How Will the European Commission's Proposed Directives on Insurance Change the Way We Look at Deals?

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The European insurance market will undergo significant changes in the next few years. The Solvency II project is well underway and the European Commission recently proposed a Directive on reinsurance. Any entity seeking to acquire or invest in an insurance company with European operations should be aware of these developments. Since these changes could affect the solvency of a European insurer, seeking the right information and asking the right questions is fast becoming a key part of the due diligence process in international transactions.

Below is a brief overview of Solvency I, the Solvency II project as well as the proposed Directive on reinsurance.

Solvency I

Solvency I was adopted by the European Union ("EU") in February 2002 and consists of two Directives regulating the solvency margin requirements for life and non-life assurance undertakings, (Commission Directive 2002/12/EC & 2002/13/EC.) The two Directives collectively known as "Solvency I," strengthened the prior EU insurance regulations enacted in 1973 (non-life) and 1979 (life) respectively. Solvency I applies to all insurance organisations utilizing the EU's "single passport" system, under which any insurance undertaking authorized by its home Member State in accordance with certain uniform guidelines may conduct business throughout the EU.

Solvency I primarily altered the existing rules for the calculation of insurance company solvency margins. Specifically, the Directives' principal provisions include:

- A minimum capital level of EUR 3 million for all participating insurance undertakings. Certain classes of non-life insurance companies need only maintain EUR 2 million in capital. These amounts will be indexed for future inflation.
- Increased threshold levels below which higher solvency margins are required. Accounts operating on a premium basis must maintain a solvency margin of 18% up to the first EUR 50 million of premium, and 16% above EUR 50 million. Accounts on a claims basis must maintain a 26% solvency margin on the first EUR 35 million, and 23% above EUR 35 million.

- Increased powers to supervisory bodies, allowing them to intervene and take remedial action where policyholders' interests are threatened.
- A 50% higher required solvency margin for certain categories of non-life business with particularly high risk profiles (e.g., marine, aviation and general liability).

These guidelines set minimum requirements for EU insurance regimes, allowing Member States to implement more stringent regulations to account for local risk factors. Participating insurance undertakings must apply the Directives to all company accounts for financial years beginning in 2004.

Solvency II Project

Immediately after passage of Solvency I, the European Commission began work on a broader, more comprehensive reform of the EU's insurance regulations. Dubbed "Solvency II," the new project seeks to expand on the reforms implemented by Solvency I and bring greater uniformity to the EU insurance regulatory scheme. Indeed, while Solvency I essentially focused on a single aspect of an insurance company's financial character, Solvency II aims to better match overall solvency requirements with the true risk encountered by insurance undertakings, as well as encourage insurers to improve their measurement and monitoring of risks incurred. The Solvency II project will take into account changes in the financial market, such as the use of derivatives, new insurance products and new risk management techniques introduced since the current insurance Directives were introduced in the 1970s.

The Solvency II project has two phases. In phase 1, the Commission proposed a wide-ranging study of the European insurance sector, focusing particularly on the rules governing assets and liabilities, asset and liability matching systems, reinsurance arrangements and the implications of current accounting and actuarial policies. Phase 2 of the project involves distilling the information gathered in phase 1's comprehensive review into actual policy regulations and Directives.

After extensive consultation with the EU insurance industry, Member State regulatory bodies and external insurance experts, the Commission formally ended phase 1 in the early part of 2003. Commission Services, a subcommittee of the Commission's Insurance Committee, published recommendations for Solvency II Directives based on the data gathered by the initial phase of the project. These broad outlines will form the basis for a more specific framework Directive, slated for completion in 2005.

Commission Service's recommendations for the substantive provisions of Solvency II are divided into a three-pillar structure. First pillar provisions implement external regulations binding on all EU insurance undertakings. Second pillar law regulates the adoption of internal control and review mechanisms by participating companies. Finally, third pillar rules create disclosure and reporting requirements applicable to EU insurance undertakings.

The Commission's Insurance Committee adopted these general recommendations on April 9, 2003, officially ending phase 1 of the Solvency II project. Principle supervision over the project now rests with Commission Services and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Commission Services plans to proceed with Solvency II on two fronts: drafting a proposal for a framework Directive and drafting mandates to CEIOPS for technical work in order to prepare implementing measures as soon as possible after the adoption of the framework Directive.

Proposed Reinsurance Directive

In response to the growing concern among Member States regarding the lack of regulatory supervision over the European reinsurance industry, the European Commission proposed a new Reinsurance Directive in April 2004. The Directive is a "fast track" solution pending the passage of the more comprehensive Solvency II package regulating the entire insurance industry. The proposal is currently under consideration by the European Parliament and Council of Ministers.

The new Directive features two main proposals. First, it creates an EU-wide reinsurance company licensing system, under which reinsurers will receive EU wide authorisation from their home Member State in accordance with a uniform set of licensing standards. Second, the Directive implements EU-wide prudential rules for the supervision of these licensed reinsurance undertakings. These rules mirror those already in place for direct insurers, including minimum capital requirements, required solvency margins and rules on the investment of assets.

The following summary highlights certain key topics covered by the proposed Reinsurance Directive.

