessment of equivalence will be forthcoming or that you will benefit from transitional measures would be imprudent.

Following from this, insurers should give careful consideration to the length of the transitional period. Many third countries will want a long transitional, to give them enough time to adapt their regimes. Regulators, on the other hand, will want to encourage early compliance with full equivalence criteria, which could mean we see much shorter periods. We also do not have certainty at this stage about how onerous the eligibility criteria will be for transitional measures in comparison to the equivalence assessment itself, but the higher the hurdle, the greater the burden on regulatory resources to determine whether it has been jumped.

* The extension of Cases 2 and 3 to “mixed financial holding companies” under amendments to the regime established by the Financial Conglomerates Directive (2002/87/EC) is not considered in this briefing, but see Directive 2011/89/EU which came into force on 9 December 2011.
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