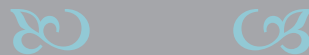


The Latest in Solvency Regulation

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Introduction

- ∞ International Convergence in Supervision
- ∞ US Financial Regulatory Framework
- ∞ Progress in SMI
- ∞ Comparison of US and EU Regulatory Regimes: Capital Requirements, Group Regulation, ORSA, Financial Reporting

Background - Evolution of the U.S. Solvency System

- ∞ US regulators have developed a detailed and uniform financial regulatory system over its years of existence.
- ∞ In the early 1990s, the NAIC's Solvency Policing Agenda resulted in a number of major changes to financial regulation (e.g., RBC, accreditation, FAST system, FAWG)
- ∞ Continuous improvement over the past 20 years have resulted in many enhancements (e.g., model audit rule, risk-focused exams, uniform statutory accounting model)
- ∞ Today, global and national developments call for another comprehensive review.

Convergence

- ∞ **Financial Sector Assessment Program (FSAP), G-20**
 - “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
- ∞ **International Association of Insurance Supervisors (IAIS) Activities (Insurance Core Principles – ICPs, Supervisory Forum, ComFrame)**
 - IAIS develops the insurance supervisory standards through ICPs that are used by the International Monetary Fund (IMF) to perform the FSAP.
 - Internationally Active Groups – IAIS ComFrame; Solvency II
- ∞ **Solvency II / US Dialogues**
- ∞ **International Accounting Standards**

Additional Reasons for SMI

- ∞ 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

What is the SMI?

- ☞ The U.S. financial regulatory system is continuously updated.
- ☞ Critically review the U.S. Regulatory Solvency Framework
 - Principles and “whys” of our system
 - International developments
 - IAIS insurance core principles, IMF FSAP
 - Financial crisis

U.S. Solvency Framework

∞ Our current framework:

http://www.naic.org/documents/committees_e_us_solvency_framework.pdf

∞ National System of state-based financial regulation

- Accreditation – Peer Review of regulatory powers and quality implementation
- All states meet the uniform requirements

∞ US Regulatory Mission:

Protect policyholders/claimants/beneficiaries first and foremost, while also facilitating an effective and efficient marketplace for insurance products.

U.S. Financial Regulation

Restriction and Approval

- A codified statutory accounting system, Conservative valuation of premium and claim reserves
- Restrictions on investment
- Commissioner preapproval on significant transactions
- Regulator transparency of key issues

