24. (3 points)

The table below provides four components of a solvency-based regulatory framework, along with options for addressing each:

Component of framework	Options to select from
(1) Regulatory basis	• Principal-based regulation • Rules-based regulation • A combination of the two
(2) Level of regulatory involvement	• Low • High • Somewhere in between
(3) Basis for minimum capital requirement	• RBC • Solvency II • Some combination thereof
(4) Accounting standard	• Statutory • GAAP • IFRS

There is a request for a proposal to develop a new solvency-based regulatory framework.

Write a proposal that addresses each of the four components of the new framework. The proposal should include compelling arguments for the options selected.

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24) Sample Answer

Regulatory Basis

a. Principal-based – Principal based regulation should be used. Rules-based approach could be gamed and could also stifle innovation
b. Rules-based – modeled solution:
   i. A rules-based approach is one way to address the potential for regulatory errors, the problem of regulatory forbearance.
   ii. Principle-based insurance relies on key assumptions: insurer's incentive to manage risk, regulators not able to distinguish between effective & ineffective firms, internal models more effective at risk differentiation, & that regulators will take action when firm's did not manage risk == these are all questioned in light of recent market turmoil
   iii. Provides consistent standard for all companies. Less prone to interpretation.
c. Combination – A combination of both. Rule: can sometime games the system. Principal: insurer needs to have incentive to manage risk& allows them to keep up with increasing complexity of insurance market.

Examiner's Report

1. Generally, each of the options could be supported.
2. For the "Combination" option, it was required that a candidate provide either a positive trait for each Principle-based & Rules-based or provide a flaw in each that could be improved by the other.
3. Also, full credit was not given for the answer "Combination provides flexibility of principle-based and structure of rules-based". A more detailed explanation was required.

Regulatory Involvement

a. Low – Regulatory involvement is highly costly and there is question as to whether regulators are even able/willing to identify risky firms and require corrective actions. An insurer has incentive to manage its own risk and has a better handle and understanding of its own challenges/risk.
b. High– A high level of regulatory involvement is recommended, including financial reporting and filing, quantitative analysis and monitoring regular examinations and regulatory intervention when necessary.
c. Combination – Somewhere in between. High regulatory involvement adds high compliance costs while low regulatory involvement may lead to insurers being slack about monitoring insolvency, thus a mix of both is preferred.

Examiner'sReport

1. Generally, each of the options could be supported.
2. Many candidates answered this part with a discussion of rate regulation (competition, rate wars, cost) and/or public interest (cost, availability), but did not specifically discuss solvency impacts

3. A complete answer could have included: corrective actions, solvency or regulatory monitoring, examinations/audits/analysis of financial performance, regulatory review of insurer, etc.

Minimum Capital Requirements

a. RBC– RBC gives regulators authority to intervene when necessary and specific actions they should take. Also, more familiar to companies, lowering expenses of making a change to Solvency II
b. Solvency II – RBC is too restrictive and does not do a good job of lining up firm risk with capital requirements, so Solvency II allows a more accurate alignment, while still providing a basis for intervention with SCR & MCR
   Or
   I propose a Solvency II type capital requirement. Some benefits include the 99.5% VAR calibration, the use of internal models to promote risk management culture, and international standards are typically more modernized.
c. Combination – RBC is great, but lacks certain risk criteria like CAT/operational risk, etc where Solvency II picks it up. And Solvency II only has prudent person approach, which can lead to non-uniform models and require a lot of work to maintain/approve for use, etc. A combination of the better attributes of each is needed as well as a uniform and convenient/efficient approach.

Examiner's Report

1. Generally, each of the options could be supported.
2. For the "Combination" option, it was required that a candidate provide either a positive trait for each RBC & Solvency II or provide a flaw in each that could be improved by the other.

Accounting Standard

a. Statutory– Accounting standard should be statutory. It still needs to focus on solvency and to ensure obligations to policy holders are met. Needs to be conservative.
b. GAAP – GAAP: as long as solvency regulation is in place most users of financial statements are concerned with the company as a going concern and its realistic market outlook. Only regulators are concerned with liquidation value and IFRS has some excessively prudent approaches.
c. IFRS – IFRS, this allows for the best estimates of currency solvency and future profitability. STAT takes on overly conservative view in order to focus purely on solvency. GAAP allows for too much management input to focus purely on earnings.

Examiner's Report

1. Generally, each of the options could be supported.
2. For the "IFRS" option, full credit was not given for answers related to global or international standard as this did not address the solvency of an organization.
3. Complete answers included commentary on the valuation methods.