

Solvency II—The U.S. Perspective

CAPITAL REQUIREMENTS FOR INSURANCE COMPANIES continue to be a hot topic in the United States. In Europe, regulatory developments of particular interest include Solvency II, the principles of which are based on quantifying risks using fair-value techniques. And in the United States, regulators continue to move forward on principles-based reserving and capital requirements. The ratings agencies, on the other hand, are focusing on the enterprise risk management function in general and, in some cases, have supplemented traditional analysis with proprietary capital models.

To date, most of the regulatory activities related to capital have been centered in Europe. These activities started with the introduction of the Individual Capital Assessment in the U.K., followed by the Swiss Solvency Test in Switzerland, and, most recently, Solvency II in the European Union. These directives aren't limited to the European insurance community; they have the attention of an international audience. The North American insurance industry is watching the European stage with curiosity. In Canada and Mexico, the plan is to adopt an approach similar to that of Solvency II with a parallel timeline.

The postponement of the implementation date of Solvency II from 2010 to 2012 provides outside observers, including those in the U.S., the opportunity to better understand and align their initiatives with those in Europe. It will also give them a chance to influence domestic policymakers in formulating strategies. This is important because the impact of changes made by companies in the global insurance industry extends beyond their individual jurisdictions and affects all their competitors. While many insurers in the U.S. are aligning their risk management activities with the methodology and techniques set forth in Solvency II, many others are taking a more passive approach while waiting for guidance from U.S. regulators.

Most of the attention paid to Solvency II has been directed at the first element of a three-pillar approach: quantitative capital requirements (economic capital).

The second pillar focuses on the supervisory review of the internal controls and risk management function. According to the EU's July 10, 2007, Solvency II Framework Directive, "The responsibility for an insurer's financial soundness will be pushed back firmly to its management, where it belongs." The third pillar addresses the supervisory reporting and public disclosure requirements.

Solvency II creates a capital framework in which the cost/benefit of taking risk is directly addressed. The strategic alignment of risk-mitigation techniques, including re-



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insurance and hedging, will provide opportunities for companies to alter their risk profiles and, consequently, change their capital requirements. Likewise, the ability to factor in capital assumptions from the outset in functions such as product pricing paves the way for more effective risk and capital management. Another change, but one that has received limited attention, is the benefit provided by an effective risk-management process and internal controls. Companies that effectively manage the risks they face may be rewarded by Solvency II with lower capital requirements.

Impact on U.S. Insurance Market

U.S. insurers are watching with nervous anticipation as Europe prepares to implement Solvency II. At the same time, U.S. regulatory activities are centered on revising principles-based valuation and capital structures. While this principles-based system promises to introduce a stochastic process for valuing insurance liabilities, the overriding methodology is very different from that of Solvency II. Concurrent with the regulatory activity, there's an evolution in risk management within the industry around internal economic capital frameworks. Without the existence or emergence of an accepted industry approach to economic capital, the U.S. insurance market is at a loss for a standard, and many companies are looking to Solvency II as a foundation upon which to build their economic capital frameworks.

But not all onlookers eagerly anticipate the introduction of Solvency II, in part because it will generate a capital requirement that isn't necessarily consistent with the NAIC risk-based capital formulas or with the principles-based approaches being explored in the U.S. If Solvency II produces capital requirements in Europe that are significantly different from those in the U.S., the profitability of products is-



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sued by U.S. companies may suffer in comparison with that of their European counterparts. Nonetheless, it's still too early to speculate how Solvency II will alter the competitive landscape for insurance companies in Europe versus those in the U.S.

Learning From European Insurers

The presence of European insurers in the U.S. market has helped bring Solvency II to the forefront because of the significant role it's playing in the development and promotion of enterprise risk management and economic capital frameworks. Lacking a standard methodology for economic capital, U.S. insurers may begin looking to their European counterparts for direction. Meanwhile, the ratings agencies are encouraging the U.S. insurance industry to put in place internal economic

capital metrics to support their risk management functions.

All evidence points toward the global convergence of capital regulations, and Solvency II is clearly the current leader. Understanding Solvency II will pay dividends to those companies that invest the resources to follow its progress. The opportunity for U.S. insurers to help shape future domestic and global regulatory developments is also in play. By monitoring the impacts of Solvency II requirements on the European insurance industry, U.S. insurers will be better able to gauge their ability to compete in the global insurance market.

No Time to Wait and See

For the moment, many U.S. insurers have chosen to delay making investments in economic capital frameworks until domestic regulatory requirements dictate the need to change. This is a dangerous strategy. The Europeans have shown that the implementation of a stochastic capital framework brings with it many challenges that take years to address. Traditional actuarial modeling platforms aren't designed to support the evolution to stochastic processes, and Europeans have learned that the difficulties surrounding technology and data are among the many hurdles they face. The cost to implement new capital frameworks reaches far beyond the financial outlay; while it will include a significant investment in hiring and training to support the framework, it will also require a cultural investment to address the resistance to change.

Given the time and investment it will take U.S. insurers to develop a stochastic capital framework, it's imperative that they recognize the urgency and not wait for U.S. regulators to drive them to act. Regardless of the direction regulatory capital requirements take, it would be myopic for U.S. insurers to adopt a wait-and-see stance.