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IIS Executive Research: Regulation

Sitting in Judgment

Over the past decade, a regulatory construct has evolved which positions one group of insurance regulators sitting in judgement (or proposing to sit in judgement) of other jurisdictions. These initiatives never assert (at least overtly) that they are seeking to establish a regulatory judicial system. They are always developed in conjunction with laudable goals such as: facilitating regulatory convergence, establishing a single language for regulators, leveling the playing field, combating regulatory arbitrage and ensuring financial stability.

Examples of this regulatory phenomenon include:

1. The US state accreditation system (which is probably the first example of a multi-lateral assessment regime).
2. Solvency II Equivalence assessments.
3. The US "Qualified Jurisdiction" regime under US credit for reinsurance laws.
4. The EU-US and UK-US covered agreements.
5. The "comparable outcomes" standard that is embedded in the agreements surrounding the development of the IAIS' International Capital Standards.
6. FSAP reviews by the IMF/ World Bank
7. The evolving Brexit discussions and the EU's increasingly insistent calls for the UK to keep their regulatory standards virtually identical to the current EU standards.

In the discussion below, I will refer to these as "regulatory assessment regimes".

Common elements of these regulatory assessment regimes are (1) the development regulatory standards by one regulator (or group of regulators) (2) great confidence by the developers that their approach is the best one for policyholder protection and financial stability, (3) a carrot and stick mechanism, whereby insurers domiciled in a jurisdiction which is viewed as "deficient", faces restricted market access or additional regulatory requirements in the other "assessing" jurisdiction, with concomitant benefits for those judged as adequate and (4) they are in or based upon EU or US insurance laws and regulations.

I believe that it is important to take a step back and reflect on this regulatory tool. There are, admittedly, some potential significant benefits that can flow from these assessment regimes. In today's increasingly global insurance markets, regulatory cooperation and establishing a level of mutual confidence among regulators is important and can be beneficial to industry, regulators and policyholders. There are also serious practical impediments to the successful implementation of these regulatory standards, which deserve consideration. There is also the danger of what might be referred to as "regulatory narcissism", as regulators naturally tend to believe that the system they create is the best and that global markets will be better served if everyone else follows their lead.

In the discussion that follows, I will briefly describe the evolution and use of several of these assessment regimes , discuss some of their most intractable issues and consider some possible alternative approaches that may provide many of the same benefits and yet reduce costs and, as importantly, friction among regulators. The parameters of this discussion will not permit a detailed examination of these assessment regimes, but I hope that this discussion will assist regulators and the industry in the evolution of relevant global regulatory rules and practices.

How did we get here?

Regulatory assessment regimes have primarily developed over the past 15 years or so.   In large part, they have been the product of regulatory alarm over solvency issues, but there has also been the goal of trying to create a more efficient regulatory ecosystems, at least in a defined region.

The US state accreditation system, developed by the National Association of Insurance Commissioners (the NAIC) beginning in 1988, and adopted in 1990, is, I believe, the first assessment regime. It predates, by a lot, the other assessments regimes discussed in this paper.

Stimulated by a wave of major insolvencies in the 1980s, US regulators realized the danger of a regulatory weak link. That is, if an insurer domiciled in a state with insufficient regulatory rules, resources, skills and will went insolvent, this could harm policyholders and markets in other states. This manifest weakness in the US state regulatory system raised calls for Federal regulation of insurance, to provide uniformed, effective regulation across the 50 states. Furthermore, some insurers viewed the establishment of a Federal regulator as the only way to create a harmonized set of regulatory requirements for those insurers who operated on a nationwide basis in the US. The US State regulators said, “not so fast” and came up with what at the time was a bold, innovative approach. It involved the creation, through the NAIC, of a core collection of certain “model laws” and “ model regulations” that make up the U.S. financial solvency framework, which all states would have to adopt and then be able to prove, through periodic “accreditation” exams by the NAIC , that they are able to implement and enforce these collections of laws and regulations. The accreditation program has not been static, with both amendments to existing model laws and entirely newly adopted model laws being regularly added to the accreditation program

About the same time as the development of the US state accreditation system, the EU was creating its first pan-EU regulatory system —Solvency I. It too was intended to harmonize laws and regulations for the EU insurance market. Although it did not have equivalence or assessment provisions, the overall EU requirements for adopting EU laws and regulations were intended to provide an enforcement mechanism.

A notable element of Solvency I, however, was that it was focused internally, that is on uniformed adoption of certain insurance laws across the EU—just like its accreditation counterpart in the US.

