

Solvency Modernization Initiative Update **March 17, 2010**

Commissioners and Financial Regulators Discuss Future Solvency Regulation

The Solvency Modernization Initiative (SMI) includes a critical self-examination of the U.S. Solvency Framework coupled with a simultaneous review of international developments in the regulatory solvency arena. The SMI will result in recommendations to improve the U.S. Solvency Framework.

Director Christina Urias, Chair of the Solvency Modernization Initiative Task Force and the Arizona Director of Insurance, said “U.S. insurance regulators have developed a system that really works; our solvency system has been a success. We need to consider changing times within a different economic environment and globalization, but maintain a system that assures ourselves and the public that companies in our states have the financial wherewithal to meet policyholder obligations. This is the premiere purpose of our solvency modernization efforts.”

U.S. regulators met in Phoenix March 11-12, 2010 to discuss the future of solvency regulation being planned through the Solvency Modernization Initiative. Discussion centered around two consultation papers released Dec 2009: (1) Consultation paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues, and (2) Consultation Paper on Corporate Governance and Risk Management. A robust discussion followed regarding the regulatory purposes supporting risk-based capital requirements, financial analysis and examination, international accounting, group solvency regulation, corporate governance, and risk management.

The following is a summary of some of the discussion. More details of the discussion can be obtained from the minutes of the meeting which will be released soon.

Financial Toolkit: RBC and Financial Analysis/Examination

The Risk-Based Capital (RBC) requirements implemented in the 1990s continue to be perceived as a necessary component in the legal framework of U.S. solvency regulation, but regulators will consider refinements to the formula, including modification to factors, how/which risks are captured in the formula (e.g. catastrophe risk), and calibration of the formula, amongst other changes. More advanced methods, such as modeling, will continue to be introduced for risks where factor-based methods are not sufficient to capture the identified risk.

U.S. regulators noted that the core of solvency regulation is in the financial analysis and examination processes, rather than mere reliance on capital requirements. Terri Vaughan, NAIC CEO said, “The RBC sits within the context of a large number of tools. Internationally, supervisors are at a disadvantage because they do not have the extensive databases that we have. They have to rely on companies’ own evaluations of risk and even internal models, while we can do

our own unbiased analysis and assessment.” Director Urias added, “When we took action during the financial crisis, we supplemented quantitative with qualitative analysis before taking action. RBC was a big piece of the puzzle because it gives us legal authority, but there were many other factors considered.”

A clear distinction was drawn between a firm’s economic capital calculations and regulatory capital requirements. Economic capital was viewed by many to be a tool for managing the firm, while RBC was intended to be a floor for triggering regulatory intervention. Well-run firms have an incentive to develop economic capital measures that promote effective risk management. While regulatory capital requirements in the U.S. should not discourage effective risk management, their purpose is primarily not to duplicate the incentives embodied in economic capital measures. In fact, many U.S. regulators believe regulatory capital would typically be well below and would not interfere with economic capital. This reaction likely reflects regulatory satisfaction with the strength of financial analysis and examination (aka off-site and on-site monitoring) in detecting risky behaviors and the ability to use the Hazardous Financial Condition Regulation to take action. In the U.S., efforts to strengthen the detection of risky behavior is more likely to focus on gathering and analyzing information targeted at those risks, rather than on internal measures of the capital required to hold the risk.

International Accounting

Recognizing the G-20’s support of international accounting standards and the continued joint efforts of the U.S. Financial Accounting Standards Board with the International Accounting Standards Board, the future of U.S. statutory accounting and financial reporting will be debated and a high-level policy decision is expected to be made in 2011.

Group Solvency Regulation

Group solvency surveillance was identified as a key area for improvement in the U.S. system. For better policyholder protection, certain risks such as contagion and reputational risk need appropriate consideration. Expectations are that a legal entity supervisory approach will remain as the main methodology for insurance regulation; however, the identification and assessment of group risk factors will complement that methodology, not replace it. Regulators emphasized that a group capital assessment should be performed, but an assessment does not necessarily require calculation of a separate group capital requirement (such as RBC).

Corporate Governance and Risk Management

An insurer’s corporate governance system is already assessed in solvency regulation, however regulators want to develop more explicit authority over an insurer’s governance processes. Particular attention will be given to avoid conflict with state law in the development of additional statutory tools.

The U.S. solvency system has been built around the assessment of risk, but questions remain about whether there should be a more formal process for requiring a risk management policy such as Enterprise Risk Management. One international idea under consideration is the Own Risk and Solvency Assessment (ORSA) that an insurance company would be required to perform and report to the regulator.

Overall the regulators noted some areas for enhancement within the U.S. solvency system and reaffirmed the desire to converge solvency systems internationally, where practicable. However, it is also recognized that business cultures are different around the world, which might result in different regulatory systems. While all countries have it as an aim, policyholder protection is the primary focus of the U.S. solvency framework. In some non-U.S. jurisdictions, policyholder protection is not the primary objective of their insurance supervisory framework, and in fact can conflict with other regulatory objectives.

As U.S. regulators consider evolving international developments, some attention has been focused on Europe's Solvency II framework. Achieving "equivalence" under Solvency II may benefit U.S. insurers active in Europe, but any equivalence process should be measured on an outcomes-based approach rather than a rules-based approach. U.S. regulators are focusing efforts on enhancing the tried and tested U.S. solvency framework, which is different from that utilized in Europe. While there are some specific components of Solvency II that may be of interest, U.S. regulators are not convinced that the entirety of Solvency II is the appropriate course of action that the U.S. regulators should adopt.

For additional information about the SMI, see the SMI web page at http://www.naic.org/index_smi.htm