

# Toward a Global Solvency Standard V

By Mike Lombardi, Naren Persad and Andrew F. Giffin

Solvency II, IAIS standards and other regulatory developments, along with parallel developments of international accounting standards and performance measures, are moving insurers and reinsurers steadily toward a common global solvency standard.

Whether moving to a single standard, or a range of comparable standards, solvency requirements are rapidly converging around some central themes — principle- and risk-based, market-consistent economic valuations of the entire balance sheet, reflective of individual insurer and reinsurer risk portfolios, and harmonized with international accounting and actuarial standards.

Solvency II has become the primary benchmark against which other reforms are measured, and was recently referred to as the “de facto global standard” by Matthew Elderfield of the Bermuda Monetary Authority at the Annual Conference of the International Association of Insurance Supervisors (IAIS) in October 2009.

Although the recent economic crisis has raised questions about how market-consistent measures can sensibly be applied when markets do not function as expected, the basics of the evolving solvency standards seem to be holding. Insurers and reinsurers worldwide need to evaluate how they will be measured under the new principles and emerging requirements in the jurisdictions in which they operate. More important, they need to anticipate the competitive opportunities that these changes will foster.

## Solvency II

On November 10, 2009, the Council of the European Union adopted the Solvency II Directive, following prior approval by the European Parliament. This will introduce economic risk-based solvency requirements across all EU member states for the first time. These requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better allowance for the real risks run by any particular insurer.

Solvency II is based on the core characteristics noted above and targets capital at a 99.5% confidence level over a one-year time frame, taking into consideration both diversification and risk mitigation effects.

The Solvency II Directive sets out the high-level principles and includes a standard formula for calculating regulatory capital (Solvency Capital Requirement or SCR) and the provision to use, in specific circumstances, partial or full internal models for calculating the SCR.

Currently, much of the work is focused on developing the details of the new framework, and this has involved the publication of over 50 consultation papers for industry feedback. This will culminate in August 2010 in a test of the impact of the new regime, with the fifth and possibly final Quantitative Impact Study (QIS5).

These directions provide a fairly clear pattern of the expected solvency standard to be applied by the EU Member States scheduled to be in effect at the start of 2013. Further detail on the shape of Solvency II and what companies should be doing about it in 2010 is provided in the article “Europe in 2010: Post-Crisis, Pre-Solvency II” on page 23.

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**Mike Lombardi**  
Senior Vice President  
and Chief Actuary,  
Reinsurance Group of  
America



**Naren Persad**  
Specializes in capital  
modeling and Solvency II  
developments.  
Towers Watson, London



**Andrew F. Giffin**  
Retired Towers Watson  
consultant

## IAIS — Capital Resources

The International Association of Insurance Supervisors (IAIS) has been working in parallel with the EU to develop global solvency standards for use by its 140 member countries. The IAIS has generally followed the Solvency II model, with some variations. At its annual conference in October 2009, it adopted a guidance paper on the structure of capital resources recognized for solvency purposes. The principles presented are subject to a separate guidance paper on asset and liability valuation that will follow.

The IAIS specifies that capital resources should both absorb losses of a going concern and reduce policyholder losses in a windup. Common stock, for example, would apply to both needs. Certain forms of subordinated debt would apply only to the second need. It was further recognized that firm capital also supports firm growth and rating requirements. The guidance calls on supervisors to define an approach for determining the capital resources eligible to meet regulatory capital requirements and their value, consistent with a total balance sheet approach for solvency assessment with regard to the quality and suitability of capital elements.

The guidance further specifies that to be certain that an insurer's obligations to policyholders are met as they fall due, liabilities, including technical provisions, must be covered by assets "over a definite period of time, to a specified level of safety" — in other words, using a statistical risk distribution.

## IAIS — Group Supervision

The IAIS also approved a Guidance Paper on the use of supervisory colleges in groupwide supervision at its Rio de Janeiro meeting. This paper built on the existing Insurance Core Principle #17, establishing a framework for international cooperation among national supervisors. The current paper further clarifies roles and responsibilities of supervisors, particularly in dealing with multinational insurance organizations.

The approach is intended to address the need to deal with and be consistent with regulation of other financial service entities within a group, as part of IAIS' role within the overall framework of the renamed Financial Stability Board (FSB).

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Objectives of this guidance include consideration of potential threats to broad financial market stability, particularly in light of the recent market difficulties.

Supervisory colleges, led by the designated group-wide supervisor for particular multinational insurers with complex structures and relevance to both local financial markets and broader financial stability, will be developed to meet the need for effective and efficient supervision of each insurer. Critical to success is a mutual understanding among participating supervisors of the group's business strategy, financial position, legal and regulatory status, risk exposure and management, governance structure and processes, and group solvency. Mutual trust and effective division of supervisory tasks have been identified as critical.

The IAIS program, "Multilateral Memorandums of Understanding on Cooperation and Information Exchange," provides a formal basis for the formation and management of cross-border supervision. This guidance will be supplemented by current work on solvency assessment on a groupwide basis, the treatment of nonregulated entities and criteria for the assessment of equivalence among regulatory regimes.

## Insurance Contract Accounting

Both the EU and IAIS have noted the importance of establishing and maintaining compatibility between accounting and regulatory standards for harmonization of requirements, transparency and avoidance of arbitrage, both among jurisdictions and across other financial sectors such as banking. The International Accounting Standards Board (IASB) has been reviewing the treatment of insurance contracts (currently governed by the International Financial Reporting Standard 4) for some years and has recently been joined in this effort by the Financial Accounting Standards Board (FASB), the U.S. accounting standard setter. Both boards are expected to publish an exposure draft of an insurance contract standard during the second quarter of 2010.



