

Southern California Casualty Actuarial Club December 2011

**SOLVENCY MODERNIZATION
INITIATIVE** *(and why it should matter to
actuaries!)*

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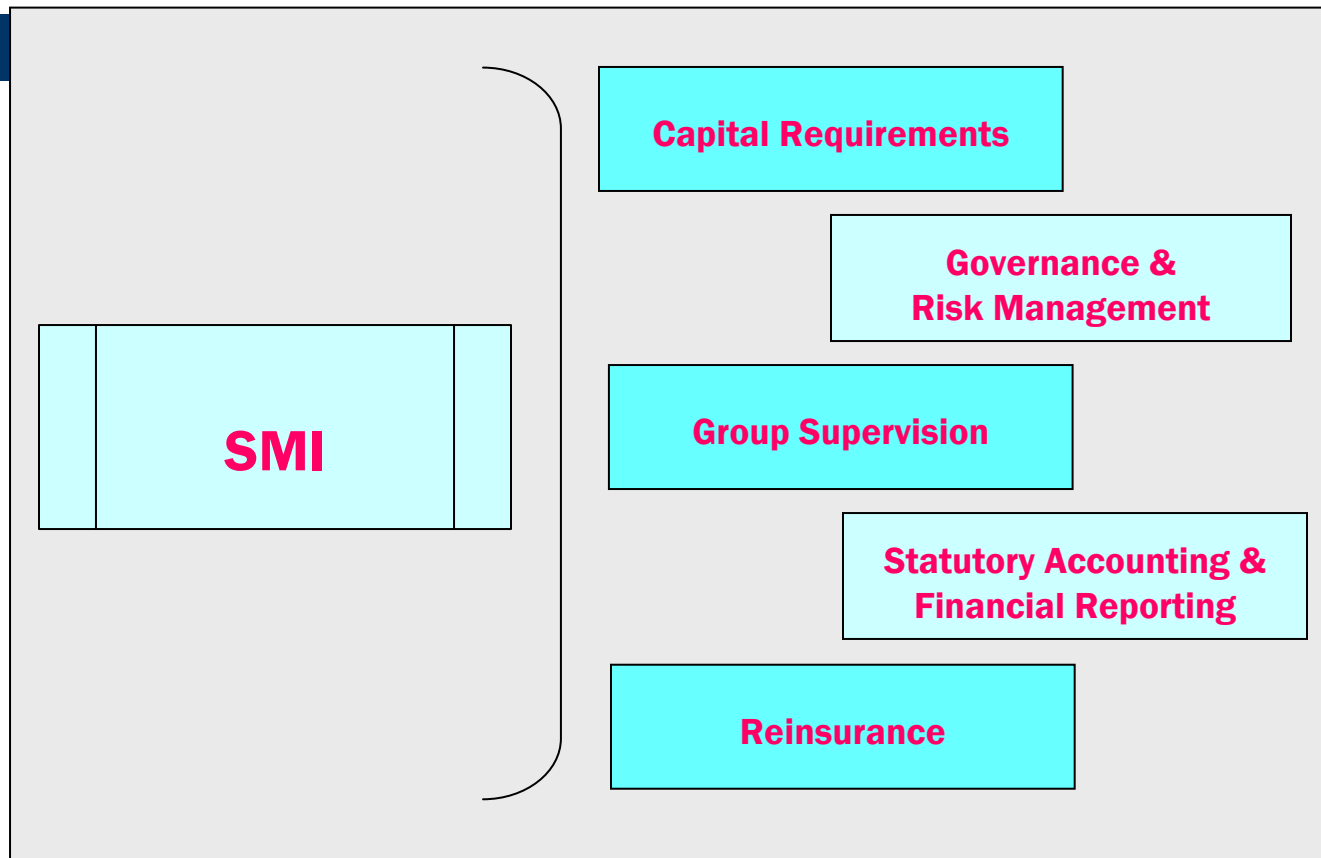
Solvency Modernization Initiative

- Solvency Modernization Initiative (SMI) adopted by NAIC in July 2008
 - This initiative will specifically examine international developments and their potential use in U.S. insurance regulation
 - Reinsurance
 - Group supervision & group capital
 - Governance & risk management
 - Accounting and valuation
 - Risk-based capital

