Many thanks to the Geneva Association for this opportunity to present the views of the North American insurance industry on this important subject.

What is GNAIE?

GNAIE

- Group of North American Insurance Enterprises (GNAIE) is an industry organization of US, Bermudian, and Canadian based international insurance companies.
- GNAIE was established to influence the International Accounting Standard Board (IASB) objective of unifying insurance accounting.
- A Solvency Committee was formed to examine the proposals for insurance solvency requirements.

GNAIE is an industry organization established in 2003 to influence the International Accounting Standard Board's (IASB) objective of unifying insurance accounting. In 2006 the GNAIE Board of Directors approved the creation of a Solvency Committee to examine the proposals for insurance solvency requirements, including proposals of the European Commission and the International Association of Insurance Supervisors. More specifically, the Solvency Committee is working on the impact that the Solvency II proposals will have on international standards and the standards of US state regulation. This Committee is examining and commenting on proposals, working to establish generally applicable principles and conducting appropriate research.

Representing North America, GNAIE's members includes the largest insurers in North America. All have a significant international presence.

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GNAIE Research…

- "Development of Alternative Accounting Methodology for Life Insurance and Similar Products," a research report by Watson Wyatt Worldwide
- Second Watson Wyatt report, "Alternative GAAP Issues," that identifies and analyzes seven key issues surrounding an alternative accounting method
- Ernst and Young "The Impact of Fair Value Accounting on Property/Casualty Insurers"

Reports are available at www.gnaie.org/WWReportsSelect.php

Some examples of GNAIE sponsored research are identified in this slide and can be found on GNAIE's website.

Recently, GNAIE has commissioned Ernst & Young to undertake a Cost of Capital Study. It is my understanding that we will be making public the primary findings and recommendations.

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Why is the European Solvency Initiative important to GNAIE members?

- GNAIE members are substantial writers in international markets.
  - The new solvency framework will directly impact the current European operations of GNAIE members.
  - The IAIS Solvency Standards project will influence standards globally, and they have chosen Solvency II as the baseline for the development of that global standard.
- US efforts to converge to international accounting and solvency standards creates a direct link between standards undertaken by European regulators and insurers reporting to US regulators.

There is, of course, the direct effect of the standards on GNAIE members. Many of GNAIE's members have significant operations in the EU and in other countries. A significant portion of XL Capital's business is written from within the EU.

So, the efforts by the EU and IAIS will have a significant impact on our members. It cannot be argued that GNAIE members lack standing to comment on the effect the direction of the Solvency II standard, as we are direct constituents of these proposals.

Added to the direct effect, the US regulators of the capital markets and insurance have committed to various efforts towards convergence to international standards for solvency and accounting.

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Risk-Based Capital: the US experience…

- An increase in insurer insolvency in late 1980's
- Federal government (US Congress) pressure for more formalised capital adequacy rules on state insurance regulators (commissioners)
- Risk-based capital already existed for banks in US and internationally (under Basel 1 rules).
- Two working parties set up December 1990 under NAIC; one for life & health and one for property & casualty.
- RBC standards for insurers introduced in early 90's, with extensive input from the insurance industry.
- Introduction of RBC led to more mergers and acquisitions and to changes in financial policy, including use of off-balance sheet and derivatives arrangements to lower RBC requirements.
- Rating agencies have developed more stringent requirements.

Will we learn from the US experience?

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"Global Solvency Standards"..

