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A Comparison of Solvency Systems: US and EU

	<u>US Solvency</u>	<u>EU Solvency II</u>
Principles or Rules	<p>Principles are included in numerous NAIC handbooks. The statutory accounting framework is based on overarching statements of concepts; the aims of the Risk-Based Capital (RBC) minimum capital requirement framework are articulated as high level statements of concept; and the draft Valuation Manual would include principles.</p> <p>U.S. principles are not consolidated in one framework document.</p> <p>Significant numbers of well-defined rules – U.S. state laws and regulations, NAIC documents: Accounting Practices and Procedures Manual, Financial Examiners Handbook, Financial Analysis Handbook, Risk-Based Capital calculations</p>	<p>Over-all Framework Directive aims to be Principles-Based.</p> <p><i>Note: The Framework Directive is still in draft although largely expected to be unchanged (with group issues, “own funds”--surplus funds, and the calculation of the lowest required capital (MCR), to be the major discussion items left).</i></p> <p>Implementation Measures are not yet defined so it is unclear the level of rules.</p> <p><i>Note: Some potential Implementation Measures are embedded within Consultation Papers, but the Implementation Measures are not drafted and finalized.</i></p>
Uniformity	<p>State-based system of regulation; Uniform Financial Regulation</p> <p>NAIC Accreditation Program encourages certain levels of uniformity in regulatory practices and standards.</p>	<p>The Solvency II Framework Directive is a requirement by law for all EU member states so the principles are required and will be uniform. (Lamfalussy Level 1)</p> <p>Implementation Measures (which will include the standardized capital model) will be driven by the European Commission with veto power of Parliament and EIOPC. These are therefore requirements for all EU members so uniformity is expected. (Lamfalussy Level 2)</p> <p>Supervisory Guidance and Standards, to be written by CEIOPS, are not legally binding but will result from agreements between supervisors within CEIOPS. The ability to achieve uniformity is expected, but without legal binding, more time might be needed to achieve uniformity. (Lamfalussy Level 3)</p> <p>Differences between Member states could result from situations such as the following: judgment decisions (i.e. whether internal models pass required tests and can be used to determine a company’s capital requirement), specific requirements or internal rules</p>

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		<p>established (such as the regime establishes a minimum # of years between financial examinations), and supervisory reporting requirements (i.e. reporting forms or required information).</p> <p>Differences will exist between capital requirements of firms because of flexibility (resulting from the use of internal models or substitution of parameters in the standard formula).</p> <p>The European Commission is in charge of monitoring compliance and enforcement of requirements. (Lamfalussy Level 4) No accreditation-type program appears to be contemplated.</p>
Quality Standards of Each Regulatory Authority	<p>The NAIC Accreditation Program provides a process whereby solvency regulation of multi-state insurance companies can be enhanced and adequately monitored with emphasis on the following:</p> <ul style="list-style-type: none"> • adequate solvency laws and regulation in each accredited state to protect consumers and guarantee funds. • effective and efficient financial analysis and examination process in each accredited state • appropriate organizational and personnel practices in each accredited state. <p>The frequency of examination & analysis and the timeliness of action resulting from material adverse findings relate to the quality control process ensured by the accreditation standards.</p>	<p>The European Commission is in charge of monitoring compliance and enforcement of requirements, but the level of analysis is not yet communicated.</p>
Public Disclosure	<p>Uniform public Financial Reporting through standardized format of the NAIC Annual and Quarterly Statement Blanks (Instructions provide for consistent interpretations of disclosure requirements);</p> <p>Significant Detail reported publicly including details on investments,</p>	<p>Uniformity is expected, but it appears the public reporting will not be as extensive nor as uniform as the U.S. public reporting</p> <p>There is an Insurance Account Directive (separate from Solvency II) that was adopted in the 90s that provide rules for public financial reporting. After the Solvency II directive is</p>

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	investment quality, P&C loss reserve development	adopted with an aim to be compatible with IFRS requirements, pressure on the Insurance Account Directive is expected in order to make changes to increase compatibility with IFRS.
Governance	<p>Model Audit Rule – Based on premium thresholds, requires a management assessment of the effectiveness of internal control over financial reporting and an independent audit committee.</p> <p>Governance Subgroup of the Principles-Based Reserving WG is reviewing needs for governance requirements in the Life Insurance Principles-Based Reserving Project</p>	<p>Given that companies will be assessing their own capital needs through enterprise risk management processes and some will be modeling their capital requirements, significant responsibility is placed on management of the company and internal controls.</p> <p>Companies will have annual written policies explaining their risk management, internal controls, internal audit, and any outsourcing.</p>
Enterprise Risk Management	<p>Insurance companies are expected to manage their risks and there is encouragement from the regulatory regime to do so.</p> <ul style="list-style-type: none"> • Risk-based capital requirements encourage focus on risk and varying capital needs depending on risk. • A company's reinsurance, investment, marketing, and underwriting decisions require risk analysis; • The enhanced risk-focused examination process includes significant focus on risk and how the risk is managed, along with evaluation of governance. <p>However, there is no requirement for companies to utilize Enterprise Risk Management.</p>	<p>Enterprise Risk Management requirements are expected to be included in Implementation Measures.</p> <p>The following are IAIS standards, which are expected to be implemented in Solvency II:</p> <ul style="list-style-type: none"> • An insurer should establish and maintain a risk tolerance statement which sets out its overall quantitative and qualitative tolerance levels and defines tolerance limits for each relevant and material category of risk. • An insurer should regularly perform its own risk and solvency assessment (ORSA) to assess the adequacy of its risk management and current, and likely future, solvency position. • The ORSA should encompass all reasonably foreseeable and relevant material risks. The assessment should identify the relationship between risk management and the level and quality of financial resources needed and available. • The supervisor should undertake reviews of an insurer's risk management processes and its financial condition. The supervisor should use its powers to require strengthening of the insurer's risk management,

