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Solvency Regulation in the U.S. and Abroad Part II - The U.S. Response

CAS Seminar on Reinsurance
June 6, 2011

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Reinsurance Association of America



Presentation Overview

- U.S. Equivalence
- Overview of the NAIC SMI Project
- ORSA – ERM as a Regulatory Tool
- Risk-Based Capital Improvement
- Additional background on CAS presentation website
 - NAIC SMI Roadmap updated 5/20/11
 - AAA Report on P&C RBC – Safety Level and Missing Risks – 1/31/11



U.S. Equivalence

- Third Country Equivalence is one major Catalyst for Change in the U.S. System
 - Reinsurance Collateral Issue – a leading indicator
 - State Insurance Regulators/NAIC – Protect their relevance
- The Dodd Frank Act is the other main driver
 - FSOC – Systemic Risk and Groups
 - Federal Insurance Office
 - Non-Admitted and Reinsurance Act Provisions in DFA
- The NAIC and States believe they must improve to remain a player in the regulation of an increasingly global industry

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Equivalence -What and How?

- Two main elements of Equivalence
 - Solvency II
 - Int'l Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP's)
- How will the U.S. be evaluated?
 - IMF/World Bank Financial Sector Assessment Program (FSAP)
 - EIOPA standards / EU Commission Third Country Equivalence decisions

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Equivalence -FSAP Review

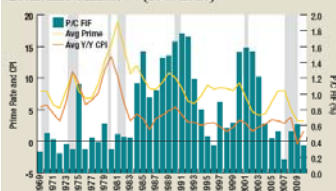
- U.S. State System Completed FSAP evaluation in 2010
 - Based on old ICP's - Revised ICP's currently under development
- NAIC Scored well on all areas except
 - Supervisory authority, group supervision, anti-money laundering
- Next FSAP review will include revised ICP's including:
 - Supervisory Cooperation and Info Exchange ICP 3
 - Corporate governance ICP 7
 - Valuation (assets & liabilities) ICP 14
 - ERM and Capital Adequacy/Internal Models ICP's 16 & 17
 - Group-wide Supervision ICP 23

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Outcomes Based Review? The U.S. System has evolved and is effective

P/C Financial Impairment Frequency (FI)* vs. Economic Climate** (1969-2010)



* The FI is calculated as the number of financially impaired companies against the number of companies in the P/C industry in any given year and, therefore, allows for meaningful comparisons between years.
** Shaded areas represent official recessions.
Source: A.M. Best Co., RAA, PIPSO, WorldLink, Bureau of Labor Statistics, Federal Reserve Board, National Bureau of Economic Research

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Size The U.S. Insurance industry dwarfs other jurisdictions

2009 Premium Volume—Worldwide

Rank	Jurisdiction	Premium Volume (in Millions USD)	Market Share	Rank	Jurisdiction	Premium Volume (in Millions USD)	Market Share
1	United States	1,142,783	28.08%	26	Finland	22,660	0.56%
2	Japan	505,956	12.43%	27	Portugal	20,312	0.50%
3	United Kingdom	309,241	7.60%	28	Norway	19,024	0.44%
4	France	283,070	6.96%	29	Mexico	17,353	0.43%
5	Germany	238,366	5.86%	30	Poland	16,286	0.40%
6	Italy	169,360	4.16%	31	Singapore	14,425	0.35%
7	China	163,047	4.01%	32	Venezuela	14,005	0.34%
8	Netherlands	108,144	2.66%	33	Thailand	10,459	0.26%
9	Canada	98,860	2.43%	34	Israel	9,777	0.24%
10	South Korea	91,963	2.26%	35	Malaysia	8,840	0.22%
11	Spain	85,775	2.09%	36	Luxembourg	8,622	0.20%
12	India	65,085	1.60%	37	Argentina	7,983	0.20%
13	Taiwan	63,647	1.56%	38	Turkey	7,853	0.19%
14	Australia	60,317	1.48%	39	Czech Republic	7,328	0.18%
15	Brazil	48,760	1.20%	40	Indonesia	7,285	0.18%
16	Switzerland	48,470	1.19%	41	Chile	6,894	0.17%
17	Ireland	44,598	1.10%	42	New Zealand	6,465	0.16%
18	Belgium	40,470	0.99%	43	Greece	6,556	0.16%
19	Russia	39,576	0.97%	44	Colombia	5,307	0.13%
20	South Africa	36,987	0.91%	45	United Arab Emirates	5,113	0.13%
21	Sweden	32,768	0.81%	46	Iran	4,316	0.11%
22	Denmark	31,798	0.78%	47	Hungary	3,896	0.10%
23	Luxembourg	27,714	0.68%	48	Saudi Arabia	3,896	0.10%
24	Hong Kong	23,201	0.57%	49	Romania	2,898	0.07%
25	Austria	22,933	0.56%	50	Slovenia	2,895	0.07%
	Other Jurisdictions	49,904	1.23%		Total Worldwide	4,069,132	100.00%

