Deloitte.

CloserLook

A Closer Look: What are the options for a U.S. insurance group capital standard?

Group capital standards might be closer to reality for U.S. insurers than ever before. Despite ongoing philosophical opposition, U.S. state insurance regulators may be expected to move reluctantly toward the adoption of U.S. group capital standards for large U.S.-based internationally active insurance groups (IAIGs), if only as a defensive move designed to better protect U.S. insurers and consumers.

State insurance regulators and U.S. industry officials have largely agreed that the U.S. insurance industry fared better during the financial downturn than many other financial services sectors, but the U.S. state-based system continues to face pressures to change from international and federal regulatory peers. Specifically, as international banking and insurance supervisors (often integrated within jurisdictions) worldwide have worked to implement the lessons learned from the downturn, the importance of enhancing group supervision has been repeatedly emphasized. Along with that has come pressure to adopt bank-influenced global capital standards for insurance groups to promote financial stability.

U.S. opposition to these standards has been based on numerous concerns, including the relevance of a group capital-based, seemingly bank-centric approach to insurance regulation despite very different business models. For example, where banking regulators tend to apply a source of strength doctrine for bank holding companies, state insurance regulators utilize a legal entity ring-fenced approach to protect U.S. policyholders. Other concerns relate to some jurisdictions placing less emphasis on policyholder protection, which is the central mission of U.S. state regulators. Robert Litan, a Nonresident Senior Fellow at The Brookings Institution, said, "Europe tends to put its primary emphasis on preserving insurers and protecting their creditors."[1]

For a while, U.S. stakeholders effectively delayed the adoption of insurance capital standards (ICS), but a directive by the G20's Financial Stability Board (FSB) to the International Association of Insurance Supervisors (IAIS) to begin work on capital standards broke the stalemate. The first such standard, the Basic Capital Requirement (BCR), applicable to Global Systemically Important Insurers (G-SIIs), is to be adopted by the G20 in 2014 with confidential reporting beginning in January 2015.

Even for those not directly affected by the BCR or the upcoming standards that will impact IAIGs under the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), capital standards creation is important. Litan observed that despite the apparently limited scope of this first set of standards, "… over time, it could become the default rule for all insurers and insurance groups in this country."[2]

Some state regulators and U.S. industry speakers at the National Association of Insurance Commissioners (NAIC) Summer 2014 meeting said that the U.S. stance was weakened because it had proposed no alternative to current IAIS global capital standards proposals. In other words, a "just say no" approach would likely no longer work, and the U.S. needed to consider other options to help protect its consumers and insurance industry by promoting standards that better aligned with U.S. regulatory frameworks.

The opening came with a May 2014 ICS Conceptual Memorandum by the IAIS. Paragraph 30 introduced jurisdictional group capital methods that could be used in place of the ICS and serve as a safe harbor for jurisdictions, where the jurisdiction has such a standard and it is deemed at least as robust as the ICS.

Produced by the Deloitte Center for Financial Services

The prospect of a safe harbor proved attractive to both regulators and industry. The NAIC's ComFrame Development and Analysis Working Group (CDAWG) held a September meeting to review options. Eight varied possible frameworks were presented. Examples of different approaches, listed under the general categories – Group RBC, Aggregated entity, and Cash flow – are summarized below.

Group RBC

The Group RBC (risk-based factor) approach is a consolidated approach intended to leverage existing U.S. frameworks in the development of a U.S. group capital standard to evaluate a group's capital adequacy. Potential inputs include: year-end audited financial statements; U.S. GAAP and/or SAP; specific conservative statutory valuation rules; and components of legal insurance entity NAIC RBC formulas and metrics.

Based on comments at the CDAWG meeting, U.S. industry seems to consider some leveraged components more critical than others. These include incorporating the U.S. statutory valuation approaches for insurance assets and liabilities. U.S. insurance groups and state insurance regulators have strong concerns that the IAIS's market consistent valuation approach is not consistent with the long-term business and product model of certain U.S. insurance groups.

Within the U.S., many insurance groups use U.S. GAAP as the basis of accounting for consolidated financial statements. The usual exception to this are mutual insurers who may file using only statutory accounting principles (SAP) and not prepare consolidated financial statements.

The Group RBC approach starts with a consolidated GAAP financial statement or a "hypothetical" consolidated U.S. SAP financial statement. The group would then make specific high-level adjustments to its respective consolidated balance sheet in order to achieve better comparability between U.S. groups and remove material valuation differences between GAAP and SAP. The adjustments could also provide a level of prudence and conservatism.

A standard factor-based formula would be applied to the "adjusted" consolidated group financials, including components of the formula that were specific to life and non-life business elements. This methodology would be consistent with the current legal entity RBC approach.

The Group RBC approach would likely be calibrated to a specific confidence level (e.g. 99.5% VAR) in order to be consistent with the risk-based factor approaches of key G20 jurisdictions, as well as, to meet the "as robust as" standard contemplated by the ICS Conceptual Memorandum.

Questions with the approach include the following:

- Might regulators choose not to develop guidance for the preparation of consolidated U.S. SAP financial statements, and instead simply require all internationally active insurance groups (including mutuals) to prepare consolidated GAAP financial statements?
- To what extent, and what type of prudent conservative adjustments would need to be made to GAAP?
- If state insurance regulators were to calibrate the group capital approach, would regulators then be incentivized to calibrate the legal entity RBC approach soon after?

