



GLOBAL INSURANCE CAPITAL STANDARDS

Origin, Perspectives and Impact on U.S.
Markets

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EXECUTIVE SUMMARY

The United States insurance regulatory system has been in existence for more than 150 years. According to the National Association of Insurance Commissioners (NAIC), the U.S. regulatory mission is “to protect the interests of the policyholder and those who rely on the insurance coverage provided to the policyholder first and foremost, while also facilitating an effective and efficient market place for insurance products.”¹

Solvency is the cornerstone of insurance regulation, providing crucial safeguards for policyholders and for the economy. This I.I.I. white paper explores efforts related to solvency regulation that could have far-reaching and critical implications for the entire global insurance system—both internationally active insurers and those whose operations are distinctly local.² Beginning with an overview of the history of key changes in the United States and European solvency regimes, the paper focuses on the current initiative to build a common framework of capital requirements and prudential capital standards for internationally active and global systemically risky insurance groups since, in theory, the failure of a systemically risky insurer can cause significant dislocation in the global financial system. The paper also describes the perspectives of various stakeholder groups and the impact of this massive undertaking on different markets.

In the United States, the standards for solvency regulation, including risk-based capital requirements, are established by the NAIC and vary by state. In Europe and much of the rest of the world, solvency regulation is done on a national level.

U.S. and European regulators also have different approaches to regulating solvency. Most large insurers are groups, made up of several individual insurance companies.³ European regulators focus on group solvency; U.S. regulators focus on each individual company.

The two approaches operated effectively in parallel for decades; however, the 2007–2009 financial crisis upset that order, due to the following actions.

- The federal government established a Federal Insurance Office (FIO) to monitor the industry and coordinate with the states on international matters.
- An international group of regulators began developing global standards for large insurance groups with significant foreign operations.

As a result, today large, complex U.S. insurers face mounting pressure to conform to global rules and capital standards. Smaller U.S. insurers feel threatened as well. A transformation of this magnitude would represent a major shift in the regulation of insurance in this country.

While some believe that “one size fits all” global capital requirements are necessary to avoid another meltdown, others strenuously disagree. Opponents claim that:

- The current U.S. regime is well established and already has sufficient regulatory financial oversight, risk-based capital requirements and other backstops to evaluate the capital adequacy of insurers.

- The European focus on group solvency offers policyholders less protection than the U.S. approach, which focuses on the individual entity. Since group capital is fungible—i.e., it can move freely from entity to entity within the group—the solvency of any firm may be at risk. The European Union (EU) focuses on protecting shareholders, bondholders and other risk takers as well as policyholders, meaning that European regulators’ primary emphasis is not on the welfare of consumers and the ability to pay claims. Since higher global requirements may not even prevent an insurer’s failure, consolidated group-wide supervision should supplement—not replace—the legal-entity approach in the United States.
- Rigid, formulaic global capital standards that apply to both insurance and non-insurance risks, based on accounting rules that differ from U.S. rules, are not compatible with this country’s insurance markets. Opponents prefer a flexible “outcomes-based” approach that allows for different assessments and valuations from country to country—as long as similar, comparable outcomes result.
- The significant differences between U.S. and European systems mean it is critical that regulators understand those differences. They should recognize the strengths and best practices of each and harmonize existing regimes. A global capital standard should be just one tool for assessing whether capital is adequate, not a requirement.
- Higher capital requirements would likely impose additional and unnecessary costs on insurers that could slow the industry’s growth and reduce the availability of coverage.

The process of creating a uniform risk-based solvency regime is complex and time-consuming. Some believe international regulators have been moving too aggressively toward adopting new rules before understanding all of their implications.

The Federal Reserve Board and FIO generally support the concept of global capital standards, but they are clear that such standards will not be imposed on U.S. insurers by foreign regulators. Higher capital requirements will be adopted only by U.S. authorities following applicable rulemaking procedures, and only after rules are deemed compatible with state laws and appropriate for U.S. insurers and markets.

Separate from the global activity, U.S. regulators are exploring the development of group wide standards for internationally active insurers, and these will likely be created. Given that more rigid requirements—whether imported from Europe or home-grown—may trickle down to smaller, non-systemically risky insurers and influence regulatory approaches in different local jurisdictions, it is important for all insurers to closely monitor developments.

THE PURPOSE OF INSURANCE SOLVENCY REGULATION

The primary goal of insurance regulators is to make sure there is sufficient capital for insurers to operate and meet their obligations to policyholders and other claimants. Solvency regulation in the United States is accomplished by various means. To conduct business in a state, insurers must meet the state's minimum capital and surplus standards. These standards vary by type of insurer (stock versus mutual) and by broad type of insurance (life versus non-life). The types and amounts of investments that insurers make (e.g., medium- and long-term government and high-grade corporate bonds) are also regulated. Furthermore, state insurance departments conduct periodic audits of companies' financial statements (usually every three to five years) and other examinations to verify that companies are complying with statutes and prudent managerial practices.

Another important feature of the U.S. regulatory structure is the provision for the effective resolution of insurer failures and claim payments against insolvent insurers. Each state has a guaranty fund system that covers claims if an insurer is unable to do so. Funds are available through assessments of all remaining insurers based on a fixed percentage (about 2 percent) of their net direct written premiums.⁴

Since the late 19th Century, U.S. solvency regulation has been at the state level. (Some aspects of insurance do require uniformity and are now regulated under a national system.) After a brief period when the Supreme Court decided that the insurance industry could be regulated by federal law, state regulation has been firmly cemented due to the passage of the McCarran-Ferguson Act of 1945.⁵ Although proposals to fully replace state regulation with federal regulation have been raised from time to time, there has never been a consensus to pass such legislation.

KEY CHANGES IN INSURANCE SOLVENCY REGULATION: 1970s–2000s

Regulation is not static – the emergence of solvency problems, new types of risks and tort liabilities, technological advances and more divergent consumer needs are just some of the challenges that have confronted regulators and insurers. To keep up, regulatory systems have had to evolve as well.

Solvency Regulation in the United States

The following provides key activities related to insurance solvency regulation and capital requirements in the United States from the 1970s to the 2000s:

- In the early 1970s, as part of its Early Warning System, the NAIC began examining financial ratios from insurers' Annual Statements to help identify potentially troubled companies. The ratios test a company's premiums, surplus, profitability, liquidity and reserves. Weak scores helped regulators target companies that may require regulatory attention. In 1979 the ratios became part of the NAIC's Insurance Regulatory Information System, often known by the acronym IRIS. These ratios are part of the NAIC's portfolio of Financial Analysis Solvency Tools (FAST).

- In the 1980s, the insolvencies of four large property/casualty (P/C) insurers caused by the liability crisis together with the U.S. savings and loan debacle prompted a Congressional subcommittee investigation that culminated in a 1990 report, “Failed Promises: Insurance Company Insolvencies.”⁶ Reasons for the insolvencies, according to the report, included insurer fraud and mismanagement combined with a weak state-based regulatory system due to inadequate reporting of loss reserves, a lack of coordination among state regulators and insufficient financial examinations of insurers. As a solution, the report proposed to incorporate a federal solvency standard.
- States responded by adopting a series of NAIC model bills in the late 1980s. Some bills required greater transparency in insurers’ financial statements, independent CPA audits and opinions of loss reserves by qualified actuaries. In 1989, the NAIC implemented Financial Regulation Standards that included, among other items, base-line regulatory practices and procedures designed to supplement the enforcement of financial solvency laws.⁷
- In 1990, the NAIC adopted a formal accreditation program to promote the effective solvency regulation of insurers, particularly multi-state writers.⁸ Subsequent enhancements were made after the General Accounting (now Accountability) Office (GAO) criticized the program for having loosely interpreted standards, a lack of focus on implementing required practices and questionable accreditation decisions.⁹
- During the 1990s, the NAIC established separate risk-based capital (RBC) requirements¹⁰ for U.S. P/C and life and health insurers, replacing the earlier fixed capital and surplus minimums that were criticized for being too low. Rather than being target/optimum levels of capital, the new standards were intended to be minimum levels of capital needed to support an insurer’s overall business operations based on its size and risk profile and to avoid regulatory action. RBC models are considered more accurate than earlier minimum capital and surplus requirements. They are used in conjunction with other early warning indicators (e.g., on-site examinations, IRIS ratios and FAST scores).
- In early 2000, NAIC members signed a “Statement of Intent: The Future of Insurance Regulation,” in which they pledged “to modernize insurance regulation to meet the realities of the new financial services marketplace” and “to work cooperatively with all our partners ... to facilitate and enhance this new and evolving market place as we begin the 21st Century.”¹¹
- In the late 2000s, as pressures leading toward the global financial crisis were building, the NAIC started another move to improve regulatory oversight. One of its key programs, launched in 2008, was the Solvency Modernization Initiative (SMI). It had two principal components: (1) the Own Risk and Solvency Assessment (ORSA); and (2) the Model Holding Company Act.

- (1) ORSA¹² requires insurers and insurance groups to conduct a self-assessment of their risk management and capital adequacy, examining all material and relevant risks—current and future—under normal conditions and under severe stress. The two primary goals of ORSA are to: (a) foster an effective level of enterprise risk management (ERM) for all insurers; and (b) provide a group-level perspective on risk and capital as a supplement to the existing legal entity view. It is a continuously evolving process that allows insurers to determine their own approach to self-evaluation. Beginning in 2015, insurers must submit to state regulators annual ORSA Summary Reports regarding their ERM capital management process.
- (2) The Model Holding Company Act is designed to improve group supervision, ensuring that regulators of global firms analyze risk concentrations across the group and between affiliates, regardless of jurisdiction. Under this model law, state regulators are given clear authority to have direct supervision over insurance companies within a holding company structure. They can participate in “supervisory colleges,”¹³ a collection of regulators that oversee a group and its individual insurance legal entities. Regulators receive additional tools to evaluate insurer risks, as well as greater access to a group’s books and records. The act requires holding companies to disclose to regulators information about changes under their control and all of their financial activities, including future business plans of insurance and non-insurance affiliates.

