

## Solvency II: First Wave of Equivalence Assessments

July 27, 2010

The European Union's Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has recommended to the European Commission that Bermuda, Switzerland and Japan be the first countries assessed for equivalence with EU insurance regulations under Solvency II. Solvency II is scheduled to become effective on December 31, 2012. The most noteworthy omission from the recommended first wave of countries to be assessed is the United States.

The recommendation by CEIOPS was included in its consultation paper setting forth the criteria the Commission should use to assess non-EU countries. The CEIOPS recommendation regarding the countries to be assessed for equivalence with Solvency II is not a final decision on the countries to be considered for equivalence, nor is it an actual recommendation or determination by CEIOPS that the three countries should be deemed equivalent.

The Commission is expected to make its final decision on which countries will be included in the first wave of assessments by mid-November 2010. The Commission has requested that CEIOPS provide final advice to the Commission by the end of July 2011 regarding whether these countries should be deemed equivalent. (If CEIOPS is replaced by the new European Insurance and Occupational Pensions Authority (EIOPA), it is expected that the EIOPA will take over the CEIOPS role in the equivalence process.) Based on this schedule, the Commission could make its final decision on equivalence for these first wave countries before the end of 2011.

The following highlights the potential implications of the equivalence assessment process.

### **Background and impact of equivalence assessments**

Solvency II empowers the European Commission to assess whether the solvency regime, or prudential supervision/regulatory framework, of a non-EU country is equivalent to Solvency II for three purposes: (i) reinsurance, (ii) group solvency and (iii) group supervision. The intention is to ascertain whether the non-EU country's system of insurance regulation provides a similar level of policyholder and beneficiary protection as Solvency II.

The equivalence assessments will affect reinsurance collateral requirements for non-EU reinsurers that reinsure EU cedents, as well as group capital requirements and other compliance requirements generally for non-EU groups with EU subsidiaries and non-EU subsidiaries of EU groups. The impact on group capital requirements

is very much uncertain at this point because those requirements will be determined by implementing measures and calculations that are still being developed. As regards reinsurance, if the Commission determines that the non-EU jurisdiction's regulatory regime is non-equivalent, or decides not to consider a non-EU jurisdiction for equivalence, reinsurers in such jurisdictions could be required to post collateral if the EU Member State where the cedent is domiciled/established chooses to impose such a requirement, as some EU Member States currently do. If the Commission makes no decision on equivalence and the reinsurer is part of a group subject to group supervision in the EU, the EU group supervisor may make its own determination on equivalence.

Non-EU reinsurers domiciled in a jurisdiction whose regulatory system is deemed equivalent to Solvency II will be treated in the same manner as if they were established/domiciled in the EU. This means that EU Member States in which the cedents are established/domiciled may not require a non-EU reinsurer to collateralize its liabilities to the cedent or require the non-EU reinsurer to maintain in the EU the assets covering its insurance liabilities for risks located in the EU.

Generally speaking, if a country is not deemed equivalent, a non-EU group or non-EU insurer may be asked to demonstrate how it satisfies Solvency II rules in addition to the rules of its domestic regulator.

### **First wave of equivalence assessments**

CEIOPS has recommended to the Commission that Bermuda, Switzerland and Japan be included in the first wave of equivalence assessments. These jurisdictions were selected as jurisdictions "where an equivalence assessment would be desirable" before Solvency II becomes effective. The Commission advised that the factors for this determination by CEIOPS should include the materiality of an equivalence finding regarding the non-EU jurisdiction; whether the jurisdiction currently has a supervisory regime that is fully risk-based or has taken measures to move towards such a system; the materiality of an equivalence finding to EU insurers and reinsurers and their policyholders; the number of entities in the non-EU jurisdiction owned by EU insurers and reinsurers; the importance of the insurance market in the non-EU jurisdiction of the equivalence finding; and the existence of any mutual recognition or equivalent arrangements between the non-EU country and EU Member States. In its recommendation to the Commission including the proposed list of first wave countries, CEIOPS added the following factors:

- The willingness of the country to engage in the process of equivalence assessment;
- The likelihood that the country will meet the criteria ultimately agreed for equivalence;
- CEIOPS' capacity to assess the first wave countries, in view of the timeframe and of CEIOPS' limited resources; and

- The proposed evolution of the country's regulatory regime to a model akin to Solvency II.

