Insurance Governance Leadership Network
ViewPoints

March 8, 2013
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Global insurance leaders actively seek clarity on standards

"It is the uncertainty that brings me here today. There are a tremendous number of crosscurrents that do not appear to be converging."

– A non-executive director[1]

On January 28, Tapestry Networks and Ernst & Young convened the fourth meeting of the Insurance Governance Leadership Network (IGLN) in New York. A select group of non-executive directors were joined by Ted Collins, Group Managing Director, Global Insurance & Managed Investments, Moody's Investors Service and Tom Leonardi, Commissioner, Connecticut State Insurance Department. This meeting, originally scheduled for November and moved in response to Hurricane Sandy, was a companion to the October 10 IGLN meeting in Amsterdam. Both meetings focused on insurers' responses to the myriad of changing regulatory, capital, and accounting standards.

Participants observed that change and uncertainty appear to be the new norm in the industry. Insurers view lack of convergence on standards as one of the most prominent industry challenges. Despite differences in products, group structure, and business practices, participating insurers believe the path to progress will involve diverse insurer groups unifying to advance dialogue on this and other challenges.

This issue of *ViewPoints* synthesizes the ideas and perspectives shared in the meeting on January 28 and in preparatory discussions with directors, executives, supervisors, and regulators.[2] The following key themes emerged:

- **Evolving risk-based standards are themselves a potential source of risk.** Regulatory regimes in Europe and North America are changing dramatically, and policymakers continue to push back expected completion dates. The ongoing regulatory uncertainty means that insurers are forced to make important investment, product, and other strategic decisions based on incomplete information. Insurers warned that the current regulatory ambiguity and threat of new regulations may motivate insurers to make strategic choices that limit diversity, which may increase systemic risk.
- **Consistent cross-border supervision is not yet a reality.** For global insurers, clear and consistent cross-border supervision is a top priority. However, insurers and regulators point to a number of challenges inhibiting more effective cross-border supervision, including supervisors' limited resources, difficulty coordinating supervisory colleges, and the introduction of several new regulatory authorities with as yet undefined roles.
- **Differences in international accounting standards introduce complexity into the global market.** Non-executive directors remain concerned about the impacts of diverse global accounting standards and the balance sheet implications of fair value reporting. Increased balance sheet volatility,

[1] In this document, "director" refers to a member of an insurer's unitary or supervisory board.

[2] All conversations were held under a modified version of the Chatham House Rule that encourages sharing of perspectives but absolutely forbids attribution to individuals or institutions. All comments from meeting participants are italicized. A complete list of meeting participants can be found in the Appendix on page 14.

resulting from mark-to-market practices, may be compounded by impending risk-based capital requirements. Insurers reported that they are striving to anticipate and deal with the impacts of these different standards.

- **The role of credit rating agencies (CRAs) is shifting.** Following the financial crisis, the role of CRAs in the insurance sector is changing, though directors assert that raters remain as important as ever, especially without convergence in accounting or solvency standards. CRAs maintain strong opinions about regulatory and other industry trends, and acknowledge the industry's frustration over inconsistent global standards. At the same time, they caution against relying on their analysis to bridge these gaps, particularly regulatory gaps. Instead, they argue that ratings should be viewed as one of many complementary analytical tools for investors, counterparties, and policyholders to evaluate relative credit risk.

Evolving risk-based standards are themselves a potential source of risk

IGLN participants list changing risk-based capital (RBC) standards and the implications for insurance boards, supervisors, management, and investors as a key concern. Non-executive directors have raised thorny questions about what new capital requirements will mean for global strategy and what the impact will be on companies that face different requirements across regulatory jurisdictions.

To date, major regulatory reforms in Europe and the United States are taking longer than first expected to implement, due in part to division within both North America and Europe over standards, though the issues are different in each geography. Continued disagreement within regimes is also threatening prospects for eventual convergence across regimes.

Questions on the final form of the Solvency Modernization Initiative (SMI)

Born out of the financial crisis, the SMI is the major regulatory reform initiative of the US National Association of Insurance Commissioners (NAIC). Recent delays in implementing parts of the SMI and ongoing conflict among state regulators as to the direction of the initiative contribute to insurers' concerns about the future of US regulation and complicate companies' operations and business strategy.

