

## A Regulator's Viewpoint on Solvency Modernization

*Spring 2011 Meeting*

**CAGNY**

# Financial Regulation Update



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- **Today's Topics and Objectives**

- State, Federal and International Regulation of Insurance
- NAIC Solvency Modernization Initiatives
- Insurer Solvency Update and Concerns
- Department Activities

# State, Federal and International Regulation of Insurance

## • State, Federal and International Regulation

—What are the buzz words of today:

- Internationally Active Insurance Groups (IAIG)
  - Financial Sector Assessment Program (FSAP)
  - Solvency Modernization
  - Com Frame
  - Insurance Core Principles
  - ERM / Governance
- Systemic Risk
  - Dodd Frank
  - Systemically Important Financial Institutions (SIFI)
  - Group Supervision
  - ORSA
  - Equivalence

- **State, Federal and International Regulation**

- Systemic Importance Designations
  - U.S.—Financial Stability Oversight Council
  - Europe—Financial Stability Board
  - Global—IAIS
- Comprehensive Regulatory Overhauls
  - U.S.—NAIC Solvency Modernization Initiative
  - Europe—Solvency II
  - Global—IAIS Revised Insurance Core Principles/ComFrame

- **State, Federal and International Regulation**

- Accounting Changes

- US – FASB, SEC

- Europe – IASB

- Global – ASPAC, APRA

- Information Gathering

- US – Federal Insurance Office

- Europe – International Monetary Fund

- Global – International Monetary Fund

- **State Regulation of Insurance**
  - State system is close to the ground
    - Consumers benefit
    - Insurer access to decision makers
    - Recent solvency track record

- **State Regulation of Insurance**

- Can States do better? **Yes.**

- Uniformity

- Rates and Forms

- Market Regulation

- Group / Holding Company Activity Risk Impact



- **Federal Regulation of Insurance**

- Why not have Feds pre-empt states to force the last of the states to comply with a NAIC uniformity initiative (i.e., the Compact)?
- What happened to Dual Charter?

- **Federal Regulation of Insurance**

- Dodd-Frank Wall Street Reform and Consumer Protection Act (enacted July 21, 2010)
  - Federal Insurance Office within U.S. Department of Treasury
  - Surplus Lines (nonadmitted) and Reinsurance
  - Financial Stability Oversight Council Systemic Risk

- **Systemic Risks**

*A risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy.*

International Monetary Fund, the Bank for International Settlements and the Financial Stability Board

- **Systemically Risky Categories**

- Size
- Interconnectedness
- Substitutability
- Leverage
- Liquidity and Maturity Mismatch
- Regulatory Scrutiny

## • Are Insurers Systemically Risky?

- Limited Size of Activities on the Global Financial Markets Due to Competition and Diversification
- Interconnectedness not Applicable except for limited Reinsurance Exposures
- Substitutability achieved through Capacity replacement and Guaranty Funds accessibility
- Leverage is almost non existent due to investment regulations and risk based capital requirements
- Liquidity and Maturity Mismatch is reduced (other than life) due to “trigger” and timing of claims payments
- Regulatory Scrutiny in the United States is Strong

**NO!!!!**

- **Financial Impact of Bank and Insurer  
“Catastrophes” (2008 USD)**

- Katrina, Rita, William: \$ 100 Billion
- Global Bank write-downs: \$ 155 Billion
- Lehman Debt at default: \$1,700 Billion

*Source: Systemic Risk in Insurance; Special Report of The Geneva Association Systemic Risk Working Group*

# NAIC Solvency Modernization Initiatives

- **NAIC Solvency Modernization Initiative (EX) Task Force**
  - Critical Self Examination
  - Articulation of U.S. Solvency Framework and Principles
    - White Paper: *The United States Insurance Financial Solvency Framework*
    - Assist in the International Equivalence Standard



- **NAIC Solvency Modernization Initiative (EX) Task Force – Statutory Accounting and Financial Reporting**

- Study of solvency / accounting initiatives and tools in other sectors / countries
  - Reviewed solvency regulatory schemes in Australia, Bermuda, Canada, Switzerland, EU Solvency II
  - Monitoring and comments on IAIS's work

- **NAIC Solvency Modernization Initiative (EX) Task Force – Statutory Accounting and Financial Reporting**

- Study of the future of Statutory Accounting

- Survey done with certain NAIC Working Groups and Task Forces asking the following:

- 1) What should be the purpose of the regulatory accounting model?

- **NAIC Solvency Modernization Initiative (EX) Task Force – Statutory Accounting and Financial Reporting**

- Survey questions continued:

- 2) Given that the IAIS and major jurisdictions are advocating the use of IFRS (possibly with modifications) for regulatory purposes, should the NAIC continue to maintain an entire codification of statutory accounting?

