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Europe – Gabriel Bernardino of EIOPA gives speech to the Insurance Institute of London

On 14 March 2012, Gabriel Bernardino, chairman of the European Insurance and Occupational Pensions Association (**"EIOPA"**) gave a lecture to the Insurance Institute of London, addressing EIOPA's mission and what he sees as the main challenges currently facing the European insurance sector. Mr. Bernardino explained that EIOPA's mission was to protect the public interest, which involved maintaining an ongoing balance between financial stability and consumer protection. He commented that EIOPA is committed to adding real value, as opposed to becoming just another layer in the regulatory structure.

Mr. Bernardino set out the five key areas EIOPA is currently involved with. These are:

1) **Regulation** – EIOPA is carrying out public consultations in relation to Solvency II, in particular in relation to ORSA (where it has published guidelines), and in the reporting and disclosure arenas.

2) **Oversight/supervisory** – Here, EIOPA's priority is a commitment to more consistent action in the colleges of supervisors (EIOPA has set the colleges a concrete action plan for 2012, as discussed in our February bulletin). EIOPA is also carrying out visits to member states and national supervisory authorities in order to better understand national markets.

3) **Consumer protection and financial innovation** – EIOPA has consulted on good practice guides for annuities, and for complaints handling by insurance companies, and is currently processing the responses received. It has also carried out an initial review of consumer trends (in particular, in relation to payment protection insurance, the increased focus on unit-linked insurance products, and the increased use by consumers of comparison websites), and is shortly holding its first consumer strategy day.

4) **Financial stability** – EIOPA has been carrying out stress tests of financial institutions, and the results of these tests show that the insurance industry would be negatively affected if the current low yield world continues. It has also been carrying out macro prudential analysis with the European systemic risk board.

5) **International relations** – EIOPA has been providing advice on equivalence, in particular in relation to Japan, Bermuda and Switzerland (as discussed in previous bulletins).

Mr. Bernardino them went on to discuss what he sees as the main challenges currently facing the European insurance sector. These were:

1) **The need to take the appropriate lessons from the crisis** – In Mr. Bernardino's view, it will be fundamental to use robust and realistic risk assessment and pricing in the future. He commented that risk can be mitigated, but only if the nature of the risk is properly understood. Holding appropriate capital is one important element in the mix, but it is not the solution to everything – what is fundamental is the effective management of risk. Mr. Bernardino went on to stress that the governing bodies of Europe will need to take appropriate consideration of transition periods in relation to Solvency II, and realise that in regulation one size does not fit all.

2) **Consumer protection** – Mr. Bernardino commented that this was a fundamental issue, and one which is here to stay. He stated that a paradigm shift was needed in various areas, including:

   a. *Taking a new look at conflicts of interest* – to take into account the complexity of the product concerned, and aiming to reach high standards in selling practices.

   b. *Disclosure and information provided to policyholders* – to recognise that consumers do not read all the documentation which they are sent when they take out an insurance policy, and that it puts a high burden on companies to provide this information which, in the end, provides no benefit to consumers. Mr. Bernardino was of the opinion that less information was better information here.

   c. *Product sustainability* – to develop a framework for early detection of unfair products. Mr. Bernardino did not believe this would require a pre-approval process, but instead he commented that it would require better insight into the development of products and the consequences for consumers.

3) **Consequences of supervisory practices in the EU** – Mr. Bernardino stated that the aim of EIOPA is to develop a 'single rulebook' of regulations which are common and standardised throughout Europe. This will also require consistency at the supervisory and implementatory levels. The overall aim is to create a level playing field and provide consumer protection. Mr. Bernardino was of the view that convergence does not mean 100% harmonisation – instead, it will require guidelines and recommendations, as well as the development of best practices. Mr. Bernardino commented that this will be a particularly important area for cross border groups.

In conclusion, Mr. Bernardino commented that EIOPA aims to create a 'European culture', taking the best it has and putting it together, in order to create intelligent and effective regulation.

In the question and answer session that followed the talk, Mr. Bernardino commented that there was great diversity in the comparative readiness of various member states for Solvency II – all of the big countries had done some work on it, but the work done by smaller companies Europe-wide was less developed. Some of the markets which previously had less involvement were becoming more involved as time progressed. The UK, owing to the background of its regulatory landscape, was further ahead than others on internal models, whereas other countries were further ahead on Pillar II implementation. What was common across all member states was the need for certainty as regards the date of implementation.

