

SOLVENCY II – THE GNAIE PERSPECTIVE

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

I will conclude my remarks in about 35 minutes to allow adequate time for Q&A. If you don't mind, therefore, I would appreciate it if you would hold your questions until the Q&A session.

- GNAIE is an industry organization of US, Bermudian and Canadian based international insurance companies
- The goals of GNAIE are to assist North American and global standard setters and regulators in cooperation with the global insurance industry and with insurance and other financial services industry trade associations to support high quality insurance accounting and solvency standards

The Group of North American Insurance Enterprises (GNAIE) is an industry organization established to work with standard setters and regulators on insurance accounting and solvency.

GNAIE has a Solvency Committee which examines the proposals for insurance solvency requirements, including the proposals of the European Commission and the IAIS. Our Solvency Committee is working on the impact that Solvency II proposals will have on

- international standards and
- the standards of US state regulation as well as
- international standards proposed by the IAIS.



GNAIE's members include the largest insurers in North America. Many have a significant international and European presence.

- “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.net

Some examples of GNAIE sponsored research are identified in this slide and can be found on GNAIE’s website. We expect soon to issue research on solvency which will also be posted to our website.

- GNAIE members are significant participants in European and world-wide insurance markets, so we care about Solvency II
- US efforts to converge US GAAP with international accounting standards and the emerging use of economic capital management in the insurance industry and by rating agencies increase the influence of European solvency concepts

There is, of course, a direct impact of Solvency II on GNAIE members. Many GNAIE members have significant operations in the EU and in other countries. Several of our members are currently participating in the QIS 3 exercise. For example, a significant amount of AIG's business is written from within the EU. AIG ranks among the top ten insurers in Europe based on its European business. So, the efforts by the EU will have a material direct impact on our members.

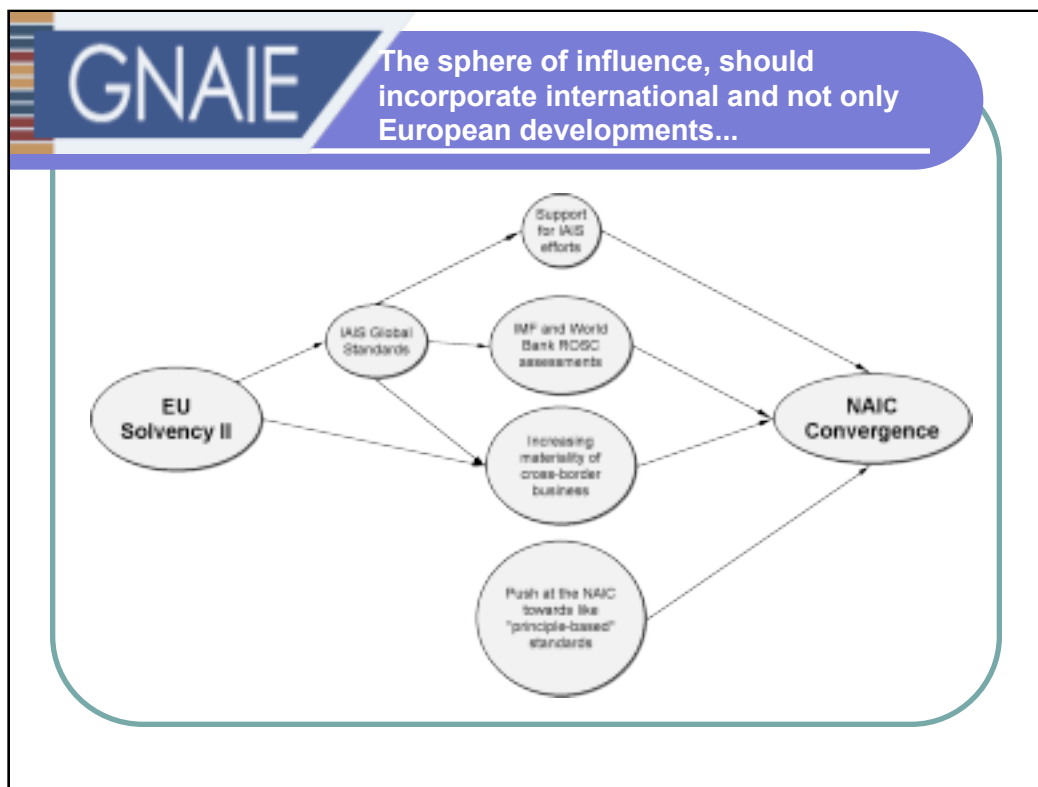
Indirectly moreover, the US accounting, capital markets and insurance standard setters and regulators have committed to various efforts towards convergence to international standards for solvency and accounting. The NAIC representing the 50 state insurance commissioners is an active participant in the work project of the IAIS to develop harmonized principles and standards for insurer solvency globally. Solvency II is likely to be viewed as "best practices" in terms of more sophisticated approaches to insurer solvency requirements, and is having a great deal of influence on the deliberations at the international level.

