Guernsey Financial Services Commission

GUERNSEY AND THE DEVELOPMENT OF GLOBAL AND EUROPEAN INSURANCE CAPITAL STANDARDS

DISCUSSION PAPER

September 2017

The Guernsey Financial Services Commission (the "Commission") invites comments on this paper. Lynn Harris in the Commission's Banking and Insurance Policy and Supervision Division is co-ordinating responses from industry and your comments should be submitted by no later than 20 October 2017.

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List of Acronyms

BSCR	Bermuda Solvency Capital Requirement
C-ROSS	China Risk Oriented Solvency System
EIOPA	European Insurance and Occupational Pensions Authority
GIIA	Guernsey International Insurance Association
IAIG	Internationally Active Insurance Group
IAIS	International Association of Insurance Supervisors
ICC	Incorporated Cell Company
ICP	Insurance Core Principle
ICS	Insurance Capital Standard
ILS	Insurance-linked Securities
MCR	Minimum Capital Requirement
ORSA	Own Risk and Solvency Assessment
PCC	Protected Cell Company
PCR	Prescribed Capital Requirement
PORC	Producer Owned Reinsurance Company
PRISM	Probability Risk and Impact System
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
VaR	Value-at-Risk

1. Introduction

This paper describes the evolution of global and European insurance capital standards and discusses the future for Guernsey's regulatory framework in that context. It considers the International Association of Insurance Supervisors' (IAIS) International Capital Standards project which may, in due course, create a global standard for insurance capital similar to that created by the Basel Committee on Banking Supervision for internationally active banks. It also reflects on the growing importance of the European Union's Solvency II regime which has, since its implementation within the European Union in January 2016, created something of an international benchmark for capital adequacy in insurance, not least due to its equivalence regime.

This paper should not be taken to reflect any predisposition to follow any particular framework. The issues around Solvency II equivalence in particular are complicated and the purpose of this paper is primarily to provide clarification.

In preparing this paper, the Commission has had bilateral discussions with many members of the Guernsey insurance industry as well as several experts outside the Bailiwick. The Commission would like to thank all these participants for giving their time so generously.

Those reading this paper are encouraged to submit their views to the Commission to help inform the important decision which has to be made as to the future of the Guernsey insurance solvency framework which will potentially affect the Bailiwick's insurance sector and its economic prosperity.

2. The Insurance Capital Standard

Since 1975 international banks – and usually de facto national banks – have been supervised along the lines agreed internationally in the Basel Committee on Banking Supervision. These rules – albeit since extensively revised – cover a series of issues that are key to determining how much capital a bank shall hold; as well as the composition of capital. These rules, when applied nationally, provide clear implementation standards for national regulators, as well as ensuring a global level playing field.

There is, at present, no equivalent for regulatory capital in the global insurance world. There are various reasons for this. One is that the insurance equivalent of the Basel Committee for Bank Supervision, the IAIS, has traditionally not issued specific quantitative standards for capital and solvency. Another reason is that there has been no global agreement on how best to value key insurance assets and liabilities.

However, in response to a request from the Financial Stability Board, IAIS is now developing an Insurance Capital Standard (ICS). The ICS potentially creates a comprehensive group-wide supervisory and regulatory framework for Internationally Active Insurance Groups (IAIGs). The ICS has been in development since 2013 and this will continue, together with testing and further refinement, until late 2019. The ICS is scheduled to come into force sometime in the early 2020s with transitional arrangements likely to be included.

The IAIS is developing the ICS as a group-wide consolidated insurance capital standard which is not intended as a legal entity requirement to replace capital standards for legal entities in any jurisdiction. However, it is anticipated that jurisdictions may elect to reference the ICS in the development of domestic solvency frameworks. The ICS is intended to achieve a greater degree of comparability across jurisdictions and firms than can be achieved through implementation of the Insurance Core Principles (ICPs).

In developing the ICS the IAIS is prioritising a standard method for determining the ICS capital requirement, a valuation approach and the definition of qualifying capital resources. The proposed ICS framework takes a risk based approach using a target criteria of 99.5% Value at Risk (VaR) over 1 year. The key categories of risk included in the standard method will be Insurance risk, Market risk, Credit risk and Operational risk.

The latest version of ICS is currently subject to extended field testing.[1] It includes two valuation approaches; the Market-Adjusted Valuation (MAV) Approach and GAAP with Adjustments (GAAP Plus). The MAV focusses on comparability across IAIGs regardless of jurisdiction and requires various prescribed adjustments to significant balance sheet components. The GAAP Plus approach is based more closely on reported GAAP amounts. The ICS also sets out two tiers of capital; Tier 1 is to absorb losses on a going-concern basis and in winding up whilst Tier 2 is to absorb losses only in winding up.

Insurance risk under ICS is dealt with using a factor based approach applied to net earned premiums and net current claims estimates. It also applies correlation factors and allows for diversification. A catastrophe risk component is also included which captures both natural and man-made perils.

Market risk components include interest rate risk, equity risk, real estate risk, currency risk and asset concentration risk. The Credit risk charge is based on exposure class, credit rating and maturity.

The approach to operational risk is currently based on factors applied to exposure measures such as premiums or liabilities but will be reconsidered for the next version of ICS.

There is as yet no certainty that IAIS will succeed in crafting an ICS to which all or most countries in the world will subscribe. Its future is dependent in part on current global political factors and the degree to which key jurisdictions are prepared to compromise in order to secure a consensus. There is also potential industry opposition. In addition, the draft ICS requires a relatively complex approach and whilst appropriate for IAIGs, may not be suitable for smaller firms.

The ICS may become a global standard if the political difficulties can be overcome. In that sense it could bring benefits, including acting as an informal passport, providing issues around assessment can be resolved. It is impossible however to predict whether adopting the ICS will

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IAIS - Risk-based Global Insurance Capital Standard Version 1.0 for extended field testing, 21 July 2017 bring any advantage in so far as the EU is concerned – though the assumption must be that the EU will continue to champion Solvency II.

In due course Guernsey will need to consider its approach to ICS in order to remain in line with international standards. Aspects of the draft ICS resemble aspects of Solvency II and therefore it is possible that achieving Solvency II equivalence would ease Guernsey's path to ICS implementation. However, this would be true, albeit to a lesser extent, of Guernsey's current risk based approach to solvency.

3. Solvency II

The Solvency II regime, applicable in EU member states from 2016, introduces a harmonised prudential framework for insurance firms. The Solvency II Directive[2] replaced 14 previous directives commonly known as 'Solvency I'. Solvency I had several structural weaknesses in that it was not risk-sensitive and did not appropriately address a number of key risks, including market, credit and operational risks. The key objectives of Solvency II included improved protection of policyholders, harmonisation, effective risk management and financial stability. The framework seeks to address the weaknesses of Solvency I and is divided into three pillars:

- Pillar 1 sets out quantitative requirements, including the rules to value assets and liabilities (in particular, technical provisions), to calculate capital requirements (including a risk-based standard formula for a Solvency Capital Requirement – (SCR) based on a 99.5% VaR over 1 year) and to identify eligible own funds to cover those requirements;
- Pillar 2 sets out requirements for risk management, governance, as well as the details of the supervisory process with competent authorities; this will ensure that the regulatory framework is combined with each undertaking's own risk-management system and informs business decisions;
- Pillar 3 addresses transparency, reporting to supervisory authorities and disclosure to the public, thereby enhancing market discipline and increasing comparability, leading to more competition.

Pillar 1 is underpinned by a market consistency approach to the calculation of technical provisions and capital requirements although there have been some compromises around certain long term guaranteed business. Solvency requirements are based on an economic valuation of the whole balance sheet. Technical provisions are calculated at the firm's best estimate of its liabilities plus a risk margin. The SCR standard formula determines a capital requirement for each of the individual risk types and these are then aggregated using specified correlation and diversification factors. There is also a Minimum Capital Requirement (MCR) which is a much simpler linear calculation based on an 85% confidence level. The MCR must fall between 25% and 45% of the SCR.

[2] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), as amended by Directive 2014/51/EU

Under Pillar 2 insurers are expected to carry out an Own Risk and Solvency Assessment (ORSA) which will include an assessment of the appropriateness of the standard formula. The ORSA should form an integral part of the firm's strategy and supervisors must assess the effectiveness of the governance around the ORSA process.

Despite the aims of harmonisation, some discretion is allowed to supervisors in areas such as reporting frequency, volatility adjustments, and capital add-ons.

Solvency II Equivalence

While the provisions of Solvency II apply to insurers in EU member states (having been incorporated into national laws), the Directive also introduces the concept of the recognition of equivalent third country (non-EU) insurance supervision regimes and specifies related criteria against which equivalence may be assessed. The European Insurance and Occupational Pensions Authority (EIOPA) is responsible for performing such assessments and making recommendations on equivalence for the ultimate approval of the European Commission and European Parliament. Insurers subject to equivalent supervision will receive certain benefits including potentially beneficial capital treatment where part of a European group or offering reinsurance to EU insurers. Equivalence does not, however, offer cross-border passporting rights to third country insurers, which are available to insurers in EU member states, to third country insurers.