SMI- Future of Financial Regulation

- Critical self examination of US system
- Create a better means to communicate internationally explaining our US system by creating documents
- Examine international developments and their potential use in US insurance regulation
- Comply with IAIS insurance core principles (ICP's) and FSAP requirements
- Apply lessons learned from financial crisis especially group supervision

SMI Focus Areas



The United States Insurance Financial Solvency Framework

- **Objective of Paper**

One of the first key objectives was to articulate an overview of the United States Insurance Financial Solvency Framework and its principles and therefore a paper was developed.

The purpose of this paper is to help US regulators in the current “globalization” of financial oversight describe the framework of the US Insurance Financial Solvency System and present a set of core financial principles underlying this framework.

Overview of Paper

This paper provides a description of the US Insurance Financial Solvency Framework that, while drawing upon ideas developed by the International Association of Insurance Supervisors (IAIS), goes beyond the IAIS in important, material ways. In particular, in the US regulatory system, ongoing collaborative regulatory peer review, regulatory checks and balances, and risk focused financial surveillance form the foundation of the regulatory process. Also, the framework indicates that the US Insurance Financial Solvency Core Principles are embodied in the NAIC's Financial Regulation Standards and Accreditation Program, which is a uniform program to which all states subscribe. Finally, included in this paper is a discussion of the US Insurance Financial Solvency Core Principles.

US Insurance Regulatory Mission

To protect the interests of the policyholder and those who rely on the insurance coverage provided to the policyholder first and foremost, while also facilitating an effective and efficient market place for insurance products.

History of State Based Regulation

The state regulatory system in the United States has had over a 100 year history of solvency regulation. This system is comprised of state insurance departments (currently 50 states, D.C. and 5 territories), and can best be described as a ***national system of state based regulation***. The NAIC assists regulators in a nonbinding, supplementary role.

Core Principles

Financial solvency core principles underlie the active regulation that exists today. A core principle, for purposes of this framework, is an approach, a process, or an action that is fundamentally and directly associated with achieving the mission. Seven core principles are identified for the US insurance regulatory system.

US Insurance Financial Solvency Core Principle 1:

- **Regulatory Reporting, Disclosure and Transparency**

Insurers are required to file standardized annual and quarterly financial reports that are used to assess the insurer's risk and financial condition. These reports contain both qualitative and quantitative information and are updated as necessary to incorporate significant common insurer risks.

US Insurance Financial Solvency Core Principle 2:

- **Off-site Monitoring and Analysis**

Off-site solvency monitoring is used to assess on an on-going basis the financial condition of the insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance. The results of the off-site analysis are included in an insurer profile for continual solvency monitoring. Many off-site monitoring tools are maintained by the NAIC for regulators (such as FAST).

US Insurance Financial Solvency Core Principle 3:

- **On-site Risk-focused Examinations**

US regulators carry out risk-focused, on-site examinations in which the insurer's corporate governance, management oversight and financial strength are evaluated, including the system of risk identification and mitigation both on a current and prospective basis. The reported financial results are assessed through the financial examination process and a determination is made of the insurer's compliance with legal requirements.

US Insurance Financial Solvency Core Principle 4:

- **Reserves, Capital Adequacy and Solvency**

To ensure that legal obligations to policyholders, contract holders, and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety. The most visible measure of capital adequacy requirements is associated with the risk based capital (RBC) system. The RBC calculation uses a standardized formula to benchmark specified level of regulatory actions for weakly capitalized insurers.

US Insurance Financial Solvency Core Principle 5:

- **Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities**

The regulatory framework recognizes that certain significant, broad-based transactions/activities affecting policyholders' interests must receive regulatory approval. These transactions/ activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance.

US Insurance Financial Solvency Core Principle 6:

- **Preventive and Corrective Measures, Including Enforcement**

The regulatory authority takes preventive and corrective measures that are timely, suitable and necessary to reduce the impact of risks identified during on-site and off-site regulatory monitoring. These regulatory actions are enforced as necessary.

