Market overhaul triggers future uncertainties

Sweeping regulatory changes under the proposed Solvency II reforms could reshape Europe's insurance market

The Solvency II (SII) package's reforms are set to have wide ranging ramifications for the Iberian insurance market. Akin to the Basel III requirements for banks, SII places new capital adequacy requirements onto insurance companies in all EU Member States with gross premium income of more than €5m.

SII will create new governance, risk management and organisation rules, entailing internal reorganisation, which could present many potential opportunities for law firms, they say.

Many expect to see a burst of M&A activity as the cherry-picking of international businesses and pan-regional consolidation intensifies. The spread of insurance sectors and the localisation of the Spanish market also means some risk being swept away. "There are around 250 insurance undertakings in Spain," says Joaquín Ruiz Echauri, Head of Insurance and Reinsurance at Hogan Lovells Spain, "and while many are linked to big European companies, many smaller regional insurers will not have the size or resources to live under SII". And these could end up disappearing or perhaps merge with other local or regional peers.

SII will likely bring in reporting requirements for insurers with a heavy focus on corporate governance and transparency. Iberian lawyers say that insurance companies have so far largely been monitoring Solvency II's governance matters internally rather than using external counsel, but this will change. Insurers will need to develop global risk management system to comply with the requirements and meet compliance standards, creating additional financial burdens that, combined with the need to balance risk and have a certain amount of liquidity under SII – presents unique challenges for Iberian insurers, and opportunities for their counsel.

Portugal has an alternative perspective to SII. The domestic market is already greatly contracted, with state-owned financial institution Caixa Geral de Depósitos holding about a third of the market. As such, the situation is less about consolidation and more about how big firms can meet the tough capital requirements, say lawyers.

"The biggest challenge for Portuguese insurers is compliance with Solvency Capital Requirements," explains José Jácome, a Founding Partner at AAA Advogados. "The rules of the new requirements, as well as the formulas for the relevant calculations, are still under discussion, but most Portuguese insurers would have difficulties in matching the capital requirements as initially set out in SII."

Insurers would need to have a stronger line of credit but economic conditions requires the need for additional support – likely external – to meet the liquidity demands. "The capital requirements also mean that insurance companies that have not yet adopted the SII risk management policies will have

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to look at improving their balance sheets," says Helena Vaz Pinto, Co-Head of M&A and Corporate Finance at Vieira de Almeida. "This could involve issuing more shares, attracting equity investors or securing other quasi-equity instruments, such as subordinated loans."

Such deals would lead to an increasing need for law firm involvement, and as the capital requirements are also very demanding in relation to the risk that insurers will have to assume, this too will change the complexion of the market, say lawyers.

"The Directive imposes more transparency as to each type of risk undertaken – some insurance products/lines are not profitable because they are high risk so companies offset those against more profitable sectors," explains Vaz Pinto. "Under SII and insurers will have to rethink their products so they can become profitable, that being the case, in particular, of long-term risk products that will involve more quantitative requirements and thus."

Heavy lobbying from the market has contributed to delays in the implementation of SII, and while the final rules may take a while to be established, say lawyers, there will no doubt be changes to the proposed regulations as well as time for companies to adjust to the new requirements. But for the time being, both Spanish and Portuguese insurers are facing big questions and an uncertain future.