Solvency Regulation in Europe

Across the Atlantic, the European Insurance and Occupational Pensions Authority (EIOPA) has been striving to modernize capital regulation for decades.¹⁴ The major piece of insurance financial regulation—the Solvency Directive—is largely based on Europe’s solvency scheme from the 1970s. In light of the close relationship between European insurers and banks, the Solvency framework focusing on insurance groups and holding companies is analogous to the Basel Capital Accord applicable to banks.¹⁵

The Solvency I Directive to assess the risk profile of insurance firms in the European Union was adopted by EIOPA in 2002 and went into effect two years later. Solvency I was inherently weak. It dealt primarily with minimum capital standards that did not reflect the true risk of insurers; it did not focus on risk management and governance within firms. It was replaced by the Solvency II Directive in 2009.

Solvency II serves as the basis for much of the ongoing capital standards work currently performed by the International Association of Insurance Supervisors (IAIS). The IAIS is a voluntary standard-setting body established in 1994 to promote effective and globally consistent supervision of the insurance industry.¹⁶ It advises international leaders on insurance matters and collaborates with the Organization for Economic Co-operation and Development (OECD) and other international supervisory associations.

Solvency II takes a risk-based approach to prudential regulation. It is intended to harmonize ERM standards and implement complex capital standards. The capital standards are based on economic principles for the valuation of assets and liabilities. Solvency II regulates an insurer's health three ways:

- (1) It sets rules for sophisticated models that develop a mathematical estimate of how much capital a company needs.
- (2) It sets rules for risk management and governance.
- (3) It sets rules for transparency and disclosure, so the free market can assess an insurer's health and become a de facto regulator.

A key feature of Solvency II is the recognition of the free flow of capital (i.e., fungibility) across individual insurers in an insurance group; hence, members of the group are financially responsible for each other.

Included in the Solvency II framework is an "equivalence" provision whereby EU insurers can use local rules to report on their operations in third countries, while third country insurers are able to operate in the EU without complying with all of its rules. The "equivalence" evaluation is based on three distinct areas: (1) solvency or group capital calculation, for EU insurers operating in a third country; (2) group supervision, for third country insurers active in the EU; and (3) reinsurance, for third country reinsurers active in the EU.¹⁷

The Solvency II regime is set to begin on January 1, 2016.¹⁸

THE GLOBAL FINANCIAL CRISIS USHERS IN A NEW ERA

The 2007–2009 global financial crisis, caused in part by rating agencies that erroneously overrated the creditworthiness of mortgage-backed securities, raised concerns about the effectiveness of financial regulation worldwide. This event is viewed primarily as a banking crisis. Banks have higher risk because they are exposed to greater asset volatility and are more susceptible to disruptions in the credit market. On the other hand, the insolvency of insurers as a whole, especially in the United States, did not appear to be threatened; insurers fared better than banks because they have less debt and more equity with which to finance their assets.

According to the GAO, "The effects of the financial crisis on insurers and policyholders were generally limited, with a few exceptions... Actions by state and federal regulators and the National Association of Insurance Commissioners (NAIC), among other factors, helped limit the effects of the crisis." During 2007–2009, there were 34 P/C receiverships and 24 P/C liquidations out of 3,000 active P/C insurers in the U.S.; the average assets of P/C companies in liquidation was \$151.4 million. It should be noted that some regulators and insurance industry representatives interviewed by the GAO stated that failures that occurred during and immediately after the

financial crisis were generally not related directly to the crisis.¹⁹ In contrast, out of roughly 8,300 commercial banks and savings institutions insured by the Federal Deposit Insurance Corporation (FDIC), there were 168 failures during this same period; their failed assets totaled \$544.3 billion (as of December 31, 2009).²⁰

Figure 1 shows that the number of property/casualty failures remained did not increase significantly during the 2008–2009 financial crisis. The 28 failures in 2009 was just slightly above the average of 26 failures the preceding seven years. Banks had fewer failures in the years leading up to the crisis but failures rose significantly in the crisis years.

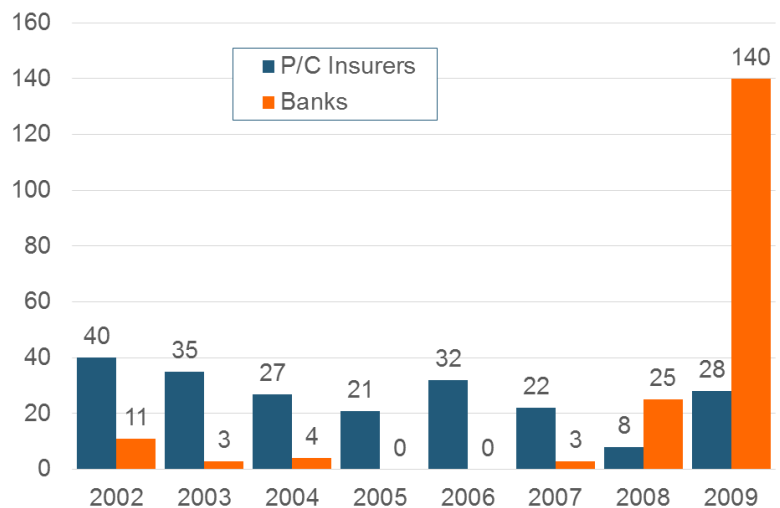
In response to the crisis, G20 leaders created the Financial Stability Board (FSB) in 2009. Succeeding the Financial Stability Forum, the FSB is an international body that monitors and evaluates vulnerabilities affecting the global financial system and proposes actions needed to address them. FSB members include international financial institutions and standard-setting, regulatory, supervisory and central bank bodies. Like the IAIS, the FSB is based in Switzerland. The U.S.

Treasury Department, Federal Reserve Board (the Fed) and Securities Exchange Commission represent the United States on the FSB. No U.S. state insurance regulators serve or are represented on the FSB. The only insurance-related member of the FSB is the IAIS, which falls under FSB's direction.

Introducing the Dodd-Frank Act

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law “to promote the financial stability of the United States by improving accountability and transparency in the financial system.”²¹ Dodd-Frank made sweeping changes, imposing stricter rules and oversight on large bank holding companies and other companies whose demise could threaten the nation's economy.

Fig. 1
NO. OF FAILED FINANCIAL INSTITUTIONS,
2002-2009*



*Includes both insurers in liquidation and in receivership
Sources: Government Accountability Office, Federal Deposit Insurance Corporation, Insurance Information Institute.

Since the U.S. insurance markets had remained competitive and financially sound during the financial crisis, Dodd-Frank preserved the role of the state regulatory system. It did establish the Federal Insurance Office (FIO) and placed it in the Treasury Department. The FIO is not authorized to regulate insurers; its functions include but are not limited to:

- Monitoring all aspects of the insurance industry.
- Coordinating federal efforts and developing federal policy on prudential aspects of international insurance matters.
- Consulting with state insurance regulators on insurance matters of international importance. The FIO represents the Treasury Department and the United States at the IAIS and in other bi-lateral and multi-lateral international insurance matters.

Dodd-Frank also established a Federal Stability Oversight Council (FSOC), accountable to Congress. The FSOC identifies risks to the financial stability of the United States that could arise during financial distress or when large financial firms fail—whether they are banks, nonbank financial companies or organizations outside the financial services marketplace. To help minimize these risks, the FSOC has the authority to designate an entity as a systemically important financial institution. Such a company is usually referred to as a SIFI and may become subject to stricter oversight by both the FSOC and the Fed, the company may also be required to put up more capital as a hedge against the risk it presents.²²

Under Dodd-Frank, it was not clear whether banking capital rules applied to insurers since bank regulation focuses on groups and insurance regulation focuses on legal entities. To clarify the matter, the Insurance Capital Standards Clarification Act of 2014 amended Dodd-Frank to confirm the distinctions between banking and insurance capital rules. It guarantees that institutions engaging in insurance are not held to the same capital standards as traditional banks. The Fed now has greater authority over insurance holding companies²³ with thrift subsidiaries and can apply insurance-based capital requirements to these entities.

THE INTERNATIONAL SOLVENCY REGULATORY LANDSCAPE OF TODAY

Until the late-2000s, it was generally believed that insurance regulatory changes taking place in Europe were not germane to other markets. However, the financial crisis and the growing presence of both the FSB (a bank regulator) and the IAIS have uprooted the landscape. Besides the U.S. and EU, other countries have been modernizing their insurance solvency regulations as well. Appendix I provides a brief overview of the recent reform efforts in China, certain Latin American nations and South Korea.

Under the direction of the FSB, the role of the IAIS has changed dramatically. The organization had been a forum for international regulators to cooperate, communicate and discuss best practices. Now it is one of the main drivers supporting and working towards global regulatory convergence.

Since 2013, the IAIS has been developing a global standard on how much capital an insurer should hold. The standard would be based on the amount of risk an insurer bears and would arrive at essentially the same answer regardless of where the insurer was located or who regulated it. The challenge has been reconciling differences among international regulatory systems.

General Differences in the U.S. and EU Solvency Regimes

Figure 2 shows the United States and the EU represent two of the world's largest insurance markets, generating nearly two-thirds of the world's P/C premiums in 2014.

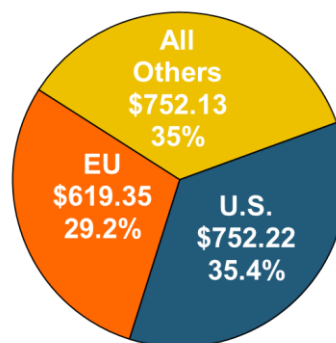
The regulatory systems of the United States and EU differ vastly in terms of philosophy, structure and operations, and this extends to requirements on how much capital to hold.