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Size - States and Non-US Jurisdictions U.S. states are as large as many sovereign jurisdictions

2009 Premium Volume—Worldwide

Rank	Jurisdiction	Premium Volume (in Millions USD)	Market Share	Rank	Jurisdiction	Premium Volume (in Millions USD)	Market Share
1	Japan	505,956	12.43%	26	Massachusetts	41,829	1.03%
2	United Kingdom	309,241	7.60%	27	Belgium	40,470	0.99%
3	France	283,070	6.96%	28	North Carolina	39,629	0.97%
4	Germany	238,366	5.86%	29	Russia	39,576	0.97%
5	Italy	169,360	4.16%	30	Georgia	38,428	0.94%
6	China	163,047	4.01%	31	South Africa	36,987	0.91%
7	New York	148,407	3.65%	32	Virginia	35,142	0.86%
8	California	138,087	3.39%	33	Connecticut	34,190	0.84%
9	Netherlands	108,144	2.66%	34	Sweden	32,768	0.81%
10	Florida	101,569	2.50%	35	Delaware	32,637	0.80%
11	Canada	98,860	2.43%	36	Denmark	31,798	0.78%
12	Texas	98,095	2.41%	37	Minnesota	30,424	0.75%
13	South Korea	91,963	2.26%	38	Wisconsin	30,321	0.75%
14	Spain	85,775	2.09%	39	Washington	30,024	0.74%
15	Pennsylvania	80,398	1.98%	40	Missouri	28,973	0.71%
16	India	65,085	1.60%	41	Luxembourg	27,714	0.68%
17	Taiwan	63,647	1.56%	42	Maryland	27,642	0.68%
18	Australia	60,317	1.48%	43	Tennessee	26,429	0.65%
19	Illinois	59,649	1.47%	44	Indiana	26,193	0.64%
20	New Jersey	55,616	1.37%	45	Colorado	24,905	0.61%
21	Ohio	54,603	1.34%	46	Arizona	24,322	0.60%
22	Michigan	51,126	1.25%	47	Hong Kong	23,201	0.57%
23	Brazil	48,760	1.20%	48	Austria	22,933	0.56%
24	Switzerland	48,470	1.19%	49	Finland	22,660	0.56%
25	Ireland	44,598	1.10%	50	Louisiana	21,855	0.54%
	Other Jurisdictions	128,893	3.17%		Total Worldwide	4,069,132	100.00%

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Overview of the NAIC SMI Project

- Solvency Modernization Task Force
 - Corporate Governance Working Group
 - Group Solvency Issues Working Group
 - International Solvency Standards and Accounting Working Group
 - Principles-based Reserving Working Group
 - Reinsurance (E) Task Force
 - SMI RBC (E) Working Group

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Corporate Governance Working Group

