NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

# U.S. State Insurance Regulators' Views: International Capital Proposals

**April, 2015**

## Purpose:

The purpose of this document is to articulate the views of U.S. state insurance regulators toward the uses of capital within prudential regulation and to help guide their ongoing work and input during the development by the International Association of Insurance Supervisors (IAIS) of a risk-based global insurance capital standard (ICS) for internationally active insurance groups (IAIGs), as well as basic capital requirements (BCR) and higher loss absorbency (HLA) requirements for global systemically important insurers (G-SIIs). This document is also intended to identify the characteristics of such developments that are necessary for U.S. state insurance regulators to support their implementation in our national system of state-based insurance regulation. As these developments continue to evolve, this document will be updated and evolve as well.

## Background:

In 2010, the IAIS began developing the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). In 2013, the IAIS agreed to develop a risk-based global ICS and to include it as a component of ComFrame. In 2014, the IAIS developed the BCR, which is applicable to G-SIIs and will serve as the basis for the HLA requirements.

In early 2014, the NAIC formed the ComFrame Development and Analysis (G) Working Group (CDAWG) to provide ongoing review, and technical as well as expedited strategic input on ComFrame and the international group capital developments. In line with its mandate, the CDAWG helped review the first IAIS Consultation Draft on the ICS, which was issued in December 2014; comprehensive comments on a number of key issues were submitted by U.S. state insurance regulators[1]. Additionally, the CDAWG has been exploring group capital concepts that would be appropriate for U.S.-based IAIGs. It is expected that a fully developed U.S. group capital proposal will result in comparable outcomes to the ICS. The CDAWG is collaborating in these efforts as well as on IAIS group capital deliberations with the U.S. Treasury (Federal Insurance Office) and Federal Reserve Board and other key stakeholders, as appropriate. The communication among all parties is dynamic, occurs frequently and helps to inform state insurance regulatory views.

## U.S. Regulator Views:

Although U.S. state insurance regulators continue to have concerns about the timing, role, and complexity of developing a global group capital standard given legal, regulatory and accounting differences around the globe, we are fully engaged in the process. Our primary objective is to ensure that should this standard be implemented, it appropriately reflects the risk characteristics of the underlying business and does not undermine legal entity capital requirements in the U.S. While we recognize the role and importance of group supervision, legal entity capital requirements are necessary to protect U.S. policyholders and promote a stable market, particularly given the structure of U.S.

[1] These comments are posted on the NAIC International Insurance Relations (G) Committee webpage.

financial regulation. As U.S. insurance regulators work within the IAIS to develop and consider implementing the various capital proposals, we will be mindful of the cost/benefit of the proposed standards, the impact on insurance product availability and affordability or other market impacts, and the compatibility of the proposed standards with the U.S. insurance regulatory system.

The following general views guide U.S. state insurance regulators' overall approach and expectations towards the development of capital standards and the various international proposals:

*Capital standards*:

- U.S. state insurance regulators support the need to assess capital adequacy as part of coordinated solvency oversight and recognize that insurance supervisors in emerging markets are calling for basic international capital standards or benchmarks of some kind; however, a single uniform capital standard is not the silver bullet solution, but rather should be seen as one of many tools used to achieve more effective regulation and/or greater financial stability.

- The business model for insurance is significantly different than the business model for banking and even the business models and risk management approaches amongst insurers are unique. The track record in the banking sector of a reliance on capital standards did not prevent a system-wide banking collapse during the recent financial crisis. Development of an ICS needs to reflect the distinct characteristics of the insurance business model and its supervision.

- The risks inherent in insurance products, even for the same business line, can be very different jurisdiction to jurisdiction. A single risk charge for that business line may well lead to incorrect assessments of the relative capital strength of IAIGs.

*Fungibility*:

- U.S. state insurance regulators are also concerned with a reliance on the assumption that capital can be freely moved within an insurance group. It is critical that the free flow of capital (i.e. assets) across a group should not jeopardize the financial strength of any insurer in the group. As such, the flow of capital out of an insurance legal entity within the group should remain subject to required approvals by that entity's domiciliary regulator. Ultimately, whatever is implemented at the group level, this should be *supplemental* to jurisdictional capital requirements. For the U.S., it will be supplemental to, and not a replacement for, the U.S. Risk-Based Capital (RBC) that applies at the legal entity level.