At present only two regimes, Bermuda and Switzerland, have achieved full equivalence. Six other jurisdictions' regimes have achieved a form of provisional equivalence with a view to eventually securing full equivalence: Australia, Brazil, Canada, Mexico, USA and Japan. The USA and EU have negotiated a Covered Agreement which: provides elimination of collateral requirements for EU/US cross border reinsurance transactions, recognises EU/US home group supervision and sets out practices for cooperation and exchange of information. While this agreement covers many of the areas within scope, this agreement stands entirely separate from the Solvency II equivalence framework. This agreement has yet to come into effect pending ratification by the respective legislative bodies.

There are three forms of equivalence relating to reinsurance, solvency and group supervision:

1. Article 172 – Reinsurance – reinsurance contracts entered into with equivalent third country reinsurers must be treated in the same manner as contracts entered into with EEA reinsurers. 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). Additionally, 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).

2. Article 227 – Solvency calculation - relevant for EEA insurers operating in a third country. Equivalence allows EEA internationally active insurance groups to use the local rules relating to capital (own funds) and capital requirements rather than the Solvency II rules. This would relieve the related companies in the third country from having to recalculate their data in conformity with the Solvency II requirements.

3. Article 260 – Group supervision - relevant for insurers from third countries with activities in the EEA. If the third country's rules are deemed equivalent in this area, EEA supervisors will under certain conditions rely on the group supervision exercised by a third country. This would free the third country international groups from being subject to the unnecessary burdens arising from dual group supervision.

a. The European Authorities

The previous section leads naturally on to a wider consideration of the equivalence process.

Once initiated by a call for advice from the European Commission, the equivalence assessment process takes about a year, involves primarily EIOPA but also the European Commission with both the European Parliament and Council having review rights at the end of the process. For EIOPA, the process involves both off-site and on-site work and the process is public. (Annex 1 to this paper provides a summary of the assessment process timeline.) The equivalence process for reinsurance in Japan offers some insight into the possible equivalence process as it might be applied to Guernsey. For Japan, EIOPA produced two public documents with an approximate length of 114 pages. Japan undertook to make certain changes to its regime in order to attain equivalence.

However the process for a jurisdiction takes longer than a year as it has to have an equivalent regime in operation before the EIOPA process starts. In Bermuda equivalence took around 6 years to complete

EIOPA will in due course have to undertake additional review work on those jurisdictions to which is has already extended various forms of equivalence – as well as overseeing those currently deemed equivalent. These countries are generally but not exclusively G-20 members. EIOPA, which has around 150 staff whose prime accountability is not equivalence, has made no commitment beyond 2017 to review other jurisdictions for equivalence

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS, the predecessor of EIOPA) published its equivalence assessment methodology in 2010. This document indicates that only the European Commission or EIOPA can initiate an equivalence assessment, though there is scope to request a group supervisor to conduct an assessment (unlikely to be relevant in the case of Guernsey) and states the following:

"*In considering own initiative assessments CEIOPS will, in particular, take into account the materiality of third country concerned and the resources available.*"

In considering the composition of the first wave of jurisdictions to be assessed the EC requested that CEIOPS consider the following criteria:

- Whether the third country currently has a supervisory regime that is fully risk-based or has taken measures to move towards such a system.

- The materiality of an equivalence finding to EU insurance and reinsurance undertakings and their policy holders

- The number of related undertakings situated in the third country held by EU insurance and reinsurance undertakings

- The importance to the insurance market in the third country of the equivalence finding

- The existence currently of mutual recognition or equivalent arrangements between third countries and Member States.

In its advice to the European Commission, given in 2010, CEIOPS indicated that the first two criteria carried more weight than the last three. In assessing the first criterion CEIOPS "*sought to exclude countries that have supervisory regimes which, at first sight, do not show evidence of being risk-based*" and it would seem difficult to argue that this criterion is not met in respect of Guernsey's supervisory regime given the implementation of Risk Based Solvency Rules and use of the Probability Risk and Impact System (PRISM).

The CEIOPS advice largely concentrates on the second criterion - materiality to the EU. Advice was given in relation to each form of equivalence. The advice on reinsurance equivalence identified Switzerland, Bermuda and the United States as the highest ranking jurisdictions in terms of importance. CEIOPS noted Japan and Barbados as being of medium relevance with Turkey and Hong Kong also being mentioned. At present only Bermuda and Switzerland have full reinsurance equivalence and only Japan has temporary equivalence.

b. Equivalence and Pillar 3

A key part of any equivalence assessment would be a consideration of whether there is a requirement for each insurer to disclose annually a report on its solvency and financial condition equivalent to the report required under Solvency II (the Solvency and Financial Condition Report or SFCR). These detailed public disclosures would impact insurers in two ways.

First, additional reporting and compliance resource may be required. A Solvency II equivalent regime would also require even more detailed direct reporting to the regulator, which may further impact resource requirements.

Second, increased public disclosure may have implications with respect to customer confidentiality and industry competition – a point considered here in some detail as Guernsey has several specialist insurers and some insurers who operate in a very limited market. A business line where client confidentiality is of paramount concern could be impacted by increased disclosure similarly local domestic insurers could be detrimentally impacted where potentially commercially sensitive information is disclosed. Solvency II gives supervisory authorities discretion to exempt insurers from information disclosure where competitors of the undertaking would gain significant undue advantage or where there are obligations to policy holders or other counterparties binding an undertaking to confidentiality. There is, however, no explicit reference to such discretion in the relevant equivalence criterion. If supervisory discretion to exempt insurers from disclosure, where this may impact customer confidentiality or competitiveness, was incorporated then it would fall to EIOPA, rather than the local regulatory authority, to assess whether this would be a proportionate approach to Solvency II equivalence. There is, however, no reason to believe that EIOPA would not take a reasonable approach to any assessment in this area, as it has already done so, for example, in its assessment of the Bermuda regime, which does allow certain disclosure waivers on the grounds of competitive disadvantage concerns. Annex 3 sets out the content required in a Solvency II Report on Solvency and Financial Condition.

In addition to public disclosure, under Solvency II there is a requirement to provide a considerable level of reporting directly to the supervisor. The Regular Supervisory Report (formerly the Report to Supervisors) follows the same structure as the SFCR (*i.e. Business and Performance, System of Governance, Risk Management, Regulatory Balance Sheet and Capital Management*) but requires more detailed and potentially market sensitive information and quarterly reporting for certain quantitative information. A framework of supervisory reporting equivalent to that under Solvency II would need to be developed locally, increasing the compliance burden on affected insurers.

CEIOPS' advice on supervisory reporting and public disclosure[3] provides extensive detail on the extent of reporting and disclosure required under Solvency II.

4. Guernsey's Insurance Industry

a. Overview

Guernsey is a leading centre for captive insurance, offering a domicile for self-insurance for firms. Guernsey is recognised as being a centre for reinsurance and insurance linked securities; offering in particular collateralised catastrophe reinsurance. Guernsey serves ex-patriates especially for life and health insurance. Finally, Guernsey has several domestic general insurance businesses serving both the local and international communities. Guernsey pioneered the protected cell company and more recently has seen growth in the use of the incorporated cell company, not least for the transfer of longevity risk for pension funds.

[3] CEIOPS' Advice for Level 2 Implementing Measures on Solvency II: Supervisory Reporting and Public Disclosure Requirements, CEIOPS, 2009, https://eiopa.europa.eu/CEIOPS-Archive/Documents/Advices/CEIOPS-L2-Final-Advice-Supervisory-Reporting-and-Disclosure.pdf

Guernsey's insurance industry comprises 835 international insurers over half of which are cells of protected cell companies. As at 31 December 2015 international insurers' aggregate gross assets stood at £23.9bn and gross written premium at £5.5bn.

In addition there are 8 licensed domestic insurers dealing with local requirements and 19 authorised managers dealing with international business.

Section 3 of the recent Insurance Sector Strategic Review by PWC[4] provides an analysis of the Guernsey insurance sector, and readers are referred to this document for further details on the Guernsey insurance sector.

b. Current Guernsey Insurance Supervisory Regime

Licensed Guernsey insurers are at present subject to a risk-based solvency requirement as set out in the Insurance Business (Solvency) Rules 2015 (the "Rules")[5]. The Rules prescribe a Minimum Capital Requirement (MCR), a Prescribed Capital Requirement (PCR) and the valuation, governance and assessment of own risk.

The MCR is intended to be the capital required to ensure that a licensed insurer should be able to meet its obligations over the next 12 months with an 85% probability. The MCR (in the case of a general insurer) is calculated as the higher of 12% of either gross written premiums or reserves. In the case of a life insurer it is calculated as 2.5% of total reserves.

The PCR is the capital required to ensure that a licensed insurer should be able to meet its obligations over the next 12 months with a confidence level specific to the type of business underwritten. For example the PCR is determined based on a Value-at-Risk ("VaR") at a 99.5% confidence level over a 1 year time horizon for a Commercial General Insurer. The PCR is calculated with reference to a standard supervisory model comprising modules covering, where relevant, the following risk categories; market risk, premium risk, reserve risk, underwriting risk and counterparty default risk. The PCR ratio represents the level of an insurer's actual regulatory capital in relation to the regulatory required level. An insurer which meets its capital requirement would have a PCR ratio of 100% or higher.

