SOLVENCY HO! AN UPDATE ON U.S. AND EUROPEAN SOLVENCY INITIATIVES

By: John Pitblado

Ramped up after the financial crises in 2008, regulatory authorities in the U.S. and Europe have undertaken comprehensive overhaul of solvency regulation for insurers and reinsurers. In Europe, the so-called "Solvency" initiative begun more than a decade ago has given way to a comprehensive second phase, deemed "Solvency II," for which the implementation date was recently pushed back to January, 2013. Meanwhile, in the U.S., the National Association of Insurance Commissioners ("NAIC") has been pushing forward with its own "Solvency Modernization Initiative," ("SMI") as well as plans to ensure that the U.S. regulatory scheme obtains "equivalency" status under Solvency II, so that U.S. and European domiciliary companies will remain on similar footing competing in each others' respective markets. This article provides a high level overview of Solvency II and SMI.

The E.U.'s Solvency Initiative

"Solvency I" was the moniker given to a comprehensive update in the early 2000's of the European Union's patchwork regulatory regime, under the guise of E.U. directives ratified in 2002 and 2003 by member states requiring them to adopt uniform laws governing regulation of the financial services industry. Both experience with Solvency I and the market crash in late 2008 prompted European regulatory authorities to initiate the planned second phase, deemed "Solvency II." As noted by Britain's Financial Services Authority, "Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements."[1]

The requirements that will be imposed on insurers and reinsurers by Solvency II are grouped into three "pillars:"

> **Pillar 1** – this covers all the financial requirements. This pillar aims to ensure firms are adequately capitalized with risk-based capital. All valuations in this pillar are to be done in a prudent and market consistent manner. This pillar also includes the use of internal models which, subject to stringent standards and prior supervisory approval, enable a firm to calculate its regulatory capital requirements using its own internal model.
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> **Pillar 2** – this pillar imposes higher standards of risk management and governance within a firm's organization. This pillar also gives

[1] *See* FSA's "Solvency II" home page (available at: http://www.fsa.gov.uk/pages/About/What/International/solvency/index.shtml).

supervisors (i.e., regulators) greater powers to challenge regulated firms on risk management issues. The ORSA ("Own Risk and Solvency Assessment") requires a firm to undertake its own forward-looking self-assessment of its risks, corresponding capital requirements and adequacy of capital resources.

Pillar 3 – this aims for greater levels of transparency for supervisors and the public. There is a private annual report to supervisors, and a public solvency and financial condition report that increases the level of disclosure required by firms. The current returns will be completely replaced by reports containing core disclosures that firms will have to make to supervisors on a quarterly and annual basis. This will ensure that, overall, supervisors have better and more up-to-date information on a firm's financial position.[2]

The latest development in Solvency II is the so-called "Omnibus II" package of proposals put up for adoption by the European Commission, which amends the entire Solvency II framework. Of note, Omnibus II changes the implementation date from October 31, 2012 to January 1, 2013, adds language pertaining to ensuring consistency in the recognition of rating agencies, corrects references to the now defunct "Committee of European Insurance and Occupational Pensions Supervisors" ("CEIOPS"), in favor of the "European Insurance and Occupational Pensions Authority"[3] ("EIOPA"), and extends EIOPA's roles and powers generally.[4]

Some in the industry are wringing their hands at the decision to delay the vote on Omnibus II. The European Parliament was scheduled to vote on Omnibus II in late 2011. It has

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2 *See* FSA's "Background to Solvency II" (updated January 4, 2012) (available at: http://www.fsa.gov.uk/Pages/About/What/International/solvency/background/index.shtml)

3 EIOPA, the successor body to CEIOPS, is part of the European System of Financial Supervision ("ESFS"), which consists of three European Supervisory Authorities and the European Systemic Risk Board. It is an independent advisory body to the European Parliament and the Council of the European Union. *See* EIOPA home page (*available at*: https://eiopa.europa.eu/)