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		including solvency assessment and capital management processes, where necessary.
Size of Company Applicable	RBC exemption criteria due to size is \$2M US	Solvency II only applies to companies with annual premium >\$5 Million Euros (or almost \$8M US) <i>Note: This amount is still under discussion and there is potential for an "Opt-in" for a company to get under the Solvency II umbrella, especially for group solvency purposes.</i>
Accounting		
Accounting Overview	Statutory Accounting Principles – based mainly on FASB but with several exceptions, usually due to higher conservatism in SAP. Uniform accounting framework with Accounting Practices & Procedures manual published by NAIC. State prescribed practices that differ from the NAIC manual are allowed and those are also published by the NAIC. Individual insurers may be granted permitted practices that differ from the NAIC manual. Insurers must disclose material accounting differences from the NAIC manual. If FASB moves to IFRS, SAP procedure requires consideration of FASB changes.	EU Accounting Regulation: IFRS is mandatory for consolidated accounts of listed companies. For other listed companies (with annual accounts), member states have the option to require or allow IFRS. Non-listed companies – member states can decide whether required, permitted, or prohibited. Accounting requirements, therefore, vary. One difference is that companies that don't use IFRS can have Equalization (Future CAT reserve) provisions for non-life insurance. <ul style="list-style-type: none"> Commission website – Table has options chosen by member states on the implementation of IAS. One Remaining Carve-out from IFRS: interest rate hedge accounting
Asset Valuation	Asset valuation varies: primarily market/fair value, amortized cost, equity method, or book value (cost). Asset Valuation Reserve for Life – established to smooth the impact of investment gains/losses on capital/surplus.	Market Value Fair Value (using current IFRS definition, with specifics to be developed in implementing measures) Potential Equity Dampener Approach to reduce Pro-cyclical effects <i>(although this would be adjusted in capital requirements rather than in Asset Valuation)</i>
Liability Valuation	P&C: Principles-Based, Implicit Risk Margin Life: Rules Based, but Principles-Based Reserving Project underway, Implicit Risk Margin	Technical Provisions: Current Exit Value is the overriding principle; If there is a hedgeable component in the technical provision (<i>similar to loss reserves</i>) with replicating portfolio of assets, use the market value of that portfolio (so no separation into current estimate and risk margin for these). If not hedgeable, do a proxy for market value by decomposing into a current estimate + an explicit risk margin

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		<u>Cash Flows</u> – The cash flows would include all in and out flows, including future discretionary bonuses, embedded financial guarantees, and contractual options.
Capital Resources (or Total Company Capital for comparison to RBC/Solvency II Capital Requirement)		
Quality of Capital Resources	Accounting guidance limits values on some items (goodwill) and provides for certain assets to be fully “nonadmitted” or not counted toward surplus (letters of credit). In the RBC calculation, there are higher capital requirements for higher-risk assets. Investment limitations limit the amount that can be held for certain types of assets due to their risk.	<u>Own Funds</u> –There will be a 3-tiered system to determine the value of the “own funds” allowed to be counted for regulatory capital requirements. Criteria (i.e. loss absorbancy, free of mandatory costs, etc.) are used to determine whether a capital instrument is allowed and then what tier. Included in this are percentage limits on how much can be or must be included from each tier, with the details to be determined in implementing measures. And admissibility of off-balance sheet items such as letters of credit will be subject to prior approval, with a procedure to be established in implementing procedures.
RBC vs. Solvency II Capital Calculations		
Goals of Calculations	U.S. RBC goal: calculate minimum levels of capital rather than a target/optimum level of capital.	Solvency II goal: calculate an economic required capital level (<i>which, although not defined this way in the Framework, would generally be equivalent to the “target/optimum” level of capital for a company with S&P BBB rating*</i>) and a minimum level of capital
Ladders of Intervention (Solvency Control Levels)	Company Action Level Regulatory Action Level Authorized Control Level Mandatory Control Level	SCR – Solvency Capital Requirement MCR – Minimum Capital Requirement
Capital Floor	Fixed minimum capital requirements vary by state, line of business, and stock vs. mutual companies. While the range of capital requirements is large (\$100,000 to \$5M) the median amount for health/property lines is \$750,000 and for life/auto liabilities lines is \$1M. States also have minimum surplus amounts. For surplus requirements, the median is \$1M for all four lines of	There is an absolute capital floor of 1M Euros for non-life and 2M Euros for life companies.

