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Uncertainties, Challenges and Opportunities of Global Insurance Regulatory Convergence

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THE GLOBAL INSURANCE INDUSTRY

is experiencing dramatic change as reserve and capital regulations transition from the traditional, prescriptive approach to stochastic, principles-based approaches. This fundamental change most likely portends the gradual global convergence of regulation across countries and insurance products. At the same time, the current economic crisis seems to be creating a multinational appetite for tighter regulation.

Consequently, the industry needs to pay attention to the evolving new standards for reserves and capital. These standards will impact how individual companies deploy their capital within their various jurisdictions and the amount of risk they take on to achieve comparative cost advantage. This will change global industry dynamics. The stakes are high in terms of how well companies use the changes to their competitive advantage.

In the United States, there is a movement toward the principles-based approach which is likely to lead to the outright shift from U.S. generally accepted accounting principles (GAAP) to International Financial Reporting Standards (IFRS). The initial first steps have been Statement of Financial Accounting Standards No. 157 (FAS 157) for fair value or market-consistent valuation, principles-based reserves and capital changes. Similarly, Europe has focused on the principles-based, market-consistent IFRS and Solvency II. Even though the economic crisis has been called into question and, indeed, may delay various implementation timetables and the final drafts of principles and guidance, the eventual convergence of U.S. GAAP, IFRS and Solvency II seems set.

U.S. companies cannot afford to wait until the remaining uncertainties are resolved. The challenge is to understand and anticipate the impacts, particularly on capital management and deployment, and to act on the opportunities the changes introduce. While this article cannot address such specific implications as profit emergence over time and product profitability, it does address the key capital and risk management issues immediately confronting the industry.



EVOLVING AND CONVERGING GLOBAL METHODOLOGIES FOR CAPITAL RESERVES

Across jurisdictions, there has been a steady shift toward principles-based, market-consistent methodologies for setting reserves and capital requirements. In both the U.S. and Europe, the evolving changes resemble and leverage capital-quantification techniques, including stochastic analysis across multiple risk drivers. There has been considerable progress:

- As of 2008, the definition of fair value for U.S. GAAP was clarified with FAS 157. Although fair value for insurance liabilities remains undefined under IFRS Phase II, the definition in FAS 157 resembles the approach currently being proposed under IFRS, namely that fair value is derived using market-consistent techniques.
- The economic crisis is already driving an intensifying dialogue between the International Accounting Standards Board and the Financial Accounting Standards Board, so it is likely that there will be an accelerated convergence



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of principles as all jurisdictions work through the dramatic effects the crisis has had on the equity markets.

- Solvency II, the evolving European capital standard, is currently scheduled to be introduced in 2012, but is still in flux. In rough parallel with FAS 157 and IFRS Phase II, Solvency II employs a market-consistent approach to the valuation of insurance liabilities. At first glance, convergence might seem logical because of this common approach. However, each approach uses a different interpretation of market consistency for insurance liabilities. The Solvency II treatment of capital requirements at group and business unit levels (specifically the amount of credit that can be taken for group support as a means to cover local business unit capital requirements), has recently been tabled for further debate and could change significantly before final adoption.
- Proposed changes to U.S. statutory reserves and capital are being developed and are expected to be in place by year-end 2009. The standards are principles-based, with a run-off of liability cash flows calculated over a set of scenarios. The statutory approach is based on a real-world projection of asset and liability cash flows over the life of the liabilities.

When comparing new U.S. statutory reserves and capital with the prospective new frameworks and regulations of GAAP, IFRS and Solvency II, it is clear that there are similarities and differences among the underlying mechanics. The key variable is to what extent and how the evolving standards will deal with market-consistent valuation of assets and liabilities currently held.

Having said that, it is a virtual certainty that country regulators will ultimately achieve a global transformation—a harmonization—of capital and solvency requirements. At the end of the day, underlying differences in methodologies will not impede the trend toward that global harmonization.