The Commission operates a Ladder of Intervention policy[6] under which the level of supervisory intervention intensifies as solvency levels deteriorate. Where the PCR ratio falls below 100% insurers will be required to initiate a recovery plan and be subject to increasing levels of scrutiny should solvency continue to fall. Eventually in the event that the MCR is breached, and in the absence of immediate recapitalisation, the licensee may be deemed to be non-viable and ultimately wound-up.

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[4] States of Guernsey, Insurance Sector Strategic Review, PWC, December 2016, https://www.gov.gg/article/157182/Committee-for-Economic-Development-and-PwC-release-a-Strategy-to-enable-the-continued-success-of-Guernseys-Insurance-Sector

[5] The Insurance Business (Solvency) Rules 2015, Guernsey Financial Services Commission. https://www.gfsc.gg/sites/default/files/20161208%20-%20%20INSURANCE%20BUSINESS%20%28SOLVENCY%29%20RULES%202015.pdf

[6] Guidance Note on Supervisory Ladder of Intervention, Guernsey Financial Services Commission, https://www.gfsc.gg/sites/default/files/Guidance%20Note%20on%20Supervisory%20Ladder%20of%20Intervention.pdf

5. The Future for Guernsey

In considering how Guernsey's regulatory regime should evolve there are three high level options:

1. Continue to follow the IAIS ICPs
2. Await and then adopt the IAIS ICS
3. Apply for Solvency II Equivalence

The above three options are not mutually exclusive since all three follow the same high level principles and attempt to achieve similar outcomes in consumer protection and financial stability. They should therefore be regarded as complementary options rather than alternatives.

Guernsey already follows the IAIS ICPs and therefore this would not involve any significant updates to the supervisory framework in the near future. There is some work to be done in relation to public disclosure but major policy work in relation to solvency and corporate governance has been carried out in recent years.

ICS is still several years away and it may remain something that is only applicable to IAIGs and therefore not relevant for the majority of insurers in Guernsey. A decision on whether or not to follow ICS cannot be taken at this time although we continue to closely follow its development.

Therefore the immediate decision for Guernsey will concern Solvency II Equivalence – and this is the issue that the Guernsey International Insurance Association (GIIA) has asked the Commission to consider.

The following sections discuss how equivalence might be implemented in Guernsey.

a. Size and Scope of Equivalence in Guernsey

Of the three forms of equivalence provided by the EU authorities, GIIA's focus is on reinsurance equivalence only, in the event that any application were to be made. This is because there are few licensed subsidiaries of EEA insurers and there is no appetite among the industry on Guernsey for the Bailiwick to become a home authority for large international insurance companies.

However, during the course of working on this paper it emerged that there may be an argument for additionally seeking group solvency equivalence, if the intention would be to extend the scope of equivalence to direct commercial insurers, as discussed in the section below. Having said that, this is not considered in detail in this paper as the focus is on re-insurance.

Given the above objective, it is as a first step helpful to establish the size of the Guernsey insurance sector. In relation to equivalence, the Guernsey insurance industry can be divided into 3 sectors:

Sector A - There are currently 29 reinsurance firms in Guernsey with gross premium of £582m. Of these 29 reinsurers, 24 are general reinsurers and 5 are life reinsurers. Solvency

II does not apply a de minimis approach to reinsurance so all these firms would be required to follow a Solvency II equivalent regime. It is possible that some insurers which are attracted to Guernsey by virtue of its current non-equivalent status might re-domicile were Guernsey to become equivalent as that would not be commercially attractive for their business models.

Sector B - There are currently 48 firms, including the above 29 reinsurers, who would potentially be eligible for equivalence. This sector includes 32 general (re)insurers and 16 life (re)insurers. The number of 48 excludes those general and life insurers who fall under the de minimis requirements of Solvency II – that is gross written premium of less than €5mn and with technical provisions not exceeding €25mn. The current gross written premium of this sector is £1.92bn.

Sector C - The rest of the Guernsey insurance sector including captives and Insurance Linked Securities (ILS) comprises the largest of these three sectors; that is 86% of insurers by number and 68% in terms of gross written premium.

Having established the size of the various sectors of the Guernsey insurance industry, there are various options in terms of the potential future scope of equivalence in Guernsey. These are:

1. Applying under Article 172 (re-insurance) for equivalence to cover sector A.
2. In the event that (1) may be seen by the EU authorities to fail tests of materiality and relevance (see below), then the scope would cover sector B.
3. If (2) is chosen then an option would be to extend equivalence to Article 227 (group solvency).

For the avoidance of doubt sector C would always be outside equivalence, assuming EU authorities agree bifurcation as they have done for Bermuda. Thus were there to be any decision to seek some form of Solvency II equivalence, Insurance Linked Securities (ILS), and captives would be outside the scope. This would align with the position in Bermuda. It should also be pointed out that currently only Japan has the equivalent of option (1) but, even here, Japan also has provisional equivalence around group solvency (effectively option 3).

Whilst the above options are available to Guernsey, any preference needs to be considered in practice in the context of the EU equivalence process. As already set about above, EIOPA is obliged to consider the materiality of the appellant jurisdiction. 'Materiality' is of course a general term and it would be for EIOPA to define this more precisely. However at this point it seems likely that two relevant components of materiality are the comparable size of the Guernsey insurance sector and the extent to which it touches the EU.

On the first question of size, the following table is relevant:

Insurers within scope of SII

	Japan	Bermuda	Guernsey: Sector A	Guernsey: Sector B
Total insurers in scope/potentially in scope of SII	99	222	29	48
Gross Written Premium (millions)	$531,506	$70,620	$767	$2,820
Average GWP per insurer (millions)	$5,369	$318	$26	$59
Commercial general insurers with net premiums > $50m	N/A	22	3	3
Commercial general insurers with capital > $100m	N/A	41	3	3
Commercial life insurers with total assets > $250m but < $500m	N/A	8	0	1
Commercial life insurers with total assets > £500m	N/A	29	0	1

On the second question – that is materiality to the EU – it is more difficult to assess the overall significance of European business to Guernsey as the Commission does not have detailed, granular data for the geographical distribution of the risks underwritten by Guernsey insurers (relevance to the EU is another equivalence formal requirement).

Some high level information is available, however, which provides an indication of the origin of insurance risk. Of the estimated 48 Guernsey insurers which might fall within scope of a Guernsey Solvency II-equivalent regime approximately 52% have some exposure to European risk, and 20 of these insurers indicate underwriting such risk in this region exclusively. When UK business is excluded these numbers fall to 27% and three respectively.

Another factor that may be relevant to the EU authorities is whether offering equivalence to smaller regimes is one way of developing Solvency II as a global standard.

This section has set out the options around equivalence. It has also provided some background for readers to consider how the EU authorities might view these options and this perspective may in turn colour readers' views as to their choice of option.

b. The Commission

For reinsurance equivalence, Guernsey would be assessed against the principles contained in the Solvency II Directive as well as specific criteria for assessing third country equivalence to be found in the Solvency II Delegated Regulation[7] (the "Delegated Regulation"). An equivalence assessment would include consideration of the following areas: supervisory powers, solvency, governance, transparency, cooperation and financial stability impact. The criteria for assessing reinsurance equivalence are provided in full in Annex 2.

[7] Article 378, Commission Delegated Regulation(EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

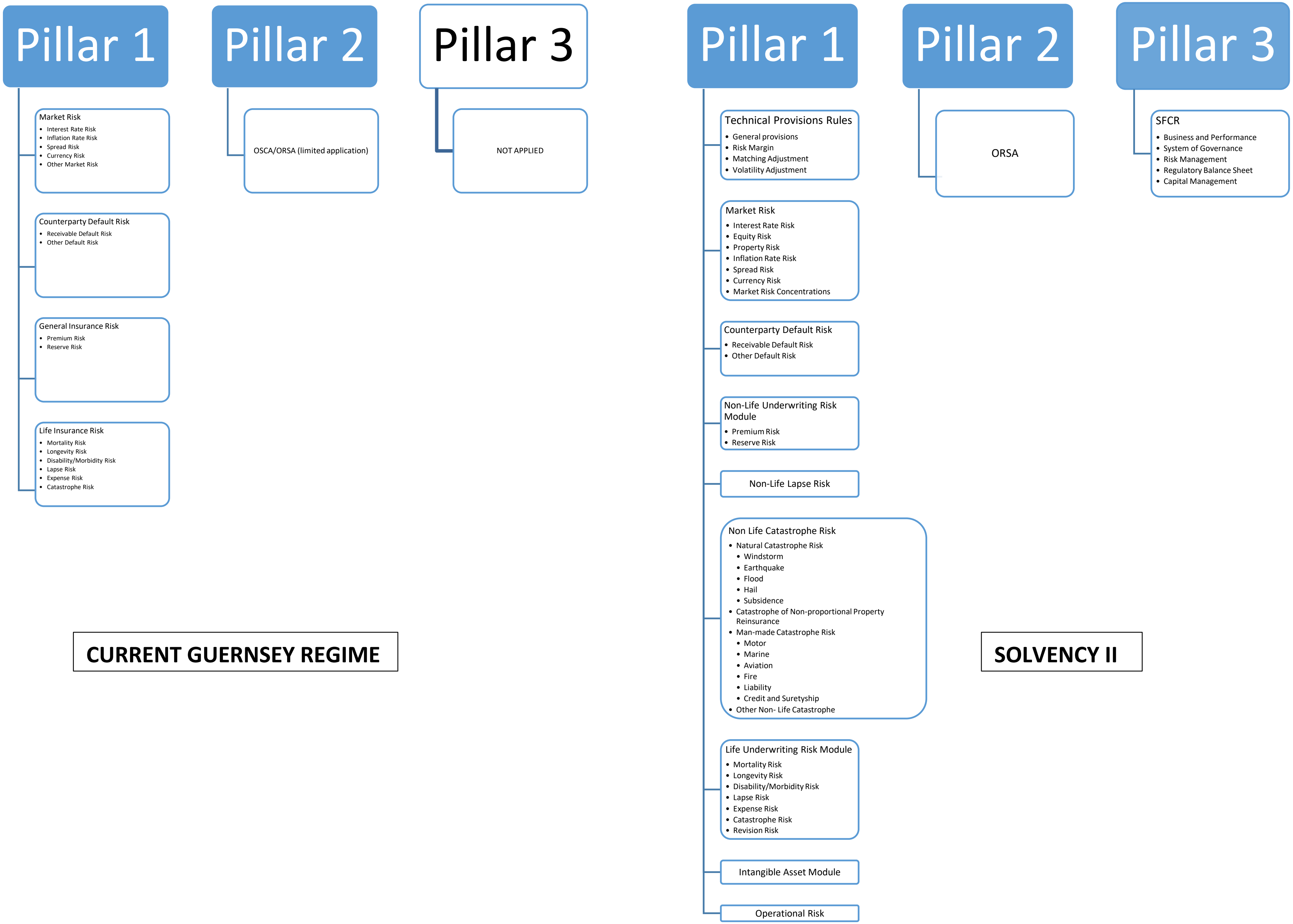
In order to gain equivalence, the Commission would become subject to assessments by EIOPA. The Commission considers that it would have no major difficulty in satisfying EIOPA that its general powers, structure, and rules are appropriate; nor that Guernsey's jurisdictional powers, anti-financial crime regime, and insurance laws are in the same category. Having said that, whilst so far the Commission has assessed itself against international rules, it would have to assess itself against specific EU requirements were equivalence to be sought. The Commission would need to undertake a thorough gap analysis and some changes would be likely; some possibly material in areas such as Catastrophe Risk, Operational Risk and especially in relation to Pillar 3 and disclosure.

The Commission is reasonably confident that it would be positively assessed for its risk-based approach (PRISM) and its requirements around the ORSA. Irrespective of equivalence, the Commission plans to review its approach to reporting periodicity and disclosure in due course.

A high level comparison of the Commission's current requirement with those of Solvency II suggest that the Commission would have to enhance its requirements around the solvency model, the reinsurance confidence period, valuation, periodicity, reporting, data analysis and disclosure of both quantitative and qualitative data. Figure 1 on the next page provides the high level comparison of the elements of the Guernsey framework and Solvency II. Please note that this is provided as an illustration of some of the key components of the two frameworks and should not be regarded as a complete or detailed gap analysis.

Whilst, even if a decision is made not to pursue Solvency II equivalence, the Commission may in the future follow Solvency II in some of these areas, it has no plans to do so entirely. Therefore, Solvency II equivalence would represent extra requirements for both the Commission and equivalent firms in Guernsey.

Figure 1 - High Level Comparison of Guernsey Insurance Framework and Solvency II



c. Bespoke Equivalence?

Upon review of the equivalence assessment criteria (see Annex 2) it can be observed that, while in some cases making specific reference to provisions of the Directive, generally these are high level in nature. The equivalence assessment methodology[8] published by CEIOPS[9] in 2010 states that "*equivalence is a flexible process based on principles and objectives*" and that a "*positive equivalence finding does not require that every indicator [of equivalence] is fulfilled*". Moreover the point is made that "*equivalence incorporates the proportionality principle"* and that use of a proportional approach in application of regulatory provisions "*not in itself be an obstacle or a prerequisite to the recognition of equivalence*".

Practical application of this approach is evidenced in EIOPA's equivalence advice to the European Commission for example in the case of the advice on the Bermudian supervisory system[10] which states, in relation to the Bermuda standard capital model (the BSCR), "*EIOPA's approach has been to assess whether the BSCR and the SCR provided a similar overall level of safety and risk-sensitivity, not to look for an exact match between the formulae*" and goes on to highlight by way of example differences in correlation assumptions used. This overall approach is in evidence throughout the advice document and can also be noted in that relating to the Swiss supervisory system[11].

There is a question, therefore, as to how closely an equivalent regime need mirror the provisions of Solvency II. If the only consideration is to ensure attaining equivalence then any Guernsey regime should seek to replicate the Solvency II rules as closely as possible. Any assessment, if performed purely on a technical level, would likely be positive. Development and implementation costs, for the Commission and insurers, may also be lower because greater reliance can be placed on existing models and resources within the Solvency II sphere, whether these are made available by European authorities, group entities or third party service providers.

An approach replicating Solvency II, however, may not be appropriate or desirable for the local insurance sector. In terms of Pillar 1 the argument can be made that the SCR has not been designed appropriately to reflect the Guernsey market and that an outcome of effective supervision and policyholder protection may be achieved with a modified version of the SCR or an alternative model entirely. Similarly an argument can be made that the levels of reporting and disclosure under Solvency II are overly burdensome considering the largely institutional nature of the Guernsey industry.

If these arguments are accepted then an approach based on a modified version of Solvency II, a modified version of the current Guernsey framework or an entirely new bespoke model

[8] The methodology for equivalence assessments by CEIOPS under Solvency II, CEIOPS, 12 November 2010

[9] The forerunner agency to EIOPA

[10] Final Report on Public Consultation No. 14/042 EIOPA Advice to the European Commission, Equivalence assessment of the Bermudian supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive, page 50

[11] Final Report on Public Consultation No. 14/0421 EIOPA Advice to the European Commission, Equivalence assessment of the Swiss supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive

would appear to be the likely options. However moving from a pre-existing model to a bespoke model, is likely to incur greater implementation costs. Moreover where there is deviation from the Solvency II model, the EIOPA assessment becomes more subjective as it will be based on an opinion of the ultimate effect or outcome. The jurisdiction can be less certain of achieving an equivalence recommendation on a purely technical assessment and also may be more vulnerable at the point where the equivalence assessment requires approval of the European Parliament if equivalence is based on anything other than a direct copy of the directive.

d. Aspects of Equivalence

Passporting

For the avoidance of doubt, equivalence gives no passporting rights into the EU. It would not for example give Guernsey general insurers the right to sell services cross-border in member states where this is currently prohibited.

Non reinsurers

If group solvency equivalence under Article 227 was obtained (as described in option 3 earlier in this paper), then current (and future) group subsidiaries of EU or equivalent regime firms would be able to have their Guernsey capital assessment recognised as equivalent. In practice, this would bring little benefit to these firms as a) current Guernsey subsidiaries comprise a very small component of these groups and b) Guernsey can be assessed within the group capital standard even without group solvency.

Capital benefits for foreign insurers

For all forms of reinsurance there is an SCR Credit Default Risk charge for the cedant in relation to any reinsurance recoverables. The amount of capital required to be held by an EEA cedant to meet the Credit Default Risk charge may be reduced where the third country reinsurer is subject to a Solvency II equivalent regime, because a lower probability of default is assumed. The materiality of this charge is difficult to assess and will differ from company to company as the calculation of this charge also takes into account the level of collateral posted - both in terms of significance to the specific deal and to the overall balance sheet position of the reinsurer.

For non-rated, non-collateralised Guernsey reinsurers, equivalence delivers a lower underwriting capital requirement – and thereby possibly greater attractiveness to EU insurers. Where the reinsurer is based in an equivalent regime, the impact of reinsurance will be taken into account in the calculation of the cedant's Solvency Capital Requirement ("SCR") underwriting risk charge. However in practice, few EU insurers would consider using non-rated, non-collateralised reinsurance.

Collateralised general insurance in the form of ILS bears the same underwriting capital cost for EU cedants wherever domiciled. However, the Commission has been told (but has not been able to verify) that some EU regulators may be blocking the use by national insurers of non-EU ILS. This issue is considered below under the brand aspects of equivalence.

Equivalence would give a specific advantage to Guernsey rated reinsurers. The reason for this is that, whilst Solvency II gives an equal capital weighting to a rated reinsurer whether it is inside or outside the EU, various EU member states still require collateral against a non-EU rated reinsurer. In addition, there is a view among some in the local industry that some EU member states in effect block local insurers using non EU rated insurers through moral suasion. The Commission has no evidence of this but reports this view here.

Capital costs for Guernsey insurers

With respect to the regulatory capital requirement applicable to Guernsey insurers this is likely to increase to reflect a more complex and stringent Solvency II equivalent regime. It is not possible to quantify the likely change until a Pillar 1 model is created and applied to relevant insurers. However, the impact of a higher solvency requirement may be limited because few Guernsey insurers manage capital to the regulatory standard, instead maintaining capital at a higher level in line with internal risk appetite.

