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Solvency II and Europe's regulatory reach

25 November 2013

Summary

On November 13, an important provisional agreement was reached in Brussels on the EU's flagship regulation of insurance companies – Solvency II. As part of the package the EU appears to have reassessed the way it approached the question of regulating EU insurers operating in third countries – especially the US. A tough line on demanding regulatory 'equivalence' from foreign jurisdictions has been softened, and a vaguer target of 'regulatory convergence' set. The last minute pragmatism – mainly at the hands of the European Parliament – is a reflection of the limits of Europe's ability to export its own financial regulatory standards to other developed markets. With the EU-US TTIP on the horizon, it also says something about the trade-offs European regulators may have to strike between Europe's desire to export its standards, and its desire to export its services.

On November 13, a provisional agreement between the European Parliament and the European Member States was struck on the EU's flagship legislation for insurance, Solvency II. Solvency II, like the Capital Requirements Directive 4 for banking, resets the prudential, transparency and governance standards for European insurers. One element of the final package is particularly noteworthy to anyone interested in the way the EU thinks about its ability to set global regulatory standards. After spending most of the Solvency II process (all thirteen years of it) working on the assumption that Solvency II would be a key vehicle for exporting European regulatory standards, the final package – chiefly at the urging of the European Parliament – appears to have taken a sharply pragmatic turn.

The principle in question is 'third country equivalence' (TCE) – the idea that EU insurers could only be subject to foreign regulators in jurisdictions with regulatory standards equivalent to those of the EU, just as foreign insurers in the EU would be required have home regulators that matched EU standards. In line with most EU post-financial crisis regulatory initiatives, the original TCE provision of Solvency II was primarily designed as a consumer protection safeguard to shelter European policyholders from poorly regulated foreign (re)insurance companies operating in the European market. In practice, however, the original TCE provision was also conceived as a platform for exporting the Solvency II regime by requiring foreign regulators to commit formally to reforming their regulatory systems to match it. The implicit calculation behind the Commission's original TCE text was that foreign regulators would rush to modernise their regulatory structures by adopting Solvency II-like measures both as best practice, but also to enable their home country companies to have access to the sizeable and profitable EU internal market. So what happened?

Commission's initial position	Probable provisional deal
• Foreign regulators need to formally apply for provisional equivalence and commit to reforms • Relatively strict criteria for provisional equivalence • Renewable once after 5 years	• Unilateral assessment by European Commission • General qualifying criteria for provisional equivalence. • Renewable every 10 years (10+10+) on same criteria regardless of regulatory evolution

Table 1: Evolution of the TCE provision in Solvency II
Source: Public statements

Failure to engage

The basic miscalculation of the original TCE provision was the failure to anticipate a scenario where foreign regulators declined to engage in a formal equivalence process with the Commission. This would have seen European insurers operating in jurisdictions that did not request or obtain equivalence required to comply with (generally more costly) Solvency II prudential and conduct regulatory requirements. This could duplicate processes and reduce their relative competitiveness in these markets. While this problem was initially theoretical, it became progressively less so as regulators in key jurisdictions failed to express interest in engaging in formal equivalence processes. This culminated in a mini-crisis in when Canada and the US made explicit their unwillingness to seek equivalence in November 2013.

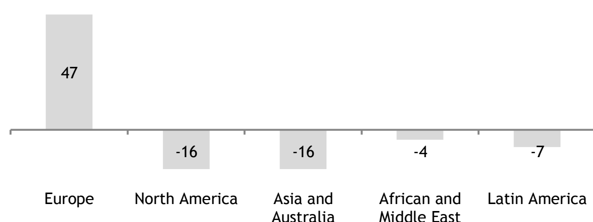

Fig1: Net risk positions in the global insurance market 2011 ($bn)
Source: IAIS

If the European Commission leaned towards intractability on the equivalence question, the Parliament position, strongly shaped by British MEPs with plenty of direct experience with London-based financial services business operating in the US in particular, was a lot more pragmatic. The Commission's position was certainly rooted in post-crisis consumer protection concerns, it also reflected a strong residual belief in Brussels in the ability of the EU to act as a global standard setter and to reduce global regulatory fragmentation – albeit through others doing things Europe's way.

Indeed, the European Parliament made a virtue of blinking first given the prospect of disadvantaging EU insurers such as AXA, Allianz, Aegon or ING in large markets like the US. Low interest rates, the adverse impact of local or IFRS accounting rules, and the need to shore up capital under the regulatory uncertainty surrounding Solvency II have all contributed to weakening the position of European insurers in the US insurance market in the last couple of years, with Aviva divesting in 2012.The added uncertainty and costs of the original TCE provision for European insurers in the US risked accelerating this trend (Fig 3).