There is also a direct relationship between

- Solvency II,
- the IAIS proposed standards and
- international accounting standards.

In recent remarks, Peter Clark, the IASB's Insurance Contracts Project Director, noted the similarity between the proposals in the recently issued Insurance Contracts Discussion Paper and Solvency II, clearly noting that the similarity was not coincidental.

Therefore, the North American Insurance industry definitely has an interest in what is happening with respect to Solvency II, as we are significantly affected by these proposals both directly and indirectly.



As we heard yesterday from Michel Flamee, the European insurance supervisors' activity is driven by internal European developments at the moment, without much concern about international implications.

We could well anticipate difficulties when the US and other regulators are asked to agree to many of the principles derived from Solvency II. In order to give the IAIS solvency proposals international legitimacy and to ensure that non-European regulators feel they've had their say, its governance should fulfil the same requirements as the Basel II committee. It should bring together the views from all jurisdictions across the globe, not only Europe.

Also, the US industry still has problems with a significant part of the proposed Solvency II methodology. Whereas Solvency II will be a mandatory regime in Europe, the IAIS sets voluntary principles. North American insurers are **not** convinced that

- the mark-to-market (and in some instances mark-to-model) balance sheet approach to the calculation of solvency requirements contemplated under Solvency II is workable in some segments of our markets,
- that it is fully compatible with principles-based reserving methods endorsed by the US regulators, or
- that it is compatible with the perspective of large North American insurers in determining their internal economic capital requirements.

We could well anticipate difficulties if the US and other regulators are, at some time in the future, asked to sign up to many of the principles of Solvency II. The NAIC which is increasingly raising its own questions and taking note of the North American industry's concerns may very well divert from what the IAIS recommends. In GNAIE's view the only way to avoid disharmony breaking out in the future, which could slow down if not halt the move to uniform solvency standards globally (i.e. a level playing field), is for the Solvency II project to give explicit recognition to some of the concerns being raised at the broader international level on the shape of international solvency standards.

GNAIE Solvency vs Accounting -
Different horses, Different courses...

Solvency	Accounting
Liabilities based on probability ranges	Liabilities based on "best estimate"
Focus is on total balance sheet (liabilities + equity) measured against risks	Separate focus on assets, equities and liabilities
For <i>regulators</i> to focus on monitoring financial capacity to satisfy policyholder obligations – consumer protection	For <i>investors</i> to focus on performance, operating results and current financial position – capital market information
Regulators focus mainly on unexpected losses	Shareholders focus on maximising value in relation to risk

- While it is important that the definition of liabilities for accounting and solvency purposes be consistent and reconcilable – ***it's not necessary that they be the same.*** The split between risk provisions included in liabilities and those in capital requirements is not important for solvency purposes ('total capital requirement' concept).
- The risk premium demanded by providers of capital may differ from what regulators consider is an appropriate level of return on that capital
- Therefore, consistency between solvency and accounting is not required!

As already mentioned, Solvency II developments will have wider consequences, impacting in some important ways the development of international insurance accounting.

GNAIE believes that the basic premise of Solvency II to proceed lock-step with the development of IFRS on insurance contracts is mistaken. Solvency and accounting differ in many important ways, and we believe in the principle of "different horses for different courses". Let me explain why.

Solvency regulation is appropriately 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, to protect the policyholder. 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 the going concern results of a company's performance;
its operations and
its financial position

at a period in time, to assess the company's relative market position. Accounting is not based on a set of "what if" scenarios but a single best estimate at a reporting date.

Furthermore, solvency and accounting standard setters have different constituencies. The primary constituents for regulators are policyholders. Regulators focus on monitoring financial capacity to satisfy policyholder obligations and maintaining consumer protection. The primary constituents for accounting standard setters are stockholders and bond holders, creating and protecting a marketplace for insurers to operate in efficiently by appropriately capturing an entity's performance, operating results and current financial position.