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	<p>business.</p> <p>States sometimes have a combined capital and surplus requirement.</p> <p>The final minimum capital and surplus requirement for the insurer is the greater of the fixed minimum capital and surplus amount and the RBC amount.</p>	
Calculation Methodology	<p>All ladders of intervention are derived from one method: Risk-Based Capital (RBC);</p> <p>RBC is formulaic with some limited internal modeling</p> <p>Quite detailed;</p> <p>Data is auditable.</p> <p>Risk-based capital (RBC) is a method of measuring the minimum amount of capital appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile. It provides an elastic means of setting the capital requirement in which the degree of risk taken by the insurer is the primary determinant.</p> <p>A company's risk-based capital is calculated by applying factors to various asset, premium, claim, expense and reserve items. The factor is higher for those items with greater underlying risk and lower for less risky items. The adequacy of a company's actual capital can then be measured by a comparison to its risk-based capital as determined by the formula.</p> <p>Risk-based capital standards will be used by regulators to set in motion appropriate regulatory actions relating to insurers that show indications of weak or deteriorating conditions. It also provides an additional standard for minimum capital requirements that companies should meet to avoid being placed in rehabilitation or liquidation.</p> <p>Other financial ratios (IRIS ratios, FAST</p>	<p>Different methods might be applied for SCR and MCR.</p> <p>SCR could be done by Formula (Standard Model) – unclear the detailed level of this formula – or by Internal Models.</p> <p>Standard Model: The detailed specifications will be adopted through implementing measures, however the basic requirement for the formula is defined in an annex of the Directive, including the modules for risk, correlation factors between those risks, and specific sub-modules for underwriting and market risk.</p> <p>The SCR will require data in detail beyond audited data.</p> <p>Framework is open on the calculation of the MCR but it will be a "simple and robust formula to be calculated quarterly based on auditable data." They are currently testing an MCR that is related to the SCR calculation. A formula for the MCR may be significantly less detailed than the U.S. RBC.</p>

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	scores) are also considered when reviewing the solvency of the company.	
Risks Included in the Capital Requirement	<p>The Management's Discussion and Analysis that is required in the Annual Financial Statement requires disclosure to enable regulators to assess the financial condition and results of operations of the reporting entity. Prospective information, Liquidity, Asset/Liability Matching, Capital Resources, Volatility in Loss Reserves, and Off-Balance Sheet items are to be addressed.</p> <p>Specific significant risks are identified and measured. Notably, operational risk and an explicit catastrophe risk are not included.</p> <p><u>Life RBC</u> C0 = Asset Risk – Certain Affiliated Investments C1o = Asset Risk – All Other Assets C1cs = Asset Risk – Common Stock and Certain Unaffiliated/Affiliated Assets C2 = Insurance Risk C3a = Interest Rate Risk C3b = Health Provider Credit Risk C3c = Market Risk C4a = Business Risk – Non-Health (Guar. Fund & SA) C4b = Business Risk – Health Administrative Expense</p> <p><u>Property/Casualty RBC</u> R0 = Asset Risk – Affiliated Insurance Company Assets R1 = Asset Risk – Fixed Income Investments R2 = Asset Risk – Equity Investments R3 = Asset/Credit Risk – (Recoverables, Reinsurance) R4 = Underwriting Risk – Reserves RBC R5 = Underwriting Risk – Net Written Premiums</p> <p><u>Health RBC</u> H0 = Asset Risk – Affiliated Company</p>	<p>Directive: “The Solvency Capital Requirement reflects the true risk profile of the undertaking, taking account of all quantifiable risks, ...” “Some risks may only be addressed through governance requirements rather than by setting quantitative requirements.”</p> <p>The structure (modules, etc.) of the standardized formula: (a) non-life underwriting risk (premium, reserve, catastrophe); (b) life underwriting risk (mortality, longevity, disability – morbidity risk, life expense risk, revision risk, lapse risk, life catastrophe risk). (c) special health underwriting risk (expense, premium and reserve, and epidemic); (d) market risk – market price levels and volatility and mismatch between assets and liabilities; (interest rate risk, equity risk, property risk, spread risk, currency risk, market risk concentrations) (e) counterparty default risk (f) Operational Risk</p> <p>While the risks are required to be evaluated in internal models, differences might be allowed in categorization within internal models.</p>

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	Investments H1 = Asset Risk – Other Invested Assets H2 = Insurance/Underwriting Risk H3 = Credit Risk H4 = Business Risk	
Differential between the Ladders	Company Action Level: 200%, or triggered by a Trend Test. Regulatory Action Level: 150% Authorized Control Level: 100% Mandatory Control Level: 70% Mandatory Control is 35% of the Company Action Level.	QIS 4: MCR to be tested as CEIOPS Linear Approach, with a cap of 50% and floor of 20% of SCR EC-3/26/08
Industry Capital Level (Calibration)	U.S. RBC does not specify an overall certainty level, but tends to rely more on CTE methodology than other methods. <i>(Actuarial Note: CTE and VaR produce similar answers except when there is risk of large losses, and then the CTE methodology is generally preferable.)</i>	99.5% VaR over a 1-year Time Horizon; <i>(originally selected as an S&P BBB company)</i> Cost of Capital Methodology for non-hedgeable risks: Cost of Capital = 6% + risk-free cost <i>(while 6% was originally selected as a placeholder, it might require calibration)</i> Calibration Remains, QIS4 in progress
Internal Models	Limited internal modeling P&C: Developing CAT modeling within the RBC charge Life: C-3 Market/interest risk for variable annuities and group annuities with guarantees product designs. No requirement to use the model to make business decisions. No prior approval of the model required.	Internal Modeling Option to determine SCR. Expected provisions of the implementation measures are as follows: <ul style="list-style-type: none"> • Prior approval of model required; • Internal Model must pass a Use Test so that the model is not just a regulatory requirement but is used by the company in making decisions. • Internal Model must also pass a Statistical Quality Test and a Calibration Test.
Capital charges by Risk	A comparison can be made at the detailed level of charges between RBC and QIS 4 (the quantitative impact study), although these are not necessarily final numbers for Solvency II. In addition, the comparison must consider the different US and EU accounting bases that impact the calculations. While there could be differences in accounting bases between companies in the EU, the quantitative analysis (ideally) requires assets and liabilities to be re-valued to minimize the differences in accounting bases when determining the capital requirement.	
Securities Pricing and Review	NAIC Securities Valuation Office (SVO) serves the national regulatory community as an independent source of investment expertise. This gives regulators unbiased information about investment risks and	Rely on market.