RBC standards

Most US-based insurers view RBC standards as a useful "guardrail," with directors quick to observe that RBC standards form a baseline solvency calculation. However, one US director noted that even within the United States, there is no clear consensus on appropriate RBC standards: *"Countervailing voices exist. Regulators want larger reserves, but some, including investors, think [property and casualty] insurance is overcapitalized."* Most agree, however, that whatever consensus US regulators reach, Solvency II's capital standards, especially with respect to group solvency, will be more stringent. For more on Solvency II, see text box on page 3.

Own Risk Solvency Assessment (ORSA)

Despite a significant early investment in developing ORSA, some insurers indicate they may take a wait-and-see approach to future action, noting the NAIC's delays in implementing ORSA requirements. As one executive stated, *"We have put a lot of work into ORSA, but we aren't right now. The date has been pushed back officially to 2015, but I don't know when it will happen. It isn't clear what it will look like or how regulators will use it. We will probably take a step back and see what happens."*[3]

Principles-based reserving

In December 2012, the NAIC adopted a new valuation manual that lays out a principles-based approach to establishing reserves for life products. Principles-based reserving (PBR), a key feature of SMI, represents a risk-based approach to liabilities, and is designed to modernize US reserving practices in line with newer and more complex life products. Although PBR has support from the majority of states, California and New York now oppose it and could significantly delay or derail implementation – pushing full implementation out to 2015 or later.[4] Perhaps more troubling for the industry is that these large states object for different reasons. "New York [objects] because of concerns with a model-based standard and California because of the perceived difficulties in monitoring and overseeing the implementation," noted one industry expert.[5]

Delays to Solvency II prolong insurer anxiety

- **Full implementation delayed.** Solvency II's capital rules were approved by the European Parliament in 2009 and were originally due to go into effect October 31, 2012. Following a series of delays, new capital standards will not be implemented until 2016 or later. Further progress on Solvency II awaits the conclusion of an interim study and approval of Omnibus II, the amendment that makes changes to the original directive. The vote on Omnibus II was recently pushed back again from June 10 to October 22, 2013.[6] Insurers continue to express frustration and concern over the loss of momentum and the cost of readying for Solvency II thus far. One director remarked, *"I am not optimistic about the commission's ability to get [Solvency II] done – now they are saying 2017 or maybe never? That is not good – uncertainty is the worst."*
- **Supervisors seek a phased-in approach.** In an effort to maintain momentum, beginning in January 2104 the European Insurance and Occupational Pensions Authority is planning to phase in

continued overleaf

[3] The NAIC created ORSA, which ties an insurer's risk framework and controls to levels of capital, as part of the SMI. Insurers will file an ORSA annually with their lead state regulator. In July 2012, the NAIC completed its first ORSA pilot project and shortly thereafter adopted the Risk Management and ORSA Model Act, intended to serve as a template for adoption by individual states. The NAIC has pushed back ORSA requirements until 2015 and has said it will schedule a second pilot program later in 2013.

[4] Clive Davidson, State Regulators Clash over US Life Reserving Principles, *Insurance Risk,* February 1, 2013, 1. (Access to this website is limited to members of *Risk.net*.)

[5] Ibid., 2.

[6] Details of dates and timelines are available on the European Parliament legislative information web page.

Delays to Solvency II prolong insurer anxiety *continued*

aspects of Solvency II before the rules are fully implemented.[7] Insurers seem divided over whether this will help regulation move forward or create additional challenges. One executive observed, "The interim measures are an attempt to make sure everyone is heading in the same direction, but things like the determination of capital will remain outside the interim measures, and so there is still the danger that regulators will go off and do their own thing."[8]

- **Harmonization unlikely in the near term.** With many questions remaining about the final form of Solvency II and other reforms, insurers cannot expect harmonization or convergence of regimes for many years. Worryingly, some global insurers maintain that non-convergence is as threatening as delayed implementation of any one regime.

Understanding the implications of continuing uncertainty

Directors are concerned about their ability to make good product and investment decisions in such an ambiguous climate. One director asked, *"How do you know how to invest for the future if you don't even know what will happen in three years? ... We are just in a wait-and-see period right now."* Without established regulations, insurers must attempt to anticipate multiple regulatory futures. One director observed, *"We need to focus on what we need to do as a company, but you have to be aware of what regulatory realities might cause you to do in the future."*

Several insurers fear that regulatory changes could motivate changes in business models or investments that reduce overall insurance sector diversity, creating more risk. One director said, *"One [significant] concern is that regulators may force companies into asset classes that aren't as safe as they think they are – like bonds. Not only might we not be in the best investments, we would be in them together."* Another director noted, "[With] so much information [available, there will be] a lot of benchmarking internally and externally. There will be a natural tendency to move toward the benchmark."

