U.S. Solvency Regulation

THE TOPIC

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With the increasing globalization of trade, insurance regulators everywhere have come under pressure to ensure the financial reliability of the insurers for which they are responsible and to make their regulations for solvency more compatible with those of other countries. This concern led to the development of Solvency II in the European Union, see Solvency II [1] paper, and to the National Association of Insurance Commissioners? (NAIC) Solvency Modernization Initiative (SMI) in the United States. As the projects progressed, questions were raised as to whether the two solvency regimes were equivalent, an important issue given that some EU insurers have subsidiaries operating in the United States and some U.S. companies have subsidiaries in Europe. Currently, implementation of Solvency II is set for 2016.

RECENT DEVELOPMENTS

- **ORSA (Own Risk and Solvency Assessment):** A core element in Solvency II is an evaluation by each insurer of its ability to remain solvent under various scenarios of risk, requiring high standards of risk management and governance throughout the company?s operations.
- The same concept is being adopted in the United States as an addition to the key element in U.S. solvency regulation, risk-based capital (RBC). The RBC system requires insurers to match their capital to the level of risk they are assuming and allows regulators to act promptly to address the problem when a company?s capital drops too low, see Background section. It also provides the legal authority for regulators to intervene. The NAIC is modifying its RBC rules in response to Solvency II and other moves to strengthen solvency protections, and it has added the ORSA requirement as a regulatory tool to evaluate future solvency. Any insurer with more than $500 million in annual premium or insurance group that writes more than $1 billion in premium will have to complete an ORSA at least once a year. The ORSA requirement is embedded in an NAIC model law, which must be passed by each state legislature.
- According to PricewaterhouseCoopers, the accounting and consulting firm, the key elements of an ORSA are the company?s risk strategy, which should be at the heart of the organization; risk governance, a governance structure for managing all material risks; risk management, which is a formal risk identification process; and risk quantification based on high-quality models.
- **U.S. Solvency Regulation and Solvency II Equivalence:** Solvency II specifies that for insurers outside the EU to be treated in the same way as those in the European market, their home regulatory system must be deemed equivalent to Solvency II. U.S. regulators believe that the NAIC?s ORSA goes a long way to meeting this requirement. In September 2012 a committee composed of EU and U.S. representatives issued a report comparing the U.S. and EU regulatory systems in seven areas, including solvency, group supervision and reinsurance.
- At hearings on the report, the Property Casualty Insurers Association of America (PCI) argued that based on the report, equivalence should be granted. But European representatives said that equivalence should not be granted as long as the U.S. requires collateral to be posted in reinsurance transactions with non-U.S. insurers, see report on Reinsurance [2], and the Bermuda

representative was opposed to granting the U.S. any special route to equivalency not available to other countries.
- Industry observers note that one of the key differences between the two systems is that Solvency II has a more prescriptive approach than the U.S. system. The EU has set up strict rules for capital adequacy that may require a higher level of capitalization than in the U.S. in an effort to protect the interests of all stakeholders, whereas the U.S. relies more on the free-market and competition to discipline insurers and on state guaranty funds to protect policyholders and claimants in the event that the company has insufficient funds to pay claims and has to be liquidated, see report on Insolvencies/Guaranty Funds [3].
- **ComFrame:** A key focus of the NAIC?s SMI project has been strengthening the supervision of insurers that operate in multiple countries to protect against regulatory shortfalls.
- Recognition of these regulatory gaps came to a head during the recent financial crisis. Many large insurance company groups operate in many different markets. Although the company might have only one regulator in its home jurisdiction, it could have many regulators that supervise a small part of the company?s activities in other parts of the world where it competes for business. In July 2012 the International Association of Insurance Supervisors (IAIS) released a working draft of its Common Framework, or ComFrame, project, asking for comments from the international insurance community. ComFrame is designed to establish a comprehensive framework for regulators to address the group-wide activities of large, global insurers, known as Internationally Active Insurance Groups (IAIGs), and to improve supervisory cooperation.
- According to Connecticut Insurance Commissioner Tom Leonardi, who sits on several international regulatory committees, the main areas of disagreement between EU and U.S. regulators are: whether IAIGs should be governed by a single group of regulators in keeping with the EU?s ?top-down? regulatory philosophy or whether each subsidiary of the IAIG should have its own local or domiciliary regulator as in the current U.S. system. The other significant difference reflects a similar disagreement concerning capital standards where the EU?s approach again is to rely on an international capital standard and the U.S. approach is to set capital standards at the subsidiary level in compliance with the domiciliary state?s requirements.
- U.S. insurance industry trade groups representing IAIGs lauded ComFrame?s goal of increased cooperation among supervisors of IAIGs but criticized the IAIS for trying to impose another layer of regulation rather than providing guidance and increasing supervisory communication and coordination. PCI sets out what it believes should be the primary objectives of group supervision in a paper, ?*Effective and Efficient Insurance Group Supervision in the U.S.: What More, if Anything is Needed?*? published in January 2013.