U.S. regulators have capital requirements for individual insurance companies but do not have requirements at the group level. U.S. insurance groups can have many companies scattered across several states. U.S. regulators focus on individual companies, worried that the free flow of capital across a group could jeopardize individual companies within a group.

The U.S. supervisory system relies on a free market approach; for capital requirements it allows greater management discretion. The U.S. method of measuring whether capital is adequate is called Risk Based Capital (RBC). The minimum amount of capital each insurer needs is based on a formula that takes into account the amount of insurance the company writes, the lines of business it writes, the assets it invests in and other measures. The data used is auditable, much of it from the company's Annual Statement. The result is a risk-based capital amount—in theory the absolute least amount of capital an insurer needs. If an insurer's capital dwindles, regulators have the opportunity to intercede. The closer the actual capital gets to the risk-based minimum, the more powerful the intervention can be.²⁴

In addition, state regulators conduct periodic regulatory financial examinations and analysis.²⁵ If an insurer falters, each state, and the District of Columbia, has an effective system to rehabilitate the company or, if necessary, liquidate it—a system that has been in place for decades.²⁶ This important feature safeguards policyholders and claimants if a company has insufficient funds to pay claims.

Fig. 2
DISTRIBUTION OF GLOBAL NON-LIFE
INSURANCE PREMIUMS, 2014
(\$ Billions)



Source: Swiss Re, *sigma*, No. 4/2015.

In contrast, European solvency regulation (for both insurers and banks) is regionally based with a primary focus at the group level. It emphasizes a consolidated capital standard that helps to ensure that a financial entity maintains adequate capital to support its group-wide activities, both insurance and non-insurance (mostly banking). Proponents of Solvency II claim that by using this approach, capital is better aligned with an entity's true economic risks.

The standards and formulas calculate how much capital a group needs, with a prescribed confidence level for a period of time, a concept known as value-at-risk. There are two key measures calculated. The solvency capital requirement is the amount a company needs so that the probability of default is remote—less than one-in-200.²⁷ Regulators can intervene when the threshold is breached. The minimum capital requirement is the amount a company needs so that the probability of default in the next year is less than 15 percent. Breaching the minimum can cost the insurer its authorization to write business.²⁸ The calculation requires data more detailed than what is regularly audited and verified. The result is a prudential capital requirement higher than is mandated by the United States.

No capital standard is foolproof.²⁹ Twelve of the 30 countries in the EU and European Economic Area have insurance guarantee mechanisms. These plans, however, vary significantly in design and are not harmonized at the EU level. As such, according to a European Commission white paper, the guarantee funds in Europe hinder “effective and equal consumer protection,” which “may lead to a loss of consumer confidence in the relevant markets and may ultimately put at risk market stability.”³⁰

European regulation follows the premise that it should protect bond holders, equity holders and other claimants in addition to policyholders.

To summarize: The United States scrutinizes individual entities using capital standards and regular in-depth exams—a bottom-up approach designed to protect policyholders and claimants. The minimum amount of capital an entity needs is calculated using auditable data and regulators intervene if capital approaches the minimum. A coordinated set of state guaranty funds act as a backstop.

In the EU, Solvency II applies a strict set of rules to groups of insurers under the same corporate umbrella—a top-down approach designed to protect policyholders, bond holders, equity owners and other claimants. The amount of capital a group needs is calculated using data both auditable and beyond audit. The result is typically higher than the U.S. calculation. Some nations have guaranty funds as a backstop, but it is not a coordinated effort as it is in the United States.

The EU-U.S. Mutual Regulatory Understanding Dialogue Project

In 2012, the “EU-U.S. Mutual Regulatory Understanding Dialogue Project” was formally recognized to build greater mutual trust, understanding and collaboration between European and

U.S. regulators. The project is intended to help the European Commission, EIOPA, NAIC and FIO better appreciate the overall design, function and objectives of key aspects of the two capital regimes and work towards a common goal of regulatory modernization for more effective supervision. Even though the United States was recently granted “provisional equivalence” under Solvency II,³¹ U.S. state regulators prefer to work with the EU following this approach of mutual understanding.

The project released a major report in December 2012³² that compared the regions’ insurance supervisory and regulatory schemes in seven areas. These are:

- (1) Professional secrecy/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;
- (7) Independent third party reviews and supervisory on-site inspections.

The report was accompanied by a plan that outlines common objectives and initiatives to be pursued over the next five years in each area, an attempt to improve convergence and regulatory compatibility between the EU and the United States. The plan was updated in July 2014.³³ Appendix II summarizes the steps to be taken to achieve the objectives of each of the seven areas.

Fig. 3 THE IAIS REGULATORY FRAMEWORK (Guidelines for Regulators Worldwide)		
	Insurers It Would Apply to	Capital Standard
Insurance Core Principles	All insurance entities and groups	Determined by local regulators
ComFrame	Large international groups	International capital standard
Systemically Important Insurers Framework	Systemically important insurers	International capital standard* plus higher loss absorption
* Systemically important insurers must meet a basic capital requirement while international capital standard is developed.		

THE EMERGENCE OF GLOBAL INSURANCE CAPITAL STANDARDS

While the EU and state regulators were addressing their needs, a larger group of regulators was also developing standards to converge insurance regulation worldwide. The international insurance

supervisors group—the IAIS—developed a three-tiered framework of regulation and supervision, summarized in Figure 3:

- (1) A set of insurance core principles that are typically referred to by the acronym ICPs.
- (2) A common framework for supervising insurance groups that operate internationally, which is usually referred to as ComFrame. Internationally active insurance groups are often referred to as IAIGs.
- (3) Methods of handling the largest insurers, whose size and scope mean their struggles could imperil global markets. These insurers are known as global systemically important insurers, or G-SIIs.

Addressing each in order:

Insurance Core Principles - Reflect EU priorities and perspectives, but they have gained acceptance among U.S. regulators. The NAIC describes the principles as a globally accepted framework for the supervision of the insurance sector. They are based heavily on Solvency II’s top-down concepts.³⁴

As depicted by the NAIC, these principles include “the essential elements that must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection. They are applicable to the supervision of all insurers and insurance groups, regardless of their size, international orientation or systemic importance.”³⁵ There are 26 ICPs dealing with issues such as supervisory authority, corporate governance, enterprise risk management for solvency purposes, capital adequacy and group-wide supervision.

Although the core principles are not legally binding, the International Monetary Fund (IMF) and World Bank use them in evaluating a company’s insurance operations in their Financial Sector Assessment Program, a review that looks for vulnerabilities in a country’s financial system and develops appropriate responses.

The latest U.S. evaluation found, among other results, that insurance supervision has significantly improved in recent years and there is a reasonable level of observance of the core principles. However, they found gaps in risk management requirements and noted that the U.S. insurance regulatory system remains complex and fragmented. The IMF and World Bank also said: “States should have the ability to set group-wide valuation and capital requirements.” It recommended that the Federal Reserve Board, the nation’s key banking regulator, “should develop *a valuation and capital standard speedily*.”³⁶ At this time, it is unclear how the Fed, NAIC and state regulators will respond.

ComFrame - A project under development since 2010, ComFrame focuses on the effective supervision of large internationally active groups that include at least one sizeable insurance entity.

These are insurers with assets of \$50 billion or more, or gross written premiums of \$10 billion or more that operate in at least three countries with at least 10 percent of their business conducted in foreign markets.³⁷ There were about 50 groups in mid-2015,³⁸ making up about 50 percent of the global insurance market. They do not necessarily present a systemic risk, but the IAIS believes their complex structure warrants more coordinated supervision internationally.

ComFrame complements and expands upon the core principles; its structure contains three modules:

- Scope, including rules on how to identify internationally active insurance groups and the group-wide supervisor and the breadth of supervision.
- The groups themselves, including the quantitative and qualitative requirements that they must meet.
- Supervisors, which includes the process of supervision, highlighting the group-wide supervisor's responsibilities (e.g., enforcement and interaction).

According to the NAIC, ComFrame is the most significant global initiative regarding group supervision.³⁹ It will include a set of capital standards for the large international insurers, with a more stringent requirement for the systemically important.

Global Systemically Important Insurers - The IAIS is also developing measures to regulate the handful of insurers whose demise could, some believe, threaten the world financial system. These insurers are called global systemically important insurers, or G-SIIs. In July 2013, the IAIS was directed to establish measures to impose on these insurers.⁴⁰ Measures include enhanced group supervision, effective resolution of troubled companies and the development of two capital standards: (1) an international capital standard that all internationally active insurance groups will have to hold; and (2) an additional layer of capital that systemically important insurers will have to hold.⁴¹

The first standard is difficult to develop, so in the short term regulators have created a stopgap, known as the basic capital requirement (BCR), to apply to the systemically important groups. When the international capital standard is developed it will replace the BCR. Systemically important insurers will still need to hold the additional capital as part of the higher loss absorption requirement.