Nevertheless, the impact of a change to the absolute minimum capital floor can be assessed. Under Solvency II there is a minimum capital requirement floor of €3.6mn. In contrast in Guernsey the minimum is currently £0.1mn. 10 of the 29 reinsurers considered in scope are currently below this EU minimum and would be obliged to increase their capital if a similar floor level was adopted under a Guernsey equivalent regime. On the other hand, and given this, the Commission considers that many of these firms might leave the jurisdiction rather than acquiesce to EU minimum capital requirements.

Distribution

EU members have individual control over reinsurance distribution. These vary from country to country but in the case of Germany for instance direct marketing is not allowed for non-equivalent regimes.

Germany is a potentially important jurisdiction for Guernsey rated reinsurers. Timed to coincide with the introduction of Solvency II, Germany recently tightened up its distribution rules to prohibit direct marketing of reinsurance from non-equivalent regimes (i.e. where the third country reinsurer directly targets insurers in Germany directly or via a German intermediary) – although indirect marketing (i.e. where at the instigation of a German cedant, a reinsurance contract is concluded by correspondence with an insurer situated abroad) is still allowed. Equivalence would benefit Guernsey reinsurers in this respect but it is unclear how far indirect marketing could in practice deliver much the same advantages. Apart from Lichtenstein which seems to have followed the same approach as Germany, the Commission is unaware of other European jurisdictions that have followed the German example. Indeed the distribution rules for insurance differ wildly across the EU and are generally not defined by equivalence (which of course gives no EU-wide passporting rights).

Equivalence as a Brand

Irrespective of the actual – and possibly limited – concrete advantages of equivalence, there is also an argument to be made in favour of equivalence as a brand for possible future developments. In this argument the absence of a global capital standard highlights Solvency II as either a developing global brand or, at the very least, one of several future global brands. Rather than Guernsey having constantly to prove its reputation as having an effective regulatory regime for insurance, equivalence would effectively remove any such discussion. Given that the funders of reinsurance are generally highly adverse to any regulatory risk, equivalence as a brand may act as a magnet to future investment in the Guernsey reinsurance industry.

There are three provisos to the above argument. One is that there may be other ways to prove Guernsey's status as a well-managed insurance sector such as the IMF or the IAIS assurance programmes. Another is that it is up to the insurance managers to provide clarity to their clients about the actual benefits in the EU around equivalence as opposed to the brand. Thirdly, the equivalence brand can work as a deterrent. Indeed some business comes to Guernsey precisely because it is a regime perceived to be able to develop innovation free of any possible constraints of the Solvency II Directive.

The branding argument even applies to ILS which will be outside the equivalent regime. The point here being that funders believe that European supervisors will give no credit to ILS in non-equivalent regimes, even if collateralized. However, these funders believe that the reverse is true if ILS is issued in an equivalent jurisdiction, even if ILS perversely is not within the equivalent regime.

Bermuda

Bermuda may be an example of the power of the Solvency II brand. Bermuda has a wider scope of equivalence than Guernsey is interested in – that is around group solvency and group supervision; and its current level of business with the EU is in absolute terms much higher than that of Guernsey. Bermuda is also home to far more large Internationally Active Insurance Groups[12] than is the case with Guernsey and some of these are European, indeed approximately 17% of Bermuda insurers have ultimate beneficial ownership in Europe[13]. Nevertheless, Bermuda also has equivalence around re-insurance – in which Guernsey has an interest. Third party reports generally now portray Bermuda as not just having untrammelled access for reinsurance to the EU but also as having demonstrated the highest standard of regulatory observance for an offshore regime. No note is made of the fact for instance than ILS is Bermuda is outside the equivalence regime – though it must be said that Bermuda's expertise in this area is a fact. Bermuda therefore may be taken at least in part as an example for Guernsey to follow – though it should at the same time be stressed that equivalence in Bermuda goes further than is the intention in Guernsey. The Bermuda

[12] Bermuda has approximately 20 insurance groups for which the Bermuda Monetary Authority acts as Group Supervisor.

[13] Derived from the Bermuda Monetary Authority Annual Report 2015 (Statistics as at 31.12.14).

authorities have seen equivalence as being essential for the secure economic future of the overseas territory.

The Guernsey economy

There is also the question around the benefits that equivalence would bring more widely to Guernsey. If equivalence were to encourage new reinsurers then it would lead to an increase in demand for insurance and regulatory skills in Guernsey (underwriters, compliance, claims management, board members) – with such skills being highly paid. Indeed recent expansion of both ILS and rated reinsurance in Guernsey has led to more jobs – perhaps 30-50 in a sector employing 850. On the other hand, insurance skills are already in high demand in Guernsey, which might in effect price itself out of the market for some other types of insurance, at least in the short term. For example, in general, actuaries in Guernsey already have little difficulty finding employment so the additional actuarial staff required for equivalence would have to be employed under licence. Of course in the long term Guernsey could fill the gap with newly qualified actuaries but that would take time. It is likely that some insurers would leave and the commercial benefits – not least in terms of employment - that they currently bring to the Bailiwick would be lost.

Looking beyond the insurance sector, the asset side of the balance sheet could involve local custodians but its make-up would probably be determined off-island; and would probably not involve local private equity funds. It is difficult to see much of a role for local fiduciaries and the role of local banks would be limited to processing local payments. This is different from say a wealthy private individual who might well make use of many parts of the Guernsey finance sector – banks, wealth advisers, fiduciaries and so on. So it is difficult to see a benefit beyond the insurance sector.

e. Costs

Costs are an important factor in any discussion of equivalence. It is relevant therefore to estimate regulatory costs as in our discussion with the industry this has emerged as a major concern.

In terms of strategy, the Commission would adopt the following approach. The Commission regards its current approach towards supervision as satisfactory and would not change it as result of equivalence. It would supervise a firm which was subject to equivalence in the same way as it would supervise any other firm. To be clear, if this means that an equivalent firm is categorised as low impact according to the Commission's risk criteria, then it would not be elevated to a higher category simply because it is under the equivalent regime.

Nevertheless, equivalence would increase the Commission's workload. Solvency II reporting produces a mass of data points. Regulators are having to spend time sorting through these data points both for correctness and meaning. Solvency II is also likely to differ in certain areas to the Commission's approach. The Commission would have to undertake a gap analysis and tweak polices for equivalent firms. It would then have to regulate these firms on a different – albeit marginally different – basis to non-equivalent firms. This will require staff training. It is also the case that Solvency II requires the regulator's use of an actuary and therefore the Commission will have to spend more money on this resource. In order to meet these extra requirements the Commission would need extra resource and the latter would cost an estimated £200,000 pa though this is an early estimate and subject to revision. This estimate is arrived at by assuming that two more supervisors would be required, together with actuarial resource. The estimate is probably at the lower end of the scale and could end up higher. Having said this, £200,000 should be considered against the benchmark of the Commission's total costs which in 2016 amounted to £13mn.

The Commission also faces the loss of fees as firms chose to leave. The total loss here is difficult to estimate with accuracy and the Commission would simply have to absorb this loss – with potential consequence for all regulated firms. On the other hand equivalence may attract more firms.

Nevertheless, it would have to charge the insurance industry another £200,000 in fees for the above reasons. One option is simply to charge those firms who really want Solvency II the whole sum. However this would be risky as it creates reliance on just 3 firms who may in due course themselves decide to close (for example if they do not get an "appropriate version" of Solvency II). The approach therefore would be either to divide the £200,000 up between equivalent firms or between all insurance firms. Without drilling down at this stage to each firm's individual fee, the increase for the first option in aggregate terms is 43% (assuming 48 firms) and 6.25% for all firms. If, for example, only 30 of the firms in the former category remained, following post Solvency II implementation closures, then the increase aggregate fee increase would be 61%.

Another option is that those firms – or indeed anybody else – who wants equivalence could contribute to a separate escrow/trust fund to cover regular costs. Assuming, for example, that the Commission will only countenance equivalence if it were to be applied in Guernsey for at least 10 years, then the trust fund would require £2m (disregarding inflation) This option is raised here – albeit tentatively – as some industry members have suggested that reinsurance funders are interested to develop an offshore equivalent reinsurance regime close to Europe.

On top of this direct regulatory cost, equivalent firms would face additional compliance costs. In line with other regulators, one option is for the Commission not to issue a compliant Solvency II capital model to its firms as it has done for its current bespoke Guernsey model (with which it would continue for non-equivalent firms). Instead, it would require each equivalent firm to follow the Solvency II standard formula and to bear the costs of developing a standardised model of its own and then provide a third party assurance for the Commission. Our understanding is that such an approach for each firm might cost somewhere between £20,000 to £30,000 per annum – but this can only be a broadly indicative cost at this early stage. This is in addition to any fee increase.

Several equivalent firms in Guernsey would be able to potentially reduce these costs through accessing their group resources if such firms on a group basis are in the EU. Others of course would not.

If, however, a bespoke standard model differing significantly, in terms of calculation methodology, from Solvency II were to be implemented, then it might become necessary for the Commission to build the reporting model and framework. This would significantly increase Commission costs.

The Commission does not envisage a firm applying to use a bespoke non-standardised model; nor is it conceptually supportive of such models. However under Solvency II this option might need to be available. For this the Commission would charge the applicant a bespoke fee to cover all additional Commission costs.

For the avoidance of doubt these higher costs would apply for several years before an equivalence application is made as the Commission would need to ensure that the approach is in place before EIOPA arrives in Guernsey.