Fast forward to the adoption of Solvency II (which came into force on January 1,2016) and we have the first quantum leap in assessment regimes. Solvency II’s equivalence provisions are the most detailed, far reaching and rigid of the current assessment regimes. Importantly, they have extensive extraterritorial reach, as they are focused on third countries, i.e., non-EU jurisdictions.   This article will not outline the many aspects of the Solvency II equivalence provisions. But it is worth noting that there are 3 different Solvency II equivalence assessments governing reinsurance: (Art 172), group supervision (Art260), and solvency calculations (Art 227). And Solvency II has provisions for provisional and permanent equivalence determinations. It is a deep, complex assessment process. Since its inception, only two countries (Switzerland and Bermuda) have obtained full equivalence designations. A handful of countries have received certain provisional or temporary equivalence designations. For some, obtaining Solvency II equivalence required substantial changes in their domestic laws, for others the process was less impactful. A few countries—including most notably the US and Canada -- refused to engage in the Solvency II equivalence assessment process. As regards the US, the prospects of "applying" for an equivalence assessment was anathema to US regulators and the resulting tensions had a substantial adverse impact on some longstanding, important regulatory relationships.

Ultimately, the EU and US equivalence issues were resolved through the negotiation of the EU-US Covered Agreement, which was signed on January 14, 2017. (See, discussion below.)

Close to the final adoption of Solvency II, we saw the emergence of two additional assessment regimes. These are found in the US qualified and reciprocal jurisdiction assessment processes, embedded in the NAIC's Model Law on Credit for Reinsurance (which is a state accreditation requirement) and the "similar outcomes" standard agreed to by global regulators in connection with the development of the IAIS' International Capital Standards (the "ICS").

US Qualified Jurisdiction rules.

As part of the NAIC's revisions of their model credit for reinsurance model law and model regulation, they developed the concept of "Qualified Jurisdictions". This was essentially a review and approval system for determining jurisdictions which, in the eyes of the US regulators, adequately regulated their domestic reinsurers, so that these reinsurers could apply for approval for lower reinsurance collateral requirements. Originally adopted in 2011, this process was updated following the execution of the EU-US covered agreement to provide another category of country –a "Reciprocal Jurisdiction".

The NAIC's *Process for Evaluating Qualified and Reciprocal Jurisdictions*, provides in part that:

"3. The evaluation of non-U.S. jurisdictions as Qualified Jurisdictions is *intended as an outcomes-based comparison* to financial solvency regulation under the NAIC Financial Regulation Standards and Accreditation Program (Accreditation Program), adherence to international supervisory standards, and relevant international guidance for recognition of reinsurance supervision*. It is not intended as a prescriptive comparison to the NAIC Accreditation Program.* " (emphasis added.)

Accordingly, the US Qualified Jurisdiction process was intended to operate as a careful, but not overly intrusive or prescriptive process. Its ultimate goal is to answer the question, "can US regulators count on you to do an adequate job?"

The EU-US covered agreement.

On January 14, 2017, the EU and the US entered into a *"Bilateral Agreement Between the United States of America and the European Union On Prudential Measures Regarding Insurance and Reinsurance*", generally known as the EU-US Covered Agreement. As noted above, this agreement was used to resolve the objections that the US had to the Solvency II equivalence assessment process. It was also used to resolve longstanding objections by the

EU over the US treatment of EU based reinsurers. Accordingly, the covered agreement addresses group supervision, reinsurance supervision and the sharing of confidential regulatory information.

The execution of the Covered Agreement was preceded by an extended period of work by EU and US regulators to examine and discuss their respective regulatory regimes. But this was a cooperative, bi-lateral set of work streams and did not include the dynamic of a unilateral assessment of one country by another. The process was one of the parties coming to a mutual understanding of and appropriate level of confidence in the respective regulatory systems. Indeed, in the preamble to the agreement, the parties noted that the bedrock of the agreement was: "Sharing the goal of protecting insurance and reinsurance policyholders and other consumers, while respecting each Party's system for insurance and reinsurance supervision and regulation."

One of the most significant aspects of the agreement was the commitment of the US to develop a group capital assessment tool, but only has broad required criteria, namely: " i) the group capital assessment includes a worldwide group capital calculation capturing risk at the level of the entire group, including the worldwide parent undertaking of the insurance or reinsurance group, which may affect the insurance or reinsurance operations and activities occurring in the territory of the other Party; and (ii) the supervisory authority in the territory of the Party where the group capital assessment as set out in subparagraph (i) above is applied has the authority to impose preventive, corrective, or otherwise responsive measures on the basis of the assessment, including requiring, where appropriate, capital measures;" (see, *EU-US Covered Agreement*, 4(h))

A virtually identical agreement was subsequently entered into between the UK and the US, which became effective upon Brexit. The NAIC now also recognizes Bermuda, Japan, and Switzerland as "Reciprocal Jurisdictions", because each of those countries has submitted a letter to the NAIC whereby it commits to complying with the standards in the Covered Agreement between the US and the EU.