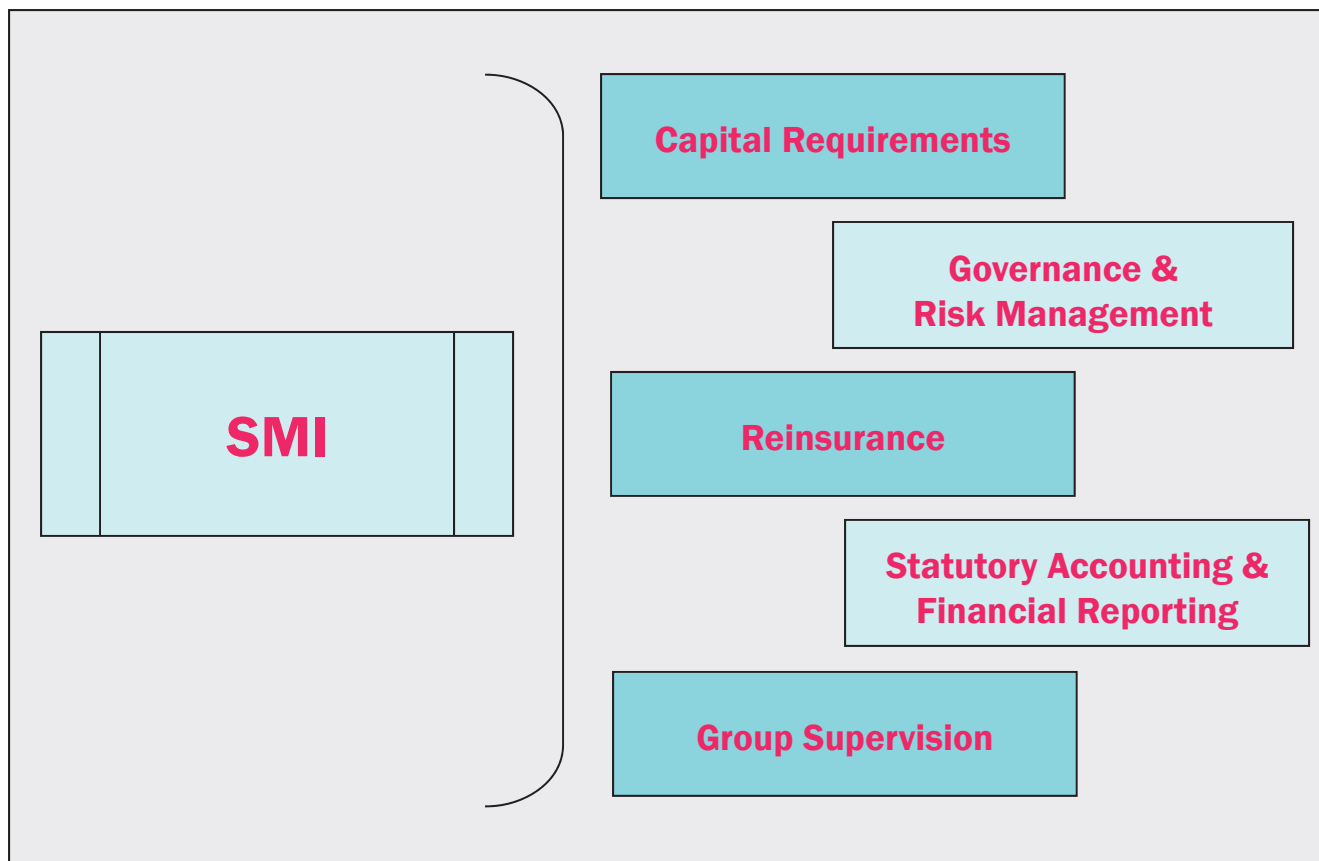
Financial Oversight

- Established grounds for regulatory action
- Focus on appropriate valuation, acceptable and mitigation of risk, and amount of capital held
- Extensive access to and use of financial reporting databases
- Financial oversight is the key to the system

Backstops and Safeguards

- Risk Based Capital (RBC) calculation and analysis, creating legal authority to provide for timely regulatory action
- Minimum capital and surplus requirements
- Guaranty Funds

SMI Roadmap



Capital Requirements - RBC

- ∞ What is RBC meant to do?
 - weakly capitalized companies
 - require regulatory action (vs. inaction)
- ∞ Ability to Handle Stresses
- ∞ The key: RBC ties into financial regulation

Capital – RBC & Group Capital

☞ RBC Improvements

- Add missing risk charges
- Improve credit risk calculation
- Re-think the correlation (e.g. square root formula)

☞ Partial Internal models for RBC

- The cost/benefit of full internal models to replace RBC entirely, especially when it comes to regulatory prior approval, does not currently pass U.S. regulatory scrutiny.
- Life RBC currently uses modeling for variable annuities with certain guarantees and similar products
- Considering expansion to other life products
- Principle-Based Reserve project will increase RBC models

☞ Group capital assessment

Governance

- ∞ Insurer corporate governance requirements includes insurance regulation – but also state governance statutes, case law, SEC requirements, etc.
 - *Existing U.S. Corporate Governance Requirements*
- ∞ Potential gaps
- ∞ Compile “best practices”

Governance

- ∞ Publication of a comparative analysis of existing US governance requirements, international standards, and regulatory needs.
- ∞ Includes exposure of proposals for change:
 - additional disclosure requirements
 - a new requirement for large insurers to have an INTERNAL audit function (requiring a change to the Model Audit Rule),
 - a corporate governance assessment (rating) tool that could be directly linked to assessment of hazardous financial condition,
 - accreditation proposals to require implementation of part of the Hazardous Financial Condition Model Law to directly refer to governance needs.
- ∞ No new governance law is recommended.

Risk Management

- ∞ CRO Input – including from the North American CRO Council
- ∞ Own Risk and Solvency Assessment “ORSA”
 - (1) Description of risk management framework
 - (2) Assessment of Risk Exposures (Stress Tests)
 - (3) *Prospective* Solvency Assessment & Group Capital

Reinsurance

- ∞ Reinsurance Regulatory Modernization Framework
 - Conceptual framework – consider collateralization regarding unauthorized reinsurers & the design of the U.S. reinsurance regulatory framework
- ∞ State reinsurance collateral reforms
- ∞ Revisions to Reinsurance Model Laws
 - Potential collateral reduction for reinsurers meeting certain financial strength and business practices.
 - Reinsurers will be certified: financial strength, timely claims payment, domiciled and licensed in a qualified jurisdiction.
 - An NAIC committee will produce a list of qualified jurisdictions

Statutory Accounting & Financial Reporting

∞ Valuation (Life Insurance Principles-Based Reserving)

- 2011 Impact Study
- Standard Valuation Model Law
- Valuation Manual

∞ Future of Statutory Accounting

- International accounting standards development
- SEC's expected decisions
- IAIS valuation standards
- At present this discussion is on hold, pending further developments.
- IFRS influence on GAAP influences our SAP already

Group Supervision

- ∞ Lesson learned from the financial crisis:
 - Holding company Enterprise risk
 - “Windows and Walls”
- ∞ Holding Company Model Act and Regulation Dec. 2010
- ∞ IAIS ComFrame for the supervision of internationally active groups
- ∞ Current activity:
 - Accreditation changes for the new models
 - Holding company best practices & reporting requirements
 - Supervisory Colleges
 - Enhanced coordination with banking and other regulators as well as insurance regulators from non-US jurisdictions
 - IAIS Supervisory Forum

U.S. Enterprise Risk Filing

- ∞ “Form F” for group holding companies
- ∞ Identifies material risks that could pose enterprise risk to the insurer or the holding company system.
- ∞ Discloses material developments (e.g. strategy, internal audit findings, compliance or risk management, regulatory investigations, litigations, etc.) affecting the holding company.

US Own Risk & Solvency Assessment (ORSA)

- ORSA Manual developed with industry comments
- Two primary goals:
 - Foster effective level of ERM, thru which each insurer identifies and quantifies material and relevant risks using techniques appropriate to the nature, scale and complexity of the insurer's risks, in a manner adequate to support risk and capital decisions
 - Provide a group-level perspective on risk and capital as a supplement to the existing legal entity view
- ORSA Exemption
 - Individual insurer's annual direct written and unaffiliated assumed premium, including international direct and assumed premium but excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, is less than \$500,000,000; and
 - Insurance group's (all insurance legal entities within the group) same annual premium is less than \$1,000,000,000
 - Insurer specific waiver granted by Commissioner based upon unique circumstances including, but not limited to, type and/or volume of business written

ORSA

- ORSA process is one element of insurer's broader ERM framework
 - Links the insurer's risk identification, measurement and prioritization processes with capital management and strategic planning
 - Each insurer's ORSA process will be unique, reflecting its business, strategy and approach to ERM
- Regulators will use the ORSA Summary Report to gain a high-level understanding of the process
 - Summary Report may be provided in any combination as long as all insurance legal entities within the group are represented
 - Summary Report will be supplemented by the insurer's internal risk management materials
 - Summary Report, at a minimum, should discuss:
 - Section 1 – Description of Insurer's Risk Management Framework
 - Section 2 – Insurer's Assessment of Risk Exposure
 - Section 3 – Group Risk Capital and Prospective Solvency Assessment

U.S. ORSA Section 1

Description: Risk Management Framework

Risk Culture and
Governance

Risk
Identification
and Prioritization

Risk Appetite,
Tolerances and
Limits

Risk
Management
and Controls

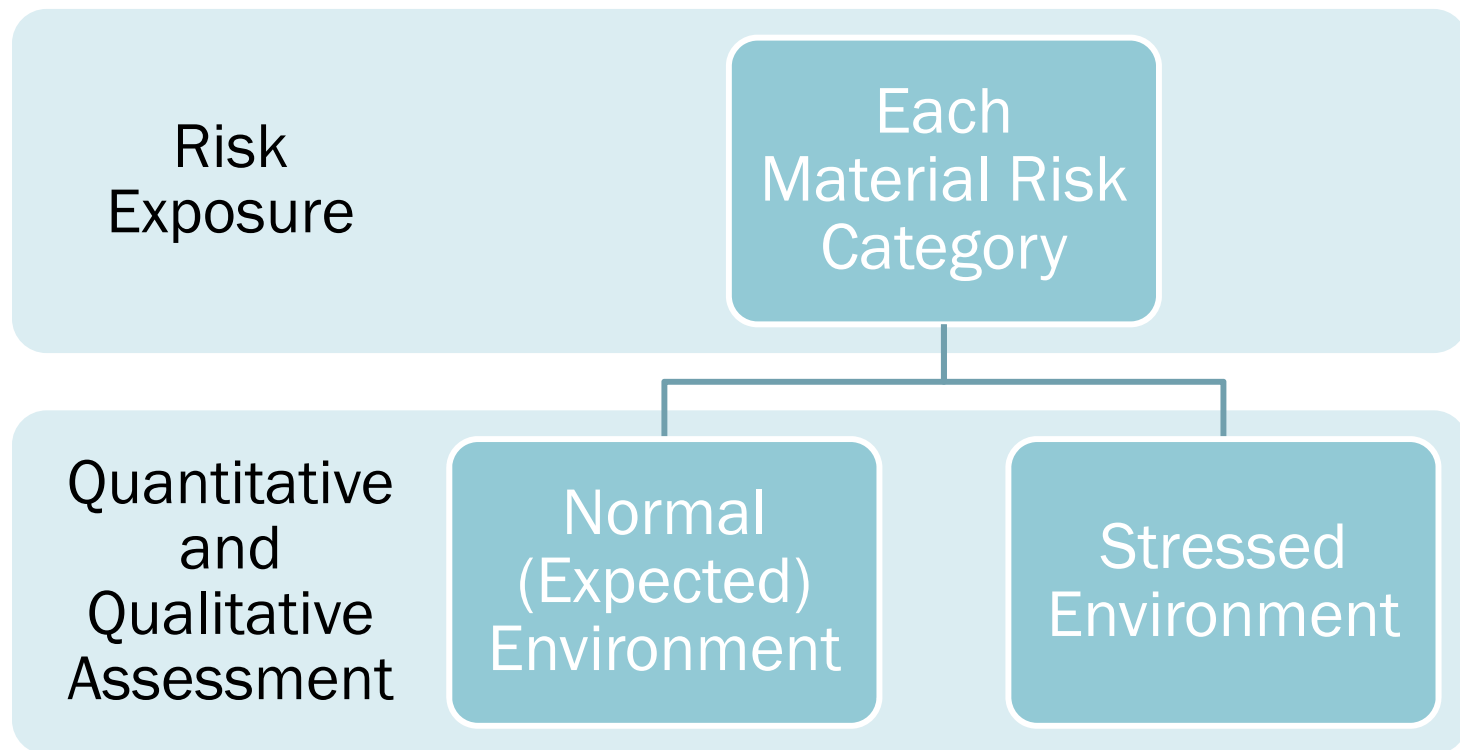
Risk Reporting
and
Communication

ORSA – Section 1

- ORSA Summary Report Section 1 – Description of Insurer’s Risk Management Framework
 - An effective ERM Framework should at a minimum include these key principles:
 - Risk Culture and Governance – Governance structure that clearly defines and articulates roles, responsibilities and accountabilities; and a risk culture that supports accountability in risk-based decision making
 - Risk Identification and Prioritization – Risk identification and prioritization process that is key to the organization; ownership of this activity is clear; the risk management function is responsible for ensuring the process is appropriate and functioning properly at all organization levels
 - Risk Appetite, Tolerances and Limits – a formal risk appetite statement, and associated risk tolerances and limits are foundational elements of risk management for an insurer; Board understanding of the risk appetite statement ensures alignment with risk strategy
 - Risk Management and Controls – Managing risk is an ongoing enterprise risk management activity, operating at many levels within the organization
 - Risk Reporting and Communication – Provides key constituents with transparency into risk management process and facilitates active, informal decisions on risk taking and management
 - Identification and categorization of relevant and material risks

