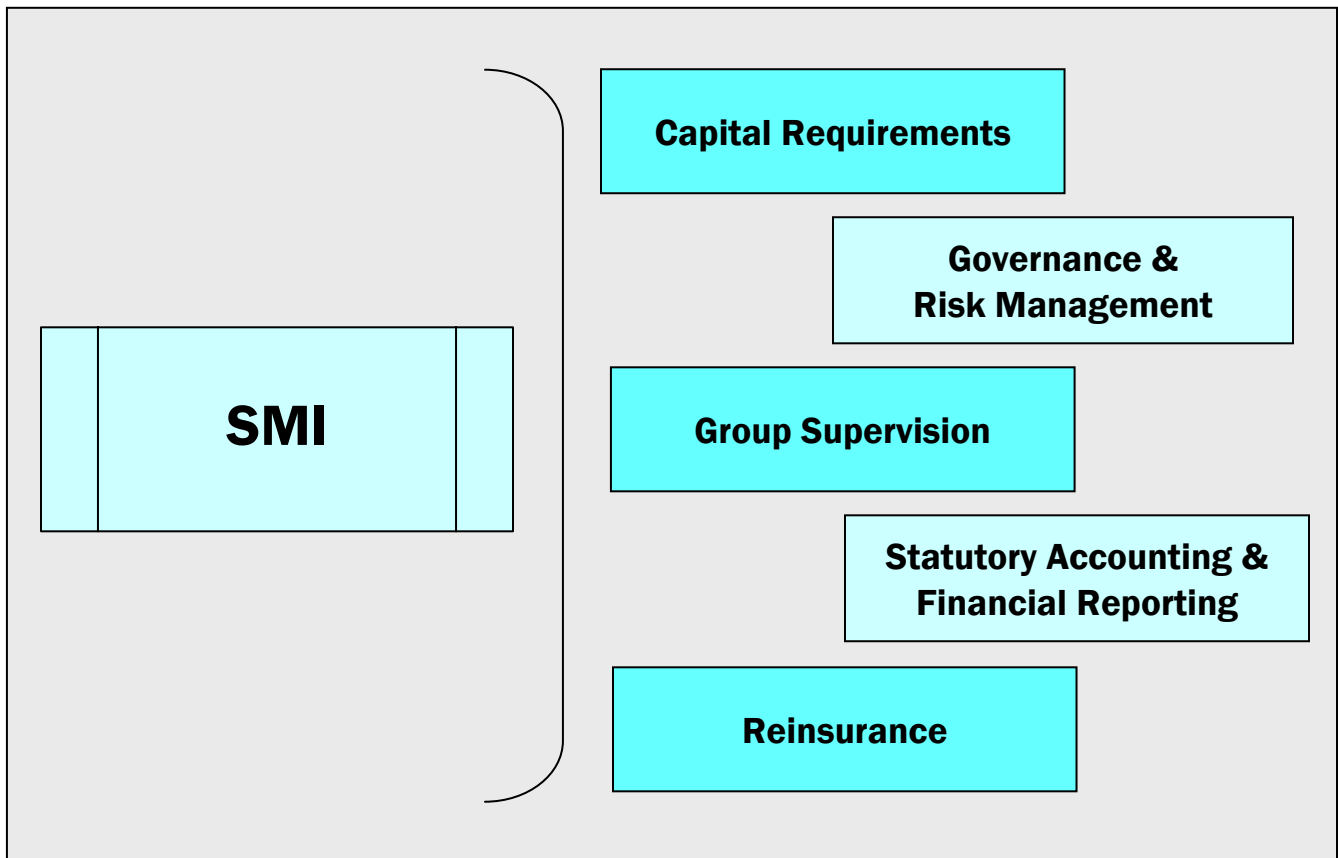


**Solvency Modernization Initiative  
ROADMAP**

**Solvency Modernization Initiative**

1. The Solvency Modernization Initiative (SMI) is a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation.
2. The SMI scope includes the entire U.S. financial regulatory system and all aspects relative to the financial condition of an insurer, and is not limited to the evaluation of solvency related areas. The SMI focuses on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting & financial reporting, and reinsurance.