Mr. Bernardino also expressed the view, in relation to the news that Prudential is considering moving their headquarters to Asia (due in part to Solvency II), that there are also important elements of Solvency II that will make companies want to be in Europe. He commented that lots of countries were moving to risk based systems, and that EIOPA would be monitoring the development of the insurance business in Europe in the future.

Europe – Solvency II: FSA speeches on EU policy issues and IMAP submissions

On 9 March 2012, the FSA published various materials following its industry briefing on Solvency II which was held on 27 February 2012. The first of these materials was a speech by Martin Etheridge, the Acting Head of Insurance Policy at the FSA, who discussed the Solvency II policy landscape. The second was presentations by David Johnston (Senior Implementation Manager for Solvency II) and Vishal Desai (Team Leader of the General Insurance Actuaries, Risk Specialists Division) on the process for making a submission for approval to use an internal model.

SPEECH BY MARTIN ETHERIDGE ON SOLVENCY II POLICY LANDSCAPE

Mr. Etheridge commented that there is still a huge amount of interest in the Omnibus II directive, and much scrutiny of the European Commission's (the **"Commission"**) draft consolidated version of the Level 2 implementing measures. He stated that there were two important areas of policy which remained open here, being long-term guaranteed liabilities and the equivalence assessment of non-EEA jurisdictions.

In relation to long-term guaranteed liabilities, the FSA feels very strongly that *"where these are matched by long-dated assets then, as a policy matter, it is undesirable for the balance sheet to be subject to unnecessary volatility brought about by short-term fluctuations in the market"*.

In relation to equivalence assessments, Omnibus II proposes a transitional arrangement whereby countries that have not yet been deemed to be equivalent will be deemed to be equivalent for five years. EIOPA has a significant role in advising the Commission on equivalence. Mr. Etheridge commented that working parties within the EU were discussing the best approach to dealing with the US, given its state-based system of insurance regulation.

Mr. Etheridge went on to discuss the next steps in the EU policy process and the domestic timetable.

EU policy process

There will be a vote in Parliament on the Omnibus II directive (which is not now expected until July 2012), following which the Commission, the European Council and the Parliament will commence the 'trialogue' phase and attempt to come to a consensus. Once the voted-up Parliament text is published, there will be a clearer indication of how far away a consensus may be. EIOPA will need to go through a more extensive public consultation once the trialogue process is complete and the Commission formally proposes its Level 2 delegated acts.

Domestic timetable

The FSA is currently going through the responses to its first consultation on the implementation of Solvency II, and the responses highlight a small number of areas where it will be necessary to not simply copy out Solvency II into the FSA Handbook. There will need to be certainty on the Level 2 text before the FSA can finalise the changes to the Handbook to take into account Solvency II. Further, the FSA will need to take a view on the certainty of the provisions proposed by the Commission once Omnibus II is finalised, before they next go out for consultation, in order to avoid having to re-consult if anything changes. The FSA will also need to coordinate closely with the Treasury, which is carrying out its own consultation and legislation process, and consider the way the existing FSA Handbook is split between the Prudential Regulation Authority and the Financial Conduct Authority.

In conclusion, Mr. Etheridge acknowledged that there was continued uncertainty about the policy timetable, and stressed that the FSA would provide as much information as it could, when it could.

PRESENTATIONS BY DAVID JOHNSTON AND VISHAL DESAI ON PROCESS FOR MAKING A SUBMISSION FOR APPROVAL TO USE AN INTERNAL MODEL

Mr. Johnston and Mr. Desai set out the timeline and steps for making a submission for approval to use an internal model, as well as some early reflections on the work done to date.

Whilst the FSA is awaiting clarity on the exact point at which it will assume legal powers under Solvency II, and cannot formally approve a model until it has the requisite powers, it is attempting to make meaningful progress in the meantime. It is not looking for 100% completeness at this stage, but it would be a waste of everyone's time for the FSA to review something where there would be no reasonable prospect of it succeeding. Firms were also requested to stick to their submission slots, as these have been carefully planned.