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	<p>their potential impact on insurers.</p> <p>The SVO conducts credit quality analysis on securities held by insurers for the purpose of assigning an NAIC designation and/or unit price. These designations and unit prices are produced solely for the benefit of NAIC members who may utilize them as part of the member's monitoring of the financial condition of its domiciliary insurers.</p> <p>SVO research staff monitors economic developments, performance of specific securities or asset classes and innovations in the financial markets. With this monitoring they can alert regulators of the potential implications for insurance companies. The SVO credit units continually assess the credit risk associated with unrated securities, which serves as the basis for calculation of regulatory capital needed to support those investments. SVO valuation services are available to insurance departments upon special request and to insurers on an ongoing basis.</p>	
Group Supervision		
Group Supervision	<p>Holding Company Model Act</p> <ul style="list-style-type: none"> • Require disclosure of pertinent information relating to changes in control of an insurer. • Require disclosure by an insurer of material transactions and relationships between the insurer and its affiliates, including certain dividends to shareholders paid by the insurer. • Provide standards governing material transactions between an insurer and its affiliates. <p>Examination Coordination</p> <ul style="list-style-type: none"> • Exam coordination is done for insurers of a group or holding company system or those P&C companies that utilize an intercompany pooling system. There 	<p>Not yet agreed in the Framework, Currently appears there will be a Group Supervisor, individual companies can hold MCR so long as capital is held at parent or other arrangement</p> <p>Details of current draft: A group supervisor from the EU Member States will be appointed and will have decision powers. Typically, the group supervisor is the one where the parent company is located, but there are some exceptions. And if the parent is outside of the EU Member States, the EU will have its own group supervisor. Any disagreements by Member States on who should be the group supervisor would be settled by CEIOPS.</p> <p>The group supervisor will be given primary responsibility for all key aspects of group supervision (group solvency, intragroup</p>

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	<p>is a “lead state” that is typically the state where the parent company is domiciled or, if there is no insurance parent, the state where the largest (by direct written premium volume) insurance subsidiary is domiciled.</p> <ul style="list-style-type: none"> • The lead state is responsible for calling the exam. • Role of the Lead State – The role of the lead state will vary from exam to exam; however, certain responsibilities are common to every lead state role, including Designating its own lead person(s), establishing lines of communication and serving as regulatory contact with top management of the organization under review, establishing points of contact with impacted states, establishing lines of communication and distribution of information with impacted states and other functional regulators, seeking consensus on content and timelines for analysis, examinations, reviews and other actions, obtaining a thorough understanding of the organization as a whole, and serving as a primary spokesman and coordinating public statements, when appropriate. The broad role of each of the non-lead states is to pledge cooperation and coordination with other states generally and to give support and recognition to the lead state. <p>NAIC Financial Analysis Working Group - monitors nationally significant insurers/groups, as well as unique trends in the industry.</p> <ul style="list-style-type: none"> • Analyze nationally significant insurers and groups that exhibit characteristics of trending toward or being financially troubled and determine if appropriate action is being taken. • Interact with domiciliary regulators and lead states to assist and advise as to what may be the most appropriate 	<p>transactions, risk concentration, contagion risk, risk management, governance, internal control, and validation of a group internal model). The group supervisor will plan and coordinate supervisory activities with local supervisors and all will participate in a coordination arrangement.</p> <p>While the IAIS has stated that group supervision does not “lessen the importance of solo supervision or ... replace the role of the solo supervisor”, Solvency II modifies how solo supervision would be applied to an entity that is part of a group. The group supervision for Solvency II is not “supplementary” to solo supervision and does not imply an additional layer of requirements, but rather utilizes a different approach.</p> <p>For capital requirements, there should be no double use of “own funds” and no reciprocal financing or intra-group creation of capital. The group would annually calculate an SCR but no MCR, although there is stipulation that the group SCR cannot fall below the sum of the individual MCRs (or the appropriate proportion of MCRs). To calculate the SCR, the default method will be the Accounting Consolidation-Based Method (using consolidated accounting). If this method is not fully appropriate, the Deduction and Aggregation Method (using the summation of the SCR of the individual companies) or a combination of these methods could be used. Capital add-ons can also be required at the group level.</p> <p>And, most importantly, what the group aspect of Solvency II does is allow capital to be held at minimum capital requirements for any individual entity so long as capital is held elsewhere in the group. This is desired by groups, obviously, because they can move capital around. The caveat to this is that the parent must supply a legally-enforceable guarantee to supply a particular amount of capital (at least equal to the SCR), there must be no foreseeable material impediment to the prompt transfer of funds, and the group must meet its regulatory capital requirements. Funds</p>

