Client Update
Solvency II: What You Need to Know as Effectiveness Nears

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Solvency II—the long-awaited new regulatory regime for European insurers—finally becomes effective on January 1, 2016. It is proving to have as substantial (and disruptive) an impact on the insurance industry as anticipated, forcing significant changes in the way insurers assess risk, develop their products and raise capital. As effectiveness nears, many of the rules for calculating capital requirements are becoming clearer, enabling not just insurers, but also other market participants, such as private equity firms and financial investors, to have a better view on valuation. But much remains to be done. The following is a summary of the current status of some of the most important aspects of Solvency II impacting insurers and other market participants, and what we expect the next steps to be as Solvency II becomes a reality.

REGULATORY APPROVAL OF INTERNAL MODELS

Solvency II allows European insurers to calculate their solvency capital requirements in two ways: using a "standard model" following formulas set out in regulation, or a full or partial "internal model" prepared by the insurer modifying the standard model to better fit the insurer's own circumstances. Use of an internal model is subject to approval of the insurer's supervisor, and the question of whether or not such models will be approved has been a significant source of uncertainty in how substantial an impact Solvency II will have on an insurer's capital requirements.

In the past several weeks, European regulators have begun announcing approval of internal models for insurers in their jurisdictions. For instance, on December 5, 2015, the PRA published a list of 19 organisations whose internal models have been approved for use under Solvency II.[1] Although the finalisation of the

[1] The list comprises: Amlin, Aspen Insurance UK, Aviva, British Gas Insurance, Just Retirement, Legal & General Group, Markel International, MBIA UK Insurance, The National Farmers' Union Mutual Insurance Society, Pacific Life Re, Pension Insurance

internal models will lead to some insurers being forced to increase capital, in general there is hope that the approval of these internal models will result in more settled valuations of insurers.

Insurers who have not had their internal model approved can continue to develop their models and apply for approval in the future, but will be required to use the standard model in the meantime.

Other jurisdictions have also begun to announce internal model approvals. So far, Allianz, Hannover Re, Munich Re and Talanx have all received approval from the German regulator, BaFin. The Danish regulator has approved internal models for Topdanmark, Tryg and Alm. Brand, and reinsurer Scor has secured approval for its internal model from the French regulator.

MATCHING AND VOLATILITY ADJUSTMENTS

Another source of uncertainty for some insurers is the extent to which they will be able to benefit from specific relief allowed in the Solvency II regulations for calculating long-term business, namely the "matching adjustment"—which essentially adjusts the value of liabilities using a discount rate equivalent to a closely matched set of assets—and "volatility adjustment"—which provides an uplift to the discount rate provided specified conditions are met. Whether or not an insurer can benefit from the matching and/or volatility adjustment will have a large impact on how their liabilities are valued, as well as a knock-on impact on their capital needs.

As in the case of the internal models, regulators have begun approving applications to use the matching adjustment, although in some jurisdictions, such as the UK, this follows a lengthy pre-approval process where early applications were scrutinised and often significant changes required to be made. On November 7, 2015, the PRA concluded its decision making in respect of current matching adjustment applications. Decisions have been provided to firms individually and approvals will be published on the Financial Services Register on January 1, 2016. The PRA also, in June 2015, released a supervisory statement on its expectations of firms' applications to use the volatility adjustment. These decisions provide greater certainty for insurers regarding their Solvency II capital requirements, although further clarity is needed in particular on the status of the volatility adjustment.

Corporation, Phoenix Group, Prudential, QBE European Operations, RSA, Scottish Widows Group, the Society of Lloyd's, Standard Life and Unum European Holding Company.

EQUIVALENCE DECISIONS FOR THIRD COUNTRIES

On November 26, 2015, Bermuda became the second country to be granted full Solvency II equivalence, following Switzerland which was granted equivalence on June 5, 2015, allowing insurance groups with parent or other entities located in those jurisdictions to be treated as if they were located in the EEA. This should be a boon for Swiss and Bermudian firms, as they will be placed on a level playing field with European firms when acquiring European companies and insurance portfolios, while still allowing them to benefit from domestic tax and regulatory treatment.

