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U.S.-EU Dialogue Project: A Comparison of the Two Regulatory Regimes and the Way Forward

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For more than a decade, the NAIC and state insurance regulators have regularly taken part in on-going U.S.-EU (European Union) insurance regulatory dialogues on various issues of mutual regulatory concern. Together, the U.S. and the EU oversee more than 70% of the global insurance market. The global financial crisis has proven that better cross-border cooperation and regulatory modernization is important so that our regulatory communities are better equipped to face challenges that arise. These recurring dialogues have been critical to harmonizing regulatory approaches where appropriate and fostering regulator trust and mutual understanding between our respective jurisdictions. They have also established the basis on which to build new cooperation projects.

In early 2012, the NAIC, the Federal Insurance Office (FIO), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Commission (EC) initiated a U.S.-EU Dialogue Project (Project) to deepen insight into the overall design, function and objectives of the key aspects of the insurance regulatory regimes in the U.S. and EU, and to identify important characteristics of both regimes. The Project builds on the ongoing U.S.-E.U. dialogue and is being led by a Steering Committee that includes three top supervisory officials from the U.S. and three from the EU.

The Steering Committee committed to a series of discussions to improve their understanding of each other's regulatory systems. In addition to having several meetings in person and via phone, the Steering Committee identified the following seven topics that members agreed were important to a sound regulatory regime, the protection of policyholders and financial stability:

1. Professional secrecy and confidentiality;
2. Group supervision;
3. Solvency and capital requirements;
4. Reinsurance and collateral requirements;
5. Supervisory reporting, data collection and analysis and disclosure;
6. Supervisory peer reviews; and
7. Independent third-party reviews and supervisory onsite inspections.

The Steering Committee established several technical committees (TCs) comprised of insurance experts for each of the seven topics to objectively compare the two systems. The TCs were tasked with preparing objective, fact-based reports that identify areas of alignment and differences between the two regulatory systems. The discussions focused on a comparison of the seven core principles identified in the state-based system in the U.S. Insurance Financial Solvency Framework and the three-pillar approach of the Solvency II Directive in Europe, including the rules that are currently under development for Solvency II implementation.

In September 2012, a compilation of the seven technical reports was exposed for public review and comment. The reports explain the work and findings of each of the respective committees in their efforts to compare and contrast the two regulatory systems. The Steering Committee held public hearings Oct. 12, 2012, in Washington, D.C., and Oct. 16, 2012, in Belgium to offer participants a chance to comment on the draft report. Following the public hearings, the report was revised to increase accuracy and provide clarification of certain content. In December 2012, a revised report, "Comparing Certain Aspects on the Insurance Supervisory and Regulatory Regimes in the European Union and the United States," was released.

The report represents an important crossroads on the path toward greater mutual understanding and cooperation. Overall, the TCs found that many of the policy objectives were quite similar among the two regulatory systems. Although there were some notable differences, the similarities between the two regimes were greater than anticipated. Examples of some of the key observations from the Project are outlined below. The full report can be found on the NAIC website.[1]

1. Professional Secrecy and Confidentiality

- Both regimes seek to balance the objective of maintaining professional secrecy with appropriate flexibility to share information with other supervisory authorities with a legitimate and material interest in the information. Key differences in structural approach can be observed. In the EU, the basic presumption incorporated in insurance legislation is that nearly all information acquired by the supervisory authorities in the course of their activities is bound by the obligation of professional secrecy. In the U.S., state laws generally

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[1] *www.naic.org/documents/eu_us_dialogue_report_121220.pdf*

provide for the confidentiality of certain information submitted to, obtained by or otherwise in the possession of an insurance department. The approach is more often focused on protecting specific information from being available for public inspection.

- Both regimes include general authorizations to share confidential information with other financial regulators, law enforcement officials and other governmental bodies in need of such information to perform their duties. Confidential information may only be disclosed to such persons if they can maintain confidentiality and/or demonstrate their ability to protect such information from disclosure when the information is in their possession.

- Both regimes allow for regulators to enter into agreements or memoranda of understanding (MoUs) with counterparts in other jurisdictions to facilitate the sharing of confidential information. Both regimes provide broad discretion to regulators to establish the terms of such agreements, including the verification of each regulator's ability to maintain the confidentiality of information received from another jurisdiction.

- Moreover, both regimes address the issue of potential sharing of information with third parties, but achieve similar outcomes in different ways. EU member state requirements that the recipient of confidential information obtain explicit permission from the originating source before sharing with another regulator are often developed as a result of legal constraints under the EU directives, while U.S. state insurance regulators are bound by general legal requirements to respect the confidentiality of information under the laws of the providing jurisdiction and the memorialization of this respect in written confidentiality agreements.

2. Group Supervision[2]

- Under Solvency II, the scope of group supervision includes all entities within the entire group, regulated or otherwise, on a global basis; however, authority outside of the group capital requirement is limited to entities located within the European Economic Area. In the U.S., group supervision includes all entities within the entire group, but authority is limited to U.S.-based insurers and the focus of group supervision is on analyzing the financial condition of the group from the perspective of its potential impact on the regulated insurers.