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	<p>regulatory strategies, methods, and action(s).</p> <ul style="list-style-type: none"> • Support, encourage, promote and coordinate multi-state efforts in addressing solvency problems. • Review and make appropriate updates and enhancements to the <i>NAIC Troubled Insurance Company Handbook</i>. 	<p>from other companies within the group would also be allowed to be transferred so long as all capital requirements are still met.</p>
Reinsurance & Third Country Issues		
Reinsurance	<p>Statutory accounting for reinsurance varies depending on risk transfer. If there is sufficient risk transfer, reinsurance accounting applies. If there is not, then deposit accounting applies.</p> <p>RBC formulas include charges for reinsurance recoverables and for affiliated investments for insurers in third countries.</p> <p>Quality of Reinsurer: The risk-based capital charge does not differentiate by type of reinsurer. The NAIC is currently undertaking a reinsurance regulatory modernization proposal that could result in amended RBC charges for reinsurance recoverables and would also result in reduced collateral requirements for highly rated reinsurers (both U.S. and non-U.S.)</p> <p>Intercompany Pooling Agreements</p> <p>“Voluntary market mechanism pools and associations” are defined those which meet either of the two following sets of criteria:</p> <p>Criteria #1</p> <ul style="list-style-type: none"> • the members/reinsurers of the pool share pro rata in the experience of the pool; and • there are sufficient participants to provide a reasonably broad sharing of the risk, which shall be evidenced by a maximum 15% retention by any one 	<p>The Solvency II Framework Directive integrates the Reinsurance Directive.</p> <p>In valuation, reinsurance is not netted in the data.</p>

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	<p>participant.</p> <p>Criteria #2</p> <ul style="list-style-type: none"> the purpose of the pool or association is to depopulate a residual market; the pool or association must be specifically approved by the Commissioner of the domestic state; liability of the reinsurers in the pool or association is joint and several; at least five insurers participate in the pool; and the premium volume of the pool or association exceeds \$25 million. <p>The intercompany pooling agreement reduces the risk to each individual legal entity. The risk-based capital formula therefore eliminates the risk charge for reinsurance recoverables from affiliated U.S.-domiciled insurers.</p> <p>Reinsurance is not netted in the data.</p>	
3 rd Country Equivalence	<p>Other supervisory regimes are not currently evaluated.</p> <p>The U.S. group supervision does not require evaluation of other supervisory regimes.</p> <p>Reinsurance proposals include assessment of regulatory effectiveness of non-U.S. jurisdictions through an “outcomes-oriented” approach.</p>	<p>Equivalency of other solvency regimes will be determined. This evaluation is not yet clear.</p> <p>The EC is granted the power, after consultation with others, to decide whether solvency regimes applied to reinsurers in third countries are equivalent to the Solvency II Directive. If deemed equivalent, then reinsurance contracts from third countries would be treated the same as reinsurance contracts from a Member State. The Council will be involved in negotiating agreements with third countries. These agreements will “seek to ensure, under conditions of equivalence of prudential regulation, effective market access for reinsurance undertakings and provide for mutual recognition of supervisory rules and practices on reinsurance.” It is not clear what the reinsurance contract treatment would be if a third country’s solvency regime is not considered equivalent, although there are more details on the treatment of companies.</p>

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		For a parent company in a third country, the Solvency II section on groups offers some alternative supervisory actions. If the EC deems a third-country's solvency regime not to be equivalent, it appears the parent company in the third country would effectively be treated as a subsidiary to the group (for group solvency calculations), although alternatives are allowed. Alternatively, if equivalent, the solvency capital requirement and own funds established in the third country would be used.
Other Issues		
Licensing	<p>NAIC Company Licensing Best Practices Handbook Best Practices states a benchmark for the number of days to licensure after receipt of a complete application:</p> <ul style="list-style-type: none"> • Primary license in domestic state -- review period of 90 days • Expansion into non-domiciliary states -- review period of 60 days <p>Time lines may be extended when there are specific concerns with the application.</p> <p>Minimum uniform documentation is required by all states; some states require additional documentation.</p>	Supervisors have 6 months to authorize an insurer
Examinations	<p>A full-scope, on-site risk-focused examination requires a full review of the financial statements of an insurer as well as an assessment of all significant financial solvency risks of the insurer.</p> <p>Lead State – typically the domestic state, but there are other options, especially regarding coordinated exams of a holding company. Some situations result in other states participating in the exams.</p> <p>Frequency: On-site exam required at least once every 5 years (some states require every 3 years); limited scope exams can be called as needed</p> <p>The SVO Portfolio Analysis Memorandum (PAM) analyzes the</p>	<p>Framework: "Supervision shall be carried out both off-site and on-site." Details are left to implementation measures.</p> <p>Home Member State in charge; Host Member state can participate</p> <p>Frequency: will be determined based upon nature, scale, and complexity. Member states have individual internal rules on the frequency of examinations.</p>