So, the covered agreement approach is a significant departure from the Solvency II assessment process. Most importantly, it is a bi-lateral agreement, providing mutual benefits, recognitions and commitments. It accommodates profoundly different regulatory regimes, and yet does so with a focus on reciprocal acknowledgement that each system adequately protects policyholders and other consumers. It is important to note, that these covered agreements do set up an assessment process, which will involve an assessment of the adequacy of the US group capital provisions that are under development.

IAIS Insurance Capital Standard.

The efforts by the IAIS to develop an agreed Insurance Capital Standard (the "ICS") for Internationally Active Insurance Groups has led to the most recent example of an assessment regime. The IAIS' description of the goals of the ICS are worth noting. In November 2019, the IAIS stated that;

"The Insurance Capital Standard (ICS) is being developed by the International Association of Insurance Supervisors (IAIS) with the purpose of creating a common language for supervisory discussions of group solvency of Internationally Active Insurance Groups (IAIGs) to enhance global convergence among group capital standards. The ultimate goal is a single ICS that includes a common methodology by which one ICS achieves comparable, i.e., substantially the same, outcomes across jurisdictions. "IAIS: *High Level Messages: ICS Version 2.0 for the monitoring period and Comparability Assessment.*

The current draft ICS is modelled very closely on Solvency II's capital standards. Predictably, it has reignited the tensions we witnessed with the EU's attempts to apply their Solvency II equivalence assessments on the US. However, through a series of agreements, the IAIS and the US regulators have agreed upon a way by which the group capital standards being developed by the US (the "aggregation method") will be considered as acceptable under the ICS. Most importantly, the assessment will be based upon whether the systems produce "*comparable outcomes* "

The IAIS has provided this definition of *comparable outcomes:*

"Comparable outcomes to the ICS means that the Aggregation Method (AM) would produce similar, but not necessarily identical, results over time that trigger supervisory action on the group capital adequacy grounds." (See, IAIS, *Explanatory Note on the ICS and Comparability*, November 14, 2019.)

This definition is, of course, a mouthful. It could mean different things to different people, but it does establish a principle that different systems may produce similar results and be viewed as acceptable. This is important. But it must also be noted that the IAIS will be developing during the next two years some "high-level principles" and criteria for judging the aggregation method. So, the stage is set for a further act of regulatory judging.

IMF -World Bank Financial Sector Assessment Program (FSAP).

The FSAP assessments of global financial systems is one further assessment regime that deserves consideration. Launched in 1999 and significantly enhanced in 2009, in the wake of the financial crisis, the FSAP process is a broad review of the financial sectors in subject, including 29 countries where FSAP assessments are mandatory. It includes, but is not limited to, a review of regulatory and supervisory frameworks. In reviewing insurance regulatory frameworks, the FSAP teams benchmark national systems against the IAIS' Insurance Core Principles (the "ICPS"). The ICPs are 25 broad regulatory principles that the IAIS has set forth that all well-regulated markets should adopt.

These are, to the best of my knowledge the universe of assessment regimes.

The costs, benefits and challenges surrounding these systems?

The assessment regimes developed to date have been motivated, in large part, to promote desirable goals such as more effective (pro-solvency) and efficient (minimizing overlapping, duplicative and contradictory) regulatory requirements. They have also been used to facilitate cross-border transactions and to encourage regulatory cooperation and accommodation. These goals are critical for the growth of the insurance industry, helping to close the protection gap that exists in every country and helping to improve financial inclusion. All of these are advanced by more open markets and regulatory systems that enable insurers to operate, consistent with sound prudential supervision. Some assessment regimes have also had some additional goals, such as the creation of a "common language" for regulators, which we see in the IAIS statement on the ICS, or establishing level playing fields, which at times seems to be code for, "our capital standards are higher than yours and therefore we need to have you raise your standards." In addition, the costs (hard, soft, opportunity costs) of developing and then trying to transition to these systems has been considerable—for industry and regulators.

We have also seen that these systems face some significant practical, legal and political challenges. These include:

- Different valuation systems—e.g., US GAAP vs IFRS, differences between various national GAAP standards.
- Unique market product needs—for example, countries with higher long-term savings, health or liability product needs
- Sovereign rights— and national pride
- National and international politics
- Varying approaches to non-capital policyholder protection measurers (e.g., guaranty funds)
- The regulatory reality that we do not know what the most effective and efficient regulatory systems is or whether there is one such system
- The potential for increasing systemic risk if all regulatory systems are identical or fundamentally alike. If one is going to put all of one's regulatory eggs in one basket, one must be certain that that basket is very secure. Even then, good risk management suggests this is not a good idea.