The costs would also have to be sustained for several years. We cannot jump in and out of equivalence and to leave after a few years would weaken the Bailiwick's international reputation.

f. Industry Considerations

Over the last few months the Commission has held detailed discussions with the insurance industry in Guernsey.

Set down below are the sort of questions that have arisen in discussion with the Commission. This will give a flavour of the sort of issues that the local insurance sector may regard as relevant.

a) Captives and PORCs - Will this sector be excluded from equivalence and, if so, is exclusion permanent? Will there be issues about accessing local insurance skills in a more competitive environment? Will captive owners still see Guernsey as a friendly regime?
b) ILS – How convincing is the brand argument given that this sector will be outside equivalence?
c) General and Life Insurers within the equivalence scope – If part of the bigger group already uses Solvency II, what are the additional compliance costs? If not part of a larger Solvency II group, how much higher will the costs be? Are there material benefits in terms of risk management to local equivalence? Has Article 227 advantages?
d) Guernsey reinsurers – How material are the benefits of equivalence? What will happen without equivalence?

There are at least some of the issues so far raised. One general concern is about an increase in fees and extra compliance costs.

Reinsurance Broking

A discussion about capital standards also has relevance in Guernsey to other aspects of the local regulatory regime. There is no immediate local demand for this but it is rather a question the Commission has asked itself in the interest of innovation. Were Guernsey to adopt equivalence primarily to increase reinsurance business, then the question arises as to whether Guernsey should also introduce a regulatory regime for reinsurance broking. The argument being that the two sectors are complementary.

Reinsurance broking is an expert wholesale operation and so far has only thrived in centres of major reinsurance activity – largely Bermuda, London and New York. The limited size of Guernsey's reinsurance sector means that a market such as that in the aforementioned jurisdictions has never developed. The intermediary sector in Guernsey is focussed primarily on servicing local retail and commercial customers in the primary insurance market. To the extent that technology has not yet made the same inroads into reinsurance broking as it has into primary insurance it remains very much a face to face business and one that could potentially develop in the wake of a growing reinsurance market. Whether Guernsey has the appetite and infrastructure to grow such business is a relevant consideration.

It therefore seems appropriate to consider what tangential developments Solvency II equivalence might ultimately bring in the area of reinsurance broking and therefore whether that sector should be brought within the regulatory sphere.

The regulatory confidence level for reinsurance

In Guernsey, the regulatory confidence level for commercial reinsurers presently stands below international norms at 97.5% VaR over one year. The Commission has a general predisposition to raise it to the level applicable to commercial insurers under the current Guernsey solvency framework which is 99.5% VaR over one year; the same target criteria applied under Solvency II. This of course is subject to any eventual outcome in relation to other developments highlighted here, not least the equivalence discussion.

g. Views of the Future

In essence there are two strategic views about the future of the Guernsey insurance industry.

The first view is that Guernsey is doing reasonably under the present, recently reformed, insurance capital standards. Business grows each year. Demand for local insurance skills is rising such that average wages are increasing in real terms. The captive industry is flat but still constitutes a healthy part of the industry. Insurance is a niche art and over the years Guernsey has shown itself adept at innovation – the Protected Cell Company (PCC), the Incorporated Cell Company (ICC), and the Producer Owned Reinsurance Company (PORC) and so on. It houses types of insurance industry with which the EU is less familiar – captives, Kidnap and Ransom and ex-pat life insurance. New niches have developed – ILS and now rated reinsurers. The latter two might benefit from equivalence but they will still grow without equivalence – with concerns over being shut out of the EU discounted as alarmist. This view also majors on the risks and costs of equivalence. Some – perhaps many – firms will leave if equivalence is introduced. The commercial and regulatory costs will be material. Finally the Commission will lose some of its independence to EIOPA.

The second view dwells on the iceberg comparison familiar to management consultants. According to this view the iceberg is melting; that is to say that captive insurance is declining, ex-pat insurance is relatively static and Guernsey, without Solvency II equivalence, might be less likely to be able to provide admitted insurance into a post-Brexit UK. The main long-term hope for the local insurance industry is the continued growth of ILS and reinsurance. This growth in turn depends to a considerable degree on equivalence. Solvency II will become a de facto global standard and any serious international insurance company will only want to deal with jurisdictions that are equivalent. The reinsurance industry has now reached a size that it can 'take-off' but only through equivalence. Without equivalence, the reinsurance sector will go into reverse. Guernsey has the long-term opportunity to become a simulacrum of Bermuda.

These two views present a contrasting understanding of the present and a different perception of the future. However they could exist side by side - through bifurcation. It could be said to those supporting the first view that, whilst Solvency II allows minimal national discretion, it is not supposed to prevent innovation. The brand image of Solvency II is becoming increasingly important. To those of the second view, it could be argued that the iceberg is not melting but it could still usefully grow bigger. Guernsey does not need to be another Bermuda to be successful – it just needs more of the type of business that Bermuda has.

Equivalence however comes with a cost. In one sense Guernsey is at an advantage here. It already has a functioning risk-based solvency and supervisory system. For the majority of Guernsey firms this would continue. The increased cost to the Commission is one cost, though it may be that this is not that substantial. This is not however the main cost. The main cost is the permanent increased cost of compliance to affected general and life insurers. This is in addition to the short-term cost of loss of some business in Guernsey. In so far that there may be gains these will be long-term rather than short-term and are uncertain – whereas the short term costs are certain. Also those industry participants who will pay the short term costs are generally not those industry participants who stand to gain from the long-term benefits. Numerically the numbers of the former far exceed the numbers of the latter. It is this dichotomy of interest – between short-term and long-term – and between those who will benefit and those which will not that make any decision about equivalence difficult to make.

6. The Global Perspective

There are other capital standards that are relevant if Guernsey is to make an informed choice about the future direction of its capital and solvency regime.

The United States

The US has a national system of state-based regulation which is supported by the National Association of Insurance Commissioners (NAIC). The NAIC has developed a series of model laws, including a risk based capital model, which are then enacted by individual states.

Foreign reinsurers are obliged to meet certain tests in order to operate in the US although equivalence is not a requirement. In order to reduce collateral requirements for foreign reinsurers, a foreign regulatory regime has to achieve Qualified Jurisdiction status in the particular state in which it wants to operate. In order to facilitate this process the NAIC has established a nation-wide committee that will advise the individual states but the decision remains with the particular state.

An application to a state can only occur where a reasonably-sized insurer from the relevant jurisdiction is already conducting business in that state. In addition, the application process has in effect to be dual – that is both from the regulator and the relevant firm. At present there is no such reinsurer in Guernsey like this and no reinsurer has come forward over the last two years of internal discussion to express a desire to undergo the application process. This largely reflects the fact that Guernsey has little US business and that collateral requirements are not thought decisive.

China

Guernsey as a jurisdiction is committed to developing its insurance links with Asia and the Far East, especially China. At present there is minimal Chinese insurance business in Guernsey; though this may change soon. The China Risk Oriented Solvency System (C-ROSS) imposes a risk-based solvency requirement on Chinese insurers. Under this framework the credit risk charge for cedants of Chinese authorised reinsurers is much more favourable than that in respect of credit exposure to foreign reinsurers. This charge can be significantly reduced, however, through the use of collateral. Equivalence with the Solvency II framework has no direct bearing on the treatment of inward reinsurance for Chinese insurers.

There is a view that Guernsey should seek to provide specialist insurance services to China e.g. ILS, PORCS, captives and so on. While it is the assumed that such insurers would fall outside the scope of an equivalent regime, any risk or perception that they might fall inside scope, and therefore be subject to increased compliance costs, may limit the attractiveness of Guernsey as a provider of niche insurance services to China.

Japan

The Japanese non-life insurance market is the fourth largest in the world but is highly concentrated with three groups accounting for approximately 90% of business written. Inwards reinsurance is therefore an important mechanism for the spreading of risk and these three groups have approximately 70 offices in 11 European countries.[14]

[14] Final Report on Public Consultation No. 14/043 EIOPA Advice to the European Commission Equivalence assessment of the Japanese supervisory system in relation to article 172 of the Solvency II Directive

Japan serves as the example of the only regime to have been granted temporary Solvency II equivalence and this relates only to reinsurance equivalence (Article 172). Japan, along with five other jurisdictions, also holds provisional equivalent status in relation to solvency calculation (Article 227). Japan's temporary equivalence was awarded in November 2015 and will expire on 31 December 2020, when temporary equivalence ceases to be available, although the Solvency II Directive makes provision for possible extension of one year.

In order to achieve temporary equivalence a number of criteria must be met including a commitment to the EU to adopt and apply a solvency regime that is capable of being assessed equivalent before the end of the period of temporary equivalence and to engage in the equivalence assessment process. The European Commission awarded temporary equivalence on the basis that proposed amendments to the Japanese solvency framework gave "reasons to believe that future evolutions of the Japanese solvency regime will produce enhanced convergence"[15] with Solvency II. The assessment process conducted by EIOPA involved several reports and field tests carried out in 2011, 2012 and 2014.

UK

The UK currently allows foreign insurers to underwrite many UK risks on a non-admitted basis although this does not include statutory classes such as employers' liability and motor third party liability.