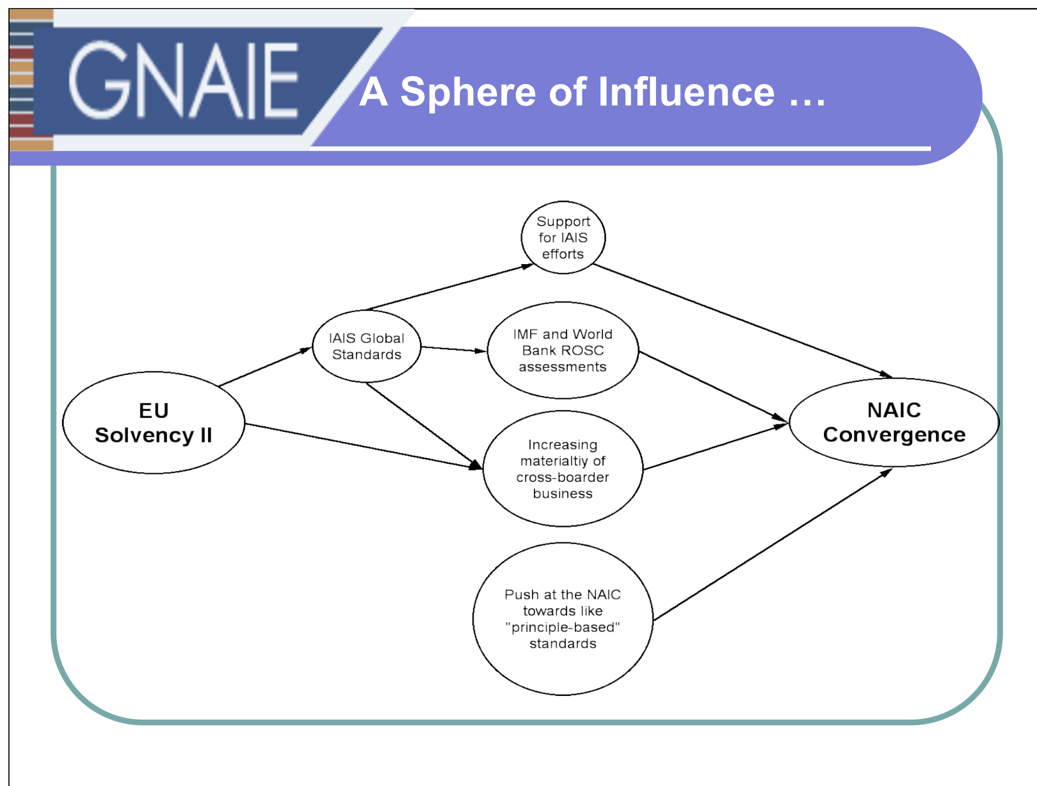
- Basel Committee and Ministers of Finance of G10 have stated that they wish to have a more standardised regulatory architecture globally and across all financial services sectors.
- The International Association of Insurance Supervisors (IAIS) consistently refers to the EU's Solvency II effort as a benchmark in the development of their global standard.
- The National Association of Insurance Commissioners (NAIC) played a critical role in the formation of the IAIS.
  - The NAIC has publicly supported the IAIS' development of a global solvency standard and provided member and staff support and leadership to the effort.
  - Recent NAIC establishments of a new Risk-based State regulatory examination process which will take effect in 2010.
- The NAIC is currently undertaking a project to make statutory reserving, for life insurance, more "principle-based", which will impact capital and solvency requirements.
- The IMF and World Bank reference IAIS standards in their country assessments

In conjunction with the development of Solvency II, the IAIS is drafting global solvency standards that use Solvency II as the starting point. The NAIC has and does play an important role in supporting the development of this global standard, in spite of the fact that US standards differ in many important ways. Having supported the effort to develop the standard, once it is established, it is hard to imagine the NAIC not making significant overtures towards convergence.

For instance, the NAIC and the American Academy of Actuaries are currently undertaking a project to revise the model statutory reserving and capital requirements for life insurance to make them more "principle-based". Those working on the project describe it as a separate effort from Solvency II on the one hand, but on the other hand, both the groups have committees that are reviewing the Solvency II proposals.

The NAIC, who are US state regulators, and are also engaged in an effort to stave off the passage of legislation at the federal level that would create federal charter options for national insurers. It is difficult to know the role that commitments to convergence, not only among state regulators but with international standards, will play in that effort.

Lastly the IMF and the World Bank use the IAIS Core Principles in their assessment of the strength of a country's financial regulation. If, once completed, the IAIS Solvency Standards are given equal standing, US regulators are likely to feel pressure to converge with that standard, simply because they have supported its development and supported the application of those standards to others.



The link between EU Solvency II and the IAIS Global Solvency Standards and the forces that will therefore move the NAIC and US regulators towards convergence with international standards lead GNAIE to the conclusion that EU Solvency II is a critical foundation to the future development of solvency regulation for insurers reporting to US regulators.

While the effective date of the linkage is not immediate, examiners and inspectors of insurance companies attitudes are affected immediately, that's why are we concerned with the development of Solvency II. It is our experience that changing a standard once it is established is harder than influencing its direction, at its formation. Efforts to modify the home regulations that are needed to implement the global standard also frequently fail, because modification runs counter to the forces that are driving convergence in the first place.

To sum up, GNAIE has concluded that not only is Solvency II critical to our future regulation, but the time to be actively involved in their development is now, at the onset.