Following is a description of the three standards and their timelines, with details in Figure 4:

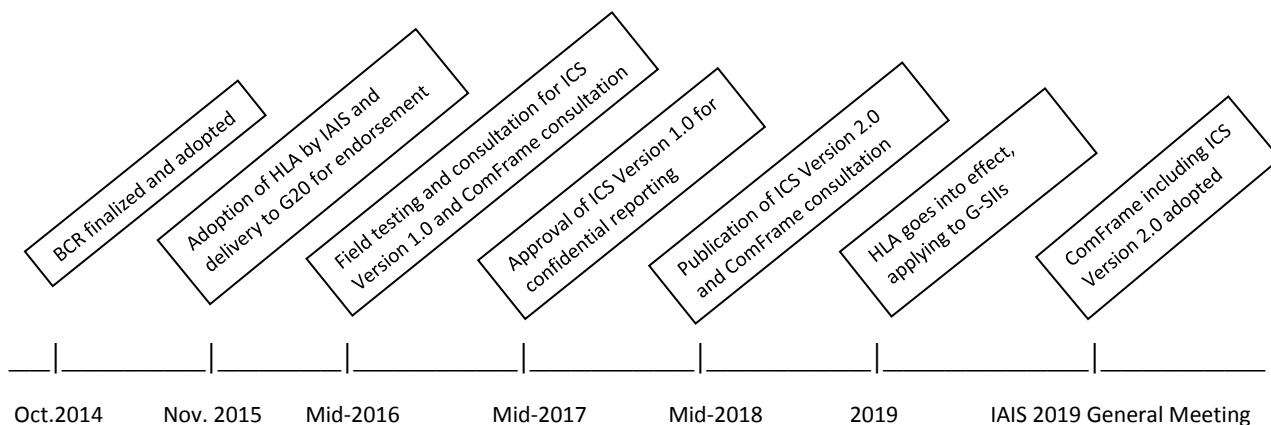
- *Step 1:* The basic capital requirement was created to reflect the insurance and non-insurance risks of all group activities of a company designated as systemically important. It was designed to be simple, practical and transparent. It was intended to show a group's

resilience to financial stress and give comparable results from nation to nation. The international supervisors adopted a standard in October 2014. The average BCR is 75 percent of the reported average prescribed capital requirement.⁴²

- *Step 2:* The higher loss absorption standard is designed to build on the foundation of the basic requirement. The first public consultation document requesting feedback from stakeholders was released in June 2015. G20 leaders endorsed the HLA standard in November. It is planned to go into effect in 2019.⁴³
- *Step 3:* The international capital standard will be more detailed and comprehensive than the basic capital requirement. It will reflect all material risks to which internationally active groups are exposed.

The target date for adopting ICS Version 1.0 is May/June 2017. ICS Version 2.0 will be a part of ComFrame and adopted in late 2019. ComFrame, including ICS Version 2.0, is now planned to go into effect in early 2020. Then the IAIS will continue working to create a final, single ICS whose completion date is not yet known.⁴⁴

**Fig. 4
IAIS TIMETABLE**



PERSPECTIVES OF COMFRAME AND GLOBAL INSURANCE CAPITAL STANDARDS

Many are concerned that new foreign regulatory standards could fundamentally alter insurer solvency regulation and product availability in the United States.

Benefits of ComFrame and Global Insurance Capital Standards

Creating an approach to supervise internationally active insurers and developing global risk-based capital standards is not without merit. Proponents claim these standards would:

- Provide an accurate measure of capital and risks and promote financial stability.
- Prevent gaps in regulation that could create global vulnerability and stress in the financial system.
- Provide a level playing field in regulating insurers and quantifying their capital.
- Reduce inefficiency and duplication across jurisdictions and drive down compliance costs.
- Streamline supervisory roles so supervisors make more effective decisions, potentially lowering coverage costs for consumers.
- Limit regulatory arbitrage and jurisdiction shopping; i.e., an insurer would not be tempted to move to another country with more favorable regulations to save costs.
- Encourage competition, new entrants and growth in markets.

U.S. attitudes on the topic vary, even among regulators.

Federal Reserve Board and Federal Insurance Office Perspectives

The Fed generally believes in the use of effective global capital standards for regulating internationally active firms. U.S. insurers entering and expanding into international markets stand to benefit greatly from reasonably consistent global requirements that consider the risks across the entire firm and a consolidated regulatory framework that is strong but pragmatic. The Fed recognizes the importance of consolidated group-wide supervision and capital standards that supplement the legal-entity approach.⁴⁵

Similarly, the FIO agrees that global capital standards will enhance the U.S. regulatory system, but notes the standards must be developed correctly. Testifying before Congress, the FIO expressed concern that developing the higher loss absorption standard—the capital the largest insurers would hold against the systemic risk they present— “represents a significant technical challenge for the IAIS because of the heterogeneity of insurance firms and the variety and complexity of products sold by insurers across the world.” International standards must be compatible with the unique features of the U.S. insurance sector, the FIO says. They should promote effective financial stability and policyholder protection, and foster competition and consumer choice.⁴⁶

Both the Fed and the FIO are adamant that these standards and rules cannot be imposed on U.S. firms by an international body; rather, their adoption will be done through federal and state authorities only, following typical U.S. rulemaking procedures: a transparent process for proposal issuance, solicitation of public comments and rule finalization. The standards should not conflict with U.S. law, according to the Fed and the FIO, and they must accommodate U.S. insurance

markets and individual insurers. Before they are adopted, they must be tested for accuracy, value and impact.

NAIC and U.S. State Regulator Perspectives

Although the NAIC and state regulators favor greater international coordination, they have serious concerns about ComFrame and global capital standards, believing that:⁴⁷

- “One size fits all” global standards are not appropriate in the United States. The unique nature of insurance requires similarly unique models compatible with the insurance business, not other financial sectors. According to a past president of the NAIC, “taking a more homogenous regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry.”
- Countries differ—sometimes significantly—in how they measure and monitor capital. The differences will make it necessary to consider the usefulness of stress and scenario-based testing, local jurisdictional capital requirements, intra-group transactions and the fungible nature of capital. Another consideration: Inconsistent accounting rules among countries call for the use of different valuation/balance sheets.
- Global capital standards could supersede the U.S. state-based system of regulation for insurance groups—contravening Dodd-Frank—and undermine legal entity capital requirements. The problem: Allowing capital to flow freely from entity to entity within a group could jeopardize the financial strength of one entity. State regulators say flow of capital out of a company should be subject to regulator approval.
- ComFrame should follow an “outcomes based” approach rather than a rigid approach. In other words, instead of following an exact methodology, different assessments and different valuations should be acceptable as long as they result in similar outcomes of capital adequacy. To do otherwise, state regulators warn, could increase costs for U.S. insurers and their customers.
- To avoid duplication, new rules should supplement, not replace, current U.S. capital requirements for legal entities.
- The rules may have unintended consequences such as limiting insurance products or stagnating growth.

U.S. state regulators have also been frustrated by an IAIS decision in 2015 to limit participation in its work. As a result of closed door meetings, state regulators are unable to provide a U.S. perspective. They say this lack of transparency and accountability brings into question both the credibility and the legitimacy of the work.

Trade Association and Insurer Perspectives

U.S. trade associations, primary insurers and reinsurers have taken a strong stance against foreign-imposed global capital standards. Some claim the Financial Standards Board does not appreciate the critical variances between banks and insurers and hence should not be making significant decisions affecting insurance markets. Furthermore, they say the IAIS has neither demonstrated a need for global standards nor has it clearly defined any problems or performed any cost-benefit analyses. Their standards would only place unwarranted and exorbitant costs and other burdens, without notable regulatory benefit.

There is consensus, they say, that the current U.S. system is robust and already provides important safeguards that have long served the industry and markets well. Higher capital requirements that follow banking or Solvency II rules are not necessary, especially since the industry has shown its resilience to market disruptions and catastrophes. The policyholder surplus (or net worth) of the P/C insurance industry is at a record, as shown in Figure 5.

Fig. 5
P/C POLICYHOLDER SURPLUS, 2006-2015
(\$ Billions)



* Through second quarter.

Source: A.M. Best.

Other concerns include:

- A complex and prescriptive ComFrame is simply not practical. Large international insurers differ in exposures, geographic scope, product lines, distribution channels, customer base

and other areas. All those differences means the type of comparability that the IAIS is seeking would not be easily achieved.

- Some observers believe undercapitalization is not the cause insurance companies to fail. If that is the case, global capital standards are not necessarily a solution and the IAIS should make sure insurers price products more accurately and maintain adequate reserves.
- Any capital standard must follow a pragmatic approach, recognize local requirements and be set as a minimum solvency measure. Development of the standard should be done incrementally, benefiting from the best practices of regulators worldwide while keeping in place local capital requirements that work well.
- The IAIS should spend more time refining group supervision tools to enhance global cooperation. Not only would supervisors be in a better position to determine whether insurers have adequate capital, but they could also more accurately evaluate insurers' risk management and governance.
- Despite all of the work, questions remain. For example, who determines capital sufficiency? If this is the role of a group supervisor, what legal authority does a supervisor in one jurisdiction have to order an insurer to add capital in another? If a group needs additional capital, to which entity should it be added?
- Global convergence may result in unintended consequences. These would likely include:
 - “Altering the competitive balance” between purely domestic insurers and internationally active insurers.
 - “Changing a U.S. insurance regulatory approach that has historically worked.
 - “Creating pressure to supplant local rules with international standards.
 - “Increasing consolidation, reducing market discipline, and ultimately driving more homogeneity in insurer behaviors, to the detriment of diversity and financial resilience.”⁴⁸
- Higher financial standards may encourage some insurers to stop writing lines that require a lot of capital in favor of ones that require little. This could reduce product availability or increase prices.
- Foreign regulations could create two classes of insurers: internationally active groups and everyone else. They would differ in how much capital they needed. The situation invites questions:
 - If one class of insurers is perceived as receiving unfair treatment relative to the other, how would this impact the market?

- Would the standards create advantages or disadvantages in specific insurance markets?

The latest proposals for higher loss absorption requirements—the extra capital that systemically important insurers must hold—present the typical concerns. The additional capital would be a percentage of the basic capital requirement, which is the stopgap measurement systemically important insurers would comply with while they await a formal international standard.

Eight of the nine systemically important insurers—AIG was the exception—question why companies are targeted, suggesting it makes more sense to restrict risky activities themselves.

