The Implications of Europe’s Solvency II

By Editor Test *Thu, Oct 20, 2011*

As Europe raises its bar on insurance regulation, it's in America's best interest to follow suit, writes Ms. Toland, managing director, Retirement Income Consulting, at Strategic Insight.

Europe can seem either close at hand or miles away, especially when it comes to annuities. Across the globe, each country represents a distinct jurisdiction with its own rules regarding retirement vehicles and products, not to mention regulations. Therefore, it is easy to become myopically focused on what is happening on the home front and ignore what may seem like irrelevant trends in foreign waters. However, the **impending changes to insurance regulation in Europe in the form of Solvency II could have important implications here in the United States**, and not just for multinationals.

Of course, there are many insurers in the U.S. that are part of European parent companies, and there is a possibility that they will ultimately have to conform to the European requirements for their U.S. businesses. In addition, U.S. companies with a European presence will have to deal with similar issues in order to continue to operate over there. However, even for purely domestic insurers, Solvency II may have an enduring effect on the regulation of insurance at home.

What is Solvency II?

Solvency II is a modernization of the regulatory system for insurance companies and products in Europe. The model is based on three pillars: quantitative capital requirements; qualitative supervisory review; and disclosure requirements.

The details are still being worked out, so Solvency II will be implemented on a rolling basis, with the first stages starting in 2013 and **new capital requirements coming into play at the beginning of 2014** (companies will likely have to producing new calculations during 2013, either on a voluntary or mandatory basis). As each pillar is clarified and codified, the parameters for the next become more defined. Some of the early information about the effects of the new rules on certain product lines will not play out as initially anticipated, since the assumptions behind those rules and the rules themselves are being adjusted.

The new system imposes **more rigorous enterprise risk management requirements** and it changes the treatment of various products. Solvency II requires analysis of group risk rather than simply looking at each individual subsidiary. This is perhaps the biggest fundamental difference in the two systems and it is a key element to modernization. The consideration of true enterprise risk by regulators can have either a positive or negative effect on capital requirements, as the new rules allow credit for diversification of risk and penalize for overconcentration.

As for life insurance products, though the early estimates put many at a significant disadvantage, more **recent adjustments to the rules and models make the changes to fixed and variable**

annuities largely neutral compared with Solvency I, according to analysis by Morgan Stanley/Oliver Wyman. However, the **same cannot be said of the comparison with U.S. capital requirements**. Under Solvency I, which did not require a capital calculation for the entire group, this difference did not matter; under Solvency II, European insurers are required to embrace their U.S. subsidiaries into the new calculation.

Mark-to-Market Mayhem

The mark-to-market treatment of assets under Solvency II has material implications because it is so different from the U.S. system. In particular, this affects long-dated instruments, which of course play a significant role in any longevity guarantee, from life annuities to living benefits. The argument against fair value accounting is that it introduces volatility that unfairly represents the assets held against those particular liabilities, which are long-dated and therefore not so sensitive to the short-term volatility reflected in fair value.

The question of whether fair value is the “correct” way of treating long-dated assets is less important than the difference between the two systems. Product management and regulatory capital systems are geared for one or the other, but companies that straddle jurisdictions and must make calculations under both regimes have to deal with a higher degree of complexity.

One of the immediate concerns about Solvency II is that **purely U.S.-based companies will have a pricing advantage over their European counterparts** because they are not required to comply with the European capital requirements. Pricing benefit or not, some believe that the market advantage will swing the other direction and that **companies bound to the more rigorous requirements of Solvency II will tout the superiority of that regime**.

Like it or not, European companies that have significant operations in the U.S. have had to make adjustments to their assumptions about capital allocations accordingly. Similarly, American insurers with a European presence have had to do the same, and these companies have to make sure that their European businesses are carefully segregated from the U.S. parent.

Regulatory Equivalence

However, the short-term saving grace of Solvency II is a provision for regulatory equivalence, which would serve to level the playing field in the U.S.; it is possible for non-European regulatory systems to be considered similar enough to Solvency II that those subsidiaries would not require a new set of calculations. Equivalence allows the foreign units of European insurers to operate under the local regulatory regime and vice versa.

The rub? The United States is not among the first wave of countries being considered for equivalence. Instead, Bermuda, Switzerland and Japan are the first jurisdictions getting assessed (even membership in the first wave does not make these countries shoo-ins, and they will have to justify their stance with European regulators). In the meantime, the **U.S. qualifies for “transitional equivalence” for a period of up to five years**, with the option for permanent equivalence.