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	content of an insurer's investment portfolio, providing regulators with a valuable examination planning tool. The PAM is a holistic analysis of an insurer's entire investment book as opposed to an investment by investment analysis.	
Financial Analysis	<p>Risk-Focused Analysis Process</p> <ul style="list-style-type: none"> • Quarterly analysis • Depth of analysis procedures will vary based on complexity and financial strength or other problems of the insurer, but a minimum level of analysis exists • Holding company analysis is incorporated into the analysis procedures • NAIC Financial Analysis Working Group monitors nationally significant insurers/groups, as well as unique trends in the industry • Timely action is taken with material adverse findings • States share findings and other information when confidentiality is provided • NAIC provides numerous confidential financial analysis solvency tools 	Framework: "Supervision shall be carried out both off-site and on-site." Details are left to implementation measures.
Audits	<p>External: Annual external statutory audit requirement with some small companies excluded.</p> <p>The audit report includes the following: report of independent certified public accountants, balance sheet, statement of operations, statement of cash flows, statement of changes in capital and surplus and notes to the financial statements. There are certain requirements that the CPA firm must meet in order to be eligible to perform audits of insurance companies, and there are certain rules governing auditor independence.</p> <p>Internal: No internal audit function is required.</p>	<p>External: The external auditor would be required to do a typical audit function, but would also have to report whether the auditor is aware of any fact or decision that might bring about non-compliance with the regulatory capital requirements.</p> <p>Internal: Each company must have an internal audit function to examine compliance with internal strategies, processes, and reporting procedures and the appropriateness of internal controls.</p>

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	<p>However, the Model Audit Rule requires every insurer to have an Audit Committee comprised of members of the board of directors. This Committee is responsible for the appointment, compensation and oversight of the independent CPA. The independent CPA is required to communicate certain matters to the Audit Committee as a result of the audit. Depending on the company's premium volume, some of the members of the Audit Committee may be required to be independent of company management. Companies with annual premium of more than \$500 million are required to annually file an assessment of the effectiveness of its internal control over financial reporting.</p>	
Actuarial involvement	<p>Annual Statements of Actuarial Opinion; requirements for detailed Actuarial Reports</p> <p>P&C Actuarial Opinion:</p> <ul style="list-style-type: none"> • Whether there is a reasonable provision for all unpaid loss and loss expense obligations (and potentially material Unearned Premium Reserves for Long Duration Contracts) • Retroactive reinsurance, financial reinsurance and reinsurance collectibility. • Risk of Material Adverse Deviation <p>Loss development detail (that shows a comparison of the company's previous incurred loss estimates to actual experience) is already publicly available in Schedule P. No actuarial opinion is required on the underwriting policy.</p> <p>Life -- The actuarial opinion certifies that the actuarial items make an adequate provision for future benefits, taking into account current assets. There is no discussion of underwriting policy nor reinsurance arrangements, however both have to be taken into account in making</p>	<p>Actuarial Opinion on</p> <ul style="list-style-type: none"> • technical provisions (e.g. loss or claim reserves) of the company, • Underwriting policy, and • Adequacy of reinsurance arrangements. <p>A comparison of previous estimates to actual experience must be made.</p>

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	<p>the certification.</p> <p>For the comparison of previous estimates to actual, the claim reserves are usually a very small part of total liabilities (relative to the size of policy reserves), so a comparison is not done.</p> <p>Health -- The actuarial opinion certifies that the actuarial items (claim reserves, policy reserves and other liabilities) make a good and sufficient provision for unpaid claims and other liabilities. There is no direct discussion of underwriting policy or reinsurance arrangements, although those two subjects should be considered in the process of getting to the certification.</p> <p>For comparison of previous estimates to actual experience, an underwriting and investment exhibit is prepared in accordance with Actuarial Standards of Practice.</p>	
Policy forms or rates	<p>Policy form requirements and rate regulation varies by state, and can vary by line of business within the state.</p> <p>% of states with "Prior Approval":</p> <ul style="list-style-type: none"> • Personal Lines -- 1/3 • Workers' compensation insurance -- 1/2 • Commercial Lines -- 1/8 	<p>No prior approval or even systemic notification of policy conditions or rates, although they can require some non-systemic notification to verify compliance with national provisions concerning insurance contracts for non-life insurance or concerning actuarial principles for life insurance.</p> <p>And there can be some general price-control systems (but the definition of these is unclear). Any noncompliance issues must be forwarded to the Home Member State for resolution. However, if those measures fail or there is an emergency, the host Member State can take action.</p>
Consumer Protection	<p>Market Conduct Regulation: Goal to protect consumers by identifying and correcting insurer operating practices that are in conflict with contract provisions, state laws, rules, regulations, or orders of the Commissioner.</p> <ul style="list-style-type: none"> • Claim Handling • Company 	

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	<u>US Solvency</u>	<u>EU Solvency II</u>
	<p>Operations/Management (audit program, antifraud plan and disaster recovery plan)</p> <ul style="list-style-type: none"> • Complaints • Marketing & Sales (producer training) • Policyholder Service (policy issuance and cancellation) • Producer Licensing • Underwriting & Rating (The rates charged for the policy coverage are in accordance with filed rates (if applicable) or the company rating plan. The company does not permit illegal rebating, commission cutting, or inducements. Credits and deviations are consistently applied on a non-discriminatory basis. All forms and endorsements forming a part of the contract are listed on the declarations.) <p>Communication between various insurance department divisions is key. Market regulatory reforms are focusing on analysis, uniformity and collaboration.</p>	
Additional Solvency Information	<ul style="list-style-type: none"> • Confidential Financial Analysis Tools • NAIC P&C Profitability Report • Competition Database • Catastrophe Simulation Model Handbook • Regulation of Risk Retention Groups Handbook • Fast Track Data • Statistical Handbook of Data for Insurance Regulation • ...many more... 	