Moving forward amid uncertainty

Despite concerns over continuing regulatory uncertainty, insurers are keen to concentrate individual and collective energy on progress. Insurers discussed the following three strategies for moving the dialogue forward:

- **Focus on local regulatory reform ahead of global convergence.** One director noted, *"We need to get our own house in order."* Several insurers were of the opinion that the focus should be on solidifying Solvency II and the SMI first and foremost, and then should shift to convergence.

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[7] See European Insurance and Occupational Pensions Authority, Opinion of the European Insurance and Occupational Pensions Authority of 20 December 2012 on Interim Measures Regarding Solvency II (Frankfurt am Main: European Insurance and Occupational Pensions Authority, 2012).

[8] Michael Faulkner, "Insurers Raise Fresh Concerns over Solvency II Phase-in," *Insurance Risk,* February 7, 2013. (Access to this website is limited to members of *Risk.net*.)

- **Move forward incrementally.** Several directors noted that if reforms wait for everyone to *"catch up,"* they may never actually begin. One lesson from Solvency II is to avoid "all-or-nothing" implementation dates. One director said, *"Clearly the big-bang solution – of having one date by which everything has to happen – is hard to deliver. Phased or parallel implementation is better than delaying. The groups that are slowest need the most help. That's fine, but it shouldn't stop everyone. Letting people get on with it is better than waiting for everyone to be able to move forward."*
- **Improve data management to better integrate regulations and business practices.** Several directors said that the insurance sector is well known for having antiquated information technology (IT) systems. One director observed, "IT in insurance is not very good. We have clunky, creaking, and expensive legacy systems, especially in life insurance. What do you do with a dependence on legacy systems?" Several participants suggested that improvements in IT might be a potential solution, albeit an expensive one, to both the challenges posed by older systems and the burden of new regulations: "Companies do not have the information or IT systems to drive compliance with new regulatory requirements. The insurance industry is full of data, but is weak at using the data to identify, mitigate, and manage risk. Improving IT infrastructure now would go a long way to helping us in the future."

Consistent cross-border supervision is not yet a reality

One of the biggest challenges in the insurance sector, for insurers and supervisors alike, is consistent cross-border supervision. The International Association of Insurance Supervisors (IAIS) developed the Common Framework for the Supervision of Internationally Active Insurers (ComFrame) as "an integrated, multilateral and multidisciplinary framework for the group-wide supervision of internationally active insurance groups."[9] Participants observed that ComFrame advances the conversation on cross-border regulations, but there are many important details to work out. One director noted that while cross-border supervision generally means international supervision, interstate regulation can also be problematic in the United States. He commented, *"The US is not good at interstate regulation. In some areas, the regulator does not even know what is happening in the next state."*

Challenges to cross-border regulation

Members discussed several factors that interfere with or constrain effective cross-border regulation.

Limited resources

One participant observed, *"A number of [US] regulators are challenged by the [lack of] availability of resources, especially the depth of talent … States don't really have the resources to properly implement ORSA."* Inadequate funding may also hamper effective supervision. A director noted, *"The funding of supervisory colleges is becoming an issue. It is not just schedules but resources. Even getting the Scandinavians to fly to London can be problematic."* In an environment where regulation is becoming more subjective, and public budgets are shrinking, some regulators may face additional challenges implementing new rules.

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[9] International Association of Insurance Supervisors, "Common Framework."

Difficulty coordinating supervisory colleges

Participants continue to focus discussion on the structure of supervisory colleges, particularly the appropriate powers and role for the lead regulator. An executive noted, *"[Our regulator's] main concern is what kind of authority does the lead supervisor have? We need to have a discussion about the role of the lead supervisor. Some things are in, some are out, but we need to force the conversation."* A supervisor agreed, saying, *"In the US, [the lead supervisor] is first among equals."* In contrast, ComFrame proposals in Europe could grant lead supervisors additional authority. Some regulators have asserted, *"Let's not try to fix what isn't broken."* Pros and cons exist for each model. Critics of the European model assert it undermines the authority of other local regulators, while critics of the US model claim it may not be strong enough to effectively oversee internationally active groups during challenging times.