One possibility is that post-Brexit and as part of the "UK family" argument, the UK will in due course allow Guernsey to access its mandatory insurance sector and that it would help this significantly were Guernsey to be equivalent. This of course is speculative.

On reinsurance, the development of a PCC regime in the UK suggests that the UK seek to compete with ILS in for example Bermuda and Guernsey. Without equivalence, Guernsey, the argument goes, will find it difficult to compete with the UK within the EU. On the other hand this argument has no bearing to the ILS outside the EU and equivalent regimes.

Rest of the World

Around the world jurisdictions have different approaches to allowing international reinsurers accessing the local market. One view is that over time Solvency II and equivalence will come to be a key determinant for access – or at least that it will make the process easier

For example, South Africa has recently issued a list of jurisdictions to which it allows reinsurance access. All EU members are on that list – though a few other non-EU and non-equivalent countries are there too such as Brazil and Canada. Guernsey however is not. The Commission is actively discussing being listed with the South Africa authorities with a view to being added to the South African list but it is noteworthy that Solvency II appears to have been used as an initial benchmark by the South African regulator, in lieu of any other insurance capital standard.

[15] COMMISSION DELEGATED DECISION (EU) 2016/310 of 26 November 2015 on the equivalence of the solvency regime for insurance and reinsurance undertakings in force in Japan to the regime laid down in Directive 2009/138/EC of the European Parliament and of the Council

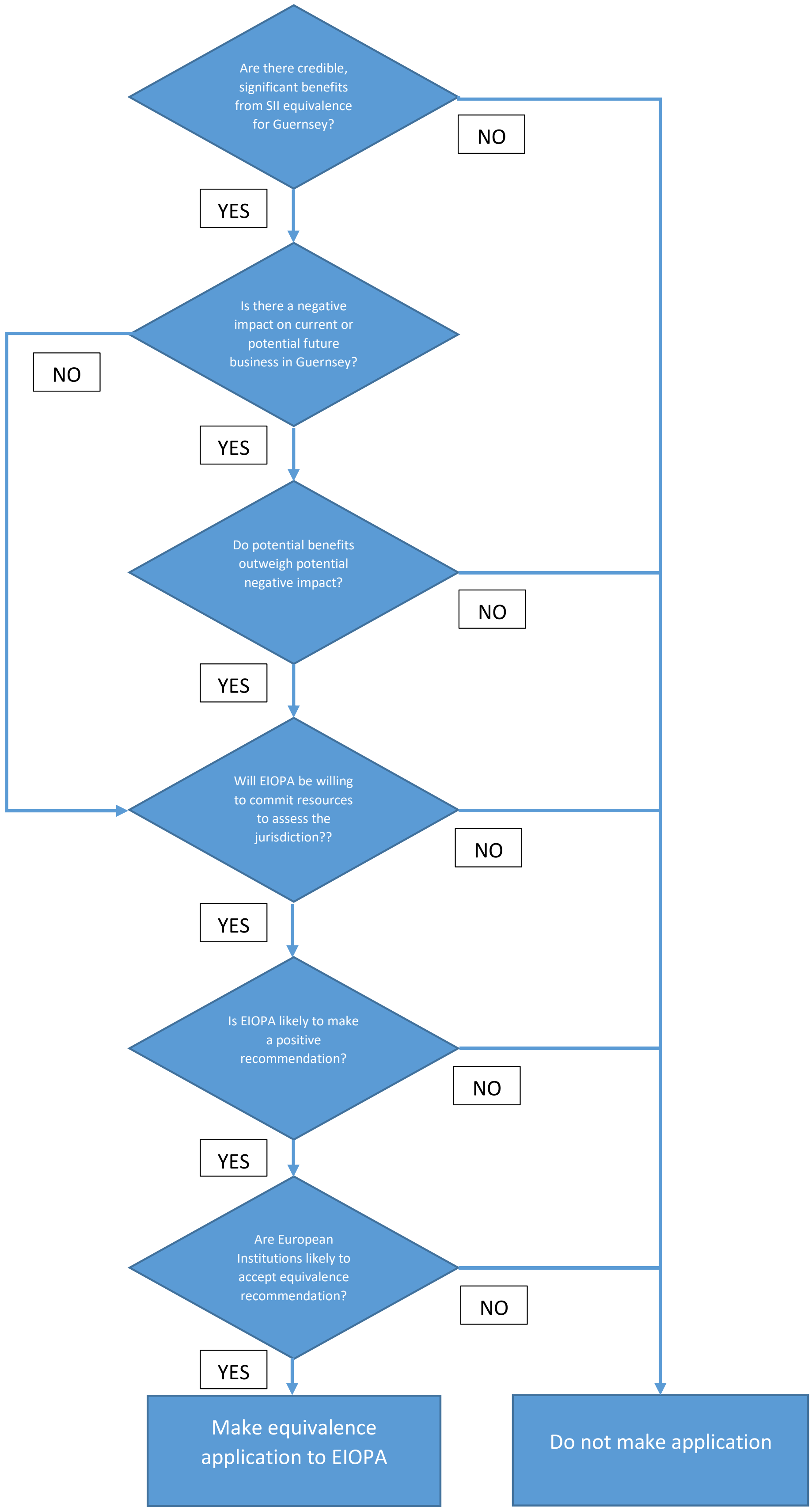
Options

Readers are requested to consider the following specific options:

1) Do nothing now other than continue to ensure that Guernsey meets the IAIS Insurance Core Principles and to consider in due course whether to adopt the ICS or a version of the ICS. The challenge here is to consider how this might affect the nascent re-insurance sector in Guernsey.
2) Request equivalence for Re-insurance firms only under Article 172. The challenge here is whether the EU authorities will deem that the current Guernsey insurance sector is big enough to justify the equivalence.
3) Request equivalence for re-insurance firms under Article 172 and include eligible life and general insurers in the assessment. This option entails extra costs and no obvious benefit for non-reinsurers.
4) The same as 3 but also to apply for group solvency under Article 227. This provides some but limited benefit to life and general companies plus additional regulatory costs.

To help readers consider these options a decision process tree is set out in Figure 2 below.

Figure 2 – Equivalence Decision Tree



A graphical analysis of the impact of Solvency II equivalence on the Guernsey insurance market using Porter's Five Forces is provided as an additional point of consideration at Annex 4.

In considering the above options it would be useful if respondents could consider the following points and address these in any response to the Commission:

a) Do you consider ICS a medium-term option for Guernsey and if so why?
b) What is the business case for your business for rejection or pursuit of equivalence (as applicable)? Please share the outcomes of any cost/benefit analysis which may have been conducted.
c) Do you believe there is a case for equivalence when considering the broader Guernsey insurance industry?
d) Does the cost of achieving equivalence, both in terms of the cost of doing business and the potential effect on regulatory fees, influence your answer?
e) If so what do you consider would be a reasonable cost?
f) Please describe any assumptions which have been made in forming your response.
g) If you are in favour of equivalence, is this opinion based on an assumed modified version of the Solvency II requirements? If so please indicate the specific modifications to the Solvency II rules upon which support of equivalence would be contingent?
h) If you are not in favour of equivalence, is this opinion based on an assumption of a strict replication of the Solvency II rules? If so, would any specific modification to the Solvency II rules change your position on equivalence?
i) What might, in your assessment, be the views of the EU authorities?
j) Do you have a view on increasing the current regulatory confidence level for reinsurers in Guernsey and if so why?
k) Do you think the Commission should regulate reinsurance brokers?
l) How do you view equivalence in terms of a global brand that might support Guernsey as a global insurance centre?

7. Next Steps

Interested stakeholders are invited to respond to this paper no later than 20 October 2017. Feedback received will be reviewed by the Commission and summarised in a follow-up feedback paper.

ANNEX 1

EQUIVALENCE ASSESSMENT TIMELINE

CEIOPS published guidance on the methodology for the equivalence process in November 2010[16] and it would appear that this paper remains relevant to EIOPA as this is retained on EIOPA's website. In addition to overarching principles of assessment, this paper also sets out operational aspects and an indicative timeline for the equivalence assessment process.

The key aspects are highlighted below along with the indicative minimum timeline per the guidance note (*in italics*).

1. **Equivalence assessments will be initiated upon receiving a Call for Advice from the European Commission.** Requests received from third country supervisors to engage into an equivalence process will not be sufficient to initiate the procedure. In considering own initiative assessments CEIOPS will, in particular, take into account the materiality of the third country concerned and the resources available. (*Week 1*)

2. **EIOPA will confirm as early as possible in the process that the third country supervisory authority is willing to participate in the assessment.** An equivalence assessment will not take place in the absence of confirmation of willingness to participate from the third country supervisory authority. (*Week 1-2*)

3. **EIOPA will issue a public Call for Evidence, once an equivalence process is initiated.** Any interested party may respond - responses will not be published or responded to. (*Week 3-4*)

4. **Assessment teams with the appropriate expertise, knowledge and experience will be put in place for the equivalence assessments.** The assessment teams should include/have access to legal expertise, financial requirements expertise (pillar I issues) including actuarial expertise, expertise in supervisory review, governance and reporting (pillar II & III issues) and group supervision expertise (if applicable). The minimum number of assessors per team should be no less than 3, including a CEIOPS Secretariat member who can also cover one of the above areas. The size of the assessment team will match the extent of the assessment to be undertaken (e.g. against a single Article or against all 3 Articles) as well as the complexity of the third country supervisory system.