Although preparing different financial information for solvency and accounting reporting purposes may be somewhat burdensome, we don't believe the burden justifies choosing an inappropriate methodology for either. We believe we should select and employ the methodology that best serves the purpose of each requirement!

The bottom line is that solvency methodologies serve specific needs (i.e. consumer protection) and GNAIE does not believe that this is the answer for general purpose financial reporting. Solvency is concerned with total capital and liabilities (i.e. total balance sheet approach measured against risks) while accounting focuses separately on assets and liabilities.

Ignoring these differences, we believe, can adversely affect the industry's access to global capital markets compared to other industries, to the detriment of our cost of capital.

Cost of capital vs percentile vs best estimate approaches

- Proposed “mark to model” approaches for non-hedgeable risks
 - The percentile approach
 - a purely statistical methodology
 - requires complex stochastic modelling of the distribution of risks
 - produces results which are inevitably arbitrary
 - Cost of capital
 - arbitrary decision on the quantum of risk margin
 - scope of application not clear
 - a uniform risk margin is inappropriate for long-tail non-life contracts
- Best estimate for non-hedgeable risks
 - Average distribution of claims outcomes
 - Relies on a variety of assumptions, and each will give different insights into claims development
 - Projected cash flows is based on past experience and allow for expected changes in company practices and external changes
 - Tried, tested and understood by users

Under IFRS and Solvency II proposals non-hedgeable risks are supposed to be taken into account by an appropriate mark to model approach. This will require the explicit calculation of a market value margin (MVM), which is similar to the methodology proposed in the IASB’s recently released Insurance Contracts Discussion Paper. The Discussion Paper recommends an explicit risk margin in establishing liabilities for non-hedgeable risks. However, GNAIE has significant concerns regarding the calibration difficulties associated with the calculation of explicit risk margins, particularly for long-tail non-life contracts, given the lack of observable insurance market inputs and reliance on so called “market consistent” modelled techniques, which are not necessarily aligned with the unique features of insurance contracts.

I’d like to provide an overview of approaches that are being considered in valuing non-hedgeable insurance liabilities.

Firstly, **the percentile approach** is based on ensuring that risks can be covered at an appropriate level of confidence, typically 75 percent for liabilities. The percentile approach is a purely statistical methodology. It requires complex stochastic modelling of the distribution of risks, and even then produces results which inevitably have an arbitrary element and may have no observable foundation in market realities. This is why this approach has been largely dismissed.

Secondly, **the cost of capital approach** also has conceptual difficulties. Its scope of application is not entirely clear, in particular the distinction between hedgeable and non-hedgeable risk is not black and white, and may vary over time. We are also concerned about the practical application of the cost of capital methodology, which is very theoretical in nature, and the ability to produce stable and consistent results. In our view, more guidance from the regulators and the industry is needed on practical questions such as the calibration of the cost of capital rate, and the validation of the risk margin to objective parameters and benchmarks.

Interestingly, the QIS 3 technical specification suggests that for long-tail non-life business, alternate methods are envisaged other than a cost of capital approach. It remains unclear how the cost of capital approach can objectively capture the volatility in timing and amounts of complex long-tail non-life product lines.

The nature of general insurance business, with volatility of claims experience and different people and processes within companies and over time, makes any conceptual untested approach to setting reserves concerning. Diversification should be accurately and appropriately captured in the MVM. We believe it is premature to formulate a measurement system for insurance liabilities represented as “market consistent” values since in many jurisdictions insurance contracts cannot be traded in an open market.

Thirdly, **the best estimate approach** is a tried, tested and understood methodology, which relies on a variety of assumptions, each giving different and unique insights into claims development, allowing for any expected changes in company practices and external changes. We believe that the best estimate is a more meaningful approach for setting and valuing insurance liabilities, particularly long-tail non-life liabilities. As Rob Jones of S&P said last week in Zurich on this subject, the accounting for long-tail non-life liabilities isn’t broken and doesn’t need fixed.

Summing up, GNAIE has significant concerns with the methodology and practical application of the percentile and cost of capital approaches to valuing insurance liabilities.

- While methodologies do converge, they have different purposes
- Solvency capital models differ from internal economic capital models in several important ways:
 - Not necessarily in technology
 - But in degree of granularity
 - Time scale
 - Objectives
 - And in risk tolerance
- All insurance companies are different
 - Different risk appetites, different control processes and write different business
 - There is an essential challenge in calibrating a standardised model to suit the requirements of the few, let alone the many
 - However, get it wrong and there are consequences!

