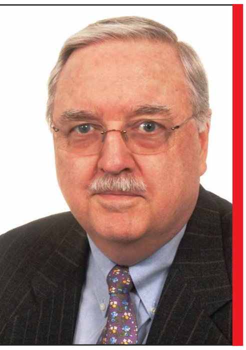
[INSIGHT] By Peter H. Bickford

Insurance Solvency Regulation: Quo Vadis?

It is hard to escape hearing about Solvency II, the EU plan to strengthen the financial requirements for insurers, and the US efforts to address the consequences of these new standards on domestic companies. For most of us our eyes glaze over with the mere mention of the subject, and certainly with the details. However, because it may change the entire approach to solvency regulation in the US, these impending changes in solvency regulation are very important developments for domestic companies, their markets and their producers, and not just to insurers doing business across international boundaries.



Peter H. Bickford

The mere suggestion that US regulators were more willing to allow company failures that the European regulators piqued my interest, so I asked Conning to answer a few questions about this statement, and they were gracious enough to provide me with thoughtful, detailed responses that I believe are important enough to share.

Recently the highly respected research and consulting firm, Conning, issued a study titled "**Insurance Solvency Regulation: The Race for a Workable Risk-Based Solution**" (© Conning Research & Consulting, 2012), which reviews the European and US approaches to solvency regulation, both current and proposed, the conflicts in approach and issues that will be raised by future changes. Being a solvency regulation junkie for the past 25 years or so, I was very curious about Conning's observations regarding the developing course of solvency regulation. Although the full report was beyond my budget ($1,750.00), Conning provided me with the Report's Executive Summary, which was itself very illuminating. One conclusion of the Report in particular caught my attention:

> "The more fundamental contrast between the two systems is in the calibration of required risk capital. RBC has no single fixed target, but one that differs by risk factor. The Solvency II target of capitalization geared to a 99.5% confidence level goes beyond the NAIC approach of identifying insurers at risk of financial difficulties and instead sets a target capital level designed to prevent any failures. *The U.S. system is oriented toward protecting the policyholder rather than the institution*. In the U.S. system, insurer failures are tolerated as long as obligations to policyholders can be absorbed by another insuring organization. *The Solvency II capital threshold appears designed to protect not only policyholders, but also shareholders, bondholders, and employees*." (Italics are mine)

The mere suggestion that US regulators were more willing to allow company failures that the European regulators piqued my interest, so I asked Conning to answer a few questions about this statement, and they were gracious enough to provide me with thoughtful, detailed responses that I believe are important enough to share. Following are my questions and Conning's responses in full:

***PB**. What is the factual basis for the Solvency II 99.5% capitalization confidence level?*

Conning: The 99.5% confidence level comes from DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009, Article 101:

> "The Solvency Capital Requirement shall be calibrated so as to ensure that all quantifiable risks to which an insurance or reinsurance undertaking is exposed are taken into account. It shall cover existing business, as well as the new business expected to be written over the following 12 months. With respect to existing business, it shall cover only unexpected losses.
>
> It shall correspond to the Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 99,5 % over a one-year period."

***PB**. Will such a high level of "certainty" act as a deterrent to capital infusion into insurance businesses subject to Solvency II?*

Conning: In the study we note that one possible consequence of the additional capital required under Solvency II could be depressed return on equity, which could impact investment in the industry. The study does not go further to speculate as to possible additional effects on capital availability to the industry.

***PB**. There is no similar percentage "confidence level" percentage stated for the NAIC approach. Is there one?*

Conning: For the NAIC RBC formulas and factors, there is no single, overarching confidence level, time horizon, or risk metric used, unlike with Solvency II SCR. The individual components of the RBC formula are calibrated separately. The ranges of confidence levels tends to be from about 90% to 96%. Our research did not uncover any factor/model calibration exercise that targeted anywhere near 99.5%. The difference between 95% and 99.5% for long-tailed distributions can be quite large.

***PB**. The paragraph concludes that the US system "tolerates" failures while the Solvency II regime is designed to "protect not only policyholders, but also shareholders, bondholders, and employees." That conclusion may come as a surprise to a lot*

continued on page 8

continued from page 6

of US regulators, and to the NAIC itself. It also raises a whole host of questions for investors, for the groups seeking convergence of insurance regulation internationally, and for the determination of equivalence with Solvency II. Does the main study give more support and basis for such a consequential conclusion, and if so would Conning be willing to share that support with me?

Conning: Our statement indicates that the confidence level built into the Solvency II directives achieves a level of attempted institutional solvency "guarantee" that may go well beyond the main intention of policyholder protection. We raised the point to make the distinction between regulation focused on policyholder protection and regulation that appears to have a much broader scope.

The NAIC's stated U.S. Insurance Regulatory Mission (from the NAIC's International Solvency Working Group Meeting 12/3/2009): "To protect the interest 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."

From that same meeting, the NAIC commented on calls for increased capitalization requirements:

> "Regulatory regimes could establish capital requirements so high as to have a zero-failure regime. However, in balancing the costs of such a system, most insurance regulatory regimes around the world accept a non-zero failure system with expectations of some insurance company failures. According to the IAA, 'It is impossible for capital requirements, by themselves, to totally prevent failures. The establishment of extremely conservative capital requirements, well beyond economic capital levels, would have the impact of discouraging the deployment of insurer capital in the jurisdiction.'"

It is important to note, also, that the U.S. system designed its RBC standards to work along with state insurance guaranty funds. The state guaranty funds are in place to protect the policyholder in the event that a financially impaired insurance company is unable to pay its insurance claims--which is a different approach from designing capital standards that will prevent company failure.

Postscript: the implementation of Solvency II has been delayed several times as its cost and consequences continue to be debated, both for the EU and internationally; and with the full scope of the Dodd-Frank legislation on insurance solvency regulation in the US not fully developed, this is a topic all industry participants need to be aware of and to follow closely. [IA]

Apartment Building coverage
in a five-minute phone call.

Call. Quote. Bind. Using TAPCO's courteous and prompt call center, Apartment Building coverage can be quoted, bound and delivered to your e-mail inbox quickly and accurately during one five-minute phone call.

CGL Coverage Available:
- Primary Limits up to $3 million Occurrence/Aggregate
- $5,000 Medical Payments Coverage
- Additional Interests
- Hired and Non-owned Auto available
- Excess or Umbrella Limits up to $5 million

** Available coverages and markets may vary dependent upon risk characteristics.*

Property Coverage Available:
- Building
- Contents
- Business Income
- Basic, Broad or Special Form
- Replacement Cost or Actual Cash Value
- Inland Marine
- Equipment Breakdown
- Computer Equipment
- Outside Signs

The TAPCO Service Pledge
- "A"-rated non-admitted carrier
- Competitive pricing
- Fast policy turnaround
- In-house financing available
- Quick claims handling
- $10 credit to your personalized TAPCO EZ Bucks Visa debit card with each policy
- Visa, MasterCard and ACH payments accepted

1,000 Strong More than 1,000 classes of P&C business written under binding authority.

tapco
UNDERWRITERS, INC.
The Logical Choice.

877-743-6977
www.gotapco.com

INSURANCE ADVOCATE®
www.insurance-advocate.com