- In the EU, group supervisors have authority over non-domiciled and non-regulated entities in the group, but most of this authority is from the perspective of the group capital requirement. In the U.S., insurance regulators do not have the same authority, but they have significant powers over the legal entity insurer and also have unlimited authority with regard to gathering and examining any information from the holding company system. In addition, it should be noted that U.S. insurance regulators use a "lead state" concept, which provides a means for the states to defer their authority to analyze and examine holding company information to a chosen group-wide U.S. lead supervisor.

- In terms of reporting at the group level, Solvency II requires reporting of group information similar to the reporting on legal entity insurers. In the U.S., there is much more extensive reporting on legal entity insurers, which includes reporting on all transactions between the insurer and other members of the holding company system, but other group information is limited to the basic financial statements and notes thereon of the consolidated group, or similar information on all entities within the group.

- Solvency II contains an explicit group capital requirement, whereas there is no similar requirement in the U.S.

- Both regimes have an Own Risk and Solvency Assessment (ORSA) requirement that is similar in concept, but the EU requirements are more prescriptive than the current U.S. ORSA requirements. In addition, small insurers in the U.S. will not be required to conduct an ORSA. A similar exemption was not identified for EU insurers.

3. Solvency and Capital Requirements

- The U.S. system relies on risk-based capital (RBC), a single calculation that produces four levels of regulatory capital used to apply escalating levels of action, but is not considered an indicator of relative financial

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[2] In general terms, a "group" refers to more than one company that coexists as part of a corporate family by virtue of ownership or affiliation. Generally speaking, an insurance group is comprised of two or more insurers, but there could be other legal entities involved, including holding companies; subsidiaries or affiliates, such as agencies, service providers or third-party administrators whose business is tangential to that of the member insurers; and other entities whose business is unrelated to the insurance operations of the group.

strength when RBC results are above action level. Solvency II includes two independently calculated capital level formulas—minimum capital requirement (MCR) and solvency capital requirement (SCR)—that allow different types of regulatory actions.

- The SCR formula incudes all quantifiable risks calibrated to a single statistical benchmark for SCR and another single benchmark for MCR. Only risks that are material for the industry are included in the RBC formula and are calibrated to varying statistical benchmarks. Currency risk and catastrophe risk are excluded from RBC, although there are plans to include catastrophe risk as part of the NAIC Solvency Modernization Initiative (SMI).

- The state-based regime in the U.S. and Solvency II both deviate from general accounting treatment. Regulatory reporting in the U.S. is required to follow statutory accounting principles (SAP), which is based on a framework that is developed around U.S. generally accepted accounting principles (GAAP) and establish more of a "winding-up" valuation. In the EU, solvency assessment of a company is based on a "market consistent," or economic, balance sheet. Assets and liabilities are valued at fair value and the basic framework is based on International Financial Reporting Standards (IFRS). This tends to make available capital more subject to year-to-year variation under Solvency II.

4. Reinsurance and Collateral Requirements

- In the EU, reinsurance undertakings (defined as legal entities authorized to pursue reinsurance activities) are required to limit their objects to the business of reinsurance and related operations, although direct insurers may also be authorized to write reinsurance business. U.S. reinsurers are generally permitted to write insurance business on a direct or assumed basis.

- Under both regimes, risk-mitigation techniques must fulfill criteria relating to genuine and effective risk transfer in order to receive credit, although some differences between the two regimes do exist. Each also requires that ceding companies reflect the counterparty default risk associated with reinsurance in their capital requirements, although this is done in different ways.

- Both regimes have specific requirements for reinsurance ceded by domestic insurers to foreign reinsurers and have recently established frameworks for reviewing the reinsurance solvency and supervisory regimes of other jurisdictions. However, there are key differences between the two regimes with respect to the requirements for recognition of reinsurance ceded to foreign reinsurers, and the frameworks for reviewing the regulatory regimes of foreign jurisdictions are different.

- In the EU, member states are prohibited from requiring collateral in relation to reinsurance arrangements entered into with companies situated in equivalent third countries (reinsurance arrangements with these companies would be treated in the same manner as reinsurance arrangements concluded with EU reinsurers). Under the U.S. state-based regime, the 2011 amendments to the NAIC Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786) (NAIC credit for reinsurance models) serve to reduce the prior reinsurance collateral requirements for non-U.S. licensed reinsurers that are licensed and domiciled in qualified jurisdictions, and those reinsurers will be required to post collateral according to their assigned rating.

- In the EU, decisions on third-country equivalence in relation to reinsurance are effective across the EU and cannot be overridden by member states, while in the U.S., collateral reduction is optional on the part of the states. If a state enacts reinsurance collateral reduction measures, those measures would be required to be substantially similar (i.e., similar in force and no less effective) to the key elements of the NAIC models.