US Insurance Financial Solvency Core Principle 7:

- **Exiting the Market and Receivership**

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines solvency and establishes a receivership scheme to ensure the payment of policyholder obligations of insolvent insurers subject to appropriate restrictions and limitations.

Capital Requirements

- RBC is a means to identify weakly capitalized companies
- This differs from Solvency II where the highest level of capital requirement is closer to the target capital level of a company
- State regulators want to improve the RBC “story”
 - Improve consistency of formula (Calibration/Correlation)
 - Add missing risk charges (P&C Catastrophe Risk)
- Regulators favor internal models for those risks where a formula simply doesn’t work, but otherwise we favor the formula approach for consistency, uniformity, and fairness
 - The cost/benefit of full internal models to replace RBC entirely, especially when it comes to regulatory prior approval, does not currently pass regulatory scrutiny.

Statutory Accounting & Financial Reporting

- **NAIC exposed a discussion document in 2010 that identified possible choices for regulators with respect to statutory accounting**
 - **Possible Identified Choices (On a Continuum):**
 - **Freeze SAP without changes**
 - **U.S. GAAP with statutory adjustments step by step review**
 - **IFRS with statutory adjustments**
 - **IFRS for public companies IFRS/GAAP with statutory adjustments for nonpublic companies**
 - **IFRS without adjustments**

Statutory Accounting & Financial Reporting

- Concerns Expressed at 2010 NAIC Summer Meeting:
 - Relegating control to a third party
 - Elimination of Prescribed and Permitted Practices
 - Principle-Based (IFRS) v. Rules-Based (SAP)
 - SAP...fully integrated... subject to abuse?
 - IFRS volatility...just another tool?
 - Decision timing
 - Valid Concerns, how to address?
- No decision until IASB/FASB Insurance Contracts/SEC decision
- Valuation (Principles-Based Reserving) – 2011 Impact Study
- Standard Valuation Model Law is already adopted
 - Working on the Valuation Manual to accompany that law now

Reinsurance

- The Reinsurance Regulatory Modernization framework proposal was adopted in 2008; this proposal allows for cross-border reinsurance with reduced collateral requirements (risk-based approach)
- The framework recommended implementation through enabling federal legislation, but was unable to procure such support
- Most recently, some states (NY, NJ, FL, IN, LA, TX) are moving forward with individual state-based reinsurance collateral reduction reforms. Changes to the Credit for Reinsurance Model Law are being contemplated and are expected to be adopted by the NAIC Membership by year-end

Federal Legislation

- The Federal Financial Reform legislation contained a section impacting reinsurance. Under this legislation, states are pre-empted from applying reinsurance regulation on an extra-territorial basis. The sole state authorized to regulate reinsurance for a ceding company is its domiciliary regulator.
- FIO report within 18 months
- Current status of Reinsurance proposals

Group Solvency

After the financial crisis, lessons learned revealed regulators needed some enhancements with regard to group supervision. To date, the following activities have been implemented related to group supervision:

- State supervisory college tracking documentation
- Web-based request form for international supervisors to request U.S. state participation in supervisory colleges
- Enhanced Holding Company Model Act #440 and Regulation #450 adopted
 - New Form F-Statement regarding material risks within the insurance holding company system that could pose enterprise risk to the insurer
- Accreditation Part B Guidelines regarding depth of review and documentation of the holding company analysis

Additionally, regulators continue to work on the following activities:

- Holding Company and Supervisory Best Practices document
- Studying the need for more uniform holding company financial reporting
- Drafting a proposal for group-wide economic capital assessment

Group Supervision

Regulation - Enterprise Risk Report (Form F) – Include the following areas:

- Identification of material concerns of the insurance holding company system raised by supervisory college, if any, in last year;
- Identification of insurance holding company system capital resources and material distribution patterns;
- Identification of any negative movement, or discussions with rating agencies which may have caused, or may cause, potential negative movement in the credit ratings and individual insurer financial strength ratings assessment of the insurance holding company system (including both the rating score and outlook);
- Information on corporate or parental guarantees throughout the holding company and the expected source of liquidity should such guarantees be called upon; and
- Identification of any material activity or development of the insurance holding company system that, in the opinion of senior management, could adversely affect the insurance holding company system

