Insurance regulation – On the Move

The EU-U.S. Dialogue joint study paper

At the conclusion of the annual International Association of Insurance Supervisors (IAIS) conference held in early October in Washington, DC, the EU-U.S. Dialogue on Insurance Regulation, an informal body which includes top supervisors from the EU and U.S., held a special session to compare EU and U.S. regulatory regimes.

The EU-U.S. Dialogue formally presented a 100-page paper on the two insurance regulatory regimes.

Executive summary

The joint study compared certain aspects of the insurance supervisory and regulatory regimes that are expected to be part of Solvency II in the EU with the state-based regime in the U.S. A group steering committee agreed upon seven topics considered of fundamental importance to a sound regulatory regime and to the protection of policyholders and financial stability:

- Professional secrecy/confidentiality
- Group supervision
- Solvency and capital requirements
- Reinsurance and collateral requirements
- Supervisory reporting, data collection, and analysis
- Supervisory peer reviews
- Independent third-party review and supervisory on-site inspection

Separate technical committees, composed of industry experts, were formed to consider each of the seven topics.

Key outcomes:

The paper provides two main observations without offering a firm commitment to change, reflective of the highly sensitive environment that has come to dominate the EU/U.S. insurance supervisory relationship:

1. The state-based regime overseen and enforced by the NAIC is a more mature regime that has been in effect for some years and is viewed as a robust system that coordinates effectively across jurisdictions, notwithstanding the varying regulation which applies across states. In comparison, Solvency II and the European Insurance and Occupational Pensions Authority (EIOPA) are still largely "work-in-progress." For example, guidelines in some cases are still being drafted with supervisors conscious of capital and liquidity problems faced by the industry.

2. In an attempt to coordinate and harmonize regulation across borders, the EU regime adopts a more rules-based prescriptive approach with quantitative and qualitative checkpoints and criteria, compared to the U.S. regime which relies on the NAIC to enforce adherence.

Below is a topic-by-topic summary of the report and the different points of comparison:

1. Professional secrecy and confidentiality

This section of the report focuses on the analysis of the policy objectives of confidentiality laws, the relationship between freedom of information laws and insurance confidentiality laws in the U.S and the EU, authority to share information across borders, and the laws associated with information exchanges.

The report points out that both regimes seek to balance the objective of maintaining professional secrecy with appropriate flexibility to share information with other supervisory authorities that have a legitimate and material interest in the information.

Key commonalities:

- Neither regime provides a single, all-encompassing definition of "confidential information."
- Both regimes have a spectrum of penalties that can be administered to violators of professional secrecy laws, depending on the severity of the breach.
- Primary regulatory oversight responsibility rests with the U.S. states' insurance departments and the EU Member State supervisory authorities.

Key differences:

- Structural approaches to confidentiality are very different. The EU starts from the presumption of confidentiality and identifies exceptions. U.S. penalties vary from state to state as there is a clearer emphasis on access to public records.
- In the EU regime, EIOPA participates as a competent authority in its own right whereas in the U.S., the NAIC is not considered a supervisory authority.
- In the U.S., the states rather than the federal government have primary regulatory responsibility for regulating the insurance business including professional secrecy laws.

2. Group supervision

This section primarily serves to compare the EU and the U.S.'s application of regulatory oversight to a group. Group supervision has become an important aspect of the overall supervisory process because group membership can pose unique risks such as reputational risk as well as benefits such as capital options and risk diversification.

Key commonalities:

- Both regimes set a primary policy objective for group supervision of policyholders, which is to enhance the financial stability of the insurance group.
- Both regimes have requirements for group reporting with a particular focus on group-specific risk and intragroup transactions (IGTs).
- In both regimes, the Own Risk and Solvency Assessment (ORSA) will be reported on at least an annual basis.

Key differences:

- The U.S. supervision of insurance companies is described as a "windows and walls" approach (i.e., still state-based with no formal groupwide requirements), whereas the EU supervision is according to Art. 212 of the Solvency II Directive, which does formalize a groupwide approach.
- The risk-based capital (RBC) formula used in the state-based regime in the U.S. is a factor-based model using an RBC ratio as an aggregation method for assessing overall insurance group capital whereas the Solvency II Directive provides for an explicit group capital requirement.
- The EU's group solvency assessment includes a total balance sheet approach using the default approach calibration to a confidence level of 99.5 percent over a one-year period whereas in the U.S., risk aggregation is carried out through the RBC and the group ORSA.
- The legal requirements are more prescriptive in the EU, whereas in the U.S., management has discretion to determine the specific methodologies chosen.

3. Solvency and capital requirements

Both the EU and the U.S. operate a capital adequacy program. The RBC system in the U.S. sets a minimum amount of capital (to identify weakly capitalized companies) to be held before action is prompted, at a level lower than the EU Solvency Capital Requirement (SCR). While the primary objective of both regimes is to protect policyholders, for this purpose, both regimes take different approaches.

Both regimes have a similar concept of ORSA assuming Solvency II adoption within Europe, but the EU sets the process in law and prescribes that the qualitative and quantitative assessments are performed against a set standard. In comparison, the U.S. allows for more management discretion.

The role of capital varies under the two regimes. The RBC calculation is a standardized approach to measuring a minimum amount of capital used to calculate different levels of action points; it is not an indicator of financial strength. Solvency II includes two independently calculated capital levels, the Minimum Capital Requirement and Solvency Capital Requirement (MCR and SCR, respectively), that allow different types of regulatory actions to be taken.