- Other jurisdictions may allow for greater discretion of capital movement within a group if they believe it is appropriate for their markets and regulatory regimes. However, international standards should not favor one regulatory approach over another but rather focus on ensuring an outcome of appropriately capitalized insurance groups on the whole.

*Regulatory diversity and coordination*:

- There are stabilizing benefits to retaining diversity in regulatory approaches even as greater consistency is achieved. An over-reliance or over-confidence in a single capital standard or single regulatory approach could actually increase systemic risk as all insurers and regulators model their behavior around those standards.

- Supervisory colleges should serve as the central coordinating forum regarding the setting and assessment of group capital standards. The group-wide supervisor must actively communicate with other involved jurisdictions and coordinate decisions regarding the assessment of capital shortfalls.

*Accounting and Valuation*:

- There remain major differences among jurisdictions in accounting systems and approaches to valuation of assets and liabilities, as well as differences in regulatory objectives. As long as these differences exist, the development of an ICS, BCR and HLA will need to take this into account.

- U.S. state insurance regulators support the development of a "GAAP Plus" valuation approach that can be utilized by insurance groups and which can result in comparable outcomes across jurisdictions. It achieves sufficient comparability, and differences between other approaches can readily be understood by the group-wide supervisor for purposes of prudential supervision.

- U.S. state insurance regulators do not support market adjusted as the sole approach for valuation for the ICS due to concerns related to volatility swings in the balance sheet as a result of using market values and its failure to adequately address the long-term business largely written by life insurers. Additionally, as the market adjusted valuation approach has little or no connection to U.S. public financial reporting, it would require new systems to be implemented at a significant cost.

*Timelines and Goals*:

- In February 2015, the IAIS Executive Committee agreed on the following ultimate goal of the ICS (without specifying a date):

  > *The ultimate goal of a single ICS will include a common methodology by which one ICS achieves comparable, i.e. substantially the same, outcomes across jurisdictions. Ongoing work is intended to lead to improved convergence over time on the key elements of the ICS towards the ultimate goal. Not prejudging the substance, the key elements include valuation, capital resources and capital requirements.*

  Additionally, the IAIS will be considering interim goals for the end of 2016 and the end of 2018, balancing the need to be ambitious while acknowledging the need to focus on what is realistically achievable given the different starting points in different jurisdictions.

- Development of these goals recognizes that the objectives of the ICS are not easily achieved and will require significant resources over many years. The timing for the various goals should continue to be driven by IAIS Members based on resources available and achieving high-quality results. U.S. state insurance regulators remain committed to work constructively towards the goal of developing an ICS that works for all jurisdictions; the need to develop a suitable end-product should not be superseded by artificial timelines.

- Related to these goals is the role of the ICS in minimizing regulatory capital arbitrage. While we support this idea, we also recognize that given the variety of differences between jurisdictions one tool alone (such as the ICS) cannot completely eliminate arbitrage, nor should the idea of minimizing regulatory capital arbitrage be used to push for a one-size-fits-all approach.

*Basic Capital Requirements (BCR):*

- The goal of the BCR is to provide a common metric across various jurisdictional capital requirements at the group level for purposes of applying HLA, which will be the additional capital requirement for G-SIIs. Given the intention of the ICS to ultimately replace the BCR as a basis to apply HLA, the form and role of the BCR will evolve.

*Higher Loss Absorbency (HLA):*

- The HLA should be developed for application to G-SIIs as a way to address systemic risk issues; as it has a very specific purpose, HLA should not be applied to insurers which are not designated as systemically important. As it is specific activities that are the focus of assessing potential systemic risk within the insurance sector, not traditional insurance business itself, the HLA should be developed in a manner that addresses those specific activities which may pose potential systemic concerns.

*Insurance Capital Standard (ICS):*

- A global ICS for IAIGs should continue to be developed as a supplement to jurisdictional capital requirements. For the U.S., it would supplement the U.S. RBC that applies at the legal entity level; we do not intend for RBC to be replaced by any new group capital rules but rather augment our existing approach.

- It is important to have adequate capital at the group level, but this cannot be a substitute for having adequate capital at the legal entity level. Measurement of a global ICS should be against available capital resources (rather than existing jurisdictional requirements) on either an aggregated entity basis (bottom up approach) or a consolidated basis (top down approach). It should not be used to adjust jurisdictional entity requirements.

- A primary objective of a global ICS should be enhancing the efficacy of capital requirements in order to help facilitate solvency systems in developing markets be on par with, though not necessarily identical to, such systems in developed markets.