

Balancing Three Pillars across a Hundred Countries

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Symposium:

*International Standards and
Financial Stability*

Washington, November 18, 2004



INTERNATIONAL INSURANCE FOUNDATION

Solvency matters

- Core supervisory responsibility
- Financial stability concern led to standard setting mandate
- Mutual recognition depends on satisfactory solution
- Confidence issue



Solvency requirements

- fixed minimums
- proportional solvency margin
- risk sensitive capital requirement
- dynamic analysis
- probabilistic analysis

- IAIS Issues Paper on Solvency

- KPMG Study for Solvency II Project



Three Pillar Approach

- Pillar 1: Minimum requirements for all
- Pillar 2: Effective risk management
 - identification of risk profile of firm
 - use of internal models
 - interaction of management and supervisors
- Pillar 3: Market discipline
 - disclosure requirements
 - transparency



Underlying Assumptions

- **Pillar 1** -
 - supervisors know best
- **Pillar 2** -
 - managers and supervisors have same goal; together they know best
- **Pillar 3** -
 - public, managers, and supervisors together know best



Problems with Pillar 2

- Attempts to be too precise
- Oversimplifies choice of solvency regime
- Models can be opaque
- Ignores institutional factors
- Does not capture experience adjustments
- Can create misplaced confidence in supervisory system



Pillar 3 essentials

- Recognize effect of different environments
- Consider market structure
- Identify all factors contributing to solvency surveillance
- Do not undermine market discipline



Every system has strengths and weaknesses

- Sound supervision builds on strengths
- Regulation is neither good nor bad per se
 - it can distort market, undermine transparency
 - it can also enhance market, strengthen transparency, provide tools
- Design of supervisory system involves a series of tradeoffs



Public policy tradeoffs

- competition vs. stability
- moral hazard vs. policyholder protection
- safety vs. growth [attractiveness for investors]
- price freedom vs. stability
- regulatory burden vs. market soundness



Common Goals

- Supervisors want to protect policyholders from insolvencies
- Firms want to survive and prosper
- Customers want confidence in the long-term viability of their insurer



Value of staying in business

- franchise value higher with:
 - fewer players
 - more brand recognition
 - expectation of professionalism
- goal is to maximize franchise value
- otherwise greater risk of insolvency



Responses to insurer insolvency

- Licensing
- Financial reporting
- Supervision
- Separation of life and non-life accounts
- Investment regulation
- Uniform accounting rules
- Financial examinations
- Public disclosure
- Mandatory audits
- Actuarial opinion letter
- Risk-based capital requirements



Effects of market discipline

- More eyes looking for problems
- Scrutiny of enterprise, not merely policyholder funds
- Greater differentiation among firms
 - easier to recognize risk



Financial Stability

- G-7 Finance Ministers mandate to IMF
- Standard-setting bodies
- IAIS Core Principles
- Financial Sector Assessments
- Reports on Standards and Codes
- Identification of deficiencies, training needs
- Follow-up?



Markets develop progressively

- monopoly
- limited market, regulated prices
- licensing - entry and exit
- increased competition makes market more dynamic
- more differentiation of firms
- many players requires more supervision, especially **potential** financial condition



Lessons from emerging markets

- Standards help
 - provide political cover for sound supervision
 - facilitate education
- But precise specification of standards is less important than effective implementation
 - too much theoretical refinement can be a source of confusion
 - consistent application more likely to result from simpler standards



IAIS Core Curriculum Project

- Papers elucidating each of the IAIS Core Principles
- Pilot seminars to test and refine material
- Distance learning to reach all supervisors with consistent education on international standards



Conclusion

- Solvency monitoring should build on features of market
- Avoid rules that distort market
- Promote market discipline
- Emphasize training of supervisors