The review process would consist of a basic completeness check and a review phase (based on an individual work plan and including a review of methodology and actual calculation). Once this is complete, a preliminary view will be given. Once the FSA has assumed legal powers, a further formal application will be required. However, the FSA is of the opinion that this will be a relatively straightforward submission, depending on the stability of a firm's policies since the the preliminary view was given.

The FSA also provided a summary of the themes that are emerging from its early review and assessment work. The key points of this included:

- The level of engagement of firms has visibly ramped up in the last six to seven months.
- There are concerns about certain firms (particularly those with early submission slots) who are falling behind where they need to be.
- The FSA has to approach its review work with a healthy degree of scepticism – before it can accept a firm's assertion that something is immaterial, the FSA will want to understand how and why that firm has come to that conclusion.
- The quality of the documentation received to date is extremely variable, with a lot of sweeping and general statements. The FSA recommends spending more time on checking that there is enough 'why' (i.e. the rationale for arriving at conclusions) in the documentation they provide to the FSA, as well as the 'what'.
- Firms should be advancing their contingency planning arrangements in case they do not get approval.

Europe – CEA changes name to Insurance Europe

The CEA (Comité Européen des Assurances) issued a press release on 1 March 2012 (the **"Press Release"**) announcing that it had changed its name to 'Insurance Europe'.

The Press Release notes that the European insurance industry has a 37% share of the global market. With 34 member associations, Insurance Europe represents more than 5,000 European insurance and reinsurance companies. Michaela Koller, director general of Insurance Europe commented that "*with a strong, new brand, Insurance Europe will be better positioned to represent this vital sector*".

Europe/UK – Discrimination update

On 14 March 2012, Insurance Europe wrote a letter to the Danish Presidency of the Council of the EU, setting out its comments on the revised Anti-Discrimination Directive (the **"Letter"**). It comments that it is "*of the utmost importance for insurers to avoid any risk of a similar ECJ judgement [to Test-Achats] resulting in a ban on the use of age or disability in insurance*". It is of the opinion that such a ban would lead to the end of the current insurance business model, higher premiums and a reduced choice of providers. Whilst it comments that the latest proposal is "*going in the right direction*", it still raises several concerns, which are detailed in the annexes to the Letter.

US – Additional States enact legislation addressing the treatment of qualified financial contracts under insurance insolvencies

The Governors of New Jersey and Tennessee signed bills in 2012 that add important provisions to their respective insurance laws regarding the treatment of qualified financial contracts in an insurance insolvency proceeding. (In the case of New Jersey, the new legislation applies only to life and health insurers.) New Jersey and Tennessee became the 19^{th} and 20^{th} states to have enacted provisions governing the treatment of qualified financial contracts under insurance insolvencies based on the 2005 amendments to the Insurance Receivership Model Act (**"IRMA"**) of the National Association of Insurance Commissioners.

"Qualified financial contracts" include derivatives, securities lending, repurchase agreements, futures contracts and other financial instruments. These contracts are typically documented under master agreements providing for netting of obligations between the parties. The agreements also establish a right of the non-defaulting party to close out, liquidate and terminate the agreements immediately upon the insolvency of the other party and provide for collateralization of obligations on a net, rather than gross, basis.

While both the U.S. Bankruptcy Code, which governs the insolvency of most U.S. companies, and the Federal Deposit Insurance Act, which governs the insolvency of U.S. banks, contain provisions exempting qualified financial contracts and netting agreements from the automatic stay mechanism, most state insurance codes governing the insolvency of insurance companies have historically not included such provisions, creating significant uncertainty for counterparties of insurance companies. This uncertainty has led to reluctance on the part of banks and other financial institutions to enter into swap agreements with insurance companies out of concern that they may be unable to exercise termination, netting and collateral realization rights under the agreements if the insurer becomes insolvent.

The IRMA provisions should alleviate the concerns of counterparties dealing with insurers that are domiciled in the states that have enacted those provisions, which are Arizona, Connecticut, Delaware, Illinois, Indiana, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Jersey, New York, Ohio, Tennessee, Texas, Utah and Virginia. Of the 20 states that have enacted the IRMA provisions relating to qualified financial contracts, 15 of them have done so within the past two years, indicating that there is significant momentum across the US with respect to this type of legislation.