Key commonalities:

- Both regimes provide thresholds, which when breached, result in regulatory actions.
- The capital requirements in both regimes are supported by the requirements on governance, supervisory review, and reporting to supervisors.
- Both regimes have requirements with regard to investments that aim to ensure that the investment portfolios are established and managed prudently; however, these objectives are achieved in different ways.

Key differences:

- The SCR under Solvency II includes all quantifiable risks of the insurer while the RBC includes risks considered material to the industry with some modules looking at company-specific assumptions.
- In enforcing, the Solvency II framework is designed to provide incentives for risk management, whereas the RBC primarily relies on supervisory tools other than capital requirements.

4. Reinsurance and collateral requirements
This section covers the key differences and commonalities that exist between both regimes in relation to the supervisory requirements for reinsurance and collateral. Topics covered include policy objectives, risk transfer requirements, credit for reinsurance and collateral requirements, capital requirements, and consistency.

Key commonalities:

- Both regimes seek to ensure the ongoing solvency of domestic insurance and reinsurance companies in order to protect policyholders.
- In both regimes, the solvency requirements applied to reinsurance companies largely mirror the solvency regime applied to direct insurers. These requirements and other risk mitigation techniques must fulfill criteria relating to genuine and effective risk transfer in order to receive credit.
- Under both regimes, insurers ceding reinsurance must reflect the counterparty default risk associated with reinsurance counterparties in their capital requirements.

Key differences:

- In the EU, reinsurance undertakings are required to limit their objectives to the business of insurance and related operations, although direct insurers may be authorized to write reinsurance business. U.S. reinsurers are generally permitted to write insurance businesses on a direct or assumed basis.
- The state-based regime in the U.S. generally applies a fixed RBC charge for the recoverable amounts depending on the line of business.

5. Supervisory reporting, data collection, and analysis
While there are differences in the means by which the EU regime and the U.S. regimes handle reporting, data collection, and analysis, there are similarities in the overall objectives and approach. Both regimes seek or require:

- Harmonized and comprehensive reporting
- Data is analyzed for the identification of risks posed to insurers
- Disclosure requirements on undertakings
- The use of reporting to monitor compliance.

Key commonalities:

- Both the EU and U.S. will require ORSA reporting.
- Both regimes require harmonized data collection that is straightforward, transparent, and fair. Findings and data will be stored in a comprehensive database, which will also allow for retrieval and analysis.
- Regular and ad hoc quantitative and qualitative reporting and analysis are provided.

Key differences:

- The state-based system in the U.S. has a mature, harmonized data collection and analysis function administered by the NAIC. While the EU has a mature system in place, these are at member-state level and not across the EU as a whole.
- The EU includes a detailed description of governance and risk management systems, while the U.S. system prefers the monitoring to occur mostly through on-site examinations and focuses on expected outcomes.
- The EU will fully integrate ORSA within the Solvency II framework, whereas in the U.S., the ORSA is still pending implementation of the forthcoming model law, following the NAIC guidance manual on ORSA.

6. Supervisory peer reviews

The report focuses on the practice of EIOPA and the NAIC, referring to the activities of other institutions where relevant. Review programs are developed by representatives of states/competent authorities that are subject to review. Nonregulators may provide input to the development of the program.

The report is structured to address issues relevant to the scope, process, and outcomes of the Accreditation Program and the EIOPA Review Process.

Key commonalities:

- For both regimes, persons responsible for coordination of the process ensure relevant procedures are followed.
- Both regimes involve legal counsel on a consultative basis.
- Both regimes require those responsible for conducting reviews to be insurance regulation specialists, and appropriate steps are taken in order to avoid possible conflicts of interest.

Key differences:

- The accreditation in the U.S. system deals with financial solvency regulation, but does not include market conduct issues. In contrast, the EU peer review process covers prudential and market conduct issues.
- The objectives vary between regimes too: the state-based regime assesses whether the insurance departments are meeting minimum standards while the EU regime strives to achieve high-quality supervisory outcomes.

7. Independent third-party review and supervisory on-site inspection

This section covers significantly different areas of external scrutiny, internal controls, and supervisory inspections within the supervisory regime. Specifically, this report covers three key topics: independent audits, actuarial reports, and on-site examinations.

Key commonalities:

- Both regimes have directives or regulations that require an annual external audit.
- Supervisors in both regimes are provided the necessary authority to conduct on-site examinations.
- Both regimes have regulations that allow supervisors to conduct examinations of all companies writing insurance business in their states as often as necessary.

Key differences:

- In the EU, all insurers are required to have their annual accounts and consolidated accounts audited whereas in the U.S., audits are not required for insurers that have fewer than 1,000 policyholders or if they have annual premium income of less than $1 million.
- The state-based regime in the U.S. requires a full-scope financial examination to be performed at least once every five years. Under the Solvency II Directive, there are no frequency requirements for examinations.

Conclusion

International dialogue and debate continues at pace for the insurance industry. It is clear that many regimes share both differences and similarities. The decisions made at both an international and domestic level impact the playing field on which insurance companies operate. It is important for insurers to stay abreast of the changing regulatory environment and to understand the impacts of regulatory change on the business model of the insurer.

Contributing authors:

David Sherwood
Head of Insurance Regulatory
T: 212-954-5861
E: davidsherwood@kpmg.com

Solomon Abuliak
Manager, Insurance Risk
T: 212-954-7709
E: sabuliak@kpmg.com

Contact us:

Laura Hay
National Sector Leader Insurance
T: 212-872-3383
E: ljhay@kpmg.com

Lourdes Munier
National Marketing Director Insurance
T: 201-505-3732
E: lmunier@kpmg.com

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