Participants are generally hopeful about the prospects of supervisory colleges, but noted that real success may require supervisors to move out of a zero-sum mind-set. Directors, executives, and regulators alike acknowledge that such a mentality can be challenging in the face of a disaster and the resulting political pressure. For insurers, cross-border regulation and its politics can have real business implications. One director noted,

> *Political or regulatory issues drive concerns [within individual states]. States don't want to pay for disasters in other areas, but think other states should chip in when something happens to them. Companies end up creating stand-alone subsidiaries to deal with a state – it defeats the point of insurance, the sharing of risk.*

New regulatory players

A number of new players have recently joined the regulatory fray, including several in the United States. Insurers are trying to understand the challenges they may face serving multiple supervisory masters:

- **Federal Insurance Office (FIO).** The FIO was recently established to monitor all aspects of the US insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the industry or the financial system. The FIO also coordinates and develops federal policy on international insurance concerns. Both the FIO and state regulators note that the FIO is not a regulator: "To be clear, the FIO is not a regulator – that remains the province of the states."[10] However, the extent and nature of the FIO's duties and power are still unclear, which is a source of uneasiness for insurers. At present the industry is eagerly awaiting the delivery of the FIO's mandated report on the US system of insurance supervision, which some predict will call for changes to the state-based regulation.

- **Federal Reserve (the Fed).** Receiving a designation of global systemically important financial institution (G-SIFI) or global systemically important insurer (G-SII) will significantly impact insurers. In the United States, insurers receiving either designation will move from state-based regulation to regulation by the Fed, an institution that has historically only regulated banking institutions. Directors fear the Fed may attempt bank-like regulation of insurers, though one director observed, *"We [several*

[10] Michael McRaith, Remarks at the Property/Casualty Insurance Joint Industry Forum (New York, January 10, 2012).

committee chairmen] met with the Fed and found it very encouraging … I was happy to see that kind of engagement, given the Fed has little knowledge of the insurance industry."

- **Other possible supervisory authorities.** Two additional federal departments may play a role in insurance regulation in the United States: the Department of Housing and Urban Development (HUD) and the Consumer Financial Protection Bureau (CFPB). HUD recently finalized regulations that insurers worry will make HUD a de facto regulator of home insurance and that some have said could threaten state-approved actuarial practices.[11] One director said, *"Another big issue out there for [US home insurers] is coming out of HUD. What role do we play in affordability and availability? It is about disparate impact. It may be a personal-lines issue, but it is serious. The CFPB and [CFPB director] Cordray are looking into these issues and looking into capital adequacy."*

The implications of supervisory challenges

Whether supervision is across national or state borders, insurers mentioned two primary concerns: being caught between conflicting standards and dealing with ineffective or insufficient supervision.

Conflicting standards

Insurers noted that in both the United States and Europe, each supervisor often has a distinct agenda, which may not necessarily be aligned with that of other supervisors. All supervisors focus on solvency, but take different approaches. One non-executive perceived the difference in priorities as follows:

> *We are regulated by [several entities in the United States] and have great working relationships, but there is an increasing intensity around the process. The Fed is focused on safety and soundness. They are not intrusive but inquisitive. They have been helpful at making us look at risk. [On the other hand] we are also in the state environment, and [state regulators] focus on affordability and availability. The regulators have different goals, and [we] are in the middle.*

The challenge of compliance with the requirements of multiple supervisors is exacerbated by the fact that leadership roles among supervisors within colleges are still being defined. Regulators note significant coordination among supervisors through colleges; however, one industry perspective is that colleges are still evolving, and authorities will have to firmly establish whose rules will take precedence. Insurers and regulators alike have acknowledged the potential for competition among supervisory bodies, especially when agendas conflict.

Ineffective or insufficient supervision

Responding to multiple regulators will increase inefficiency for insurers, but may also contribute to less effective supervision. Insurers wonder whether national and state authorities, constrained by limited financial and personnel resources, will be able to enforce new regulations effectively.

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[11] Arthur D. Postal, HUD Finalizes Disparate-impact Criteria; Insurers Claim Regulatory Overreach, *PropertyCasualty360,* February 12, 2013.