4 *See* Burkhard Balz, European Committee on Economic and Monetary Affairs, Draft report (July 7, 2011) (*available at*: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-466.970+02+DOC+PDF+V0//EN&language=EN)

decided to delay the vote until April, 2012, with some predicting that will further delay the already amended January, 2013 implementation date.[5]

Meanwhile, the U.S. and others continue to work out "equivalency" status from European authorities under Solvency II, which requires that foreign companies operating in Europe must be supervised by a "functionally equivalent" domestic regulator to receive equitable treatment.[6] The NAIC's CEO recently voiced confidence that the U.S. will gain equivalency, in part based on the fact that its own solvency initiative (discussed below) shares similar goals and methodology. But an obstacle to the U.S. gaining equivalency is its lack of a single, unified national regime.[7] According to Michael McRaith, the first Director of the newly formed Federal Insurance Office ("FIO"), which has joined the International Association of Insurance Supervisors ("IAIS"), the FIO will be a "national leader" in the discussion of U.S. equivalence under Solvency II. [8]

At any rate, the U.S. was not among the first countries considered in the official review process. EIOPA, which makes equivalence recommendations to the European Commission, began preliminary consideration of Bermuda, Japan and Switzerland during the Summer of 2011, finding each could gain equivalency, with certain suggested changes.[9] It issued its final recommendation and suggestions October 26, 2011.[10]

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5 *See*, "Delayed Solvency II Vote Adds Uncertainty for Insurers," Business Insurance (Dec. 13, 2011) (*available at*: http://www.businessinsurance.com/article/20111213/NEWS04/111219970?tags=|306|76|73|81#).

6 *See* Sean Carr, "NAIC CEO: US Will Gain Solvency II Equivalence," A.M. Best Company, Inc. (Nov. 14, 2011) (*available at*: http://insurancenewsnet.com/article.aspx?id=299048&type=international).

7 *Id*.

8 *See* Meg Green, "FIO Won't Duplicate State Regulation, Paperwork," A.M. Best Company, Inc. (Jan. 11, 2012)(*available at*:http://insurancenewsnet.com/article.aspx?id=325684)

9 *See* Carr, *supra*.

10 *See* October 26, 2011 EIOPA Recommendation letter (available at: https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/20111026-EIOPA-Letter-Equivalence-Advice-submission.pdf), and accompanying recommendation reports for Switzerland (available at https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/EIOPA-BoS-11-028-Swiss-Equivalence-advice.pdf); Bermuda (availablet at: https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/20111026-EIOPA-Letter-Equivalence-Advice-submission.pdf), and Japan (available at

The three areas in which equivalency may be sought is laid out in particular Articles of the Solvency II framework, including reinsurance (Article 172), Group Solvency Calculation (Article 227) for a resident parent company with a subsidiary in a third country; and Group Supervision (Article 260) for a parent company in a third country with a resident subsidiary.[11] Japan's reinsurance regulatory structure was found equivalent by EIOPA, and it will likely seek equivalence in the other two areas as well. The European Commission is expected to make equivalence decisions in the summer of 2012.[12]

NAIC's Solvency Modernization Initiative

Like its European Union counterpart, the NAIC began modernizing U.S. solvency regulation and implementing uniform practices in the decade or so leading up to the financial crisis. Based on NAIC-developed model laws, risk-based capital requirements were eventually adopted by all states. Statutory accounting principles were codified into a comprehensive guide. Stress tests were developed for nationally significant insurers that were identified as potentially troubled. Regulators continued to modify the system, leading up to the development in 2008 of the SMI.[13]

The NAIC touts the SMI as an over-arching critical analysis of U.S. insurance solvency regulation, with a focus on capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues. The review includes study of other countries' solvency regulation, and its articulated goals include the development of improved tools for insurer examinations, creation of a new reinsurance regulatory framework, a movement to principles-based reserving for life insurers, and changes to supervision of insurer groups (including foreign affiliates).[14]

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https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/EIOPA-BoS-11-030-Japan-Equivalence-advice.pdf).