It is our understanding that the final provisional text has effectively reduced what was initially a requirement of equivalence in the *form* of foreign regulatory standards, to one where the Commission would unilaterally 'grant' equivalence based on the *outcome* of these standards. Jurisdictions will be provisionally awarded equivalence for ten years, renewable for a further ten year period. Although jurisdictions identified by the Commission as 'equivalent' will be monitored for their 'convergence' with Solvency II standards, quite what this means is not clear (the current draft seems to provide room for equivalence even if a jurisdiction is only thinking of implementing Solvency II-like measures).

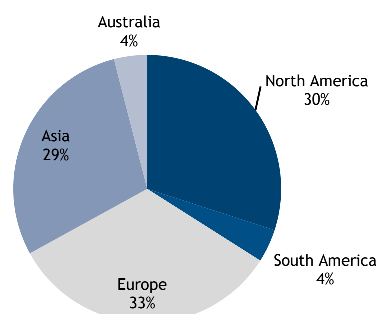

Fig2: Global market for insurance premiums
Source: Insurance Europe

In the case of the US, this now leaves enough room for equivalence to be granted on the basis of the Transatlantic Trade and Investment Partnership (TTIP) negotiations between the EU and the US. The fact that regulatory convergence in insurance is currently in the agenda of TTIP would seem to provide a basis for arguing that individual American states – who regulate their own insurance markets -

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are currently thinking of implementing Solvency II-like regulatory standards.

Rethinking regulatory soft power

The failure of foreign regulators to express an interest in engaging in formal equivalence discussions with the EU is telling. It is at least partially symptomatic of the fading strength of the convergent dynamic in international financial regulation immediately after the 2008 crisis and especially after the 2010 G20 meeting in London. As regulatory dossiers moved from broad political cooperation guidelines towards the technical rulemaking stage, and the urgency of action waned, the tension between regulatory cultures across the Atlantic applied a break on the effective harmonisation of standards. More widely, there was a general reluctance to have either the EU or the US held up as a paradigm for financial regulation. The EU's desire to be a global standard setter in this context was probably always going to be somewhat frustrated.

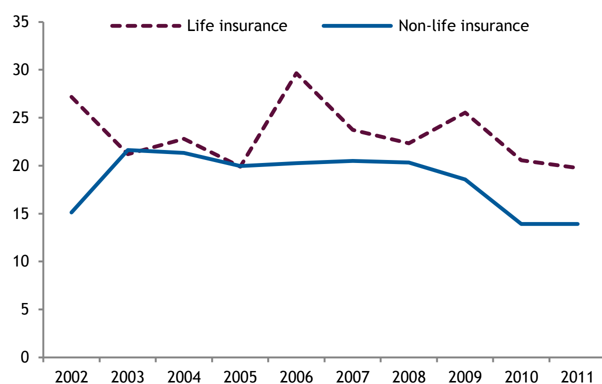

Fig3: Foreign presence in US insurance market (%market share)
Source: OECD

In this sense, the Solvency II provisional compromise on TCE probably constitutes a more realistic approach to regulatory convergence than the unilateralism of the European Commission's first TCE proposal. It is certainly more in tune with what is likely to be achievable in negotiations like the EU-US TTIP. It also slots well into the plans of the International Association of Insurance Supervisors (IAIS) to work towards a global capital standard regime for the insurance industry.

After decades of asymmetric negotiations with smaller economies, where the sheer size of the EU's economy provided both 'stick and carrot' for the adoption of EU standards, the new TCE provisions reflect the reality of dealing with big, parochial developed jurisdictions like the US, who are as jealous of their standards as the EU is of its own. Both the CETA deal between the EU and Canada and the prospective TTIP with the United States are likely to reflect the same pragmatism. If Solvency II sets a precedent, we can expect less of the old hard-nosed talk of strict equivalence in the extraterritoriality of EU law and more focus on regulatory convergence through 'living agreements'.

The balance in the provisional Solvency II text on TCE is essentially between the EU's regulatory power to set standards, and its commercial power to access third country markets on equal terms. The subjectivity of some of the qualifying equivalence criteria in the compromise text provides both enough space for the Commission to assert prudential principle on unquestionably weaker regulatory jurisdictions like China and India, for example, but flexibility in dealing with large, important and broadly comparable regulated markets such as Canada and the US. In this sense, it trades a measure of soft power of setting global regulatory standards for the soft power of ensuring that EU firms continue to be global exporters of insurance services.

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