- Objectives
 - Review IAIS ICP's regarding corporate governance, ERM and internal controls
 - Inventory best practices for CG in the states
 - Develop a Whitepaper including high-level standards and best practices recommendations
- Controversial Issues
 - Suitability of persons
 - Prescriptive requirements
 - Overlap with other NAIC/state requirements
 - Board legal duties to policyholders
 - General over-reach

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Int'l Solvency Standards and Accounting Working Group


- Objectives
 - Evaluate IASB Insurance Accounting standards and determine if they should form the basis of the future regulatory accounting model
 - Evaluate other ICP's as appropriate
- Current Focus
 - ICP 14 Valuation – Does "economic valuation" mean that the NAIC will be forced to adopt IASB model?
 - Decision on whether to adopt IASB as the basis for SAP accounting depends on GAAP and SEC convergence

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Principles-Based Reserving

- **Life Principles-based reserving project**
 - Near completion of NAIC Valuation Manual and reserving methodologies for major product lines
 - Using consultant to test the impact on the industry of the completed sections of the VM (Impact Study/Field Test)
 - Exploring NAIC's possible role as statistical agent to compile industry PBR data for use by smaller less sophisticated life insurers
 - Plan is to finalize guidance and give states a few years to implement the new economic based reserving methodology
 - Industry concerns about the FIT impact

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Reinsurance Task Force

- **Reinsurance regulatory modernization (a.k.a. collateral reform)**
 - Near completion of Revisions to NAIC Model Credit For Reinsurance Model Law and Regulation
 - Provides states with the option of requiring less than 100% collateral for unauthorized reinsurers
 - Integrated with requirements of DFA (NRRRA provisions)
 - CFR determined by cedent's domestic regulator
 - Preempts host states from requiring collateral
 - Several states have adopted similar legislation (FL, NY, NJ, IN)
 - Other states considering legislation (IL, LA, TX)

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Group Solvency Issues Working Group

- **Revised Holding Company Act in 2010**
 - Annual Form F filing – Annual report identifying material risk within the holding co. system that could pose systemic risk to the insurer (financial contagion)
 - Increased requirements and reporting of affiliate transactions and management and service agreements
 - Required group financial filings to be made to and maintained by the NAIC
 - Authorized states to participate in supervisory colleges at the insurance group's expense
 - Developing Holding Co. Regulation best practices guidance

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Group Solvency Issues Working Group

- Current Projects
 - Own Risk Solvency Assessment (ORSA)
 - Group Capital Requirements or GC Assessment (very preliminary – part of ORSA?)
- Targeted Completion Date of December 2011 for both projects – Very Aggressive!
- Interim Meeting July 2011 – Jacksonville
 - Individual co. ERM presentations to regulators

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Group Solvency Issues Working Group

- ORSA - NAIC staff draft issued in February
 - Annual self assessment of all reasonably foreseeable and relevant material risks
 - Legal entity basis
 - Section 1 – Description of RM policies
 - Prescriptive laundry list of risk categories
 - Section 2 – Quantitative measurement of risk exposure in normal & stressed scenarios
 - For each risk category, detailed descriptions of risks, assumptions and outcomes
 - Section 3 - Prospective Solvency Assessment
 - Projected 3 to 5 year business plan, if lack necessary capital = company action level RBC requirements

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Group Solvency Issues Working Group

- ORSA – Industry Response
 - Overall – too detailed, too prescriptive
 - Many thoughtful industry comments
 - Trade associations
 - AAA
 - North American CRO Council (new)
- NAIC reaction to comments = positive
- Possibly roll in group capital assessment into ORSA requirement

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Group Solvency Issues Working Group

- ORSA - Summary of industry comments
 - S/B principles-based & flexible so compliance is a logical extension of existing ERM practices
 - S/N/B mandated at legal entity level – s/b filed on same basis used in management’s ERM processes
 - Should accept group level ORSA filed by offshore domiciled groups. Offshore jurisdictions should accept U.S. ORSA’s
 - Should not create new entity level capital requirements (i.e. on an economic basis)
 - Evidence of effective ERM should result in a regulatory benefit
 - Consider review of ERM on periodic on-site exams as a substitute to annual ORSA filing
- Model Law/Confidentiality protection needed