Marika Brady
Director, International Relations & Insurance Regulation

October 31, 2008

Mr. Ramon Calderon
Chair- International Solvency and Accounting (E) Working Group
Deputy Commissioner, Financial Surveillance
California Department of Insurance
300 Capitol Mall, Suite 1700
Sacramento, California 95814

Dear Mr. Calderon,

The American Council of Life Insurers (ACLI) is pleased to submit the following comments regarding the Solvency Comparison of the US Solvency and the EU Solvency II regimes (the Comparison), on behalf of our member companies. The ACLI represents three hundred fifty-three (353) member companies operating in the United States, of which three hundred forty-five (345) are legal reserve life insurance companies, and eight (8) are fraternal benefit societies. These 353 member companies account for 93 percent of total assets, 93 percent of the life insurance premiums, and 94 percent of annuity considerations in the United States.

The ACLI appreciates the opportunity to provide comments on the Comparison that has been developed by the NAIC International Solvency and Accounting (E) Working Group.

We understand that the Comparison is developed to identify key similarities and differences between the solvency regime in the US and Europe in order to determine if the US would want to consider incorporating Solvency II Principles.

On September 3-4, the NAIC's International Solvency and Accounting (E) Working Group and Financial Conditions (E) Committee met in a joint session in Chicago and commenced work on the Solvency Modernization Initiative (SMI). We anticipate that the SMI will explore and evaluate different possible capital regimes. While the ACLI supports a "Principle-based" solvency framework that aligns regulatory capital with best practice risk management techniques, we are still evaluating the ways in which our board-approved Insurer Solvency Principles might be implemented. We urge the NAIC, through the SMI project, to establish its own vision of solvency reform and to develop a roadmap for achieving that vision.

When we look at the Comparison, we find that there are a couple of areas where we see major differences in the solvency approaches in the US and the EU. We encourage you to also examine the standards on solvency that have been adopted by the International Association of Insurance Supervisors (IAIS) and endorsed by the NAIC in order to further clarify the areas of divergence between the US and International Solvency Principles. For purpose of this letter, we highlight the main areas where we believe the US Solvency regime seems to differ from international developments:

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- Principles versus Rules: International Solvency Standards are developed as a Principles-based framework for Solvency that will be further governed by implementing measures. In contrast, the US Solvency regime is Rules-based in nature, even for some of the recently adopted Principle-based proposals (ie, VACARVM).
- Uniformity: International Solvency Standards provide for a market-wide solvency standard. U.S. Solvency operates under a state- based system of regulation. International Solvency Standards provide for a top down solvency framework for all lines of business. In contrast, the current revisions to RBC are being designed from the bottom-up as a series of standards instead of one standard that applies to all products.
- Enterprise Risk Management and use of Internal Models: International Solvency Standards establish a robust risk management and governance framework for all insurers that incorporates risk identification processes, risk management policies and risk monitoring and reporting procedures. The IAIS acknowledges the importance of internal models for the purpose of integrated risk management and capital requirements. In contrast, US solvency does not include requirements covering the risk management framework. The US system prescribes the risks that must be taken into account in the solvency assessment, and the methodology by which capital requirements are quantified.
- Group Supervision: International Solvency Standards are considering innovative group supervision proposals. The proposals would ensure that insurance groups assess and manage risk at the aggregate group level. The US Solvency regime does not currently address the assessment of solvency at group level.
- Reinsurance: International Solvency Standards provide for increased focus of regulation on risk-based principles and integrated risk assessment and greater consistency among the different forms of risk transfer. A modern regulatory framework aims at better recognizing the financial strength of the reinsurer at a global level and the effectiveness of home country supervision.

We appreciate the opportunity to comment and we look forward to an engaged discussion on the SMI.

Do not hesitate to contact us in case of any questions.

Best regards,



Marike Brady

To: Mr. Ramon Calderon
Chair- International Solvency and Accounting (E) Working Group
Deputy Commissioner, Financial Surveillance
California Department of Insurance
300 Capitol Mall, Suite 1700
Sacramento, California 95814

Subject: CEA's response to NAIC's comparison between US and EU Solvency Systems

Brussels, 31 October 2008

Dear Mr. Calderon,

The CEA welcomes the interest shown by the NAIC in the EU Solvency II regime and it is supportive of the initiative to compare the US and proposed EU Solvency regimes in preparation for a concrete exchange of views on prudential supervision between the US and the EU. We are similarly supportive of the initiatives taken by the IAIS to encourage supervisory dialogue which we believe will ultimately foster supervisory convergence and benefit the insurance industry on a global scale.