The basic capital requirement uses volatile inputs, they note. The International Actuarial Association expressed concern over using market valuations, which gyrate with the financial markets. Systemically important U.S. insurers worry about the use of long-term discount rates, which also can change abruptly. Making the higher loss requirement a percentage of the basic requirement doubles down on the volatility.

Meanwhile, it is starting to appear that the eventual standard—the international capital standard—will be higher than the basic capital requirement in place now. The IAIS has proposed a sort of on-ramp to move from one standard to the other: a 33 percent increase in the basic requirement—11 percent annually for three years.

All of these measures would become more complex if the IAIS falls behind in creating the eventual capital standard.

The current proposals, though, do not seem overwhelming. The IAIS concluded the nine systemically risky insurers in 2013 and 2014 had 2.6 times as much capital as they would need.

But the process creates a lot of uncertainty for insurers. “There is a lack of clarity and certainty for executives, who need to know what the capital charges are going to be and how capital management will be affected,” said Thomas Leonardi, a former Connecticut insurance commissioner who is a senior advisor at Evercore Partners, an independent investment bank.⁴⁹

Development of Regulatory Standards in the U.S.

As an alternative to IAIS-crafted regulations, the Fed, FIO, NAIC and insurance regulators have been developing a U.S. capital model for large, internationally active insurers.⁵⁰

U.S. model builders are accounting for the unique needs of the U.S. insurance sector. The model will be designed to promote competition and consumer choice and safeguard policyholder protection and financial stability. No common approach has been determined. Supporters of the set of U.S. regulators believe that ample time should be allowed to develop and implement the approach under the Fed rulemaking process and study its impact before considering any IAIS model.

THE IMPACT OF HIGHER GLOBAL CAPITAL STANDARDS ON U.S. P/C MARKETS

Although higher insurance capital standards are intended to promote financial stability, the CEA, a group of European insurance associations, analyzed Solvency II⁵¹ and concluded:

Reliance on capital requirements alone is insufficient. Indeed, analysis of the history of insurance company insolvencies has shown that the vast majority of insolvencies were preceded by either internal management or governance shortcomings or some external trigger events.

Furthermore, “overly prudent capital requirements do not help insurers and regulators in further reducing the risk of financial distress...” and “placing excessive capital requirements on the insurance industry would have widespread detrimental effects...”

According to the CEA, there is a price to pay for overly prudent capital requirements. Their analysis parallels the critique of the U.S. regulatory community. Specifically:

- “...potentially excessive capital charges may trigger a wave of reactions that would probably include an increase in the price of more capital-intensive products, the reduction of policyholder coverage and ... possibly even the reduction of underwriting capacity in the most affected lines (e.g., natural catastrophe covers).”
- “...substantially higher capital charges may reduce investor returns, which may trigger a reduction in new capital investments..., reducing in turn the underwriting capacity of the industry, and increasing funding costs.”
- “Small and medium-sized players, which are more affected by higher capital charges in the absence of sufficient scale and diversification effects, might be forced to consolidate with larger groups or exit the business.”
- “Policyholders, both private households and commercial buyers, would suffer the most from overly prudent capital requirements.”

Impact on Internationally Active P/C Groups in the U.S.

Sonecon, LLC,⁵² recently examined the impact of higher global capital standards on the premiums, investment growth and income of large, internationally active insurance groups operating in the United States. Its analysis of seven IAIGs⁵³ was based on the premise that an increase in capital standards that causes a drop in the insurance industry’s return on equity typically requires an increase in premium in order to maintain a similar return.

Using assumptions of 15 and 30 percentage point increases in capital requirements, with all other factors being equal, Sonecon determined the impact of higher standards on large insurers' personal lines premiums and investments, shown in Figure 6.

Fig. 6
IMPACT OF RAISING CAPITAL REQUIREMENTS ON INTERNATIONALLY ACTIVE GROUPS

	15 percentage point increase	30 percentage point increase
Avg. auto/homeowners premium, 2014-2018	\$34 per year (auto) \$45-\$55 per year (HO)	\$68 per year (auto) \$90-\$109 per year (HO)
New premium growth, 2014-2018	\$2.9 billion reduction per year	\$7.3 billion reduction per year
Growth in investment, 2014-2018	Total \$726 million reduction	Total \$1.8 billion reduction
Investment shift from risky assets to safer investments, 2014-2018	Total of \$9.4 billion	Total of \$9.4 billion
Investment income, 2014-2018	Total \$28.9-\$54.5 million reduction	Total \$28.9-\$54.5 million reduction

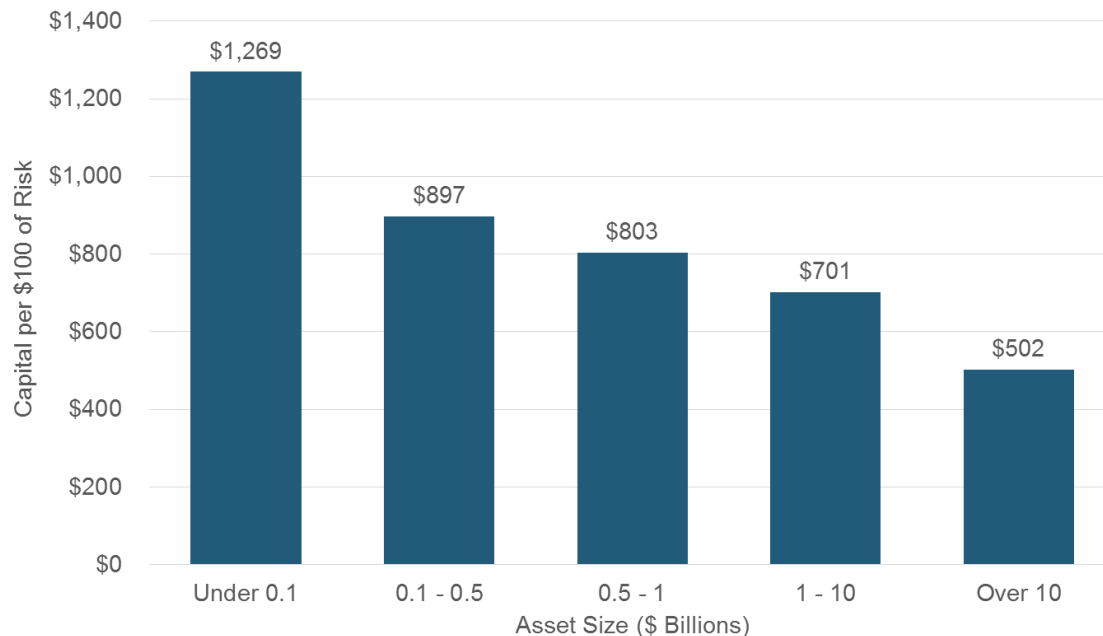
Impact on Other Insurers

The possibility of imposing global capital standards on other insurers—even those that pose no systemic risk and do not operate internationally—cannot be overlooked. One way to consider this possibility is by looking at risk-based capital ratios (RBC) for insurers of various sizes. These RBC ratios indicate the adequacy of capital, given an insurer's size and the degree of risk assumed. The ratio itself is actual capital ("total adjusted capital") divided by the required or risk-based capital. For example a company with a 200 percent RBC ratio has capital equal to twice its risk-based capital, the latter being the minimum needed to take on all the risks the insurer takes. Put another way, an RBC ratio of 200 percent means that the company holds \$200 of capital for every \$100 of risk taken. As shown in the Sonecon report, RBC ratios vary considerably among insurers, based on their asset size.⁵⁴

Based on Sonecon's 2012 median RBC ratios,⁵⁵ the I.I.I. estimates that P/C insurers with smaller assets (less than \$500 million) hold about 1.8 to 2.5 times more capital per unit of risk (\$897 to \$1,269 compared to \$502) than insurers with larger assets, as shown in Figure 7 on the next page. It should not be surprising that smaller insurers have higher RBC ratios; they may choose to operate with higher capital margins (i.e., the excess of actual capital over required capital) since

they tend to be less diversified and may have greater vulnerability to various shocks due to their size.

Fig. 7
CAPITAL HELD BY P/C INSURERS VARIES BY ASSET SIZE



Sources: Insurance Information Institute, based on data from Sonecon and SNL Financial LC.

Since smaller insurers have higher levels of capitalization, a mandate to hold even more could have far-reaching effects. It could mean an increase in mergers and acquisitions, as mentioned earlier by the European trade consortium CEA in its analysis. It could also result in higher costs because smaller firms would have to buy more reinsurance. Another possibility is a withdrawal from the market, which could reduce competition among insurers and leave consumers with fewer choices of products, perhaps at higher prices.

Not only does the impact of higher prudential capital standards differ based on the size of the insurer, but it also differs based on the structure of the insurer and the lines of business it writes. Mutual insurers could face a competitive disadvantage, attributable to their structure, in which the policyholder is also considered an owner. The policyholder-as-owner relationship implies that these insurers are unlikely to substantially increase their rates quickly to raise external capital. Yet their structure also limits their access to public financial markets; and they have higher RBC ratios than stock insurers that have easier access to these markets.

To raise cash they might consider demutualizing (i.e., converting to a stock company). Or they might consider changing their operating model and merge with other insurers to create an expanded corporation that is more financially sound.^{56, 57}

One study⁵⁸ that examined long-tail versus short-tail lines of insurance concluded that the former tends to generate less income from underwriting than the latter. Hence, long-tailed insurers are at a disadvantage in terms of raising internal capital.

CONCLUSION

Since the latest financial crisis, the global solvency regulatory landscape has been in a state of flux. The IAIS is committed to developing a common methodology and a global capital standard that would provide a level playing field across regulatory regimes. If international rules are imported to the United States, the nation's regulatory system may undergo a major transformation. In the meantime, the set of U.S. regulators is working toward a U.S. approach to more effective and efficient capital regulation, while advocating for a system under which insurance regulators and supervisors can mutually recognize their work without rewriting it. In light of these activities, it is crucial that all insurers follow this issue closely, understand the potential implications and provide critical input to ensure the protection of U.S. state-based insurance regulation and markets.