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Risk-Based Capital Improvement

- Solvency Modernization Project
 - Targeted Improvements
 - Catastrophe RBC Charge

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Solvency Modernization RBC

- SMI RBC Subgroup charged in 2010 with Modernizing RBC
- Response to FSAP & concerns about U.S. Equivalence
- NAIC Recently Met With CEIOPS comparing to S2 standard formula – concluded RBC → OK
- Will continue work started last year to measure calibration level of RBC and make targeted improvements

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SMI - RBC Targeted Improvements (P&C)

- Revise P&C Risk Correlation/Covariance Methodology
- New Risks
 - Catastrophe risk charge
 - Improve DTA risk charge
 - Consider P&C Interest Rate risk charge
 - Consider other missing risks (AAA Report)
- Improve derivation of U/W & Reserve Risk (R4 & R5)
 - Stochastic/forward looking approach
- Improve derivation of reinsurance credit risk

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SMI - RBC Targeted Improvements (P&C)

- Consider/Introduce Total Balance Sheet Approach
- Calibrate Risk Margin in reserves
 - Overall calibration = confidence level over a defined time horizon
- Improve RBC for reinsurers
- Introduce RBC for Captives, RRG's
- Introduce RBC for title and financial and mortgage guaranty insurers

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Catastrophe RBC Charge

- Project has been underway since 2006
- Cat RBC charge replaced statutory cat reserve as preferred approach
- RAA supports the proposal yet there are several tough issues that need resolution
- Views of primary industry are mixed
- Moving rather slowly though priority of NAIC SMI project is likely to accelerate completion

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Catastrophe RBC Charge - Description

- Charge based on 1 of 3 commercially available models
- Will require a confidential report to regulators
- 1 in 100 loss level but disclose 1-250, 1-500 & 1-1000
- Hurricane and Earthquake perils only—the two separate computations subject to covariance
- Charge computed gross but will receive negative charge for reinsurance = Net
- Separate contingent credit risk charge for reinsurance = 10%
- No prescribed assumptions/switches, but attest to use test in confidential report

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Catastrophe RBC Charge - Description Cont'd

- NAIC will remove Cat losses included in the existing RBC U/W factors (US Losses)
- Insurers will have to remove cat losses from their own individual RBC calculation
- Confidential RBC Report
 - Attest Co's cat risk charges used in their RBC model are the same as used to manage risk for the company
 - Commentary & rationale for modeling options/switches (time dependency, demand surge, fire following, etc.)
 - Process for ensuring completeness and accuracy of underlying data including the extent it is geo-coded to GPS or zip code locations
- Exam processes will be added to test cat exposure input data
- Commissioner empowered to reject insurers' models or data and require remedial action

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Catastrophe RBC Charge - Description Cont'd


- Insurers Exempt from Cat RBC Charge
 - Any insurer with property values insured in states bordering Atlantic or Gulf that are less than 5% of surplus
 - Any insurer with property values insured for EQ or fire following (in states subject to EQ risk) that are less than 5% of surplus
- Plan is for reporting on confidential basis for two years before full implementation in RBC formula

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Catastrophe RBC Charge - Industry Reaction

- RAA Supports – Primary industry = mixed
- Prefer 1-250 for all perils vs 1-100 for each
- RBC should consider offset for reinstatement premium and effect of income taxes
- 10% credit risk charge on modeled reinsurance recoveries too high
- Should not require short-term models for solvency, while requiring LT models for ratemaking
- Reinsurers exposed to non-US cats will be penalized as these will not be pulled out of the NAIC U/W factors
- Reinsurers aggregate risk and don't always have access to direct insurers' geo-coded risk exposure (if it exists)

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