5. **EIOPA will invite the third country supervisory authorities to complete questionnaires relevant to the Articles of the Solvency II Directive and perform a desk-based assessment thereon.** Where necessary, EIOPA will request additional evidence from the respective third country supervisory authority. A thorough analysis of the information received, including practical evidence, will be carried out. A thorough analysis of the legal texts invoked by the responding authority will be performed. The assessment will also take into account any practical evidence of applicable criteria observance available to EIOPA. (*Questionnaire completion Week 4-12, Desk-based assessment Week 24-28*)

6. **An on-site visit will be part of the assessment process.** EIOPA will consult the supervisory authority and may also wish to consult other relevant parties in the country who may include relevant government ministries, undertakings, insurance industry associations, actuaries, auditors and other financial sector participants. (*Week 24-28*)

[16] https://eiopa.europa.eu/CEIOPS-Archive/Documents/Consultations/CEIOPS-%20Methodology-equivalence-assessments-Solvency-II.pdf

7. **EIOPA prepares advice for public consultation (**Week 28-32**)**

8. **EIOPA finalises advice for submission to the European Commission (***Week 32-42***)**

Decision

The European Commission makes the decision as to equivalence by way of a Delegated Act.

This Act is then subject to a 3 month review process by the European Parliament and Council. The European Parliament and Council have three months (plus a possible three month extension) to consider acts and they have rights either to adopt or to reject them.

[In the case of the Bermuda equivalence process there was 4 months between EIOPA’s final advice (31 July 2015) and the decision by the EC (26 November 2015). Final approval was completed on 4 March 2016.]

ANNEX 2

CRITERIA FOR ASSESSING THIRD COUNTRY REINSURANCE EQUIVALENCE

Source: Article 378, of the Delegated Regulation

The criteria to be taken into account in order to assess whether the solvency regime of a third country that applies to reinsurance activities of undertakings with their head office in that third country is equivalent to that laid down in Title I of Directive 2009/138/EC (*Solvency II*) shall be the following:

(a) whether the supervisory authorities of that third country have the power, by law or regulation, to effectively supervise domestic insurance undertakings carrying out reinsurance activities or reinsurance undertakings and impose sanctions or take enforcement action where necessary;

(b) whether the supervisory authorities of that third country have the necessary means, the relevant expertise, capacities including financial and human resources, and mandate to effectively protect policy holders and beneficiaries regardless of their nationality or place of residence;

(c) whether the supervisory authorities of that third country, in the exercise of their general duties, duly consider the potential impact of their decisions on the stability of financial systems globally, particularly during emergency situations, on the basis of the information available at that time;

(d) whether the supervisory authorities of that third country take into account the potential pro-cyclical effects of their actions where exceptional movements in the financial markets occur;

(e) whether the taking-up of the business of reinsurance in that third country is subject to prior authorisation conditional on a clear, objective and publicly available set of written standards;

(f) whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance activities to have an effective system of governance in place which provides for sound and prudent management of the business and prescribes all of the following:

> (i) the existence of an adequate, transparent organisational structure with a clear allocation and appropriate segregation of responsibilities,
>
> (ii) requirements for ensuring that persons who effectively run the undertaking are fit and proper, which are equivalent to Article 42 of Directive 2009/138/EC,
>
> (iii) the existence of effective processes to ensure the timely transmission of information both within the undertaking and to the relevant supervisory authorities;
>
> (iv) requirements for ensuring that the outsourced functions or activities are effectively supervised;

(g) whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance activities to have an effective risk-management system in place comprising all of the following:

(i) strategies, processes and internal reporting procedures necessary to identify, measure, monitor, manage and report risks, to which the undertaking is or could be exposed, at an individual and an aggregated level and on a continuous basis, and their interdependencies;

(ii) an effective internal control system;

(h) whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance activities to establish and maintain effective risk-management, compliance, internal audit and actuarial functions;

(i) whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance activities to:

(i) provide third country supervisory authorities with any information necessary for the purposes of supervision;

(ii) disclose publicly, on at least an annual basis, a report on their solvency and financial condition equivalent to that specified in Article 51 of Directive 2009/138/EC;

(j) whether the solvency regime of that third country requires that proposed changes to the business policy or management of domestic insurance or reinsurance undertakings carrying out reinsurance activities, or to qualifying holdings in such undertakings, are consistent with maintaining a sound and prudent management of those undertakings;

(k) whether the assessment of the financial position of domestic insurance or reinsurance undertakings carrying out reinsurance activities relies on sound economic principles and whether solvency requirements are based on an economic valuation of all assets and liabilities;

(l) whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance activities to hold adequate financial resources including all of the following requirements:

(i) a requirement that those undertakings establish technical provisions with respect to all of their reinsurance obligations towards policy holders and beneficiaries of reinsurance contracts,

(ii) a requirement that assets held to cover technical provisions are invested in the best interests of all policy holders and beneficiaries taking into account any disclosed policy objective,

(iii) a requirement that those undertakings only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report,

(iv) a requirement that those undertakings meet capital requirements set at a level equivalent to that referred to in Article 101(3) of Directive 2009/138/EC which ensures that in the event of significant losses policy holders and beneficiaries are adequately protected and continue to receive payments as they become due,

(v) a requirement that those undertakings maintain a minimum level of capital, non-compliance with which triggers immediate and ultimate supervisory intervention,

(vi) a requirement that those undertakings meet the capital requirements referred to in points (iv) and (v) with own funds that are of a sufficient quality and which are able to absorb significant losses, and that own-fund items considered by the supervisory authorities to be of a high quality shall absorb losses both in a going concern and in case of a winding up;

(m) whether the capital requirements of the solvency regime of that third country are risk-based with the objective of capturing quantifiable risks and that where a significant risk is not quantifiable and cannot be captured in the capital requirements, then that risk is addressed through another supervisory mechanism;

(n) whether the solvency regime of that third country ensures timely intervention by supervisory authorities of the third country in the event that the capital requirement referred to in point (l)(iv) is not complied with;

(o) whether the solvency regime of the third country provides that all persons who are working or who have worked for the supervisory authorities of that third country, as well as auditors and experts acting on behalf of those authorities, are bound by obligations of professional secrecy and whether such obligations of professional secrecy extend to information received from all supervisory authorities;

(p) whether the solvency regime of the third country provides that, without prejudice to cases covered by criminal law, any confidential information received by all persons who are working or who have worked for the supervisory authorities of that third country is not divulged to any person or authority whatsoever, except in summary or aggregate form, such that individual insurance and reinsurance undertakings cannot be identified;

(q) whether the solvency regime of the third country provides that, where an insurance or reinsurance undertaking has been declared bankrupt or is being compulsorily wound up, confidential information which does not concern third parties involved in attempts to rescue that undertaking may be divulged in civil or commercial proceedings;

(r) whether third country supervisory authorities which receive confidential information from supervisory authorities only use that information in the course of their duties and for any of the following purposes:

(i) to check that the conditions governing the taking-up of business of reinsurance, system of governance and public disclosure and solvency assessment have been met,

(ii) to impose sanctions,

(iii) in administrative appeals against decisions of the supervisory authorities,

(iv) in court proceedings relating to the solvency regime in that third country;

(s) whether third country supervisory authorities are permitted to exchange information received from supervisory authorities, in the discharge of their supervisory functions or the detection and investigation of breaches of company law, with other authorities, bodies or persons where that authority, body or person is subject to the obligation of professional secrecy in the relevant third country and whether that information is only disclosed once the express agreement of the supervisory authority from which it originates has been obtained and, where appropriate, has been obtained solely for the purposes for which the authority gave its agreement.

ANNEX 3

Content Required in a Solvency II Report on Solvency and Financial Condition.

Source: Article 51 of Solvency II

The report shall contain the following information, either in full or by way of references to equivalent information, both in nature and scope, disclosed publicly under other legal or regulatory requirements:

(a) a description of the business and the performance of the undertaking;

(b) a description of the system of governance and an assessment of its adequacy for the risk profile of the undertaking;

(c) a description, separately for each category of risk, of the risk exposure, concentration, mitigation and sensitivity;

(d) a description, separately for assets, technical provisions, and other liabilities, of the bases and methods used for their valuation, together with an explanation of any major differences in the bases and methods used for their valuation in financial statements;

(e) a description of the capital management, including at least the following:

> (i) the structure and amount of own funds, and their quality;
>
> (ii) the amounts of the Solvency Capital Requirement and of the Minimum Capital Requirement;
>
> (iii) the option set out in Article 304 used for the calculation of the Solvency Capital Requirement;
>
> (iv) information allowing a proper understanding of the main differences between the underlying assumptions of the standard formula and those of any internal model used by the undertaking for the calculation of its Solvency Capital Requirement;
>
> (v) the amount of any non-compliance with the Minimum Capital Requirement or any significant non-compliance with the Solvency Capital Requirement during the reporting period, even if subsequently resolved, with an explanation of its origin and consequences as well as any remedial measures taken.

ANNEX 4

PORTER'S FIVE FORCES – IMPACT OF SOLVENCY II EQUIVALENCE