GRAVITATING TO MARKETS OFFERING COMPETITIVE ADVANTAGE

While each of the evolving standards is an improvement over existing regulations, the variances among the standards suggest that formal global convergence may be farther off than expected. Nonetheless, differences in capital requirements will impact the competitive positions

of insurers throughout the global insurance market. The practical marketplace reality is that as new standards are phased in, capital and risk will gravitate to areas that offer companies the lowest overall cost of capital and risk. An efficient market should encourage the evolution of a converged global regulatory framework.

In such a converging, dynamic global market, if the competitive balance shifts toward a particular regulatory basis (all things being equal), one of two actions will occur: (1) the regulations in the jurisdiction at a competitive disadvantage will converge to those requiring less capital; or (2) the insurance liabilities will gravitate toward the jurisdiction that provides the most favorable reserve and capital requirements.

Companies domiciled in a jurisdiction with significantly lower capital requirements should be able to capture greater market share by passing on the lower cost of capital to policyholders through more competitive pricing. There will likely be additional barriers to the movement of risk, or a limitation on the credit taken for capital held across jurisdictions, but the impact will nonetheless be felt throughout the insurance industry. Countries within the European Union have retained control over risk incurred by companies within their boundaries. These country controls will likely continue as the global economy works its way out of the current crisis.

PROPOSED CHANGES PRESENT OPPORTUNITIES AND CHALLENGES

Increasing the understanding of the proposed regulatory reforms and potential convergence will help companies deal with and even embrace the proposed changes. The reserve and capital requirements currently applied to many U.S. products have led the insurance industry to find alternative approaches to capitalization.

Most actuaries would agree that the reserves required for term insurance are excessive. The capital requirement for variable annuities was altered under C3 Phase 2 to align the risk profile at a company level. The proposed changes will produce a reporting basis in which the required reserves and capital reflect the risks inherent in the product design. The key difference from a global perspective is the definition and quantification of risk.

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As indicated above, the current differences in the proposed bases should converge. If the future brings reserve and capital requirements consistent with the risks taken, pricing methodologies will inevitably change as well. Convergence may present an opportunity, depending on such factors as products, markets and the future regulatory basis.

The timing and potential to alter the financing or change the pricing and marketing focus of an insurer requires insight into the proposed regulatory changes around the globe. It could be catastrophic for an insurer to ignore the cost of the changes outside its current jurisdiction. Likewise, the ability to anticipate the impact of changes on in-force business could prove invaluable.

BUSINESS IMPLICATIONS

The proposed global regulatory changes will have significant implications for the business:

- *Pricing.* The methodologies and metrics used to set product prices will likely adjust to reflect the change in reporting basis.
- *Financial reporting.* Organizations are already working on solutions to meet the increased processing and modeling demands. The challenge will be to produce stochastic results over a short time horizon.
- *Strategic decision-making.* Management will need to climb a steep learning curve to understand the results and movement in capital under a new reporting basis. When results are counterintuitive from the perspective of existing frameworks, actuaries and management will need to have confidence in the new reporting structure.

- *Benchmarking.* The metrics used to compare companies will need to change. This will require adapting the metrics currently used by outside parties, as well as additional disclosures. The goal will be to achieve a balance between information overload and information needed to understand the financial results.

CONCLUSION

Global insurance regulations are converging. Countries are not likely to support regulation or reserving methodologies that place their home-based insurance sectors at competitive disadvantage.

The journey forward will undoubtedly be a bit protracted and uncertain. But, patiently waiting for closure will not likely be rewarded. It is important for insurers to understand how each evolving regulatory change, both in and outside of their countries of domicile, will impact the capital they and their competitors are required to hold. Given the time and investment it will take to develop a stochastic capital framework, it is imperative that companies recognize the urgency and not wait for the regulators to drive them to act. Regardless of the direction regulatory capital requirements take, it would be myopic for insurers to adopt a wait-and-see stance.

The challenge for each company will be to achieve the most effective and efficient balance of capital cost and acceptable risk. This is a familiar challenge, but as the economy moves through the current crisis, the stakes have never been higher. ♦