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Internal economic capital management is designed to help management evaluate whether the business risks being taken on are commensurate with the rewards that are expected, and whether unwanted risks are being properly dealt with. Managements set risk appetites varying from company to company, but management must also communicate their means of monitoring, measuring, and managing those risks to rating agencies and capital providers. Many insurers develop specialized knowledge of certain kinds of risk. Capital models that incorporate this information might need protection from disclosure at too granular a level, for competitive reasons.

Accordingly, solvency capital models must differ from internal capital models in several ways – not necessarily only in technology, but also perhaps in degree of granularity, time scale, objectives, and in risk tolerance. Let me expand on these points:

Granularity – the solvency capital model must allow protection of sensitive company information by allowing sufficient aggregation of publicly required information.

Time scale and objectives – the management of an insurer wants to assure capital providers that it can continue to operate and provide a sufficient return on capital given any reasonably foreseeable event. This requires a long term perspective in managing the risks, including the potential need to re-capitalize when unforeseen events happen. Solvency regulators typically have a shorter time scale, and have a responsibility to close down an insurer who does not meet a minimum capital requirement.

Risk tolerance – For example, an insurer may target an AAA rating, in which case a solvency regulator may have little to do with that company save continued monitoring to ensure that the company is maintaining its required capital standards. Not enough recognition has been given in the Solvency II and IAIS standards to the differences between the minimum capital that a regulator needs to protect policyholders (that satisfies a BBB credit rating standard over a one-year period) and the economic capital that an insurer has to compute and hold to manage its risks adequately and to achieve its financial strategies.

Third country insurance Issues

- Level regulatory playing fields – competitive considerations
- Group structure and supervision
- Regulatory equivalence
- Group capital requirements

One can only conclude from what is known about Solvency II right now that it leaves a number of fundamental questions unanswered when it comes to its dynamics on the international scene. Namely,

Level regulatory playing fields - Care should be taken that Solvency II does not constitute an un-level playing field for non-EU country-insurers (i.e. third country insurers) in several ways. It is crucial that the benefits of Solvency II must also be available to non-EU based companies. If such benefits are not available, then as a consequence competition issues might arise.

Group structure and supervision – Development of Pillar II regulations for local and group supervision, need clear-cut roles and authorities.

Regulatory Equivalence - Equivalence is a key component of Solvency II, yet it is undefined. It is further complicated because third-country groups do not automatically have an insurance group supervisor in their home territory. This may be an impediment to fulfilling the criteria on equivalence assessment, thereby contributing to an un-level regulatory playing field. We strongly recommend that appropriate due consideration is given to the issue of third country regulatory equivalence.

Group Capital requirements - Even if the home-regime of a third country insurer is deemed equivalent, its capital would only be that which is actually held in its EU entities so that the strength of the parent would still be of no benefit for group support. However, an European group with a holding within the EU and operations in a third country would get credit for its holdings in that country, to count as eligible capital on its parent-level. One can only conclude that what is known about Solvency II right now leaves a number of fundamental questions unanswered, when it comes to its dynamics on the international scene.

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- Need to determine what capital “counts” when evaluating insurer solvency
- Identical insurers writing exactly the same business, assuming same quality of management, should be treated identically from a solvency viewpoint, regardless of domicile
- Solvency II should accurately reflect both diversification and risk mitigation
- Solvency II group diversification benefits have been designed with EU groups in mind
 - Little consideration given as to how Solvency II should be implemented in third countries and by third country groups
 - Ironically, EU groups are nevertheless lobbying hard for recognition in the EU of realisable diversification benefits attributable to their third country operations

As we speak, companies are compiling QIS 3 responses and the European Commission is translating its draft Solvency II directive into 27 languages.

We question whether this proposal will provide the EU consumer with the maximum benefits from quality competition for his or her business? or

will barriers to entry to the EU insurance marketplace be raised so high that EU consumers are forced to pay excessive premiums for coverage from protected insurers?