Solvency vs Accounting …

Solvency	Accounting
Liabilities based on probability ranges; Focus is on total balance sheet (liabilities + equity) measured against risks	Liabilities based on “best estimate”
For *regulators* to focus on monitoring financial capacity to satisfy policyholder obligations	For *investors* to focus on performance, operating results and current financial position.
“Run-off perspective”	“Going-concern perspective”

- While it is important that the definition of liabilities for accounting and solvency purposes are consistent and reconcilable – it’s not necessary that they be the same. The split between liabilities and equity are not important for solvency purposes.
- The risk premium demanded by providers of capital may differ from what regulators consider is an appropriate level of capital

Solvency vs Accounting, different horses for different courses. Let me explain why.

Solvency regulation is scenario based, with graduated responses at different confidence and capital levels. While it is based on probabilities and ranges, regulators want to understand how our business will respond under diverse scenarios. Especially for non-life contracts, statutory solvency measurement considers a range of solutions – not a single best estimate.

On the other hand, accounting looks to achieve a faithful representation of results of a company’s performance; its operations and the financial position of a company at a period in time. It is not based on a set of “what if” scenarios using highly subjective and unverifiable assumptions.

Although preparing different financial information for solvency and general reporting purposes adds complication and expense, we believe we should select and employ the methodology that serves the purpose of each requirement! We should not be overly influenced by the economics of executing and fulfilling diverse requirements.

The bottom line is that solvency methodologies serve different needs and GNAIE does not believe that this is the answer for general purpose financial reporting.

GNAIE — Differences between Life & Non-life…

- For life contracts,
  - the exposure is generally fixed (i.e. the face amount of the contract), and
  - there are mainly three outcomes in any given period (i.e. policyholders will either lapse, die or expire)
- For non-life contracts, the exposure is variable (i.e. from zero to the contract limit), as for any given period we do not know
  - if a loss will occur,
  - the amount of the loss, and for many non-life claims
  - when the loss will be paid , or
  - when the loss will be reported to the insurer and then to the reinsurers

  In addition, the number of claims can, in some instances, be unlimited!
- Non-life claim liabilities possess greater inherent uncertainty than life contracts
  - Inherent uncertainty -
    - In part due to time to settle, often related to vagary of the courts
    - Conceptually a wide range of values
    - True value known only after all claims settled
    - Complexities of the coverages involved
- Life Contracts better suited to discounting measurement techniques
- This will carry over if solvency follows the proposed accounting model!

The development of different accounting models, one for life and the other for non-life contracts, has been an issue of much debate within the accounting debate, one which will have implications for Solvency if similar approaches are used.

For accounting, GNAIE strongly believes that discounting and the use of explicit risk margins for non-life liabilities will not produce verifiable, market consistent fair-values for those liabilities and will instead produce less reliable, less transparent, less comparable and less robust measurement of these liabilities.

Some of us already discount non-life liabilities for our economic capital models and for our submissions to certain regulators for solvency purposes. While we find it quite useful for capital planning and understand its value in solvency regulation, we don't believe it is appropriate for general-purpose financial statements.

Focusing here on general purpose financial statements, discounting has major shortcomings for non-life contracts:

Payout pattern assumptions are often highly uncertain. As an industry, we have historically struggled to accurately predict exposures for long-tail lines on a nominal basis, let alone having those amounts be the basis for additional subjective adjustments that a proposed "exit value" approach would require.

In a nutshell, non-life claim liabilities possess significantly more inherent uncertainty. Accordingly, we do not believe that non-life contracts should be accounted for in a manner similar to life insurance contracts.

FOR NON-LIFE CONTRACTS:

- The range of values of potential loss outcomes is often very difficult to estimate with a high degree of certainty.
- Even when the value of a potential loss can be reasonably estimated, the amount of time required to settle claims varies widely. The actual settlement may often be based on legal proceedings with indeterminate timing and outcome, making any reasonable estimate of the timing of cash flows significantly less reliable.

Life contracts are better suitable to the application of discounted measurement techniques. In most instances there is greater certainty that a policyholder will either die or surrender, the face amount of the basic contract is generally known, and the insurer possesses mortality tables and lapse studies that aid in predicting when mortality or lapse events are most likely to occur.