Australia, Brazil, Canada, Mexico, the United States and Japan have been granted provisional equivalence with regard to group solvency calculations for 10 years, allowing European-headed groups with subsidiaries located in those jurisdictions to use the local capital calculations in certain circumstances. Japan has also been granted temporary equivalence with regard to reinsurance for five years.

However, insurance groups with a parent in a non-EEA jurisdiction (and not located in Bermuda or Switzerland) that has subsidiaries in the EEA could still be subject to group supervision in the EEA unless EEA Member State regulators grant a waiver or permit alternative measures that allow the non-EEA group to demonstrate that group-wide supervision is not needed. Provisional equivalence does not remove the need to comply with the group supervision requirements, unless a waiver is obtained or the applicable European regulator otherwise determines that group supervision is not needed. In the United Kingdom, for instance, the PRA has indicated that a formal waiver will be required.

The United States and European Union have agreed to negotiate an agreement to address reinsurance collateral, confidentiality issues and group supervision issues. Currently, EEA insurers and reinsurers must comply with both Solvency II and U.S. reinsurance collateral requirements. The agreement could pave the way towards full Solvency II equivalence for the United States, making it easier for U.S. insurers or reinsurers to operate in the EEA, and vice versa.

For more information on the recent equivalence decisions, see our Previous Update.

UK TAX TREATMENT OF TIER 1 HYBRID CAPITAL INSTRUMENTS

The UK tax treatment of Tier 1 hybrid capital instruments—previously an open question given the equity-like nature of the requirements imposed by Solvency II—has been clarified. Regulations prescribing the tax treatment of Tier 1 hybrid capital instruments have been published, and are expected to go into effect on

January 1, 2016. Now both Tier 1 hybrid capital and Tier 2 note instruments are capable of being treated as loan relationships for tax purposes, meaning that they will be exempt from withholding tax and stamp duty, and coupon payments will be tax deductible. This is an important development for the market of Tier 1 notes, as while there have been several issuances of Tier 2 bonds in anticipation of Solvency II, the uncertainty of the tax treatment of Tier 1 capital has been an impediment to the issuance of these forms of instruments.

ALSO COMING: NEW INTERNATIONAL CAPITAL STANDARDS FOR LARGE INSURERS

Coming alongside Solvency II have been extensive developments in global capital standards for the largest insurers. In October of this year, the International Association of Insurance Supervisors concluded its initial development of the Higher Loss Absorbency ("HLA") requirement for Global Systemically Important Insurers ("G-SIIs"). G-SIIs in the EEA will have to comply with this requirement as well as the incoming Solvency II requirements. Currently the G-SIIs domiciled in the EEA are Aegon N.V., Allianz SE Aviva plc., AXA S.A. and Prudential plc.

The HLA is expected to increase the amount of regulatory capital a G-SII must hold by approximately 10% on average. The precise extent of additional capital required to be held will depend on the business mix of the particular G-SII and how risky supervisors deem its activities to be. For more information on the development of the HLA, which is due to come into effect by 2019, see our Previous Update.

WHAT NEXT?

The focus for insurers in 2016, post the implementation of Solvency II, is likely to be on the management and optimisation of the new balance sheets, as well as managing new disclosure, reporting and governance procedures. Governance arrangements will need to be closely monitored and documented in light of the Senior Insurance Managers Regime which forms part of the Solvency II framework, as discussed in our Previous Update.

Further developments to monitor include the second wave of internal model approvals and the Solvency II Commission Delegated Regulation (EU) 2015/35 in relation to infrastructure investments and European long-term investment funds (see our Previous Update for more information). The European Parliament and Council are also set to consider and negotiate the proposed Securitisation Regulation later in 2016.

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Please do not hesitate to contact us with any questions.