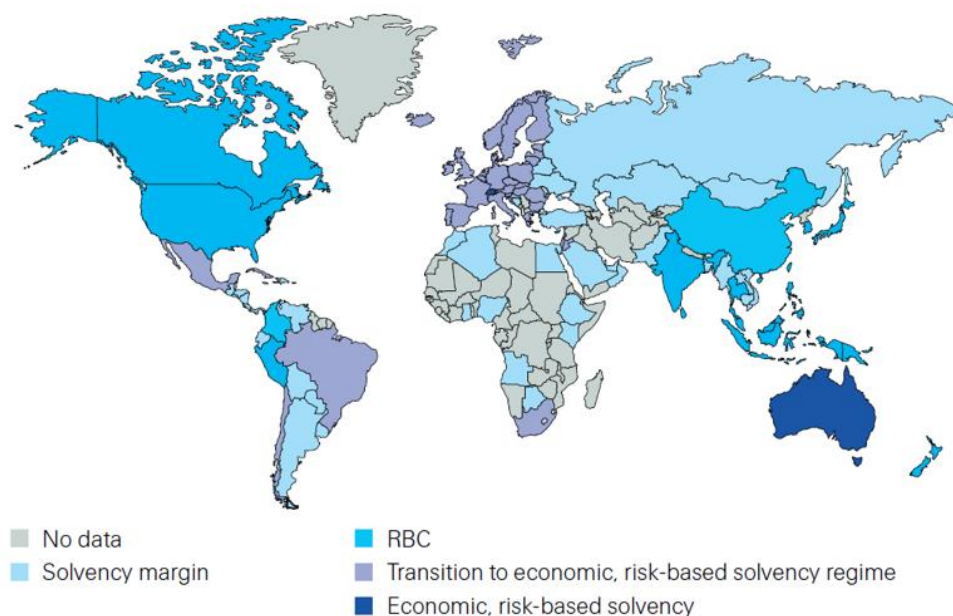
APPENDIX I

INSURANCE REGULATORY REFORM ACTIVITIES IN CHINA AND OTHER COUNTRIES

The 2007-2009 economic crisis has had a long-lasting and profound impact on financial services sectors around the world. To strengthen financial stability, enhance prudential regulation and build global alliances, insurance markets in both developing and well-established nations have been taking steps to bolster their solvency regulatory systems. Some of these efforts stem from assessments made by the IMF/World Bank regarding countries' compliance with the IAIS Insurance Core Principles.

Besides the U.S. and Europe, China has developed a comprehensive solvency regime, which is described below. Many other countries have been modifying their systems as well; a brief discussion of several nations' reform activities follows.

Fig. 8
SOLVENCY REGIMES AROUND THE WORLD



Source: Swiss Re Economic Research and Consulting.

China⁵⁹

China's insurance industry is now the third largest (2014). Since March 2012, the China Insurance Regulatory Commission (CIRC), has been redeveloping its nation's capital regime; China's Risk Oriented Solvency System (C-ROSS) has regulatory authority over insurance holding groups, non-

insurance holding companies, and conglomerate groups.⁶⁰ Based on the principle of “giving the market a decision role in resource allocation,” the objective of C-ROSS is to allow free market forces to operate in order to stimulate innovation and effectively identify, analyze and measure the risk profile of insurers more accurately and promptly.

The C-ROSS framework is made up of three pillars:

- (1) Quantitative requirements for insurers to hold adequate capital; regulatory tools include available capital evaluation criteria, minimum capital requirements, capital classification, stress testing and supervisory measures.
- (2) Qualitative requirements for risks in emerging or immature markets that cannot be quantified easily due to incomplete data. Some regulatory tools include solvency risk management requirements and assessment, liquidity risk supervision and supervisory inspection and analysis.
- (3) A market discipline mechanism for risks other than those under Pillars 1 and 2. Regulatory tools include requirements governing insurers’ public information disclosure on solvency, a sustainable means of communication between regulators and market stakeholders and insurer ratings issued by credit rating agencies.

The three-pillar structure allows C-ROSS to be comparable with other solvency mechanisms in the world. By becoming more closely connected with other international markets, China will be able to attract more foreign capital and have a larger global presence. At present, C-ROSS is in a transitional implementation stage that began in early 2015; full implementation will be determined after an evaluation by the CIRC.

Latin America⁶¹

Three Latin American nations (Brazil, Chile and Mexico) have made considerable progress in developing new risk-based solvency capital regimes:

- Restrictive measures that tend to discourage modernization in Brazil have prompted the Superintendence of Private Insurance (SUSEP) to implement rules and directives, including the regulation of different types of risks (e.g., credit, operational and market), in piecemeal fashion. A hybrid risk-based capital (RBC) model is now in place, and an ORSA (Own Risk and Solvency Assessment) framework is planned for operation in 2015.
- Under the aegis of the Superintendence of Securities and Insurance (SVS), Chile is revising its corporate governance and ERM regulations and refining its calculation of RBC using a value-at-risk (VaR) methodology. Insurers will be required to undergo a self-assessment of their risk management and capital sufficiency. Chile’s regulatory system is akin to Solvency II and is expected to go into effect in 2016.

- Mexico's new economic regime that is overseen by the Insurance and Surety National Commission (CNSF) borrows from Solvency II, U.S. regulations and the Swiss Solvency Test. Implementation is expected in 2015. Like Chile, it uses a VaR approach to determine risk capital requirements. Given the country's high potential for natural catastrophes, the capital requirements will take into consideration earthquake and hurricane exposures. Solvency testing requires that insurers' capital positions be tested against periodically updated stress scenarios.

South Korea⁶²

The South Korean insurance industry is eighth largest in total premium volume. After its EU Solvency-type regime was found to be weak in assessing the total risk of insurers, the country's two financial supervisory authorities (the Financial Services Commission and Financial Supervisory Service) put into place a risk-based capital approach similar to that of the United States, Canada and Australia in April 2011.

To further strengthen the country's financial regulations, an "RBC road map" was announced by the supervisory authorities in July 2014. This map will follow the principles underlying both the EU Solvency II and the NAIC Solvency Modernization Initiative. It is said to be a collection of policy changes related to the measurement and management of risk and the assessment of insurance liability in a more refined way to reflect the "fair" value. These changes will be implemented in various stages over five years.

APPENDIX II

EU-U.S. MUTUAL REGULATORY UNDERSTANDING DIALOGUE PROJECT SUMMARY OF “THE WAY FORWARD” REPORT (JULY 2014 UPDATE)

The table below summarizes the main objectives for each of the seven key areas addressed in the EU-U.S. Way Forward Update.⁶³ These areas are considered essential for sound regulation and effective financial stability and consumer protection. Also included are some of the steps needed to achieve these objectives.

Key Areas	Objective	Action Steps
1 - Professional secrecy and confidentiality	Promote the free flow of information between EU and U.S. supervisors under conditions of professional secrecy by removing barriers to information exchange	Have constituents join IAIS Multi-lateral Memorandum of Understanding; assess effectiveness of EU-U.S. MOUs on information exchange
2 - Group supervision	Have a robust regime of effective group supervision, holistic approach to determine group solvency/financial condition, greater cooperation and coordination among regulators, and efficient enforcement measures for effective supervision	U.S. to report on total system of supervision; EU-U.S. to share best practices among supervisors, harmonize ORSA reports, and promote effective college procedures and greater comparability of solvency among groups
3 - Solvency and capital requirements	Develop an approach to valuation which accurately reflects insurers' risk profile, is sensitive to changes in risk profile and which has capital requirements that are fully risk-based, transparent and consistent	EU-U.S. to share views on developing capital standards; establish transparent calibration with a time horizon; have a consistent approach to solvency; study standards vis-à-vis other financial tools
4 - Reinsurance and collateral requirements	Have a consistent approach within each jurisdiction; study the reduction and possible removal of collateral requirements to ensure a risk-based determination of all reinsurers relative to reinsurance credit	U.S. to study NAIC Model laws on reinsurance credit passed in different states and work with EU toward a covered agreement based on Model

– continued on following page –

Key Areas	Objective	Action Steps
5 - Supervisory reporting, data collection and analysis	Have greater coordination in monitoring insurers' solvency and financial condition through analysis of supervisory reporting; facilitate exchange of information via exchange of best practices and greater consistency of reporting	EU-U.S. to learn from each other's experiences: EU group reporting and NAIC centralized database/analysis; both to explore greater consistency in group reporting, possible data exchange and platforms for data sharing
6 - Peer reviews	Ensure a consistent application of prudential requirements and commitment to supervisory best practices through different peer review processes, so independent view of jurisdiction is examined	EU to implement process to oversee supervisory-related tasks carried out; U.S. to consider including supervision of colleges in the accreditation program; both to coordinate best practices to promote consistency of group supervision across jurisdictions
7 - Independent third party review & supervisory on-site examinations	Ensure consistency and effectiveness in the supervision of solo entities and groups	EU to learn from U.S. experience in supervisory tools and consider need for more consistent standards re: actuarial credentials; both to promote enhanced cooperation and have ongoing dialogue re: consistent requirements for on-site monitoring and examinations

LIST OF KEY ACRONYMS

BCR:	Basic (or Backstop) Capital Requirement
EIOPA:	European Insurance and Occupational Pensions Authority
ERM:	Enterprise Risk Management
EU:	European Union
FAST:	Financial Analysis Solvency Tools
FIO:	Federal Insurance Office
FRB:	Federal Reserve Board
FSAP:	Financial Sector Assessment Program
FSB:	Financial Stability Board
FSOC:	Financial Stability Oversight Council
G-SII:	Global Systemically Important Insurer
HLA:	Higher Loss Absorption (or Absorbency)
IAIG:	Internationally Active Insurance Group
IAIS:	International Association of Insurance Supervisors
ICP:	Insurance Core Principle
ICS:	Insurance Capital Standard
II:	Insurance Information Institute
IMF:	International Monetary Fund
IRIS:	Insurance Regulatory Information System
NAIC:	National Association of Insurance Commissioners
ORSA:	Own Risk and Solvency Assessment
RBC:	Risk-Based Capital
SIFI:	Systemically Important Financial Institution

ENDNOTES

¹ National Association of Insurance Commissioners, “The United States Insurance Financial Solvency Framework,” 2010, 6, http://www.naic.org/documents/committees_e_us_solvency_framework.pdf. The NAIC is a standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories.