Interested persons can submit comments on the CEIOPS recommendations to the Commission on first wave countries and the rest of the CEIOPS consultation paper until August 13, 2010.

### **Omission of the United States**

CEIOPS based its recommendation to the Commission that the US be excluded from the first wave of equivalence assessments on the fact that day to day regulation of the insurance industry remains at individual state level. CEIOPS reasoned that the National Association of Insurance Commissioners (NAIC) does not qualify as a "competent authority" under Solvency II because it does not have supervisory authority in its own right. CEIOPS also cited the inadequacy of group supervision in the US, as well as restrictions on the ability of US state insurance regulators to exchange information, mainly due to state-specific laws on confidentiality. CEIOPS further noted "the current difficulties in pursuing an assessment of the United States, and CEIOPS' own ability to undertake multiple assessments .... CEIOPS would not be in a position to take on additional equivalence assessments due to the high level of resources required by equivalence exercises and the very limited timeframe specified."

### **Conclusion and possible next steps**

Based on the CEIOPS recommendation and subject to the Commission's final decision, the Commission would consider Switzerland and Bermuda for equivalence for reinsurance, group supervision and group solvency, and Japan for equivalence for reinsurance. Positive equivalence decisions could occur before Solvency II becomes effective. The impact of Solvency II on (re)insurers and groups established/domiciled in these jurisdictions should be neutral or positive if they are ultimately determined to be equivalent.

For reinsurers in countries like the US that might not be deemed equivalent (affirmatively or because they are not assessed at all), Solvency II could result in an increase in reinsurance collateral requirements. The decision on whether to maintain, introduce or increase collateral requirements will be one for each Member State to make in relation to cedents regulated in that Member State. Therefore, mixed requirements across the EU could arise. A determination regarding equivalence could also impact compliance and capital requirements for non-EU groups with EU subsidiaries and non-EU subsidiaries of EU groups.

The recommended exclusion of the US from the first wave of equivalence assessments is not a surprise. The basis for the CEIOPS recommendation is consistent with the International Monetary Fund's financial market assessment of the US system of insurance regulation published in May 2010. Although the US received a rating of

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"observed" or "largely observed" for 25 of the 28 insurance core principles in the IMF report, the principles the IMF concluded the US only "partly observed" – namely, regarding 50-state regulation, group supervision and information sharing/confidentiality, essentially mirror the basis for the CEIOPS recommendation. Further, the NAIC is embarking on a top-to-bottom review of solvency regulation with its solvency modernization initiative (SMI) and possible changes to risk-based capital requirements and group supervision via the model holding company act. Against this background, how do CEIOPS and the Commission assess a solvency regulatory scheme that is in flux?

The NAIC and/or individual state insurance regulators can be expected to attempt to persuade European regulators to deem the US an equivalent jurisdiction. Their ability to succeed in that effort is uncertain. If that effort is not successful, might individual states or the NAIC consider building into their solvency assessments a determination as to equivalence – for example, through reduced reinsurance collateral requirements such as those adopted in Florida and currently being considered in New Jersey and New York and elsewhere? Other questions include whether and to what extent states will continue with their collateral reduction efforts if European regulators impose reinsurance collateral requirements on US reinsurers.

It is unclear what role in this process the new Federal Insurance Office (FIO) to be created by the Federal Dodd-Frank legislation signed into law by President Obama on July 21, 2010 will have. It is possible the FIO could seek to negotiate with European regulators to reduce collateral requirements. There are at least two obstacles for any FIO involvement. The first is practical and whether it is even feasible to staff and otherwise prepare the FIO to engage European insurance regulators in time for CEIOPS and the Commission to assess the US as an equivalent jurisdiction before Solvency II becomes effective. The second is substantive – and more significant – and is whether the FIO will have sufficient authority to negotiate on behalf of US insurance regulators as a whole. The fact that there are several potential negotiators for the US on these issues – individual states, the NAIC and the FIO, as well as the US Trade Representative and other representatives of the US Federal government – is perhaps the point for European regulators.

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