Critical to answering these questions are the provisions that determine what capital “counts” when evaluating insurer solvency. Suppose there are identical insurers writing exactly the same business, but one is domiciled in the EU with half its business written through a third country domiciled subsidiary, and the other is domiciled in that third country with half its business written in an EU subsidiary. Given the same quality of management, we believe that these companies should be treated identically from a solvency viewpoint. However, it is our understanding that under Solvency II the EU parent company may get to count all its actual capital and its worldwide diversification credit, while the US parent company could count only its EU capital and its EU generated diversification credit. This would be unfair. Further, EU supervisors will be allowed to require a third country-group to set up an EU holding company. This may be very costly, disadvantaging third country-groups with a proven track-record of serving the interest of European policyholders and will, on the contrary, do nothing to enhance these policyholders’ protection.

Many non-EU insurers have served EU customers for decades, and those EU insurers have for years done business all over the world facing the same regulation as domestic insurers in those countries. Is now the time for the EU to challenge this tradition that has provided the benefits of competition to insurance consumers worldwide?

Solvency II group diversification benefits have been designed with EU groups in mind. Given their history, they have a European structure with a clear parent undertaking and subsidiaries that will allow them to get the best of these benefits. For good reasons at the time, third country-groups (even if all their entities clearly have the same owner in a third country) are not all set up in that way – thus being comparatively disadvantaged since they cannot benefit from diversification within their operation in the EU. Little consideration has been given as to how Solvency II should be implemented regarding third countries and as applied to third country

- The calibration of non-life underwriting risk module was flawed
 - No allowance for the underwriting cycle -a pronounced effect in the UK and many other markets
 - No allowance for complex interaction of pricing and reserving risk,
 - No allowance for the fact that claim frequency and volatility may need to be assessed separately
 - No allowance for large volatile claims
 - Simple factors cannot easily capture the risks in long tail non-life business
 - Policy terms and conditions and premiums will vary by company even within a similar product class
- Correlation matrices have limitations – they will not usually capture non-linear effects
- Non proportional reinsurance is a further important element that is not captured by the current framework
- Reinsurance inwards not dealt with appropriately
- The QIS2 approach to the calculation of MCR was flawed, particularly for groups
- Consistency between eligible capital in insurance and banking
- Geographic effects
- Scenario analysis – CAT scenarios not adequately dealt with

I summarise in this slide an overview of the key findings which arose from the QIS 2 study. I would like to expand on a few points identified in this slide, to highlight the importance of appropriate field testing.

Notably, the QIS2 approach to the calculation of MCR was flawed, particularly for groups. It was both arbitrary and complex. The MCR would often be too high and in some cases was higher than the SCR, as it failed to take into account risk mitigation and diversification effects. The coefficient for the MCR is still to be determined, but it is important that this is set at a sufficiently low level, to be commensurate with the role of the MCR as the trigger for the most severe regulatory intervention.

Solvency II proposals still need to consider how a company is capitalised, for example, offshore vs onshore entities. Furthermore, the model deals with business from a single location but different geographical sources or locations of business will bring diversification that the QIS2 model did not recognise.

Scenario analysis provides valuable insights that cannot be captured in a factor-based approach. CAT-risk and Market risk are prime examples where a scenario approach is not only desirable, but an essential pre-requisite for any meaningful analysis of these risks. This would need to include an examination of trend risk and uncertainty, which are very difficult to capture within a factor. Scenarios are capable of capturing non-linear effects, which is extremely difficult to achieve using a factor-based approach. In QIS 2 CAT scenarios, including latent claims, were not dealt with consistently across Europe.

There is also a broader point about the use of stress testing or scenario analysis of long-term trends or risks across various risk factors in order for the regulator/investors/public to evaluate the capital buffer available to insurers to withstand such events that extend beyond the one-year period contemplated in the shock factor approach. Again, the item could be captured in a Pillar II requirement.

GNAIE believes that adequate field testing is vital.

- Important to get Solvency II approximately right
- Field testing is a must to reduce the risk of a failure
 - How does Solvency II compare to standards in the US and elsewhere?
 - Will there be market disruptions caused by insurers being forced out inappropriately?
 - Or does a well-designed system allow insurance consumers to benefit from existing insurers and allow new EU and non-EU insurers to compete on a level playing field?
 - Market consistent - methodology challenge for non-tradeable risks
- QIS 3 is a start, but the end is not in sight!

Frankly, we believe that it is more important to get Solvency II right than it is to meet arbitrary deadlines. Solvency II is the most significant attempt to create a modernized insurance regulatory framework using the newly available capital management tools. It will be hugely influential whether it succeeds or fails, as the IAIS is already developing similar approaches for their Model Standards.