US – Legislation to amend credit for reinsurance provisions introduced in additional states

Connecticut, Louisiana and Missouri are the latest states where bills have been introduced to amend existing credit for reinsurance laws to conform to the November 2011 changes to the National Association of Insurance Commissioners (**"NAIC"**) model law, and a similar Virginia bill has now been enacted into law. In Indiana, where amendments to the credit for reinsurance laws were already adopted in April 2011, additional amendments have recently been enacted to closely track the NAIC model law. Meanwhile, the New Jersey Department of Banking and Insurance (**"NJDOBI"**) has released a regulatory bulletin to discuss proposed new rules and amendments to existing rules to implement New Jersey's recently amended credit for reinsurance statute based on the NAIC model law. As we have previously reported, the following states have already adopted reduced collateral requirements:

- Florida (property and casualty only)
- Indiana (life, property and casualty)
- New Jersey (life, property and casualty)
- New York (life, property and casualty)

Recently Enacted State Legislation

On 15 March 2012, Indiana Governor Mitch Daniels, Jr, signed Indiana House Bill 1226, effective 1 July 2012, which amends Indiana's Insurance Code to conform with the NAIC model law. Among other things, this legislation adds provisions requiring ceding insurers to manage their concentration risk, and provides that the statutory provisions governing credit for reinsurance, as amended by the new legislation, only apply to cessions by a ceding insurer to an assuming insurer that occur after 30 June 2012, and under a reinsurance agreement that has an inception, renewal or anniversary date after 31 December 2012, thus limiting the ability of reinsurers to reduce their collateral on in-force business.

On 4 April 2012, Virginia Governor Bob McDonnell signed Virginia House Bill 1139, amending the statutory provisions governing credit for reinsurance in Virginia to allow for reduced collateral requirements. For more information on the Virginia legislation, please see our article from the February 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Additional states introduce credit for reinsurance reform legislation; New Jersey proposes new credit for reinsurance regulations* (see page 10).

For more information on the amendments to the NAIC model law and regulation, please see our article from the October 2011 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *NAIC Fall 2011 Meeting Notes*, as well as the February 2012 article noted above (see page 6).

For background on the progression of reinsurance collateral requirements reform in the US, please see our article, *US reinsurance collateral reform picks up pace*.

Pending State Legislation

The recently introduced Connecticut House Bill 5484, Louisiana House Bill 849 and Missouri House Bill 1936 contain provisions that track the amended NAIC model law and would make a significant change to the statutory provisions governing credit for reinsurance in those states by potentially allowing full credit to insurers that cede risk to unauthorized reinsurers that post less than 100% collateral. Under the newly proposed legislation in those states, credit will be allowed to a domestic insurer when risk is ceded to an assuming insurer that has been "certified" as a reinsurer by the state insurance regulatory authority and that secures its obligations in accordance with the requirements of the relevant state's insurance code. In order to be eligible for certification, an assuming insurer must meet certain requirements, including being domiciled and licensed in a "qualified jurisdiction" as determined by the relevant state, maintaining specified financial strength ratings, maintaining minimum capital and surplus, submitting to the jurisdiction of the relevant state, meeting filing requirements and satisfying any other requirements of the relevant state. A rating will be assigned to each certified reinsurer, giving consideration to the financial strength ratings of the certified reinsurer. Most significantly, the proposed legislation provides that a certified reinsurer must secure its obligations at a level consistent with its ratings, as specified in rules to be adopted by the state insurance regulatory authorities, opening the door for the possibility of risk-based collateral requirements under which a certified reinsurer will be able to post less than 100% collateral, with the ceding insurer still receiving credit for the ceded insurance.