Making progress despite supervisory challenges

Insurers expect that the evolution of supervisory practices will take longer than any rulemaking. In the meantime, boards and executives plan to keep an eye on the evolution of supervisory colleges as the principal hub for interaction among authorities. One executive noted, *"Colleges are still pretty new, especially in the US. We'll see what happens. Hopefully we can provide some feedback to [the] NAIC about how well they work."*

Several directors also stressed the importance of venues in which insurers and regulators can engage in dialogue and share their experiences. Non-executives highlighted the tremendous diversity in the sector as an obstacle to speaking with a unified voice, but noted that forums for dialogue served to highlight the many shared concerns across different elements of the industry. *"I am not sure you can refer to the insurance industry as a monolith. You can go to Washington and hear 12 different stories … [but] I'm interested to hear what others think."*

Differences in international accounting standards introduce complexity into the global market

Several non-executives noted the significant impact that non-aligned global accounting standards have on the industry. In particular, directors expressed concern over balance sheet volatility under International Financial Reporting Standards (IFRS) as compared with other standards, including US Generally Accepted Accounting Principles (GAAP).[12] See box below for a snapshot of the two standards. One director noted,

> *The company moved over to IFRS, which has made things much more interesting. It brings a lot more volatility. In the US, there is not as much volatility [because of the accounting.] We are impacted by the volatility; it makes our risk management and capital allocation decisions much more difficult. The last day of the quarter can have a disproportionate impact on the earnings, which just does not seem right."*

Accounting standards: IFRS versus US GAAP[13]

- **International Financial Reporting Standards (IFRS).** Considered the global standard for public company accounting, IFRS is developed by the International Accounting Standards Board (IASB). IFRS is required or permitted in about 120 jurisdictions, including Canada and all of Europe.[14]

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[12] The increased volatility associated with IFRS accounting can be attributed to several factors, including fair value recognition of additional financial assets and liabilities (including derivatives), the requirement to recognize actuarial gains and losses in the financial statements, tougher rules on recording special-purpose vehicles or similar structures on the balance sheet, more rigorous asset impairment reviews, and a compulsory annual impairment test of goodwill. For more information, see Eva Jermakowicz and Sylwia Gornik-Tomaszewski, "Implementing IFRS from the Perspective of EU Publicly Traded Companies," Journal of International Accounting, Auditing and Taxation 15 (2006), 186.

[13] Information drawn from the American Institute of Certified Public Accountants, "IFRS FAQs," 2013.

[14] IFRS Foundation, "The Move towards Global Standards."

Accounting standards: IFRS versus US GAAP[15] *continued*

- **US Generally Accepted Accounting Principles (GAAP).** In the United States, the Financial Accounting Standards Board (FASB) sets GAAP for US public companies.
- **Convergence of IFRS and GAAP.** IASB and FASB are working together to develop compatible standards for insurance contracts. This project intends to simplify and harmonize reporting requirements for insurance contracts and to provide investors with better information. In July 2012, the Securities and Exchange Commission issued a report that neither recommended nor advised against adoption of IFRS for US companies, and it has not provided an estimated date by which such a recommendation will be made.

Implications of different accounting standards

Differences in accounting standards, compounded by differences in regulatory regimes, amplify insurers' uncertainty. Some nations are transitioning to, or augmenting, IFRS requirements while simultaneously implementing new RBC standards. One meeting participant noted, *"The IAIS and the insurance core principles said there had to be comparability across regimes. You don't have convergence on accounting. You don't have convergence on the balance sheet. Insurers need to understand the fair value of risk so they can know how bad [the risk] could be. Without that, how can anyone advise the board on risk?"* Top global insurers and supervisors identified several areas that are affected by the differences in accounting standards:

- **Strategy and practice.** Without the prospect of near-term US adoption of IFRS, and due to the volatility inherent in using IFRS, many companies may change how they approach risk. One non-executive commented, *"We are very strong, financially, but are in the process of a strategic business model change because of the regulatory differentiation and the need to be conservative. We have become very tight around risk management practices."* Because IFRS accounting is more likely to reveal mismatches between assets and liabilities, some insurers are evaluating their risk profiles and financial management practices.
- **Systemic risk.** Market-consistent valuation, as required under IFRS and Solvency II, may contribute to systemic risk in the insurance sector. One participant reported, *"Market-consistent valuation can create more systemic risk because of the volatility. At a recent Solvency II conference, people said mark-to-market is the biggest systemic risk."*
- **Product or company reputation.** Several directors noted that impacts to balance sheets resulting from mark-to-market practices could be enough to make products or companies appear weak to consumers. One director observed, *"Mark-to-market on liabilities is the real problem. You end up trying to gauge what the customer will do – for example, surrender [the policy] – when everyone should be focused on*

[15] Information drawn from the American Institute of Certified Public Accountants, "IFRS FAQs," 2013.

sustainability. [Mark-to-market] creates a perception of weakness in the company that can cause a policyholder to take an action that is not truly reflective of the capital position."