Whereas Non-life contracts are less suitable to the application of discounted measurement techniques. The insurer cannot reliably predict losses, other than on a gross, undiscounted basis primarily due to the wide range of potential losses (i.e. any amount between zero and the contractual policy limits) , which can occur in any individual reporting period during which the policies provide coverage. The inability to reliably estimate non-life claims and related expenses for individual reporting periods over the life of the contracts (as opposed to life contracts where this is possible) is a principal reason why GNAIE believes that a any proposed accounting model should treat the

Some Challenging issues …

- Market value margin calibration difficulties
  - Cost of capital approach still has questions to answer!
    - Does it capture the volatility in timing and amounts of 'tricky' product lines?
    - How will it link up the concepts of current value in the IFRS Phase II Insurance Contracts Discussion Paper?
    - What will regulators think of the judgmental assumptions needed to determine how much capital is required to settle ultimate liabilities?
  - The real issue rests with the reliability, consistency and comparability of the model output.
  - All liability (Accounting) or part equity and part liability (Solvency) - How much will the risk/prudential margins within the Insurance liabilities be allowed for within the Solvency Capital Requirement (SCR)?
- Consistent solvency framework to be designed for groups and single entities
- Efficient supervisory structures
- Setting of incentives for enhanced risk management / internal risk capital models
- Cross sector consistency of regulation to prevent regulatory arbitrage
- Greater alignment between views of rating agencies and regulators
- Use of appropriate prudence
- Assess at an early stage interfaces and potential overlaps with other regulation
- Data / field testing – a significant challenge for Solvency II

Listed in this slide are some challenging issues which remain unresolved. I'll briefly expand on a few identified in this slide.

The calibration of a suitable risk margin methodology is an area that requires further work. In the recent QIS 2 survey, the industry indicated its concerns on risk margin calibration difficulties, particularly for non-life reserves and premium risk. Despite the continuing efforts of many, there still appears to be a lack of consensus on the appropriate level for risk margins. Why?

- Data used will most likely be entity specific, creating significant calibration difficulties to any market data, further exacerbating comparability concerns.
- Even if one could calibrate to a theoretical market based assumption, there's no reliable method, especially for long tail non-life business.
- We believe that it is not possible to reliably determine the risk margins at a product level due to the extreme volatility in the timing and amounts of some of the product lines. We also believe that due to a lack of information for many product lines, it would be extremely difficult to certify the model assumptions under SOX 404. We also question whether the additional information would be useful.
- In particular, the suggested cost of capital approach for risk based is based on a transfer not a settlement notion with the policyholder. Typically, insurance liabilities cannot be transferred and thus a transfer notion would not represent the underlying economic phenomena that it purports to represent. We fail to understand how a measurement approach that could never occur in the real world would provide useful information to investors or regulators. The insurer typically intends to hold it to maturity and settle claims. Not to sell it into some non-existent secondary market.

The real issue rests with the reliability, comparability and consistency of the model output; and the difficulty of calibrating the assumptions to parameters observable in the market for insurance contracts, in order to achieve consistency from company to company.

This issue should be considered in connection with the objective of fair value, which is to arrive at a measure that is representative of a transaction with an independent third party that reflects an exchange value. I'd like to remind you of the disclaimers that accompany most valuations that are received from third party experts. It is our experience that most third party valuation reports come with a standard disclaimer that cautions the user that such valuations may not represent a market based transaction.

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Final Thoughts ...

- Our support, as EU and global market participants, will greatly add weight to acceptance and convergence of the Solvency II standards.
  - Our support at the IAIS will speed the development of a global standard equivalent to Solvency II.
  - Our efforts in the US could lead to convergence to an equivalent standard in the US.
- For either to occur, North American constituents must feel that Solvency II, generally, meets their needs and circumstance, and that the process of development is open and receptive to their comments.
- GNAIE desire to work closely with our European counterparts on global solvency principles, as we have done so successfully on global accounting principles.

I've reviewed why participation is important to GNAIE, but why should our participation in the Solvency II deliberation be important to the EU? Because not only are GNAIE members constituents of the standard, but global convergence to the standards with which European companies will be required to comply is critical to the success of those standards, the European insurance market, and EU regulated companies.

The agreement and support of the companies that are members of GNAIE, important participants in the global market, will greatly improve the opportunities for global convergence.

Furthermore, GNAIE's wish to work closely with our counterparts in Europe (CFO/CRO Forum/CEA etc) and Japan on global solvency principles, as we have done successfully on global accounting principles. Solvency II cannot evolve into the global standard that the Europeans desire if it does not have input from North American, Japan and other interested parties.

Thank you.