Each of the three bills also contains provisions requiring ceding insurers to manage their concentration risk, following amendments to the NAIC model law that were added in the wake of similar provisions added to New York's Regulation 20, Credit for Reinsurance from Unauthorized Insurers. Under the proposed legislation, a ceding insurer would have to take steps to manage its reinsurance recoverable proportionate to its own book of business. A domestic ceding insurer would have to notify its home-state commissioner within 30 days after reinsurance recoverable from any single assuming reinsurer, or group of affiliated assuming reinsurers, exceeds 50% of the domestic ceding insurer's last reported surplus to policyholders, or after it is determined that reinsurance recoverables are likely to exceed this limit. The proposed legislation would also require a ceding insurer to take steps to diversify its reinsurance program and notify its home-state commissioner within 30 days after ceding to any single reinsurer, or group of affiliated assuming reinsurers, more than 20% of the ceding insurer's gross written premium in the prior calendar year, or after it is determined that the reinsurance ceded is likely to exceed this limit. In both situations, the notification to the commissioner is intended to demonstrate that the exposure is being safely managed by the domestic ceding insurer.

In Illinois, legislation has already been introduced to amend the existing credit for reinsurance laws to conform with the revised NAIC models. For more information on the legislation introduced in Illinois, please see our article from the January 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Illinois continues to pursue credit for reinsurance reform* (see page 3). For information on similar legislation introduced in Georgia, please see our article from the February 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Additional states introduce credit for reinsurance reform legislation; New Jersey proposes new credit for reinsurance regulations* (see page 10).

We expect a number of other states to consider similar legislation this year to amend their laws and regulations to bring them into line with the amendments to the NAIC Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786) that were adopted at the NAIC's 2011 Fall Meeting. Although NAIC model laws and regulations do not become effective in any given state unless and until they are enacted by the legislature or promulgated by the insurance regulatory authority of that state, the NAIC model law and regulation generally have an influence on state laws and regulations to the extent that certain aspects of the amended models become accreditation standards of the NAIC. States strive to maintain their NAIC accreditation so that other states will defer to them as the primary regulatory authority for insurers domiciled in their states. Inclusion of the amended versions of the model law and model regulation in the NAIC accreditation standards will create a strong incentive for states to adopt them.

During 2012, the NAIC's Reinsurance (E) Task Force (the **"Task Force"**) has been conducting discussions to determine which aspects of the amendments to the models should become accreditation standards. At the NAIC 2012 Spring Meeting, the Task Force released for comment proposed revisions to the key elements of the standards for reinsurance ceded within the Financial Regulation Standards and Accreditation Program. The proposed revisions are being developed by the Task Force for the purpose of submitting recommendations to the Financial Regulation Standards and Accreditation (F) Committee as a result of the revisions to the credit for reinsurance model law and regulation. If the proposed revisions are adopted, states would not need to change their existing credit for reinsurance rules in order to remain accredited, but any state wishing to establish a framework allowing for reduced collateral would have to follow the revised models.

New Jersey Regulatory Activity Bulletin

On 14 March 2012, NJDOBI released Bulletin 12-04 discussing the proposed new rules and amendments to existing rules to implement the amendments to New Jersey's credit for reinsurance statute that were enacted last year. The proposed new rules and rule amendments are based on the amendments to the NAIC models and include procedures by which an insurer may become a certified reinsurer, the basis on which a certified insurer would be rated, standards for determining whether a jurisdiction is a qualified jurisdiction, the creation of a sliding scale based on ratings to determine the amount of collateral required and the addition of a provision addressing concentration risk. The proposed new rules and rule amendments limit the ability of reinsurers to reduce their collateral on in-force business by providing that credit for reinsurance under the new section of the rules regarding credit for reinsurance from certified insurers applies only to reinsurance contracts entered into or renewed on or after the effective date of the certification of the assuming insurer. Any reinsurance contract entered into prior to the effective date of the certification of the assuming insurer that is subsequently amended after the effective date of the certification of the assuming insurer, or a new reinsurance contract, covering any risk for which collateral was provided previously, will only be subject to this new section of the rules with respect to losses incurred and reserves reported from and after the effective date of the amendment or new contract. In Bulletin 12-04, NJDOBI advised that, pending the adoption of the new and amended rules, insurers may seek to take credit for reinsurance ceded in accordance with the proposed new and amended rules. Insurers also may apply to become certified reinsurers in accordance with the proposed new rules. For more information on the proposed new rules and rule amendments introduced in New Jersey, please see our article from the February 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Additional states introduce credit for reinsurance reform legislation; New Jersey proposes new credit for reinsurance regulations* (see page 10).

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