- **Market distortion.** The existence of different accounting systems may distort the market and render comparisons across companies and products difficult. How do boards or investors benchmark or evaluate a position within the marketplace? Insurers suggest that CRAs may be able to translate between accounting or regulatory regimes and thereby level the playing field for insurers. One director noted, *"I would like to know … what do CRAs or others do to establish common ground [between regulatory or accounting regimes]?"*

Improving strategy despite uncertainty

IGLN participants highlighted several possible ways to move companies and the insurance sector forward. One director noted, *"The accounting standards process should be coordinated with risk and solvency processes. It isn't right now."* Insurers can focus more attention on coordinating accounting and regulatory processes. In particular, as Solvency II and the SMI move forward and new risk-based capital requirements become clearer, insurers should coordinate projects related to accounting and regulatory standards. Insurers may also need to explore new ways to communicate balance sheet realities with policyholders and the market. Insurers can consider better ways to prepare for and get ahead of policyholder or market *"perceptions of weakness."*

The role of credit rating agencies (CRAs) is shifting

As noted above, some insurers have suggested that CRAs can play a bridging role – in regulation, accounting, and across borders generally. In a diverse global marketplace, CRAs can potentially contribute to de facto convergence and field leveling across different regimes. CRAs themselves, however, do not wish to be the only resource for the marketplace, especially after the financial crisis. CRAs maintain that the market benefits from many opinions and that a CRA opinion should be just one of many tools, not a backstop for analysis. Likewise, CRAs do not want their analysis to be written into regulations and rules. In testimony before the United States House of Representatives, Michael Rowan, managing director of Moody's Investors Service, commented, "Moody's credit ratings are opinions about credit risk, and as such they should be used as just one perspective on an issuer's or debt obligation's credit worthiness."[16]

The role of CRAs is shifting in response to criticism flowing from their part in the financial crisis. Critics have argued that markets and regulators alike relied too heavily on ratings as the primary consideration in an evaluation of risk. To improve effectiveness and comply with new regulatory requirements, CRAs are changing their practices.

[16] Michael Rowan, Testimony before the United States House of Representatives Committee on Financial Services Subcommittee on Oversight and Investigations (Washington, DC, July 27, 2011), 5.

Continuing to modify practices following the crisis

In recent conversations, participants representing CRAs have spoken clearly about changes intended to improve performance and address criticism.[17] Specifically, CRAs have focused on improving assessments of risk, broadening analysis, limiting potential conflicts of interest, and promoting independent analysis.

Regarding their efforts to broaden their analysis, one representative commented, *"CRAs now have teams of people that step back and look at the bigger picture. They have a better chance to identify the interconnectedness of the markets."* On the topic of independence and possible conflicts of interest, a participant stated, *"CRAs have separated the commercial function from the ratings and analytical function, and have beefed up the credit policy oversight function, which stands apart from the ratings teams."* With respect to taking necessary action in the face of pressure, another said, *"The view we take is that the analyst should consider a rating action whenever appropriate, guided by metrics provided by our methodologies. You should never refrain from an appropriate rating action out of concern about consequences."*

Taking a strong view of insurance sector trends

Despite their insistence that they not be the sole resource used to judge insurers, CRAs are undeniably a powerful force in the sector. One director noted, "In the US, regulations are not driving risk work. US regulations are still behind the times. Progress is driven more by the ratings agencies. Standard & Poor's, in particular, is a driving force in ERM [enterprise risk management]." Within this context, CRAs shared their thoughts on trends in the insurance industry.