BACKGROUND

In the United States, the regulation of insurance companies, including a company?s capital adequacy, is a function of the individual states. Insurance regulators in each state monitor the solvency of insurers domiciled in their state and the National Association of Insurance Commissioners (NAIC), which is composed of state insurance regulators, sets standards for solvency regulation and provides regulatory support and coordination. While NAIC members are state government officials, either appointed or elected, the NAIC itself is not a governmental agency. It recommends best practices in the form of model laws, but state legislatures choose whether or not to adopt them.

U.S. Regulation for Solvency: State insurance departments monitor the financial health of insurance companies through regular in-depth financial analysis and periodic on-site examinations. The NAIC uses a series of tests?the Insurance Regulatory Information System (IRIS)?to help identify companies in trouble. All insurers are required to file annual financial statements with regulators in all states in which they are licensed to do business. Statistical data taken from these statements are run through IRIS tests. If the tests indicate a company's financial ratios are outside the normal range in more than four areas, its finances are reviewed in greater detail to determine whether it is in need of immediate regulatory attention.

State insurance departments must meet certain standards to ensure they have the capacity to oversee the financial condition of the insurers they regulate. Under state accreditation program rules, accredited states are subject to a full review every five years and a lesser audit every year. However, accreditation may be suspended at any time, after notice to the state and a hearing, if regulators become aware that a state is no longer in compliance with certification standards.

Risk-Based Capital Standards: The NAIC has been strengthening solvency regulation since the early 1990s. The old blanket minimum requirements were replaced with standards geared to the specific characteristics of the company and the riskiness of its business activities. An insurance company that insures medical device manufacturers or high-rise buildings along California's earthquake faults needs a larger cushion of capital than a company specializing in Main Street businesses. A company that is heavily reinsured may have more security than a similar one that is not, but what happens if its reinsurer is in poor financial health when it comes time to honor the reinsurance contract?

RBC formulas therefore set out minimum levels of capital that will help maintain solvency in the event of a serious miscalculation. The likelihood and extent of these errors are built into the formulas for various elements of an insurer's business. These include the risk that loss reserves set aside for future claims will be inadequate. (Loss reserve risk is tied to the kind of business the company underwrites. There is more uncertainty in liability than property lines of insurance because of the long-tail nature of claims, where it may take years to arrive at a settlement for injuries.) In addition there is credit risk?the chance that an insurance agent or reinsurer will default on monies owed under contracts. Premium risk assesses the degree to which insurance policy prices may inadequately reflect the cost of claims. Capital levels are also established for investment and off-balance sheet risks. An allowance is made in the calculations for the fact that everything is unlikely to go wrong at the same time.

The adequacy of a company's capital is assessed by comparing its total adjusted capital, which is basically its net worth, with its RBC?an amount of capital that reflects the level of risk the company has assumed. The greater the total riskiness, the greater the minimum financial cushion must be. The result is expressed as the company's RBC ratio. Ratios are categorized in six levels, or zones, that run from adequate (125 percent and higher) to mandatory control or below 35 percent, at which point the insurance commissioner is authorized to seize the company, unless there is some reasonable expectation that the circumstances that caused the depletion of capital will be remedied within 90 days.

Insurance companies are required to disclose in financial statements filed with regulators their total adjusted capital and their ?authorized control level? of risk-based capital. This is one level above mandatory control, the point at which a regulator may take control of the company if it is deemed to be in the best interests of the policyholders, creditors and the general public. However, when RBC ratios are published outside of the annual statement, they usually refer to the "company action level," (75-99 percent), where a company is required to file a plan with regulators to correct its capital deficiencies.

RBC data are not a measure of financial performance. They are designed to help identify companies whose capital has fallen below regulatory-determined minimums rather than assess the financial strength of adequately capitalized insurers as rating agencies do from reviews of both financial data and discussion with company management. A company that fails the RBC tests may not be on the brink of insolvency and it is possible for a company in poor financial shape to pass the tests.

Recently, as part of their review of the RBC system in relation to Solvency II, regulators have been considering adjustments to improve the RBC formula.

Differences Between the Two Systems: According to Conning Research & Consulting, ?the European and the U.S. approaches represent competing views of regulation: one, a hands-on approach involved heavily in establishing best practices and creating rules and implementing disclosure requirements; the other, a freer market approach in which government just takes care of outliers and lets the discipline of the market police the participants.? Solvency II represents the former, the U.S. the latter.

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