Group Supervision

FSAP Recommendations

- U.S. supervisors should (i) include fuller assessment of the financial condition of the whole group including quantitative techniques used internationally; (ii) extend the risk-focused examinations to groups; (iii) ensure that colleges of supervisors for the U.S. groups with major international operations are established and functioning effectively—and led by U.S. regulators with appropriate insurance expertise
- Be given additional powers, such as clear authority to license insurance holding companies, apply insurance capital requirements to the consolidated insurance group and direct the insurance holding company to make changes at the group level to rectify any shortcomings

Governance and Risk Management

- U.S. regulators acknowledged that the revised risk-focused surveillance approach already includes a review of certain corporate governance activities
 - White Paper on U.S. Corporate Governance Principles was exposed for comment
 - US regulators have developed 20 high-level corporate governance principles (based upon IAIS and other country's requirements) but have yet to determine if such principles should be supported through a model law or other means
- Interim meeting on corporate governance and risk principles occurred on July 20, 2011 and a new draft of proposed guidance will be released

Governance and Risk Management

- Focus on Risk Management with an Own Risk and Solvency Assessment (ORSA)
 - Many US regulators believe that some form of ORSA would have regulatory value as companies' risk management process is integrated into assessment
- Most recent draft of ORSA guidance manual is dated October 2011
- Sections proposed
 - Section 1 - Description of the Risk Management Framework
 - Section 2 – Insurer's Assessment of Risk Exposures
 - Section 3 – Group Risk Capital and Prospective Solvency Assessment
- ERM Interim Meeting (July 2011)
 - Insurance groups will introduce their ERM so regulators can observe the current state of practice

ORSA Section 1

Description of Insurers Risk Management Framework

- Risk Culture and Governance
- Risk Identification and Prioritization
- Risk Appetite, Tolerances and Limits
- Risk Management and Controls
- Risk Reporting and Communication

ORSA Section II

Insurer Assessment of Risk Exposures

- This section of the ORSA summary report should document the quantitative measurements of risk exposure in both normal and stressed environments for each material risk category identified in Section 1.
- Examples of relevant material risk categories might include credit risk, market risk, liquidity risk, underwriting risk and operational risks.

ORSA Section III

Group Risk Capital and Prospective Solvency Assessment

- Section III of the ORSA summary report should document how the company combines the qualitative elements of its risk management policy and the quantitative measures of risk exposure in determining the level of financial resources it needs to manage its current business and over a longer term business cycle such as the next 2 to 5 years.

Governance and Risk Management

Why are we proposing an ORSA?

- Comply with FSAP
 - “Each country pledges to review and report on its regulatory system . . . (A)ll G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report.”
 - November 2008 G20 Financial Summit declaration
- Supervise internationally active groups
 - International Association of Insurance Supervisors (IAIS) develops the insurance supervisory standards through Insurance Core Principles (ICPs) that are used by the International Monetary Fund (IMF) to perform the FSAP.
 - Internationally Active Groups – IAIS ComFrame; Solvency II

Governance and Risk Management

Why are we proposing an ORSA?

- Improve Solvency Regulation in the U.S
 - Well-executed risk management improves a company's chances of continuing to operate in a strong and healthy manner.
 - Quantitative analysis should improve the assessment of (hazardous) financial condition.
- Assist the Regulator with Risk-Focused Examinations
 - Frequency and depth of exams
- Aid the Ability to Evaluate the Industry's Ability to Withstand Stresses

Governance and Risk Management

- Confidentiality
- Proportionality/Exclusions
- Implementation Authority
- Reward/Penalty
- Group or Legal Entity
- Fit within the US regulatory framework/Overlap
- Reporting Requirements
 - Regulatory influence on the ORSA (prescriptive), Uniformity/International Convergence, Frequency
 - Current draft has the filing as part of Form B

Want More Info.?

NAIC Website www.naic.org



- Solvency Modernization Initiative button
- Consultation papers on capital assessment, accounting/valuation issues, governance, and risk management
- Links to Task Forces & Working Groups
- Updates & SMI Roadmap