- **Enhanced regulation and capital requirements are credit positive.** Typically, CRAs view enhanced regulation as a net credit positive because it encourages a more conservative approach and thus provides more protection to creditors and policyholders. A participant noted, *"The solvency changes are generally positive. For creditors, what's not to like? For shareholders, it may not be so positive, but for creditors it is."* Still, their support is qualified: *"We have some concerns about Solvency II. In it, 'own capital models' are the main drivers of capital, [but] financial models have a spotty record. With capital models, you shouldn't confuse the answer it gives with the truth,"* said one participant.
- **Regulators should limit use of ratings.** As noted above, CRAs believe ratings should be just one tool in the analysis of insurers' health and should not be built into regulations. Following the financial crisis, the NAIC evaluated the use of ratings and has since recommended alternative practices in some cases. One supervisor noted, *"In the 2009 Ratings Agency Workgroup, we acknowledged that there are certain instruments that we – state regulators – cannot rely on ratings agencies for but, even so, CRAs are still very important for the NAIC."* One participant acknowledged supervisor concerns and commented, *"There is a lot of risk to building ratings into regulation or using them for regulatory purposes."* Others agreed: "A mechanistic [statutory use] of ratings is something we don't recommend … Ratings were tools regulators found to be convenient, driven sometimes by a lack of confidence in [models]. But ratings should be used solely in private contracts – no one should be forced to use them."

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[17] This section reflects conversations conducted within Tapestry Networks' IGLN and Audit Committee Leadership Network. For more information on recent Tapestry Network conversations with ratings agencies, please see Audit Committee Leadership Summit, "Dialogue with Credit Rating Agencies," *ViewPoints,* May 11, 2012.

- **Regulatory forbearance is credit negative.** CRAs have a negative opinion of "regulatory forbearance," whereby regulators permit companies to opt out of, or delay, certain regulatory requirements: *"[For CRAs] forbearance in regulation creates comparability problems. The challenge is always that no matter how good the solvency structure is, its application can be inconsistent,"* said one participant.
- **CRAs have only a limited role in helping regimes converge.** Most observers believe Solvency II will ultimately set much higher capital requirements in Europe than new regulations under the SMI will in the United States, particularly with respect to group-level solvency requirements. In discussions, participants have asked whether CRAs will play a major role in narrowing these differences across regimes as they apply ratings. Indeed, since CRAs will likely insist on US insurers holding as much capital as their European counterparts to obtain the same rating, all other things being equal, the combined effect of US RBC standards and CRA expectations may greatly limit the practical differences between Solvency II and the SMI on capital requirements. However, while CRAs do seek to apply ratings equitably across different standards, they point out that this is no substitute for convergence. One participant noted, "*CRAs shouldn't replace regulatory convergence. Some of [CRAs'] information is based on non-public information. There might generally be more interest in CRAs as de facto assessors of capital, but that would be a mistake."*

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IGLN participants agreed that global convergence of regulatory, accounting, and supervisory standards remains an important goal, but accept that it is not a short-term likelihood. Non-convergence will be the norm for some time to come. While regulatory concerns can easily be eclipsed by immediate, pragmatic, and operational issues, insurers are committed to working among themselves and with policymakers to move the dialogue forward. At the same time, boards are putting more energy into evaluating risk governance structures and practices. Much progress has been made, but the journey continues. The IGLN will continue to address these topics throughout meetings in 2013.

About this document

The Insurance Governance Leadership Network (IGLN) addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy insurance institutions.

The IGLN is organized and led by Tapestry Networks with the support of Ernst & Young as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks and Ernst & Young are independent organizations. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. Ernst & Young is a global leader in assurance, tax, transaction and advisory services to the insurance industry.

ViewPoints aims to capture the essence of the IGLN discussion and associated research; it is produced by Tapestry Networks. Those who receive *ViewPoints* are encouraged to share it with others in their own network. The more board members, senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

Appendix: January 28 meeting attendees

Directors, policymakers, and supervisors

- Richard Booth, Audit and Conduct Review Committee Member, Risk Committee Member, Sun Life Financial
- Malcolm Le May, Investment Committee Chair, Remuneration Committee Member, Board Risk Committee Member, RSA plc
- Morris Offit, Finance and Risk Management Committee Chair, Regulatory, Compliance, and Public Policy Committee Member, American International Group, Inc.
- Ed Rust, Chairman, State Farm Mutual

Credit rating agencies and supervisors

- Ted Collins, Group Managing Director, Global Insurance & Managed Investments, Moody's Investors Service
- Thomas Leonardi, Commissioner, Connecticut Insurance Department

Ernst & Young

- John Latham, Partner, FSO Insurance Tax Leader
- Rick Marx, Principal, Business Advisory Services
- Tom Ward, Partner, Advisory Services

Tapestry Networks

- Leah Daly, Senior Associate
- Peter Fisher, Partner
- Christopher McDonnell, Principal