U.S. ORSA Section 2

Insurer Assessment of Risk Exposures



ORSA – Section 2

- ORSA Summary Report Section 2 – Description of Insurer’s Risk Management Framework
 - Document the quantitative and/or qualitative assessments of risk exposure in both normal and stressed environments for each material risk category identified in Section 1 (e.g., credit, market, liquidity, underwriting and operational risks)
 - The assessment process should consider a range of outcomes using risk assessment techniques appropriate to the nature, scale and complexity of the risks
 - The assessment of each risk will depend on its specific characteristics; for some risks (e.g., operational/reputation), quantitative methods are not well established, so a qualitative assessment is appropriate
 - Each insurer’s quantitative methods for assessing risk may vary, but should generally consider the likelihood and impact each material and relevant risk will have on the firm’s balance sheet, income statement and future cash flows (in both normal and stressed environments)
 - The risk assessment may consider the impact of stresses on capital, including risk capital requirements as well as available capital, and may include regulatory, economic, rating agency or other views of capital
 - Since each insurer risk profile is unique, a standard set of stress conditions was not set; but the regulator may provide input to insurer management regarding stress factors and, for stochastic models, level of measurement or parameters used

U.S. ORSA Section 3 Group Risk Capital and Prospective Solvency Assessment



Section 3 combines the qualitative elements of risk management policy with the quantitative measures of risk exposure to determine the level of financial resource needs.

ORSA – Section 3

- ORSA Summary Report Section 3 – Group Risk Capital and Prospective Solvency Assessment
 - On an annual basis, insurers must provide a group risk capital assessment for the prior period; the Commissioner may request interim updates in response to material changes to the inputs if deemed necessary for the ongoing supervisory plan
 - The goal of the assessment is to provide an overall determination of group risk capital needs for the insurer, based upon the nature, scale and complexity of risk within the group and its risk appetite, and to compare that risk capital to available capital to assess capital adequacy
 - Group risk capital should NOT be perceived as the minimum amount of capital before regulatory action (e.g., the triggers in US RBC for legal entities); rather, group risk capital should be recognized as the capital needed within a holding company system to achieve the group's business objectives
 - The insurer's prospective solvency assessment should demonstrate it has the financial resources necessary to execute its multi-year business plan in accordance with its stated risk appetite; if it does not have sufficient resources, the assessment should describe the management actions it has taken/will take to remediate any capital concerns
 - The prospective solvency assessment should also consider normal and stressed environments

ORSA Status

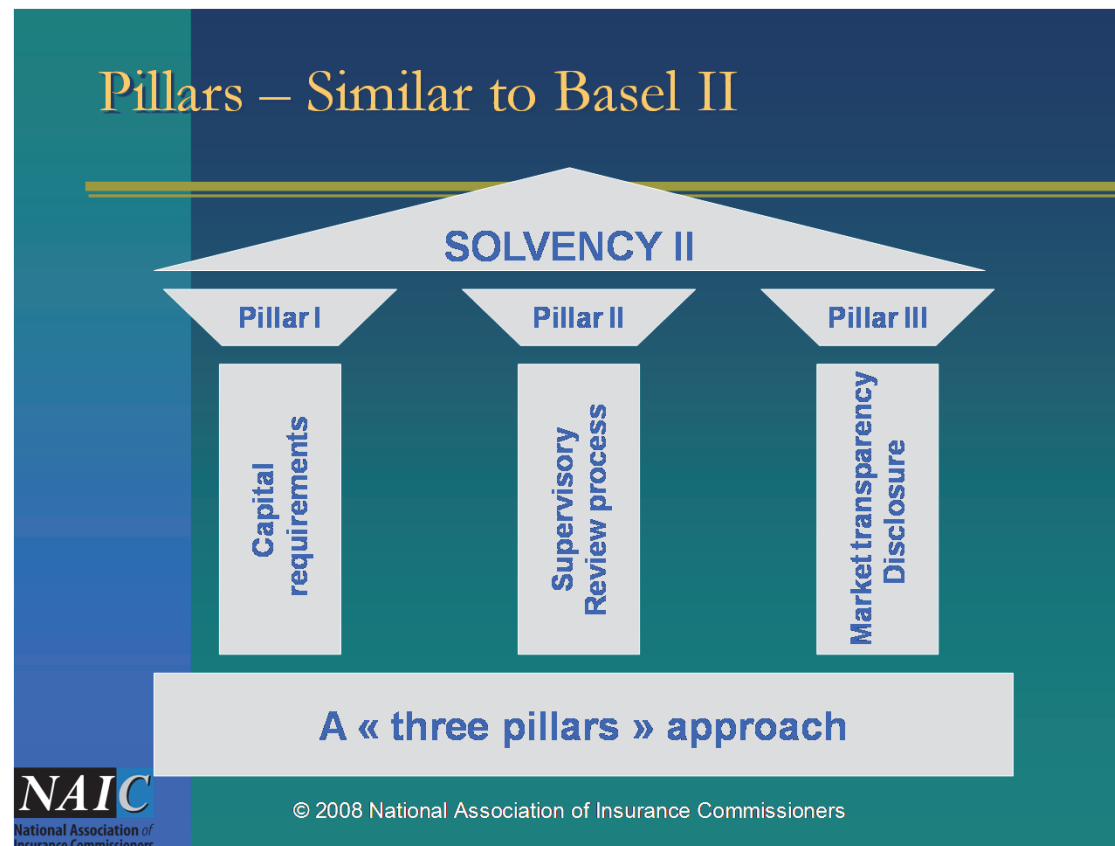
- ORSA Requirement
 - The ORSA Model Law is fully adopted at the NAIC and available for use by states to implement law. Expectations are the ORSA will be effective in 2015.
 - The NAIC Financial Regulation Standards and Accreditation F Committee will consider this requirement for inclusion in the Accreditation Program next year.
 - NAIC expects to see edits and improvements to this ORSA Framework based upon feedback from the pilot project, analysis and examination handbook work, and regulatory experience with actual ORSA Summary Documents
 - This ORSA framework reflects the different legal and regulatory environments in the U.S. and may not be appropriate for other jurisdictions