### SMI Roadmap

3. This Roadmap sets out the policy direction and priorities for SMI activities and seeks to clarify the role and scope of various task forces' and working groups' SMI activities through year-end 2012.<sup>1</sup> We anticipate that all major policy decisions will be completed by the end of 2012; at which time the NAIC, through the various appropriate committees, can then choose to proceed as considered appropriate.
4. Initial activities within the SMI that are already completed include the following:
  - Documentation of the current U.S. Insurance Financial Solvency Framework and Core Principles.
  - Initial study of international solvency systems to formulate new ideas for consideration in the U.S.
5. The SMI (EX) Task Force coordinates all NAIC efforts to successfully accomplish the SMI, utilizing the technical expertise of numerous NAIC groups. The Task Force recognizes the interplay of SMI issues and the interrelationships of activities in different NAIC groups. The Task Force will monitor the evolving proposals to ensure that work is coordinated and does not overlap.
6. The following describes the remaining projects to be completed in the SMI, establishes some expected timelines for deliverables, and identifies the committees involved.

### Capital Requirements

7. Capital requirements in the U.S. have been risk-based for more than a decade, with the initial life insurance risk-based capital (RBC) formula implemented in 1993. Numerous improvements have been implemented in the RBC formulas over time, with most recent changes including development of scenario modeling for life insurance interest and market risk ("C-3") risk and introduction of and changes to trend tests.
8. Four ladders of intervention currently exist, two as "action" levels and two as "control" levels. The amount of capital required for each level is based upon the application of industry-wide risk charges applied to each company's investment portfolio and risk profile. The RBC is calibrated to identify "weakly capitalized companies" and does not represent the economic target levels of capital that a company should hold.
9. RBC will continue to be a component in the legal framework of U.S. solvency regulation in order to maintain a floor for triggering regulatory intervention.
10. Because the NAIC made many of the RBC formula, factors and methodology decisions over a twenty-year period, we need to maintain institutional knowledge and ensure consistency in the formulas and calibrations. Therefore, we will compile historical information to explain why we developed each RBC formula, how we calculated individual factors, why/how we calibrated the formulas and factors, and why regulators subsequently made modifications to the formulas.
11. Since we knowingly excluded some risks in the calculation, regulators will re-evaluate "missing risks" to determine if we should now include them in the RBC calculation, or whether we appropriately handle those risks utilizing other regulatory methods.
12. NAIC regulators will continue to evaluate RBC formulas, factors, and methodology, concentrating first on priority risks and the method to combine risk charges (the "square root formula") and making adjustments to reflect other SMI changes, such as statutory accounting (e.g. principles-based reserving) or reinsurance modifications. As factors and methodology are updated, we will (1) aim for a specified safety level and time horizon unless such calculation is not appropriate for a particular measurement (e.g. sufficient statistical data is not available or a different time horizon is more appropriate) and (2) aim for consistency between the RBC formulas (by line of business).
13. Some additional capital assessments are under consideration in risk management and group supervision (e.g. in the Own Risk and Solvency Assessment – ORSA). These additional capital assessments will more clearly distinguish the RBC as

<sup>1</sup> The SMI also includes development of comments regarding the International Association of Insurance Supervisors (IAIS)' papers; that aspect of the SMI is not included in this Roadmap.

our final financial regulatory safeguard to (1) guaranty regulator action and (2) provide the legal authority to intervene without extensive litigation. The other capital assessments will be the tools to assess the financial stability of a company, group, or industry and disclosure of capital sufficiency in the group (to potentially aid a failing entity in the group).

14. Upon adoption of additional capital assessments, the Capital Adequacy (E) Task Force will review the public reporting of final RBC calculations and decide whether the RBC should always be public, should only be public if an action/control level is triggered, or should never be public.
15. The following identifies the timeline of activities for RBC capital requirements:
  - Development of a plan for the modification to the formulas to implement missing significant risk charges: Sept. 2011
  - Prioritization of risks in the RBC formula for evaluation: Sept. 2011
  - Historical RBC documentation, including determination of the average calibration of the current RBC: Dec. 2011
  - Proposal for improvement to the methodology to combine risk charges: December 2012
  - Plan of action for changes to RBC including definition of the standard safety level and time horizon and the public nature of some company-specific RBC calculations: Dec. 2012
16. Modifications to RBC capital requirements are considered by the Capital Adequacy (E) Task Force, its SMI RBC Subgroup, and its working groups.

### **Governance and Risk Management**

17. Today's corporate governance requirements for insurers exist in state corporate governance statutes and case law; however, to gain a better understanding of how current corporate governance statutes and case law impact insurers, the Corporate Governance (EX) Working Group performed a review of existing legislation and case law relating to corporate governance requirements for insurers and summarized corporate governance laws in California, Delaware, Georgia, Illinois, Iowa, Nevada, New York and Texas. In addition, the Working Group studied Rhode Island's recent adoption of corporate governance provisions into its insurance code. This study revealed that existing law varies significantly from state to state, is not very detailed or specific in relation to overseeing the business of insurance, and does not seem to recognize the board of directors' legal duties to policyholders.
18. In addition to reviewing existing corporate governance law in the United States, the Corporate Governance (EX) Working Group performed a study of corporate governance principles and standards placed upon insurers worldwide by the International Association of Insurance Supervisors (IAIS), Australia, Canada, Switzerland, and the United Kingdom. The study sought review and input from supervisors from each of these countries on the summarized principles and Working Group members noted that many of the standards and principles adopted in other countries, and included in the IAIS core principles, are not necessarily addressed within the current U.S. insurance regulatory system.
19. After reviewing existing corporate governance law in the United States as well as principles and requirements placed upon insurers in other countries, the Working Group developed a draft of a white paper outlining corporate governance principles for use in U.S. insurance regulation. The Working Group plans to discuss and finalize these principles before determining whether such principles should be supported through a model law or other means.
20. Although a risk-management function is included as one of the principles addressed in the corporate governance white paper, the Group Solvency Issues (EX) Working Group will consider options in developing specific requirements relating to risk-management and regulatory reporting. Regulators currently perform certain elements of risk management evaluation in the enhanced risk-focused surveillance process, which includes an assessment of risk and the insurer's ability to manage or mitigate risks. To formalize regulatory considerations in this area, regulators drafted a consultation paper to discuss risk management reporting and quantification requirements (e.g. ERM/ORSA<sup>2</sup>-type tool) in light of the global development of risk management supervisory tools that incorporate periodic risk reporting, stress tests, and prospective solvency assessment. Going forward, the Group Solvency Issues (EX) Working Group plans to schedule several meetings to discuss possible implementation and utilization of the ORSA tool within the U.S. solvency system to better assess risk-management in the industry.

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<sup>2</sup>ERM stands for "Enterprise Risk Management;" ORSA stands for "Own Risk and Solvency Assessment"

21. The projected timeline of activities for governance and risk management activities:

- Receive comments on governance principles: May 2011
- Hold interim meeting to discuss governance principles, ERM and ORSA tool: July 2011
- Finalize governance principles: August 2011
- Development of ERM/ORSA-type tool: December 2011
- Development of model law or other implementation tool: December 2012

22. Governance and Risk Management issues are currently under consideration in the Corporate Governance (EX) Working Group. The Group Solvency Issues (EX) Working Group is developing an ERM/ORSA-type tool.

### Group Supervision

23. Group supervision is currently performed under authority of the Insurance Holding Company System Regulatory Act (Model #440) and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (Model #450) and applied under practices described in the NAIC *Financial Analysis Handbook*.

24. At the heart of the lessons learned from the recent financial crisis was the need for regulators to be able to assess the enterprise risk within a holding company system and its impact or contagion upon the insurers within that group. Therefore, regulators want to enhance certain prudential features of group supervision within the models and monitoring practices, providing clearer windows into group operations, while building upon the existing walls which provide solvency protection for insurers. The concepts addressed in the enhanced “windows and walls” approach include 1) communication between regulators; 2) supervisory colleges; 3) access to and collection of information; 4) enforcement measures; 5) group capital assessment; and 6) accreditation.

25. Models #440 and #450 modified and adopted in December 2010, apply to groups of two or more affiliated persons/organizations, at least one of which is an insurer. The revised models still contain the previous windows and walls concepts, including requirements to acquire an insurer, commissioner approval of certain material transactions (e.g. large investment or reinsurance transactions) and extraordinary dividends, examination authority (of insurer and affiliates), and receivership authority; however, enhancements to the models include the following:

- Expansion on the ability to look at any entity within an insurance holding company system that may or may not directly affect the holding company system, but could pose reputational risk or financial risk to the insurer through a new Form F – Enterprise Risk Report.
- Enhancements to regulators’ rights to access information, especially regarding the examinations of affiliates and access to books and records to better ascertain the financial condition of the insurer, as well as language to require notification of divestiture of controlling interest.
- Introduction of and funding for supervisory colleges. While regulators are able to participate in supervisory colleges today, the amended models and forthcoming documented best practices will enhance the US regulators ability to participate in supervisory colleges and provide guidance on how to conduct, effectively contribute to, and learn from colleges.
- Enhancements in corporate governance, Board of Director and Senior Management responsibilities – in line with the current NAIC Model Audit Rule, state laws and legal practices.
- Guidance on the disclaimer of affiliation filings that includes disallowance of a disclaimer of affiliation language and an opportunity for an administrative hearing on those matters.
- Additional standards for reviewing affiliated agreements to enhance minimum requirements.

26. The following timeline identifies activities approved by Group Solvency Issues (EX) Working Group and/or the Financial Condition (E) Committee related to group supervision:

- Supervisory college tracking documentation: Completed August 2010
- International Supervisory College Request Form: Completed October 2010
- Enhanced Models #440 and #450 adopted: Completed December 2010
- Accreditation Part B Guidelines regarding depth of review and documentation of the holding company analysis: December 2010

27. The following timeline identifies the reviewed/proposed activities related to group supervision, in addition to the ORSA described in “Risk Management” above:

- Holding Company and Supervisory Best Practices: December 2011
- Study of Holding Company financial reporting requirements: December 2011
- Draft of a proposal for group-wide capital assessment: December 2011

### **Statutory Accounting & Financial Reporting (including Valuation)**

#### Valuation (Principles-Based Reserving)

28. Statutory accounting for life insurance reserves (“valuation”) is not yet principles-based, as it is for other lines of business. The NAIC adopted the Standard Valuation Law (Model #820) in late 2009. Regulatory actuaries drafted an initial Valuation Manual currently subject to an industry impact study by an NAIC-selected consultant. After issuance of the study’s findings, the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force will finalize the Valuation Manual, coordinating material issues with the SMI’s Principle-Based Reserving (EX) Working Group.

29. To utilize principle-based reserving, statistical agent(s) will need to provide regulators and the industry with statistical information once principle-based reserving becomes effective. We expect to determine how to collect such information in the fall of 2011.

30. The following identifies the timeline of activities for life insurance principle-based reserving:

- Industry Study Completed: July 2011
- Statistical Agent Policy Decisions: Fall 2011
- Valuation Manual (VM-20) – Initial: Adopted by LATF, Fall 2010, Final: Adopted by Plenary Fall 2011

#### Future of Statutory Accounting & Financial Reporting

31. Regulators analyze Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) pronouncements and International Financial Reporting Standards (IFRS), especially regarding insurance contracts and financial instruments, and provide input to the IAIS, the FASB, and occasionally to the IASB directly.

32. Our current statutory accounting system already includes a process to consider any new Generally Accepted Accounting Principles (GAAP) pronouncements, whereby we reject, adopt, or modify GAAP changes for implementation into our statutory accounting system. Agreed convergence between FASB and IASB have already produced some GAAP pronouncements, but even with this process in place, commissioners are contemplating (1) future policy decisions on this approach; (2) the impact of international accounting activities; (3) the extent of public disclosure versus regulatory reporting; (4) compliance with IAIS ICPs related to accounting and reporting, and (5) the need to communicate with international regulators.

33. Given the current state of play, we expect to address those policy decisions after completion of the IASB/FASB Insurance Contracts project and U.S. Securities and Exchange Commission (SEC) decision regarding IFRS. We will request the International Solvency and Accounting (EX) Working Group and Statutory Accounting Principles (E) Working Group provide technical recommendations.

34. The following identifies the timeline of activities for statutory accounting:

- Primary non-technical considerations were documented and discussed: July 2010
- Comments on IASB/FASB Insurance Contracts Exposure Draft/Discussion Paper: Provided November 30, 2010
- Comments on ICP 14-Valuation to the IAIS: Provided April 19, 2011
- Policy positions regarding IFRS and its inclusion/exclusion from the framework of insurance solvency regulation and on the regulatory impacts of non-regulatory uses of statutory financial statements:
  - a. Technical recommendation on the future of statutory accounting: Early 2012
  - b. Policy Positions Adopted by Executive/Plenary: Summer 2012