1. Purpose and Scope

The Directive *"lays down rules for the taking up and pursuit of the self-employed activity of reinsurance carried on by reinsurance undertakings . . . ."* These rules will only apply to companies exclusively engaged in the business of reinsurance. Companies who perform reinsurance activities along with other insurance business need not adhere to the Directive, as they will most likely already be subject to the life or non-life assurance regulations. The Directive will also not apply to reinsurance activities conducted by a Member State acting as a reinsurer of last resort for reasons of public interest.

2. Entry into the Reinsurance Business

As discussed above, the new Directive creates a licensing system for reinsurance companies conducting business within the EU. Under the new protocols, the licensed company's home Member State will exercise primary supervisory authority over its activities.

Minimum conditions for authorisation must require the company to: 1) have a specific legal form, 2) submit a scheme of operations providing essential information regarding its business plan, 3) possess the minimum guarantee fund provided for in Article 40 and 4) employ a company manager with a set level of technical qualifications and experience.

The proposed Directive also requires the company to disclose the identities of all its controlling shareholders or other members with a *"qualifying participation."* The Commission's comments on this requirement emphasise the need to assess the *"suitability of the shareholders"* with respect to ensuring the *"sound and prudent management of the reinsurance undertaking."* The Commission explicitly directs Member State authorities to refuse a company's application where that company has a controlling shareholder whose interests may impair the competent authorities' ability to *"exercise effectively their supervisory functions."*

An application for authorisation must be reviewed within six months of its submission. If rejected, the new Directive requires the competent authority to state the reasons for such rejections.

3. Solvency Margin

The new Directive imposes solvency margin requirements similar to those applicable to direct insurance undertakings. Non-life reinsurance businesses, for example, must adhere to the requirements set out in the non-life insurance Directive 73/239/EEC. Moreover, life reinsurance companies must retain a solvency margin calculated in accordance with the rules in the Life Insurance Directive 2002/83/EC. Additionally, where a reinsurance undertaking conducts simultaneously life and non-life reinsurance business, the required solvency margin must cover the total sum of required solvency margins for both activities.

Conscious of the competition between exclusive reinsurers and insurance companies that engage in significant reinsurance activities, the new Directive subjects the latter undertakings to the full reinsurance solvency margin requirements.

The Reinsurance Directive contains the possibility of increasing the required solvency margin. The Commission justifies this departure from the insurance regulations because of the particular risk profiles inherent to certain lines of reinsurance business. Such increases must come from the European Commission after consultation with its Insurance Committee.

The Industry Reactions

With respect to Solvency II, although many of its key regulations still require additional specification and discussion, industry groups generally accept the proposal as an improvement. A spokeswoman for Zurich noted that *"it is too early to say* [whether] *insurers are not taking* [the proposed measure] *seriously as more specific proposals have not yet been issued. As soon as they are* [adopted], *doubtless the industry will take the necessary steps to comply."* (Post Magazine, 4 December 2003). Benedict McHugo, the head of prudential reporting at the Association of British Insurers, further commented that, "[w]*e are very much in favour [sic] of a risk-based approach* [to insurance industry regulation] *of the right standard consistently applied across Europe."*

National regulatory agencies have also welcomed Solvency II as a much needed reform of the European insurance market. Karl Burkhard-Caspari, the Vice President of German financial services regulator BaFin, noted that insurance companies will be able to *"cut their regulatory capital requirements by developing internal risk-adjusted ratings for clients."* (European Pensions & Investments News, 24 May 2004). Utilising such internal models, Caspari commented, would allow insurers to develop more sophisticated risk management and control systems.

Similarly, the reinsurance industry has generally greeted the Reinsurance Directive with support, recognising the advantages of implementing a uniform regulatory regime. Reinsurance trade organisations, such as the Comite Européen de Assurances (CEA), praised the measure as increasing the international competitive standing of EU reinsurers, (Aldred, Carolyn, "Consensus Builds for Uniformity in EU Oversight," Business Insurance, 2 September 2002). Indeed, the current lack of EU-wide regulation has made it difficult for EU reinsurance undertakings to access foreign markets whose regulatory authorities often require companies from unregulated jurisdictions to post bond for potential liabilities. Lynne Routledge, a

European officer for the International Underwriting Association, stated in the same Business Insurance article as above that once in place, an industry-wide regulation like the proposed Directive would *"strengthen the European Commission's hand in any negotiations with the federal authorities in the U.S. with regard to achieving mutual recognition on the* [bond posting] *issue."*

Despite the broad consensus of support for the initiative's overall objectives, the reinsurance industry remains divided as to the details of the proposal. The principal dispute involves the solvency margin requirements in the draft Directive. Early drafts of the Directive proposed imposing solvency levels 150% above those set for direct insurance providers. The EC justified this rate hike by citing the riskier markets for reinsurance as compared to primary insurers. The reinsurance industry reacted fiercely to this initial proposal, however, and the Commission eventually set the reinsurance solvency levels equal to those of direct insurance undertakings. Yet the proposed Directive still preserves the Commission's ability to impose higher capital requirements on certain reinsurance business lines engaged in riskier activities.

Conclusion

Although Solvency II and the proposed Directive on reinsurance are not yet adopted, in light of their potential far reaching affects, keeping informed on developments and assessing how their implementation may affect an insurance company is recommended. These upcoming regulatory changes could affect how a deal is structured and evaluating their potential impact should be part of the due diligence process.

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