[11] *See* Gideon Benari, "Solvency II news: Greek preparation and Japanese equivalence" SolvencyIIwire.com (*available* at: http://solvencyiiwire.com/solvency-ii-news-greek-preparation-and-japanese-equivalence/3647).

[12] *Id*.

[13] *See*, "Solvency Modernization Initiative: A NAIC Issues Brief" (*available at:* http://www.naic.org/documents/committees_ex_isftf_smi_overview.pdf

[14] *Id*.

The SMI includes study of other solvency modernization initiatives, including Solvency II, the Basel II international capital framework for banks, solvency work by the IAIS, and other solvency proposals in place or under development elsewhere, including Australia, Bermuda, and Canada.[15]

Ultimately, SMI will likely result in various new requirements for insurers and reinsurers, as generally divided into the five basic regulatory areas targeted by SMI:

Capital Requirements
SMI promotes continued refinement to the insurance risk-based capital (RBC) formula, including development of scenario modeling for life insurance interest and market risk, in order to identify "weakly capitalized companies" and establish a floor for triggering regulatory intervention. NAIC's SMI task force is also considering whether the RBC should always be public, should only be public by regulatory trigger, or never public.

Governance and Risk Management
The SMI task force is also considering risk management and group supervision tools (such as an ORSA-like feature) similar to those promoted by Solvency II. The task force will seek to streamline the widely varied state corporate governance statutes as applied to insurers, and will address specific requirements relating to risk-management and regulatory reporting.

Group Supervision
SMI will expand regulatory authority to look at any entity within an insurance holding company system that may or may not directly affect the holding company system, but could pose reputational risk or financial risk to the insurer; it will enhance regulator access to information, especially regarding the examinations of affiliates; it will enhance regulators' ability to participate in supervisory colleges; and it will provide guidance on the disclaimer of affiliation filings.

Statutory Accounting & Financial Reporting
SMI includes a move toward standardized principles-based reserving for life insurers, convergence between FASB and IASB accounting standards, and consideration of the extent of public disclosure versus regulatory reporting.

[15] *Id.*

Reinsurance
Through the work of NAIC's Reinsurance (E) Task Force, SMI will promote and incorporate state-based reinsurance regulatory reforms into proposed model laws, such as the *Credit for Reinsurance Model Law* (#785) and *Credit for Reinsurance Model Regulation* (#786), which were recently revised by the NAIC.[16]

While it is beyond the scope of this article to provide a detailed review of the requirements of Solvency II and SMI, and of potential differences or inconsistencies in the two initiatives, one problematic area may prove to be Solvency II's move toward risk-based management, which is not entirely consistent with the NAIC's approach.

It is at least apparent at this point that 2012 will see global solvency regulation come into increased focus as Solvency II and SMI progress, but insurers and reinsurers in the meantime will struggle with the uncertainty fostered by these sweeping changes in the U.S. and European solvency regulation landscapes. The competitive impact upon U.S. domiciled companies of a lack of an equivalency filing for purposes of Solvency II and the E.U. market could be substantial, and we expect to see considerable activity in this area in 2012.

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This article does not constitute legal or other professional advice or service by JORDEN BURT LLP and/or its attorneys.

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16 *See* NAIC "Solvency Modernization Initiative Roadmap" (May 20, 2011), available at: http://www.casact.org/education/reinsure/2011/handouts/C18-NAIC.pdf, Cicchetti, "Leveling The Playing Field: NAIC Financial Condition (E) Committee Adopts Revisions To Credit For Reinsurance Models", available at http://02ec4c5.netsolhost.com/blog/wp-content/uploads/2011/10/Harris-Martin-NAIC-Reinsurance-Credit-Models-article-1.2012.pdf.