Aggregated entity

Under the aggregated entity approach, the RBC-like or prescribed capital requirements (PCR) thresholds for all regulated entities within the group are determined and assessed as the starting point.

Thus, reliance would be placed upon existing supervisor frameworks, including regulated non-insurance entities, such as securities or banking entities. For regulated legal entities outside of the U.S., existing jurisdictional supervisory capital standards would be relied upon.

Once the prescribed capital requirements have been identified for each regulated entity, a metric is calculated for each regulated entity using a ratio of available capital to the respective PCR. The regulated entity metrics are then asset weighted so they can be aggregated into a group metric for an overall assessment.

The proposal is flexible with regard to how to handle insurers in jurisdictions that may fall short of the IAIS Insurance Core Principles (ICPs). However, reliance on local supervisory knowledge and a group's supervisory college is encouraged and expected in this proposal.

Questions with the approach include the following:

- Would a jurisdiction be required to be fully observant of all ICPs or just capital-related ICPs?
- What approach should be taken for non-regulated subsidiaries?

Cash flow stress testing

As an alternative to the RBC approaches, the cash flow stress testing approach was proposed. The approach applies stresses to internal cash flow models to determine if sufficient cash flows are available to meet all obligations under each scenario.

Stresses could include a number of factors desired by regulators, including interest rates, equity returns, inflation, mortality, morbidity, catastrophic events, etc. that are relevant for both solvency and financial stability. Stresses can be applied at a group level, operating legal entity level or both. The approach appears to be accounting agnostic and that could help avoid many jurisdictional accounting wars. It has the ability to leverage jurisdictional capital requirements to ensure the insurance regulated entities meet jurisdictional solvency requirements.

Questions with the approach include the following:

- How would international supervisors consistently validate the models and tests?
- Would supervisors require significant actuarial assistance to review the models?
- How do you prevent arbitrage with regard to assumptions used within the internal models between jurisdictions?
- Does the approach only apply to regulated insurance entities within the group?

Proponents of the approach have suggested the methodology could theoretically be combined with a risk-based factor approach, where the factor methodology is applied to regulated non-life insurance entities and/or non-regulated entities within the group using existing jurisdictional factor-based approaches or new approaches.

Up for discussion

The obvious implication of the numerous presentations to CDAWG is that U.S. IAIGs are now starting to assess whether a U.S. insurance group capital standard is needed to help avoid an international standard being forced onto U.S. firms. At the September CDAWG meeting, representatives of the Fed and the Federal Insurance Office (FIO) were present, perhaps symbolizing a new "Team USA" with the combined goal to help promote U.S. interests.

At this early stage, the impact of group capital standards on insurers' strategies and internal processes is yet to be understood, and key questions remain. These include:

- Will a group capital standard be limited to U.S. groups that are GSIIs or subject to ComFrame or will it be extended to all internationally active U.S. insurance groups?
- What is the definition of an insurance group and will it level up subsidiaries currently outside the scope of RBC – life company captives for example?

Whatever the final version of U.S. group capital standards turns out to be, insurance groups may wish to analyze the effect of different options and possibly join the discussion now to help influence the outcome of areas they deem critical.

Main elements of a U.S. group capital proposal initial views – NAIC

September 2014

1. The main objective of a U.S. Group Capital Proposal (GCP) is for the protection of policyholders. Well-capitalized IAIGs also support the goals of financial stability.
2. The GCP aims at comparability of outcomes across jurisdictions and among IAIGs. A comparable outcomes approach allows for increased cross-border supervisory cooperation and collaboration.
3. The GCP is a consolidated group-wide standard at the level of the insurance group that provides for a risk-based measure of capital adequacy. The level of consolidation is generally at the financial holding company level that is immediately above the insurance entities.
4. The GCP reflects all known material risks.
5. The GCP aims to minimize procyclical outcomes.
6. The GCP reflects an appropriate balance between risk sensitivity and simplicity.
7. The GCP reflects appropriate target criteria for the regulatory capital calculation.
8. The GCP respects the jurisdictional accounting requirements (for example, GAAP, IFRS, or other comprehensive bases of accounting).

Source: NAIC

Executive sponsor
Rich Godfrey
Principal
U.S. Insurance Advisory Leader
Deloitte & Touche LLP
+1 973 602 6270
rgodfrey@deloitte.com

Deloitte Center for Financial Services
Jim Eckenrode
Executive Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Authors
Andrew N. Mais
Senior Manager
Deloitte Services LLP
+1 203 761 3649
amais@deloitte.com

Eric Meistermann
Client Service Executive
Deloitte Consulting LLP
+1 212 313 1606
ermeistermann@deloitte.com

David Sherwood
Senior Manager
Deloitte & Touche LLP
+1 203 423 4390
dsherwood@deloitte.com

David Vacca
Senior Advisor
Deloitte & Touche LLP
+1 913 486 2295
dvacca@deloitte.com

Endnotes

[1] Robert Litan, "Source of Weakness: Worrisome Trends in Solvency Regulation of Insurance Groups in a Post-Crisis World," *Economic Studies at Brookings*, August 2014.

[2] Ibid.

Deloitte Center
for Financial Services

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte network") is, by means of this communication, rendering professional advice or services. No entity in the Deloitte network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

Copyright © 2014 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited