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Some US Positions on the Evolution of Solvency Systems

Rob Esson

IAIS Solvency initiatives

- The IAIS is moving towards a common worldwide set of principles-based standards on solvency requirements and assessment
- IAIS moves are mirrored in shifts in major markets: e.g. Solvency II in Europe and Principles-Based Reserving in the US

EU Solvency II

- EU is having to update its current non risk-based solvency systems
- Largely consistent with the IAIS directions in the IAIS Solvency Subcommittee
- Would expect that for convergence, the EU will ultimately need to move to Solvency 2.1 to converge with IAIS process (good) or Solvency 3.0 (bad)



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US views

- US already has an extensive **risk-based** capital system: >50,000 Company-Years of experience.
- Unlike EU which has had to modernize significantly, US may be able to consider many new and better ideas in a step wise manner, enhancing the current risk based system



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US views continued

- Hence unlikely that US will find it necessary to undertake such massive changes as the EU in order to converge with the enhanced ideas coming out of IAIS
- This is sometimes misunderstood by those that assume that such convergence necessarily requires a quantum leap



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US convergence with IAIS

- Principles Based Reserving work on life business underway: an explicit, written, charge to the working group is to utilize and converge with IAIS principles.
- More principles-based approach to examination (risk assessment exams)
- Many good ideas and enhancements coming out of the IAIS work that will need to be considered in the US



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Future standards ...

- Two of the vital changes: capital resources, and valuation of technical provisions
- These will likely be key for a convergence between US and the IAIS, and Solvency II and the IAIS



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So, are we done yet?

- Well almost ...

• **BUT**

- Hmm ... anything going on in the outside world we ought to consider?



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A few quotes ...

- "New and improved rules for global governments to monitor banks - known as Basel II ... - rely heavily on banks' ability to build computer models to monitor the risks they are taking. Those models have lost credibility. " Wall Street Journal
- " ... global financial turmoil ... is upending fundamental assumptions about risk. Institutions world-wide have badly misjudged the safety of investments ... " WSJ



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A few more ...

- "Did banks know how much risk they were taking? Did they know how much capital they needed to cushion them from sour loans? Did they prepare themselves adequately for the evaporation of 'liquidity' or their ability to easily sell their securities or loans?
The answer to all three questions appears to be "no." WSJ
- "One key principle behind the Basel rules is that banks are the best judge of the risks they're taking. In many cases, banks have slipped up." WSJ



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More quotes ... and an uncomfortable conclusion?

- "The essential problem is that our models – both risk models and econometric models – as complex as they have become, are still too simple to capture the full array of governing variables that drive global economic reality" Alan Greenspan, FT

So ...

- Insurance supervisors are moving towards principles based systems, building on many ideas from Basel II. Much has already been invested: does effort and prior investment necessarily imply greater current value?
- Possible need to re-examine credibility and limits



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Mark To Market Is The Source of All Evil

- Mark to market accounting has been identified in the FT, the WSJ and in Congress as a problem.
- On what basis should regulators ignore market values?
- Should regulators be complicit in hiding market values?
- Will my pension administrators pay me my pension at historic cost if the market value of my pension portfolio has dropped? If I say I'm an important financial institution, will the answer be different?
- Difference between ignoring economic reality and the possibility of regulatory forbearance at times



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Possible lessons?

- Lessons to be learned from the banking regulators in the use of models?
- Need for insurance supervisors to take on board these lessons in the design & development of the new solvency assessment regimes
- As always, the supervisors' need for healthy skepticism about the adequacy of entities' risk management



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