² This paper focuses on the regulation of property/casualty (P/C) insurance rather than life or health.

³ In general, an insurance group is comprised of two or more insurers, but there could be other legal entities involved as well, such as holding companies, subsidiaries or affiliates (e.g., agencies, service providers or third party administrators) whose business is tangential to that of the member insurers, as well as other entities whose business is unrelated to the insurance operations of the group.

⁴ National Conference of Insurance Guaranty Funds, “Frequently Asked Questions about Guaranty Funds,” <http://ncigf.org/media-faqs>. With the exception of New York (which uses a pre-insolvency system), the states’ P/C guaranty funds assess after an insolvency occurs. A separate set of state guaranty associations and laws provides protection for life and health insurance claims.

⁵ In 1869, the Supreme Court held in the case of *Paul v. Virginia* (75 U.S. 168) that “issuing a policy of insurance is not a transaction of commerce;” hence, states were responsible for the taxation and regulation of insurance. This ruling was subsequently overturned on June 5, 1944, by the Supreme Court that decided the insurance industry was subject to regulation by the U.S. Congress (*United States v. Southeastern Underwriters*, 322 U.S. 533). The following year, state regulation was once again declared exempt from most federal regulation and anti-trust laws by the McCarran–Ferguson Act, 15 U.S.C. §§ 1011-1015, Public Law 15, 79th Congress, approved March 9, 1945.

⁶ U.S. Congress, House Comm. On Energy and Commerce, *Failed Promises: Insurance Company Insolvencies*, February 7, 1990, 101st Cong., 2nd sess., 1990, H.R. Rep. 26-370.

⁷ NAIC, “Financial Regulation Standards and Accreditation Program,” April 2015, 1 and 11, http://www.naic.org/documents/committees_f_FRSA_pamphlet.pdf.

⁸ All states, including the District of Columbia and Puerto Rico, are now accredited.

⁹ GAO, “Insurance Regulation: The Financial Regulation Standards and Accreditation Program of the National Association of Insurance Commissioners,” April 9, 1992, Summary of Statement, <http://www.gao.gov/assets/110/104465.pdf>. In later research, the GAO found that “the program has demonstrated its value by defining a common set of basic regulatory requirements for solvency regulation...” GAO, “Insurance Regulation: The NAIC Accreditation Program Can Be Improved,” Aug. 2001, 1, <http://www.gao.gov/assets/240/232633.pdf>.

¹⁰ The NAIC RBC standards focus on three major areas – asset risk, underwriting risk and other types of risk. A company can trigger four possible levels of action: (1) company action; (2) regulatory action; (3) authorized control; and (4) mandatory control. NAIC, “Risk Based Capital,” last updated 2/27/15, http://www.naic.org/cipr_topics/topic_risk_based_capital.htm.

¹¹ Congressional Research Service Issue Brief for Congress, “Insurance Regulation: Background and Issues,” updated May 14, 2003, CRS-3, http://assets.opencrs.com/rpts/IB10106_20030514.pdf.

¹² The NAIC’s Risk Management and Own Risk and Solvency Assessment Model Act was adopted in September 2012. ORSA applies to any individual U.S. insurer that writes more than \$500 million of annual direct written and assumed premium, and/or insurance groups that collectively write more than \$1 billion

of annual direct written and assumed premium. NAIC, “Own Risk and Solvency Assessment (ORSA),” *Last Updated: 2/27/15*, http://www.naic.org/cipr_topics/topic_own_risk_solvency_assessment.htm.

¹³ The IAIS defines a supervisory college as “a forum for cooperation and communication between the involved supervisors established for the fundamental purpose of facilitating the effectiveness of supervision of entities which belong to an insurance group; facilitating both the supervision of the group as a whole on a group-wide basis and improving the legal entity supervision of the entities within the insurance group.”

NAIC, “Supervisory Colleges,” *Last updated 2/27/15*, http://www.naic.org/cipr_topics/topic_supervisory_college.htm.

¹⁴ EIOPA is an independent advisory body to the European Parliament, the Council of the EU and the European Commission. Its core responsibilities are to support the stability of the financial system, transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries.

¹⁵ Basel III is the latest set of banking regulations and is expected to be fully implemented by 2019.

¹⁶ The IAIS includes insurance regulators from more than 200 jurisdictions in nearly 140 countries, making up 97 percent of the world’s insurance premiums. The NAIC is one of its founding members, while the Federal Reserve Board and Federal Insurance Office (representing Treasury) joined two to three years ago.

¹⁷ EIOPA recently granted Switzerland “full equivalence” in all three areas (solvency calculation, group supervision and reinsurance) for an indefinite period of time. “Provisional equivalence” in solvency calculation only was granted to Australia, Bermuda, Brazil, Canada, Mexico and the U.S. for a period of 10 years. Provisional equivalence is granted to third countries that do not meet all three criteria but their solvency regime is expected to become equivalent within a foreseeable future. European Commission Press Release, “Insurance: European Commission adopts a first package of third country equivalence decisions under Solvency II,” June 5, 2015, http://europa.eu/rapid/press-release_IP-15-5126_en.htm.

¹⁸ EIOPA, “Solvency II,” <https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii>.

¹⁹ GAO, “Insurance Markets: Impacts of and Regulatory Response to the 2007-2009 Financial Crisis,” June 2013, What GAO Found, 17 and 74, <http://www.gao.gov/assets/660/655612.pdf>. Receiverships comprise conservatorships, rehabilitations, and liquidations. An order of liquidation typically accompanies a declaration of insolvency.

²⁰ Federal Deposit Insurance Corporation, “Statistics at a Glance,” <https://www.fdic.gov/bank/statistical/stats/2009dec/fdic.html>.

²¹ Pub. L. 111–203, H.R. 4173, <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf>.

²² Companies designated as SIFI may petition the federal courts for an order “requiring that the final determination be rescinded” [Dodd-Frank, § 313(h), “Judicial Review”]. In 2013, the FSOC identified three U.S. entities [Prudential Financial, Inc., the American International Group, Inc. and GE Capital (a unit of General Electric Co.)]. In December 2014, MetLife Group was also named a SIFI. The insurer sued in early 2015, arguing that FSOC’s designation was arbitrary and capricious. On May 11, 2015, FSOC filed a redacted motion to dismiss. *The Insurance & Reinsurance Report*, “FSOC Replies to MetLife Lawsuit Challenging Nonbank SIFI Status,” June 2, 2015, <http://www.insurerereport.com/2015/06/02/fsoc-replies-to-metlife-lawsuit-challenging-nonbank-sifi-status/>.

Independent of the lawsuit, the FSOC has changed its process in response to criticisms that the designation process lacks communication, accountability, transparency and analytical rigor (bank metrics and tools should not be applied to insurers), and there is no clear path to exit the designation.

²³ According to Mark E. Van Der Weide, Deputy Director of the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System, the insurance holding companies overseen by the Fed represent approximately one-third of U.S. insurance industry assets.

²⁴ NAIC, “A Comparison of Solvency Systems: US and EU,” May 22, 2008, and accompanying letters, Attachment Two-B, Financial Condition (E) Committee, Dec. 8, 2008, http://www.naic.org/documents/committees_ex_isftf_isawg_att-2b_08_draft_us_eu_comparison.pdf.

²⁵ State regulators also enforce rating laws and conduct rigorous market conduct examinations.

²⁶ Guaranty funds also operate in Puerto Rico (all lines) and the U.S. Virgin Islands (P/C lines only). In its annual report, the National Conference of Insurance Guaranty Funds (NCIGF) states: “the existing insurance guaranty system is able to enjoy the operational efficiencies of a national system, while effectively responding to the often-local concerns of insurance consumers experiencing financial and other stresses associated with the failure of their insurance company.” Today, the overall assessment capacity of the P/C guaranty fund system is about \$7.3 billion, renewable every year. NCIGF, “Protecting Policyholders: An Overview of the Property and Casualty Insurance Guaranty Fund System,” 2014, 8 and 11, ncigf.org/media/files/2015_GF_brochure.pdf.

²⁷ A one-year 99.5 percent value-at-risk confidence level means that capital should not be expected to fully decline over 99.5 years out of 100.

²⁸ European Commission Fact Sheet, “Solvency II Overview – Frequently Asked Questions,” January 12, 2015, http://europa.eu/rapid/press-release_MEMO-15-3120_en.htm

²⁹ Several European insurers that became insolvent or were in liquidation are Euroasig (Romania, 2008), Eurolife Assurance International Limited (Gibraltar, 2007), Independent Insurance Company Limited (Ireland, 2001), and Lemma Europe Insurance Company Limited (Gibraltar, 2013).

³⁰ European Commission, “WHITE PAPER on Insurance Guarantee Schemes,” Brussels, COM(2010) 370, 2, http://ec.europa.eu/finance/insurance/consumer/guarantee_schemes/index_en.htm#maincontentSec1.

³¹ Despite being granted a “provisional equivalence” designation, the United States did not expressly seek any type of determination by EIOPA.