- Currently, 11 U.S. states have enacted reduced collateral provisions (California, Connecticut, Delaware, Florida, Georgia, Indiana, Louisiana, New York, New Jersey, Pennsylvania, and Virginia), with other states currently considering proposals.

5. Supervisory Reporting, Data Collection and Analysis and Disclosure

- The U.S. system has a mature harmonized reporting, data collection and analysis function that has been administered by the NAIC for years; it has evolved and will continue to do so. In the EU, while national reporting

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systems are also mature and continuously improving, Solvency II will put in place for the first time a harmonized prudential reporting and data-collection process across EU member states that, when fully operational and once matured with experience, should function in a similar way as that utilized by the state-based regime in the U.S.

- There are some differences in regard to reporting requirements, particularly with respect to governance issues. The EU includes a detailed description of the system of governance and risk management; while the U.S. state-based regime prefers the monitoring to occur mostly through on-site examination processes. In the future, this will be enhanced on the U.S. side with ORSA and enterprise risk management (ERM) reports.

- Concerning reporting requirements for groups, the approach is somewhat different between the two regimes. In the U.S. state-based regime, groups submit holding company filings, which are distinct from requirements of individual undertakings. In the EU, groups will file reports that are similar to those required for individual undertakings.

6. Supervisory Peer Reviews

- The NAIC Financial Regulation Standards and Accreditation Program includes a standardized scope with formal topical standards that is continually updated as necessary. Reviews of the standards are performed on a rotational basis. The areas forming the subject of the review do not, generally, change. Additional standards may be added for relevant changes in the insurance industry and/or the regulatory environment. The Financial Regulation Standards and Accreditation Program and its related processes have resulted in standards that are effectively obligatory. EU peer reviews are thematic in nature, examining subjects/issues that fall within the legal remit of EIOPA. The topics forming the subject of the reviews change, but the EU measures, which are rigorous in nature, on which they may be based (e.g., regulations, directives and guidelines), will not generally change, but can be updated where necessary. Any significant issues identified will be revisited during the follow-up process (aspects may also be considered as part of a subsequent review).

- The NAIC Financial Regulation Standards and Accreditation Program is voluntary and conducted by non-regulators. Although the program is voluntary, there is a high degree of participation in the program; currently, all 50 states, the District of Columbia and Puerto Rico are accredited. In contrast, the EIOPA regulation requires all member states to conduct periodic reviews and those reviews are conducted by member states, not EIOPA staff.

7. Independent Third-Party Review and Supervisory On-Site Inspections

- Under Solvency II, EU insurers must maintain an internal audit function. There is no independent audit function currently required under state or U.S. laws or regulations; however, insurers listed with the New York Stock Exchange (NYSE) are required by the terms of membership on the NYSE to have an internal audit function.

- In regard to the frequency of on-site examinations, the U.S. state-based regime requires a full-scope financial examination at least once every five years. The EU does not have a frequency requirement for examinations.

- The U.S. provides insurers with the opportunity to review, comment on and appeal the findings of on-site evaluations. In addition, the NAIC Model Law on Examinations (#390) specifies the process to make the report available to the public for review. There are also requirements for the examination report to be shared with other states. Examination reports are considered public documents, and many state insurance departments regularly post them on their websites. Under Solvency II, regulators are not required to share the examination report.

- Also, although both regimes require actuarial reports, the prescribed minimum content and distribution of reports are different. In the U.S., actuaries are required by state insurance regulations to release a public opinion, along with other reports that are restricted to the company and supervisors. In the EU, there is no public opinion, but internal reports can be accessed by supervisors.

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◆ WAY FORWARD

Based on the report, the Steering Committee also agreed on a "Way Forward" plan, which outlines the common objectives and initiatives for the future. A detailed project plan to operationalize these objectives and initiatives in the Way Forward plan is being developed in early 2013 to be pursued over the next five years. The Way Forward plan seeks coordination and consistency between the two regimes on each of the seven topics.

Specifically, the high-level common objectives are to:

- Promote the free flow of information between EU and U.S. supervisors under conditions of professional secrecy by removing the barriers to the exchanges of information;
- Establish a robust regime for group supervision, which would include a clear allocation of tasks, responsibilities and authority amongst supervisors, a holistic approach to the determination of the solvency and financial condition of the group, greater cooperation and coordination of supervisors within colleges and efficient enforcement measures;
- Further develop an approach to valuation that more accurately reflects the risk profile of companies and capital requirements that are fully risk-based;
- Work to achieve a consistent approach within each jurisdiction and examine the further reduction and possible removal of collateral requirements in both jurisdictions;
- Pursue greater coordination in relation to the monitoring of the solvency and financial condition of solo entities and groups through the analysis of supervisory reporting;
- Ensure the consistent application of prudential requirements and commitment to supervisory best practices through different peer review processes that ensure an independent view of the jurisdiction being examined; and
- Ensure consistency and effectiveness in the supervision of solo entities and groups.

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