- **NAIC Solvency Modernization Initiative (EX) Task Force – Statutory Accounting and Financial Reporting**
  - Survey questions continued:
    - 3) Should regulatory financial statements be utilized for public purposes or should a separate confidential financial filing be required?

- **NAIC Solvency Modernization Initiative (EX) Task Force – Reinsurance**
  - Creation of new reinsurance regulatory framework
    - Some Federal move with Dodd-Frank
    - Some States moving on their own

- **NAIC Solvency Modernization Initiative (EX) Task Force – Capital Requirements**
  - Study of the RBC calculation:
    - Select the calibration (“safety”) level and time horizon for RBC, recognizing that RBC is designed to identify weakly capitalized companies rather than mirror a company’s economic target capital calculations

- **NAIC Solvency Modernization Initiative (EX) Task Force – Capital Requirements**
  - Study of the RBC calculation continued:
    - Identify missing risks (e.g., P&C catastrophe risk, operational risk) in the RBC formula and create risk charges for those risks
    - Modify the formula: asset categories, current factors, modeling where factor-based approaches are not sufficient to capture the identified risk, and covariance

- **NAIC Solvency Modernization Initiative (EX) Task Force – Capital Requirements**
  - Study of the RBC calculation continued:
    - Develop modeling requirements and regulatory approval processes where the modeling requirements are principles-based
    - Re-evaluate the thresholds for the action and control levels



- **NAIC Solvency Modernization Initiative (EX) Task Force – Capital Requirements**
  - Study of the RBC calculation continued:
    - Recalibrate RBC
    - Complete impact studies
    - Decide on Disclosure for RBC

- **NAIC Solvency Modernization Initiative (EX) Task Force – Governance and Risk Management**
  - Study integrating corporate governance requirements into solvency
    - Outline high-level corporate governance principles and determine appropriate methodology to evaluate adherence with those principles, giving due consideration to development of a model law

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- **NAIC Solvency Modernization Initiative (EX) Task Force – Governance and Risk Management**

- Study integrating corporate governance requirements into solvency continued:
  - Analyze requirements, regulatory initiatives and best practices of the states, other countries and regulators, and the insurance industry to assist in principle development
  - Develop additional regulatory guidance including detailed best practices for the corporate governance of insurers

- **NAIC Solvency Modernization Initiative (EX) Task Force – Governance and Risk Management**
  - Review current IAIS core principles and standards related to corporate governance
    - Input and drafting to IAIS Governance and Compliance Subcommittee and other IAIS papers, as assigned by parent Task Force, and identification of future initiatives to improve state regulatory solvency system
  - Consider development of insurance regulatory education for members of insurers' boards of directors

- **NAIC Solvency Modernization Initiative (EX) Task Force – Governance and Risk Management**
  - Own Risk and Solvency Assessment (ORSA) proposal
    - ERM Framework
    - Description of the Risk Management Policy
    - Quantitative Measurements of Risk Exposure in Normal and Stressed Environments
    - Prospective Solvency Assessment

- **NAIC Solvency Modernization Initiative (EX) Task Force – Governance and Risk Management**

- White Paper on High-Level Corporation Governance Principles
  - Corporate Governance
  - Board of Directors (Education of Boards)
  - Senior Management
  - Suitability of Individuals
  - Reporting and Transparency
  - Risk Management and Internal Controls
  - Central Functions
  - Regulatory Oversight

- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Major changes to Model Holding Company Law and Regulation
    - Kingsway Provision
    - Coordinate Form A (acquisition) public hearings

- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Major changes to Model Holding Company Law and Regulation continued
    - Require holding company filings with NAIC for data collection
    - Form B (annual registration statement) new requirements:
      - Financial statements of holding company



- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**

- Form B, new requirements continued:

- Statement that the insurer's board of directors is responsible for and oversees corporate governance
- Annual confidential supplement identifying material risks within the insurance holding company system that could pose financial and/or reputational contagion to the insurer (enterprise risk management)

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- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Information required in annual confidential enterprise risk management supplement (Form F – Enterprise Risk Report):
    - Any material developments regarding strategy, internal audit findings, compliance or risk management affecting the insurance holding company system
    - Acquisition or disposal of insurance entities and reallocation of existing financial or insurance entities within the insurance holding company system

- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Form F – Enterprise Risk Report continued:
    - Changes of shareholders of the insurance holding company system exceeding 10% or more of voting securities
    - Developments in various investigations, regulatory activities or litigation that may have a significant bearing or impact on the insurance holding company system

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- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Form F – Enterprise Risk Report continued:
    - Business plans of the insurance holding company system and summarized strategies for next 12 months
    - Identification of material concerns of the insurance holding company system raised by supervisory college, if any, in last year