SMI White Paper

- ☞ *The US National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative*
- ☞ Aims: more thoroughly describe our regulatory system, explain why the system works, and detail why we made (or didn't make) changes within SMI.
- ☞ Interested parties presented their comments at the SMI Task Force meeting.
- ☞ The Task Force will discuss how to take the work forward.

Solvency Pillars

Pillar Emphasis: EU– Pillars I/II; U.S. – Pillars II/III



ORSA Requirements — US & EU

| EU | US |
|---|--|
| Both Legal Entity and Group | However a Company Manages its Risks (Legal Entity, Subgroup, Enterprise) |
| All (Re)insurers Subject to Solvency II | Group > \$1B or entity > \$500M (All Others have Significant Financial Reporting deemed Proportionate) |
| Risk Management Description, Stress Tests, Own Capital Adequacy View | Risk Management Description, Stress Tests, Own Capital Adequacy View |
| Tie to Regulatory Capital | No Requirement |
| Role and responsibilities of Board of Directors and senior management defined | Role and responsibilities of Board of Directors and senior management under discussion |

Capital Requirements — US & EU

| EU | US |
|---|--|
| SCR & MCR | 4 Action and Control Levels |
| Capital Add-ons | Hazardous Financial Condition |
| Internal Model Option (with approval) | Partial models required; embedded in RBC formula |
| All Risks; No Prudence in Valuation | All Material Risks Deemed Appropriately Quantifiable, Supplemented with Conservative Valuation |
| Defined Safety Level & Time Horizon (99.5% VaR over 1 year) | Safety Level & Time Horizon used for some Risks where enough data |

Financial Reporting Requirements — US & EU

| EU | US |
|--|---|
| Some Uniform Reporting | Extensive Uniform Reporting |
| IFRS Valuation, with some adjustments | Fully codified statutory accounting system |
| Electronic Data Collection under discussion | Electronic Data Collection warehoused at the NAIC, accessible to all regulators |
| Actuarial Function (no reserved role for an actuary) | Appointed Actuary role (but still not a reserved role) |
| Audit Requirements | Audit Requirements |
| Some Public Disclosure | Extensive Public Disclosure (for Market Discipline) |

Group Supervision – US & EU

| EU | US |
|--|--|
| Group-wide Supervisor – Powers and Responsibilities | Lead Supervisor – Responsibilities of Coordination; Dependence on Functional Regulator |
| Principles for Legal Entity Supervision Apply Equally to Group | Group Supervision is a Unique Framework: Windows and Walls |
| Group Capital Requirement | Group Capital Assessment |
| Supervisory Colleges | Supervisory Colleges |

Conclusion

- ∞ International activities are driving convergence, but differences will likely remain.
- ∞ ORSA implementation is similar in US & EU, with more requirements in EU.
- ∞ Capital requirements are not likely to converge as much as other aspects of the regulatory system. They have different roles in the regulatory regimes.
- ∞ SMI policy decisions are being finalized; implementation will take a few years.