## CFO Forum's Market-Consistent Embedded Value

Parallel with the development of the Solvency II and IAIS principles has been the evolution of the rules for the voluntary publishing of embedded values by life companies. The CFO Forum, made up principally of European multinational representatives, continues to enhance these conventions, now dubbed market-consistent embedded value (MCEV). Like Solvency II and the IAIS principles, MCEV relies on market-consistent valuation and consistent valuation of assets and liabilities. These require reliance on market prices, where deep and liquid markets exist, and on mark-to-model approaches to come as close to orderly market prices as possible.

MCEV differs in part from Solvency II and IAIS because it has a different underlying purpose. Solvency II and IAIS are primarily concerned with solvency from the point of view of policyholder protection, and hence the focus is on the capital position assuming potentially extreme events. On the other hand, MCEV is focused on the concerns of shareholders and investors for enterprise valuation and risks, and hence with measuring profit and loss in the normal course of events. The difference in purpose leads to differences in the underlying frameworks. For example, Solvency II and IAIS have focused on measurement in terms of the potential for having to wind up an insurer, considering valuation in terms of transfer of liabilities to an assuming party. MCEV focuses on liabilities from a going-concern perspective and the expected fulfillment of contract obligations.

A number of details are under review by the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), as part of Solvency II implementation, that parallel issues being addressed by the CFO Forum. These include the basis for identifying a risk-free rate (e.g., government

bonds, swaps), recognizing own credit risk, using liquidity premiums, calibrating stochastic models, best estimate assumptions, risk margins and allowance for future premiums. Depending on the results of this work, the underlying frameworks may converge further or may remain different in various aspects of measurement. However, current work on them will likely provide at least a clearer path to understanding the differences in what is reported.

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## Financial Stability Board — Systemic Risk and Procyclicality

Problems of systemic risk on a global scale were highlighted by the recent financial crisis. This has led to the formalization of the Financial Stability Forum into the Financial Stability Board (FSB). The FSB comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities, and ministries of finance), international financial institutions, standard-setting bodies and committees of central bank experts. It has been established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.

A key concern is that efforts to assure capital adequacy in a financial crisis will further weaken financial markets for assets, thereby exacerbating the problem for companies — the problem of procyclicality. The Solvency II Directive explicitly calls for member states' approaches to solvency to provide for this issue. The IAIS' guidance paper on supervisory colleges (see above) includes consideration of financial stability issues.

The FSB's initial list of institutions that pose systemic risk included only six Europe-based, multinational insurance and reinsurance firms, identified for their participation in nontraditional insurance markets.

Ideally, insurers' capital requirements would include a margin of capital, built up in good times, that could then be drawn down as needed in a crisis. There is growing acceptance of this concept, but further work is needed to develop the structure and level of the margin.

### Implications for Insurers and Reinsurers

For companies operating in Europe, the principles that are part of the Solvency II Directive are now established, with implementation under way and an effective start date in 2013. CEIOPS is still working out further details of the new framework, but it's clear that international financial reporting standards and MCEV directions are generally the same, with some variations in the details.

For the Americas and Asia Pacific, the IAIS developments, mainly in line with Solvency II, suggest a very consistent direction. What is less clear is the timetable. In the U.S., the National Association of Insurance Commissioners is proceeding with a modernization project. Government legislation promoting a federal insurance office seems likely to pass in the near future, but this will not replace the current state-by-state regulatory system anytime soon, if at all. Many in the U.S. are resisting change to a Solvency II-style system. Certain property & casualty insurers insist that traditional methods for measuring insured liabilities have worked well, without the need to use a best estimate, time value of money or explicit risk margin approach.

Some of the developing countries (e.g., Brazil and Mexico) are actively evaluating Solvency II approaches. Implementation in both developed and developing countries will require considerable effort by companies to improve data and information systems, along with the technical expertise to complete the analysis and reporting demanded under this approach.

Any change in accounting, solvency and performance measurement systems will require extensive preparation, testing and observation of results for several accounting periods before going public. Initially, this involves evaluating proposed systems — which has been under way in Europe for some time — to test the details of proposed approaches and prepare for the coming effective date in 2013. Next it will be important for companies to determine how they will perform under the new methods. Will the new measurements of capital meet the revised requirements? How will the changes affect qualification for ratings? How will a company's operations be valued in public equity markets? What do the new measures suggest about changes in strategic direction?

### Embedding ERM for Strategic Decisions

Most companies will need to understand how best to optimize their position through changes in existing strategy (e.g., change in mix of business or underwriting, investment and pricing policies). Application of the new measurement methods will be needed to evaluate alternative strategic directions, including the introduction of alternative product designs. And it is always desirable to be able to make such adjustments and establish consistent results under new rules before public reporting is required.

The IAIS and Solvency II require that a company be actively using the new solvency measures before internal models for measuring capital requirements can be used for regulatory purposes. In addition to using an acceptable model methodology, a "use test" requires that the model be used internally to assist with business decisions. Embedding ERM and capital management in the management process will not only meet a critical compliance requirement, it will provide a much-improved information base for making sound strategic decisions.

*For comments or questions, call or e-mail Naren Persad at +44 20 7170 2632, naren.persad@towerwatson.com.*

“Any change in accounting, solvency and performance measurement systems will require extensive preparation.”