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- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Form F – Enterprise Risk Report continued:
    - Information on corporate or parental guarantees throughout the holding company and the expected source of liquidity should such guarantees be called upon
    - 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; and

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- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Form F – Enterprise Risk Report continued:
    - 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)

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- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Disclaimer of control could be disallowed prior to a hearing
  - New rules for transactions within an insurance holding company system
    - Cost sharing and management agreements
    - Tax allocation agreements
    - Reinsurance agreements

- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Subsection C. requirements for management still optional (relates to board and committee membership)
  - Increase examination authority over the insurance holding company system
  - Concept of Supervisory Colleges
    - Companies have to pay
  - Changes adopted by NAIC in December 2010 and PA planning to introduce changes by fall of 2011



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- **NAIC Solvency Modernization Initiative (EX) Task Force – Group Supervision**
  - Other issues to be addressed
    - Holding company analysis guidelines
    - Holding Company and Supervisory College Best Practices

## What are the Issues with all of this?

Is it overdone?

Should it be for all companies?

How do each inter-relate and is there redundancy?

Is it too complex?

Do we need all this (Do we need to build a stadium this big?)

Can states execute this?

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## Insurer Solvency Update and Concerns

## • Solvency Update

- Low insolvency level
- 6 straight calendar years without an insolvency of a Pennsylvania domestic insurer

### **First Time in 64 Years!**

- Last Liquidation of a PA domestic: 7/2/2004
- Penn Treaty in Rehabilitation: 1/5/2009
- Last Liquidation of a P/C PA domestic: 7/28/2003
- 94 Companies Saved in PA since 1997

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- ***Economic Research: Insurance Company Insolvencies Reach A Decade Low in 2007***

- U.S insurance companies placed under regulatory supervision:

**2000 – 56**

**2004 – 19**

**2005 – 16**

**2006 – 11**

**2007 – 10**



- Largest receivership in 2007: \$79.7 million in total assets

- Study showed a decrease in both the number and severity of insurance company insolvencies

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- Insolvencies**

	2008	2009	2010	2011
<b>P &amp; C</b>	3	7	10	2
<b>L &amp; H</b>	5 (1 caused by economic crisis)	10 (1 caused by economic crisis)	3	0
<b>Title</b>	2	0	2	0
<b>Fraternal</b>	0	0	0	1
<b>Total</b>	<b>8</b>	<b>17</b>	<b>15</b>	<b>3</b>

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- **Number of Bank Failures**

Year	Bank Failures
2008	25
2009	140
2010	157
2011 (as of 3/18/11)	25

- **Enhanced Early Warning Detection of Solvency Concerns =**

1. **Less** insolvencies
2. **More** solvent run-offs – 12 PA domestics  
(Both frequency and severity)

**This is a permanent structural change.**

Example: Kemper/Royal Sun run-offs



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## Solvency Update

Estates still being administered by the Department

9 in Liquidation

2 in Rehabilitation (Penn Treaty and sub)

## Solvency Update

### Pennsylvania Workers' Compensation Security Fund

No assessment made from 2004 – 2009

2010-1%

2011 – none

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## Solvency Update

### Pennsylvania Life and Health Insurance Guaranty Association

Last assessment made in 1998

Two-phase refund in 2009 totaling \$192 million

## Solvency Update

### Pennsylvania Property and Casualty Insurance Guaranty Association

#### Report for 2009

1 new assessment (\$5,000,000)

Prior uncalled assessments reduced by  
\$31,180,000

Last time companies cut a check: 11/04

- **Solvency Concerns**

- Structured securities – Commercial Mortgage Backed
- P&C soft market
- Holding Company liquidity
- Mortgage Guaranty
- Long-Term Care insurance

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## Department Activities

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- **Department Activities**

- Continue to meet with companies
- How to Prepare for a Financial Examination
- Model Audit Rule
  - Adopted in Pennsylvania effective January 1, 2010
  - First report not due until August 1, 2011
  - Actuarial opinion restriction

- **Revisions to the NAIC Model Audit Rule**

Three main areas:

- Auditor Independence
- Corporate Governance
- Internal Control Over Financial Reporting





- **Benefits to Financial Examinations**
  - Enhanced Corporate Governance
  - Establishment and Documentation of Financial Reporting Risk Mitigation Strategies
  - Independence of Outside Auditors

- **Limitations**

- Not a Test of “Compliance”
- Limited to Financial Reporting Risk
- Not a Replacement for Regulatory Verification

- **Department Activities**

- Act 14 of 2010 (S.B. 237, P.N. 1688)  
confidentiality protections for actuarial reports
- New Chapter 118a for P&C Actuarial  
Opinions published as proposed 8/28/2010

# Questions?