## Reinsurance

35. The Reinsurance Regulatory Modernization Framework proposal (Reinsurance Framework), adopted by the NAIC during its Winter 2008 National Meeting, is a conceptual framework that the Reinsurance (E) Task Force developed in response to its charges to consider (1) the current collateralization requirements regarding unauthorized reinsurers and (2) the design of a revised U.S. reinsurance regulatory framework. The Reinsurance Framework is intended to facilitate cross-border reinsurance transactions and enhance competition within the U.S. market, while ensuring that U.S. insurers and policyholders are adequately protected against the risk of insolvency.
36. The Reinsurance Framework recommended implementation through federal legislation in order to best preserve and improve state-based regulation of reinsurance, ensure timely and uniform implementation of this legislation throughout all NAIC member jurisdictions, and be a more comprehensive alternative to related federal legislation. Throughout 2009, the Reinsurance (E) Task Force developed federal legislation intended to implement the Reinsurance Framework and in September 2009, the NAIC Government Relations Leadership Council approved the Reinsurance Regulatory Modernization Act, and agreed to submit the draft federal legislation to Congress for its further action. Unfortunately, the NAIC was unable to procure congressional sponsorship for this proposed legislation.
37. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was signed into law on July 21. This Act includes the Nonadmitted and Reinsurance Reform Act (NRRRA), as well as creates the Federal Insurance Office (FIO) within the U.S. Department of the Treasury. With respect to reinsurance, the NRRRA prohibits a state from denying credit for reinsurance if the domiciliary state of the ceding insurer recognizes such credit and is (1) an NAIC-accredited state; or (2) has financial solvency requirements substantially similar to NAIC accreditation requirements. It also preempts the extraterritorial application of a non-domiciliary state's laws, regulations, or other actions (with certain limitations), and it reserves to a reinsurer's domiciliary state sole responsibility for regulating the reinsurer's financial solvency. Finally, it prohibits any other state from requiring a reinsurer to provide financial information in addition to that required by its NAIC-compliant domiciliary state.
38. To date, some states have already implemented individual state-based reinsurance collateral reforms: Florida, New York, New Jersey and Indiana have enacted reinsurance reform legislation and other states (Illinois, Louisiana, and Texas) have bills under discussion. In October of 2010, in response to an informal request by the Financial Regulation Standards and Accreditation (F) Committee, the Reinsurance (E) Task Force adopted key elements of the Reinsurance Framework that should be considered in reviewing any individual state initiatives, and considered whether these key elements should be incorporated into the *Credit for Reinsurance Model Law* (#785) and *Credit for Reinsurance Model Regulation* (#786).
39. In December 2010, the Task Force was given a 2011 charge to consider amendments to Models #785 and #786 to incorporate key elements of the Reinsurance Framework. In addition, the NAIC Plenary approved Recommendations Regarding Key Elements of the Reinsurance Framework for Accreditation Purposes (Accreditation Recommendations). To clarify, the Accreditation Recommendations are not a change to the current NAIC accreditation standards regarding reinsurance collateral; however, the Recommendations will provide guidance to the Financial Regulation Standards and Accreditation (F) Committee to potentially use when reviewing any individual state reinsurance collateral reforms enacted prior to NAIC adoption of model law/regulation amendments and/or adopting related changes to the accreditation standards.
40. On February 22, 2011, the Task Force released exposure drafts of proposed revisions to Models # 785 and # 786 for a 30-day comment period. The Task Force received several comment letters from interested parties and discussed these drafts on March 26 during the Spring National Meeting in Austin, TX. The Task Force will hold an interim meeting in July to continue discussions, and intends to consider final drafts for adoption during the 2011 Summer National Meeting.
41. Separately, regulators may also consider the propriety of modernization of risk transfer requirements applicable to life reinsurance and the Reinsurance (E) Task Force will coordinate these considerations with the Life Actuarial (A) Task Force and Health (B) Actuarial Task Force.
42. The following identifies the timeline for reinsurance modernization activities:
  - Reinsurance (E) Task Force adoption of Recommendations Regarding Key Elements of the Reinsurance Framework for Accreditation Purposes: October 2010





- Reinsurance (E) Task Force adoption of amendments to Models #785 and #786 to ensure consistency with the Reinsurance Framework: September 2011

43. Reinsurance modernization issues are currently under consideration in the Reinsurance (E) Task Force.

#### **Future U.S. Insurance Financial Solvency Framework and Core Principles**

44. Regulators will be making changes in the SMI that will modify the U.S. solvency framework, both in the implementation of new tools and processes, as well as the elimination of aspects no longer needed. Throughout the process, we will develop a “critical review” white paper to further explain our financial regulatory framework and how and why it works so successfully.
45. At the end of the SMI process, regulators will determine whether the Solvency Modernization Initiative (EX) Task Force should make changes or revisions to the *U.S. Insurance Financial Solvency Framework and Core Principles* to reflect the work of the SMI.

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