In order to achieve permanent equivalence, the U.S. needs to be considered equivalent in the area of either group supervision or group solvency. Initially, that included fair market valuation of assets, but that requirement seems to have been dropped. The NAIC and individual states have balked at the suggestion that the U.S. comply with Solvency II requirements (in August, the Connecticut insurance commissioner issued a press release crying foul to the pressure from abroad), yet the gravity of the impending European insurance rules is impossible to ignore.

The diffuse regulatory structure in the U.S. gets in the way of international relations, both because there is no definitive central body to decide on making changes or to prevent discriminatory practices against the local subsidiaries of foreign insurers (a charge leveled at some states)

The NAIC is doing its part to try to move regulatory practices forward, and **through the Solvency Modernization Initiative, it has begun adopting Insurance Core Principles promoted by the International Association of Insurance Supervisors** (the NAIC has emphatically gone down this path rather than directly correlating modernization with Solvency II). The Federal Insurance Office, a part of the Department of the Treasury created by the Dodd-Frank Act, it not itself a regulatory body, but it has the ability to engage in international negotiations. Ultimately, this office is also charged with providing guidance about the insurance regulation system and ways of improving consumer safety.

There is clearly impetus to either give the NAIC more power to effect change or create a bona fide federal insurance regulator, both to establish consistent solvency oversight and serve as a negotiating body in international relations. For those itching to see the state insurance system dismantled, the need for national consensus may add to the argument for federal regulation of solvency, if not also products.

Dragged into the Modern Age

The larger and more lasting effect of the adoption of Solvency II is that it will, like it or not, pull U.S. insurance regulation along in its wake. **Equivalence will only come about if the U.S. makes significant changes to its system**, and the country cannot afford to stubbornly stand by its own practices while others in the international community point to the U.S. as a regulatory backwater.

Furthermore, consumer safety is a top priority for policymakers and the public following the recent financial crisis. The very job of the Federal Insurance Office is to monitor and report on matters of improving protection and reducing systemic risk. Given ongoing volatility and concerns about financial stability, it seems unlikely that the recommendations from that office will be ignored or taken lightly.

If modernization of insurance regulation is inevitable, then it stands to reason that **the real competitive advantage goes to those companies that hop to it** and make the necessary adjustments, including instituting the new enterprise risk management and other systems required. This fact may be lost in the opportunity that some may grasp in the short-term difference between capital requirements here and in Europe.

Given the country's history, it is understandable that part of the national character of America is to resist the imposition of laws and rules from abroad. Today, as Europe raises its bar on insurance regulation, is no time for the U.S. to contest change on similar principles. National borders are real but more permeable than one might imagine, and even as a sovereign entity, America does not function in isolation. Thus, **Europe's insurance modernization initiative inexorably, if haltingly, draws the United States into a new era**.

For Your Reading Pleasure

If there's one thing to be said about Solvency II, it is well studied and documented by consultants, accountants, and actuarial firms alike. This list is not exhaustive, but it represents a number of useful reports, summaries, and analysis that are easily accessed on the internet.

Title	**Description**	**Source**
The 3 Pillar Approach	A nice graphic illustrating the three pillars with links to a plethora of information on Solvency II	PricewaterhouseCoopers
Survivor's Guide to Solvency II: 2011	The title says it all; a good overview in an accessible format that is light on technical language	The Review in association with PwC
Solvency 2: Quantitative & Strategic Impact: The Tide is Going Out	Granular information about the changes that come with Solvency II based on proprietary models, including updated modeling	Morgan Stanley and Oliver Wyman
A Report to the Federal Insurance Office	Sections 2.6 and 2.10 directly address international issues, though strangely not mentioning equivalence	Networks Financial Institute at Indiana State University
Equivalence and the U.S. Market		
Solvency II and U.S. Equivalence	Very detailed discussion of equivalence and the status in the U.S.	Society of Actuaries
Solvency II Equivalence and Structural Issues for Insurance Groups	A tidy overview of equivalence and related issues, with a good section on the U.S.	Sidley Austin
Solvency II: First Wave of Equivalence Reassessments	A four-page summary on equivalence	Dewey & LeBoeuf
Solvency II Equivalence: Implications for the U.S. Market	A very brief three-page summary on the subject	Ernst & Young
Solvency II: Issues for the U.S. Insurance Market	A four-page summary of the impact to domestic insurers	KPMG