The European insurance industry believes the Solvency II regime which represents a major step forward in terms of prudential supervision. This is because it incorporates a range of features, which we have for a long time advocated, such as:

- Use of a risk-based economic approach, which ensures that the true underlying exposures of risks and risk mitigation schemes can be correctly quantified, thereby eliminating regulatory arbitrage opportunities that can distort and weaken the protection available to policyholders.
- Market-consistent approach for valuing assets and liabilities, which is the most transparent, objective and robust valuation method.
- Full recognition of diversification benefits, which are at the heart of insurance.
- Promotion and recognition of the overall standards of sound risk management and governance within companies.
- Transparency. Unlike other solvency regimes, Solvency II does not confuse prudence and capital requirements by incorporating implicit margins in the technical provisions. Instead, there are clear and distinct roles for technical provisions and capital requirements, with the latter being an explicit and objective assessment of the capital being needed to protect policyholders against unexpected adverse experience.
- Recognition of the economic reality of groups. Solvency II introduces a new and streamlined method of group supervision.

However, the CEA has strong concerns over the way Solvency II is currently depicted in the NAIC's draft comparison between the two Solvency regimes. Indeed, we feel the analysis of the Solvency II regime reflects neither the objectives nor the key features outlined above and is materially inaccurate in a large number of areas. As result, the comparison published by the NAIC does not allow to set the proper ground for a concrete exchange of views on prudential supervision between the US and the EU.

For example, when comparing the level of uniformity of the two regimes, the analysis implies that a principle based approach works against the convergence of supervisory practices. On the contrary, we believe a principle based approach allows not only for the regime to evolve to reflect changing economic conditions, but it also demands supervisors and undertakings use the flexibility inherent in the framework to ensure that the common objectives are met by all 27 EU member states.



The mechanism of the Lamfalussy process will ensure, amongst other things, an optimal level of harmonization between member states, and this is not accurately reflected in the NAIC's draft comparison. Indeed, the comparison fails to mention that, by definition, the Framework Directive and implementing measures are legally binding and the same for all EU member states. Under Level 4 of the Lamfalussy process, the European Commission will monitor the compliance and consistent enforcement of Solvency II throughout the EU. The very purpose of the Level 3 guidelines is to ensure supervisory practices converge while the "toolkit" provided by Level 1 and Level 2 is the same for all.

The absence of an accreditation program in the case of Solvency II is therefore clearly justifiable. While an accreditation program, on the other hand seems a necessary component to ensure supervisory convergence where prudential regulation operates under a state by state based system of rules without any legally binding requirements for a uniform application.

The comparison of the level of uniformity of the two regimes is only one amongst many examples which illustrate the lack of accuracy of the analysis, and where a closer dialogue would enable a more objective and appropriate comparison.

Having said this, we would like to emphasize that we do welcome the intention behind this initiative and we recognize the potential role it may play in triggering a transatlantic exchange of views on prudential supervision.

We would gladly offer our assistance in helping you to better understand Solvency II and we look forward to setting up the appropriate basis for a constructive dialogue with you.

CEA Papers

It should be noted that the comments in this letter should be considered in the context of the CEA's publications, which can be located on the CEA's website www.cea.eu.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Alberto Corinti".

Alberto Corinti
CEA Deputy Director General / Director Economics & Finance
CEA

Ecofin@cea.eu

Date:	July 3, 2008
To:	Kris DeFrain, NAIC
From:	Doug Barnert, GNAIE
Subj:	<i>A Comparison of Solvency Systems: US and EU</i>

Dear Kris:

The NAIC International Solvency and Accounting Working Group circulated the above referenced document as an example of the Group's efforts related to solvency modernization. We have a specific comment on the document. The first issue on page nine is the following:

	<u>US Solvency</u>	<u>EU Solvency</u>
Industry Capital Level (Calibration)	U.S. RBC does not specify an overall certainty level, but tends to rely more on CTE methodology than other methods. <i>(Actuarial Note: CTE and VAR produce similar answers except when there is risk of large losses, and then the CTE methodology is generally preferable.)</i>	99.5% VaR over a one year Time Horizon: <i>(originally selected as an S&P BBB company)</i> Cost of Capital method for non-hedgeable risk: Cost of Capital = 6% + risk free cost <i>(while 6% was originally selected as a placeholder, it might require calibration)</i> Calibration Remains, QIS4 in progress

We are concerned that the description of the US Solvency system above is potentially misleading. U.S. RBC does not regulate on the basis of specifying a confidence level to which the company is to design its capital levels. However, the RBC system was originally designed to result in capital levels that met specific levels of conservatism.

RBC originally targeted at least a 95th percentile level of conservatism. This level of conservatism is applied on a "worst present value of any projected year over the remaining life of the business" basis. Because of this method of application, the implicit one-year level of conservatism is generally much higher than 95%. More recent RBC changes have used a 90% Conditional Tail Expectation (CTE), which is the average of the worst 10% results. This change further increases the level of conservatism for risks with "fat tails", or losses that are concentrated in the extreme portion of the distribution of outcomes.

We are concerned that the response as drafted makes the US RBC system seem random and unsophisticated, when in fact it has been designed with specific confidence levels in mind, and using methods that are adaptive to the lines of business measured. We encourage the drafters to revise the response to better reflect the comparability of RBC to Solvency II's specified VaR level. It should also be noted that a major difference between the two is that RBC is a rules and factor based system designed to result in a confidence level, and EU Solvency specifies a confidence level and relies on the company to design the system to achieve that, with the supervisor following on to evaluate the models and processes used.

As always we appreciate the opportunity to comment and look forward to working with you on this important project. Please let me know if you have any questions or need additional information.

DWB:mtf