Much could be written on these challenges, but within the scope of this paper, it will have to suffice to say that these are all substantive challenges that the successful deployment of any assessment regimes will have to confront.

Where should we go from here?

Given the significant challenges/impediments in implementing assessment regimes, it is important to ask whether the costs or each are outweighed by the benefits? And is it prudent to explore whether there are alternative ways to achieve many of the same goals? Depending on the goals and specific requirements of an individual regimen, the answer to these questions many differ.

I do believe that in some cases, the answer is yes, that there are viable alternatives or modifications to consider. Accordingly, I think it will be useful for regulators to consider the following:

- Provide reasonable flexibility. This will include accommodating all credible regulatory systems. The FSAP reviews take this approach, as does the EU-US Covered Agreement and the US Qualified Jurisdiction review. A rigid set of rules can mistakenly value form over substance.

- Enhance regulatory dialogue. This should include greater use of supervisory colleges, but also the use of regulatory forums, such as the IAIS or regional regulatory gatherings to dig deep into the principles and operations of important regulatory systems. This should be aimed at creating a sound understanding (and hopeful confidence in) different, but still effective regulatory systems. The EU and the US regulators engaged in a series of such in depth study and discussions as a predicate for agreeing the EU-US covered agreement.

- Use Technology: Exploiting the use of technology to provide real time information regarding insurers, market conditions and other regulatory areas of interest. Increasingly sophisticated financial technology, including balance sheet and financial statement analysis and comparisons should provide greater regulatory understanding, which will support the regulatory dialogue discussed above.

- Allow convergence to happen naturally— as a result of the natural gravitational pull of best practices. We have seen this work, for example in the development of ORSAs and other risk assessment measures as well as with the development of risked based capital standards.

- Maintain a modicum of regulatory humility. The insurance sector and the economies they serve are disparate, complex and evolving. Different regulatory systems have built up in response to local needs, preferences, precedents and laws. A strong argument can be made that these different systems have all worked well. One of the lessons of the financial crisis was how well the global regulatory frameworks worked. It would, therefore, take a bold regulator to assert that his/her system is the best and is the benchmark by which to judge all others.

- Eschew the level playing field goal. Yes, it sounds good. The topic, however, is far more complicated and nuanced than generally acknowledged (including tax policy, guaranty fund obligations, social charges for employers, to name just a few.) Importantly, it is not clear that leveling commercial playing fields is a proper prudential regulation goal.

- Maintain a realistic perspective on the dangers of regulatory arbitrage (or the dreaded "race to the bottom"). I believe that true regulatory arbitrage, using a weak regulatory system to access other markets (i.e. the regulatory weak link) is, in fact, a remote danger. Yes, it requires vigilance, but I have seen few documented cases of this danger playing out in the insurance sector over the last 20 years. At times I fear that regulatory arbitrage is used as code for – "my regulatory burden is heavier than yours" and the real goal is balancing burdens, regardless of the prudential need or justification.

- *Quis custodiet ipsos custodes?* Where assessment regimes are going to be used, consideration should be given to who is judging whom? Should it be one country (or group of countries) assessing another—with inevitable home country biases? Should the assessment be done by an independent assessment process? And ultimately, who will judge the judges?

<u>Conclusion</u>

The insurance sector is becoming increasingly global. Once nascent markets are growing, attracting and requiring greater insurance capital and expertise from non-domestic insurance groups. At the same time, insurance groups are increasingly looking to grow outside of their domestic markets. These trends will continue. Accordingly, there is a growing need for global regulators and global insurers to work together to provide effective and efficient global regulatory rules.

The insurance industry wants effective global regulation. The industry shares with regulators the goals of promoting harmonization of laws, convergence of regulatory standards, avoiding unnecessary duplication and, of course, avoiding financial turmoil in the sector. Indeed, all regulators, even those who disagree on some initiatives share these broad goals.

To achieve these goals, regulators need to consider a wide range of regulatory relationships and engagements. These may include assessment regimes that are based on e*quivalence* or *similar outcomes* or *mutual recognition* or *supervisory deference* or *supervisory recognition*. Alternatively, based on some of the principles set forth above, we may find more imaginative ways for regulators to enhance how they engage, accommodate, rely and, yes, peer review, each other, but to do so in a way that provides appropriate accommodation of a variety of different, but effective systems. This is an effort worth undertaking.

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