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HOW IMPORTANT IS SOLVENCY II EQUIVALENCE FOR THIRD COUNTRY REINSURERS?

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The issue of equivalence continues to be a hot topic as the Solvency II regime is rolled out. Certain jurisdictions have worked to secure equivalent status, making changes to their own regulatory regimes in the process. Some have been granted equivalence on a provisional or temporary basis, and discussions between the US and EU representatives continue with respect to reciprocal recognition of each other's regime. Meanwhile in the UK, the Brexit vote means that the UK will likely seek equivalent status on leaving the EU.

But to what extent does equivalence impact reinsurers based in non-EEA jurisdictions (or "third countries" using the Solvency II terminology) and the credit that their EEA cedants receive for the cover they provide? As we explain below, whilst equivalence is one of the factors that may affect credit for reinsurance, the reinsurer's financial strength and the extent of collateralisation have greater weight under the Solvency II rules.

What is equivalence?

Where a third country is granted equivalence for reinsurance (pursuant to Article 172 of the Solvency II Directive), reinsurance contracts entered into with reinsurers in that jurisdiction must be treated in the same manner as contracts entered into with EEA reinsurers.

A third country may be granted equivalence in two other areas:

- Group solvency (Article 227) — This relates to EEA groups with third country subsidiaries, and provides for such groups to apply the local capital requirements for their subsidiaries located in a third country, instead of applying a Solvency II calculation.
- Group supervision (Article 260) — This relates to the group supervision of EEA firms with parents situated in a third country. Equivalence allows EEA supervisors to rely on the group supervision conducted by the regulators in that third country.

It is possible for a country to be granted equivalent status for one or two areas without being granted equivalence for all three. Currently the US, Australia, Brazil, Canada and Mexico have all been granted equivalence on a provisional (10-year) basis for group solvency, but not for reinsurance or group supervision. Japan has been granted equivalence on a temporary basis for reinsurance (until 31 December 2020), as well as equivalence on a provisional basis for group solvency. Bermuda and Switzerland have been granted equivalent status in all three areas (with the exception of captives and special purpose insurers in Bermuda).

The US may ultimately obtain equivalent status for reinsurance (and group supervision) if the EU and the US can reach agreement on recognising each other's regulatory regimes and allowing (re)insurers to conduct transatlantic business on terms equivalent to domestic competitors. Both sides have been engaged in talks this year with a view to concluding such an arrangement (known as a "covered agreement" in the US). Following meetings in July, the US and EU stated that representatives had "exchanged concrete ideas in a constructive atmosphere, and addressed next steps towards completing negotiations in a timely manner", although uncertainty remains as to whether the parties will reach agreement.

Effect of equivalence on the reinsurer's status under Solvency II

Solvency II applies certain threshold requirements in order for a cedant to take a reinsurance arrangement into account in its calculation of the Solvency Capital Requirement (SCR). Under the standard formula, the reinsurer must be either:

(a) an EEA reinsurer;

(b) a reinsurer from a jurisdiction deemed equivalent for reinsurance (Article 172); or

(c) a reinsurer with a credit rating of credit quality step 3 or better (equivalent to Standard and Poor's BBB / AM

Best bbb rating).

Thus a third country reinsurer may qualify through being located in an equivalent jurisdiction. But equally, a reinsurer that is rated credit quality step 3 or better qualifies, whether or not it is located in an equivalent jurisdiction.

And even where none of (a) to (c) applies, i.e. where the reinsurer is a third country reinsurer in a non-equivalent jurisdiction and is unrated or rated below credit quality step 3, the cedant may still claim credit to the extent that the risk exposure is covered by collateral arrangements. Therefore credit should also be available where the reinsurance is collateralised, regardless of equivalence, such as in the case of fully collateralised ILS transactions or collateralised longevity and other life reinsurance transactions.

Impact on counterparty default risk charge

Solvency II also requires cedants to calculate a counterparty default capital risk charge to reflect reinsurer credit risk in the SCR. The calculation is based on a function of the loss given default (i.e. the exposure to the reinsurer) and the probability of default.

Where the reinsurer is rated, the probability of default is determined using the reinsurer's external credit rating, irrespective of whether the reinsurer is located in an equivalent jurisdiction. For example, a reinsurer with an S&P "AA" rating is allocated a probability of default of 0.01%, under the standard formula.

Where the reinsurer is unrated and located in a third country, the probability of default does vary depending on whether it is located in a jurisdiction which is equivalent. Unrated reinsurers from equivalent jurisdictions are subject to a 0.5% probability of default under the standard formula, whereas reinsurers from non-equivalent jurisdictions are subject to a 4.2% probability of default.

However, reinsurance collateral will reduce the counterparty default capital charge. So in fully collateralised transactions, equivalence should not be material to the calculation. A high counterparty default charge can also be mitigated if the reinsurer is able to secure a guarantee from a rated affiliate, a letter of credit in which case the credit rating of the guarantee provider or the issuer of the letter of credit may be used instead of the reinsurer's rating.

It should be noted that for the purposes of the probability of default calculation, "equivalence" is defined in the Solvency II Regulations by reference to Article 227 (group solvency), rather than Article 172 (reinsurance). Accordingly, US reinsurers would in fact qualify as equivalent in this context as the US has been granted provisional equivalence for group solvency.

Requirements to pledge collateral or locate assets in the EEA

As mentioned above, equivalence for reinsurance under Article 172 requires that EEA regulators treat reinsurance with a reinsurer in the third country in the same way that they would for reinsurance entered into with an EEA reinsurer.

More specifically, Solvency II prohibits EEA authorities from requiring the pledging of assets by reinsurers based in equivalent third countries to cover unearned premiums and outstanding claims (Article 173) and prohibits them from requiring assets representing reinsurance recoverables to be held in the EEA (Article 134).

Although most EEA regulators do not require collateral to be posted by third country reinsurers as a matter of course, the risk that regulators could impose such obligations, or other regulatory or administrative burdens, is a consideration for reinsurers in non-equivalent jurisdictions. But the risk is less significant for collateralised reinsurance, including much of the ILS market and collateralised life/longevity transactions, where collateral is posted by the reinsurer in any event.

Equivalence does not provide a right to passport services

Finally, it is worth noting that whether a third country reinsurer is based in an equivalent jurisdiction does not affect the question of whether it is required to be authorised by regulators in the relevant EEA state to underwrite reinsurance business.

An EEA reinsurer (or insurer) is able to use its home state's authorisation to "passport" into other EEA states, either through cross-border services or by establishing a branch, without requiring an additional authorisation locally. However, a finding of equivalence does not enable third country reinsurers to benefit from passporting rights. For example, post-Brexit, although the UK will likely be granted equivalent status by the EU since it will be subject to Solvency II up to the point of exit, that will not of itself enable UK insurers and reinsurers to continue to take advantage of the EEA passporting regime.

Reinsurers are usually able to avoid falling within the regulatory regime by keeping all activity that relates to the business offshore. This is an issue that always needs to be considered by reference to the relevant local

regulatory regime and in particular whether that regime's requirements for authorisation are governed by the location of the risk as distinct from the place where the reinsurance business is carried on.

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