³² “EU-U.S. Dialogue Project Technical Committee Reports, Comparing Certain Aspects of the Insurance Supervisory and Regulatory Regimes in the European Union and the United States,” issued Dec. 2012, https://eiopa.europa.eu/Publications/Reports/EU_US_Dilaogue_Project_Factual_Report.pdf#search=filena me%3AEU%5FUS%5FDilaogue%5FProject%5FFactual%5FReport%2Epdf.

³³ “EU-U.S. Dialogue Project: The Way Forward: Objectives and Initiatives for the Future,” Dec. 2012, 3, https://eiopa.europa.eu/Publications/Protocols/EU_US_Dialogue_Project_The_Way_Forward_December_2012.pdf, and EU-U.S. Insurance Project, “The Way Forward, July 2014 Update,” https://eiopa.europa.eu/Publications/Events/Updated_Way_Forward_document.pdf.

³⁴ IAIS, “Insurance Core Principles, Standards, Guidance and Assessment Methodology, 1 Oct. 2011, ICP 9 amended 12 Oct. 2012, ICP 22 amended 19 Oct. 2013,” http://www.tsb.org.tr/images/Documents/Insurance_Core_Principles__Standards__Guidance_and_Assessment_Methodolog%20EN.pdf, and NAIC “Insurance Core Principles,” *last updated* 2/27/15, http://www.naic.org/cipr_topics/topic_insurance_core_principles.htm.

³⁵ NAIC, *Center for Insurance Policy & Research Newsletter*, “Navigating the Regulatory Alphabet Soup,” http://www.naic.org/cipr_newsletter_archive/vol12_regulatory_alphabet_soup.pdf.

³⁶ International Monetary Fund, IMF Country Report No. 15/90, “United States, Financial Sector Assessment Program, Detailed Assessment of Observation on Insurance Core Principles,” April 2015, 5-6,

<https://www.imf.org/external/pubs/ft/scr/2015/cr1590.pdf>. The FSAP is conducted every five years to analyze the strength and scope of an insurance regulatory system under the standards of the ICPs.

³⁷ Yoshihiro Kawai, “Development of International Insurance Supervisory Standards,” Presentation, November 19, 2013, http://www.assalweb.org/assal_nueva/documentos/upload/01_Kawai.ppt.

³⁸ The IAIS states it will not drive the process of identifying IAIGs although it may ultimately compile a list. Supervisory colleges will be the ones that identify IAIGs. IAIS, “Frequently Asked Questions for The IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame),” Updated June 25, 2015, 4, <http://www.iaisweb.org/index.cfm?event=openFile&nodeId=52819>.

³⁹ NAIC, “Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame),” last updated 2/12/2015, http://www.naic.org/cipr_topics/topic_comframe.htm.

⁴⁰ In 2014, nine insurers worldwide were designated as G-SIIs. Three (AIG, MetLife and Prudential Financial) are domiciled in the U.S.; the remaining six are Allianz SE, AXA SA, Aviva PLC, Assicurazioni Generali SpA, Ping An Insurance (Group) Co. of China, Ltd., and Prudential PLC (Allianz and AXA also operate in the U.S.). The list of G-SIIs is updated by the FSB each November.

⁴¹ IAIS, “Capital Requirements for Global Systemically Important Insurers (G-SIIs): Basic Capital Requirements (BCR) and Higher Loss Absorbency (HLA),” October 5, 2015, <http://iaisweb.org/index.cfm?event=openFile&nodeId=57111>.

⁴² IAIS, “Higher Loss Absorbency Capacity for Global Systemically Important Insurers (G-SIIs),” June 25, 2015, <http://www.fsa.go.jp/inter/iai/20150626-1/02.pdf>.

⁴³ The White House, “FACT SHEET: The 2015 G-20 Summit in Antalya, Turkey,” November 16, 2015, <https://www.whitehouse.gov/the-press-office/2015/11/16/fact-sheet-2015-g-20-summit-antalya-turkey>.

⁴⁴ IAIS, “Frequently Asked Questions for The IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame),” Updated June 25, 2015, 6, <http://www.iaisweb.org/index.cfm?event=openFile&nodeId=52819>.

⁴⁵ Testimony of Federal Reserve System Board of Governors Deputy Director of the Division of Banking Supervision and Regulation, Mark E. Van Der Weide, before the Senate Committee on Banking, Housing, and Urban Affairs, April 28, 2015, <http://www.federalreserve.gov/newsevents/testimony/vanderweide20150428a.htm>.

⁴⁶ Testimony of FIO Director Michael McRaith before the House Financial Services Subcommittee on Housing and Insurance, Nov. 18, 2014, <http://www.treasury.gov/press-center/press-releases/Pages/jl9703.aspx>.

⁴⁷ Testimony of Kevin McCarty, Commissioner, Florida Office of Insurance Regulation, on behalf of the NAIC before the Subcommittee on Housing and Insurance, U.S. House Committee on Financial Services, April 29, 2015, http://www.naic.org/documents/government_relations_150429_mccarty_house_testimony.pdf, and NAIC documents on U.S. regulators’ views on ComFrame (April 2015) and international capital proposals (April 2015), and comments on IAIS ICS Public Consultation Document (February 13, 2015), respectively, http://www.naic.org/documents/committees_g_comframe_position_statements.pdf?123, http://www.naic.org/documents/committees_g_capital_position_statements.pdf, and http://www.naic.org/documents/committees_g_related_naic_comments_iais_ics_draft.pdf.

⁴⁸ Therese M. Vaughan, Drake University, and Calabria, Mark A., Cato Institute, “International Developments in the Insurance Sector: The Road to Instability?” April 27, 2015, 3, <http://www.pciaa.net/docs/default-source/default-document-library/final-vaughan-calabria-international-insurance-developments-white-paper-amp-exec-summary----april-27.pdf?sfvrsn=2>.

⁴⁹ Philip Alexander, “Regulators forge ahead with higher loss absorbancy,” Global Risk Regulator, November 2015.

⁵⁰ A U.S. standard under the aegis of the Federal Reserve Board is consistent with the Insurance Capital Standards Clarification Act of 2014 and the underlying objectives of the Dodd-Frank Act.

⁵¹ CEA, “Why excessive capital requirements harm consumers, insurers and the economy,” March 2010, http://www.insuranceeurope.eu/uploads/Modules/Publications/1268293182_cea-capital-requirements-report.pdf. CEA (Comité Européen des Assurances) is the European insurance and reinsurance federation of more than 30 national insurance associations, representing about 94 percent of total European premium income.

⁵² Sonecon, LLC was founded as an economic advisory firm in 2001 by Robert Shapiro, a former senior government official and economic advisor with deep experience in Washington and around the world. Its report, “Unnecessary Injury: The Economic Costs of Imposing New Global Capital Requirements on Large U.S. Property and Casualty Insurers,” November 2014, was supported by two P/C trade associations: National Association of Mutual Insurance Companies and Property Casualty Insurers Association of America. http://www.sonecon.com/docs/studies/Report_on_Capital_Standards_for_PC_Insurers-Shapiro-Mathur-Sonecon-Final-November-15-2014.pdf.

⁵³ The seven U.S. IAIGs analyzed by Sonecon are Liberty Mutual Group, American International Group, Travelers’ Companies, Berkshire Hathaway, Chubb Group, ACE Group and CNA Insurance Services, representing 26.6 percent of the current U.S. P/C market.

⁵⁴ Society of Actuaries Risk Management Task Force, “Risk Based Capital,” 1, http://rmtf.soa.org/riskbased_capital.pdf, and CRE Finance Council Annual Conference Powerpoint, “Risk Based Capital,” June 11-13, 2012, http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Events/Major_Conferences/CMSA-Annual_Convention/2012/Wheres_the_MEAF.pdf.

⁵⁵ Sonecon’s RBC ratios are grouped further by the III, weighted by P/C company assets.

⁵⁶ Leo de Haan and Kakes, Jan, “Solvency of Stock Versus Mutual Insurers: Evidence from Dutch Panel Data,” Feb. 2007, <http://www.actuaries.org/AFIR/Colloquia/Stockholm/deHaan.pdf>. Note: even though the study examined Dutch insurers, it is believed that the findings apply to U.S. insurers as well.

⁵⁷ NAIC, “Capital Markets Special Report,” April 28, 2015, http://www.naic.org/capital_markets_archive/150428.htm.

⁵⁸ Leo de Haan and Kakes, Jan, “Solvency of Stock Versus Mutual Insurers: Evidence from Dutch Panel Data,” Feb. 2007, 7, <http://www.actuaries.org/AFIR/Colloquia/Stockholm/deHaan.pdf>.

⁵⁹ The Geneva Association Newsletter, Regulation and Supervision, Jungbo Xiang, Chairman, China Insurance Regulatory Commission, “C-ROSS, A Major Reform of China’s Insurance Regulatory System,” No. 59, June 2015, <https://www.genevaassociation.org/media/920437/ga2015-progres59-xiang.pdf>.

⁶⁰ Conglomerate groups are groups of multiple insurance companies (jointly) controlled by a single, de facto controller or people acting in concert with no explicit controller.

⁶¹ Swiss Re, “Insurance solvency regulation in Latin America: modernizing at varying speeds,” January 2015, http://media.swissre.com/documents/Insurance_solvency_regulation_in_Latin_America.pdf.

⁶² The Geneva Association Newsletter, Regulation and Supervision, Soonjeung Lee and Kim, Hae Sik, Korea Insurance Research Institute, “Recent Regulatory Changes in the Korean Insurance Industry,” No. 59, June 2015, <https://www.genevaassociation.org/media/920431/ga2015-progres59-leekim.pdf>.

⁶³ EU-U.S. Insurance Project, “The Way Forward, July 2014 Update,” https://eiopa.europa.eu/Publications/Events/Updated_Way_Forward_document.pdf.