Field testing is a must to reduce the risk of a failure that could damage the prospect of this sort of regulatory reform for decades.

I would like to highlight some important questions which remain unanswered:

What will happen to non-EU competitors relative to EU competitors?

What will happen to competitors using different accounting or tax standards?

What will happen to the overall level of required capital? Is it higher than today? Should it be higher than today?

How does it compare to standards in the U.S. and elsewhere? Notably, most of the proposals would result in the lowering of capital requirements – including Basel II, which is why the US regulators rejected it. Query, is this why many in the industry might support a new approach – lower required capital?

Are companies comparable within product lines?

Does “market consistent” have any meaning when applied to insurance liabilities most of which, of course, settle and do not trade?

Most importantly, are insurers able to effectively serve their customers?

Will there be market disruptions caused by insurers being forced out inappropriately?

Or does a well-designed system allow insurance consumers to benefit from existing insurers and allow new EU and non-EU insurers to compete on a level playing field?

In the US, the most important part of field testing is whether or not insurers that were in financial difficulty would have been identified by the new proposals. Field testing should look backward at insurers who failed, apply the tests to them, and determine if they would have been identified sooner. The biggest problem for regulators will be the adoption of a system that permits failing companies to hide longer in a system of complex and unregulated scenario testing.

QIS 3 might be a start to answering some of these questions. However, we don't believe that it will

- MVM – estimation and calibration difficulties
 - Cost of capital approach requires further elaboration for practical implementation, especially for long tail non-life business
 - Cost of capital approach requires further calibration, validation and benchmarking of risk parameters and the cost of capital rate
 - The real issue rests with the reliability, consistency and comparability of model-based calculations
- Consistent solvency framework to be designed for groups and single entities
- Efficient supervisory structures and appropriate treatment of non EU players
- Cross sector consistency of regulation to prevent regulatory arbitrage
- Assess at an early stage interfaces and potential overlaps with other regulation
- The requirements for calculating SCR and MCR should not be over-complicated

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

As already mentioned the calibration of an appropriate market value margin methodology is an area that requires further work, particularly for long tail non-life contracts.

Despite the continuing efforts of many, there still appears to be a lack of consensus on the appropriate level for market value margins. Why is this the case? Data used will most likely be linked to market observable inputs, creating significant estimation and 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 margin at a product level due to the extreme volatility in the timing and amounts of some of the product lines.

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

GNAIE believes that solvency standard-setters are spending too much time trying to figure out how to set risk margins in liabilities when that is really a secondary issue to the calculation of the total capital requirements - the total assets required to meet the stated obligations and the risks that may arise over an appropriate period. That is a key point that GNAIE has been making consistently to the IAIS and NAIC over the past year or so.

- 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 support convergence to an equivalent standard in the US
- For either to occur, North American constituents must feel that Solvency II, generally is consistent with their needs and circumstances, and that the process of development is open and receptive to their comments
 - Current treatment of third country insurers is far away from this requirement
- GNAIE's desire is to continue to work closely with our European counterparts on global solvency principles, as we have done successfully on global accounting principles

I've reviewed why participation in the Solvency II process 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 affected by the standard, but convergence to global 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.

Specifically, AIG has an extensive branch network throughout Europe. Should Solvency II be disadvantageous to our branches, this could endanger the security provided to European policyholders in terms of the recourse they would have in law against the parent company.

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 and creating a level playing field.

We would like to see the European institutions be a champion of international convergence, in developing closer discourse with third-country regulatory regimes, with bodies such as the NAIC. A dialogue in which we can all learn from each other.

We would like to see the governance of the IAIS reflect the international (and not principally European) interests at stake. This requires active involvement of regulators from all countries.

GNAIE desires to continue to work closely with our counterparts in Europe (CFO Forum, CRO Forum, CEA and other associations) and Japan on global solvency principles, as we have done successfully on global accounting principles. Notably, GNAIE along with our industry colleagues in Europe and four of the largest Japanese life insurance companies made a recent joint industry presentation to the IASB, which demonstrated the significant range of agreement within the global insurance industry on the insurance accounting proposals, only disagreeing on some implementation methodologies particularly with respect to long-tail non-life insurance. Copies of this presentation can be made available upon request.

Solvency II cannot evolve into the global standard that the Europeans might desire if it does not reflect the concerns of insurers input around the globe.

Thank you for your attention.