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The U.S. Solvency Modernization Initiative (SMI)

CAS Seminar on Reinsurance
June 4, 2012

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Presentation Overview

- SMI – Purpose and Scope
- Holding Company Act Changes
- ORSA Project
- Risk-Based Capital Improvements
- Other Elements
- FIO Impact
- Additional background on CAS presentation website
 - NAIC SMI Roadmap updated 03/29/12
 - NAIC White Paper on U.S. Solvency Regulation dated 03/16/12




SMI - Purpose & Scope

- Third Country Equivalence is a 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 (DFA) is the other main driver
 - FSOC – Systemic Risk and Groups
 - Federal Insurance Office (FIO)
 - Non-Admitted and Reinsurance Act Provisions in DFA

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SMI - Purpose & Scope

- 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?
 - EIOPA standards / EU Commission Third Country Equivalence decisions
 - IMF/World Bank Financial Sector Assessment Program (FSAP)

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FSAP Review = SMI Scope

- U.S. State System Completed 1st FSAP review in 2010
 - Based on old ICP's - Revised ICP's adopted in October 2011
- 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's 23, 25 & 26
- Next FSAP Review in 2014

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Insurance Core Principles (ICP's)

- ICP 1 Objectives, powers and responsibilities of the supervisor
- ICP 2 Supervisor
- **ICP 3 Information exchange**
- ICP 4 Licensing
- **ICP 5 Suitability of persons**
- ICP 6 Changes in control and portfolio transfers
- **ICP 7 Corporate governance**
- **ICP 8 Risk management and internal controls**
- ICP 9 Supervisory review and reporting
- ICP 10 Preventive and corrective measures
- ICP 11 Enforcement and sanctions
- ICP 12 Winding-up and exit from the market
- **ICP 13 Reinsurance and other forms of risk transfer**

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Insurance Core Principles (ICP's)

- **ICP 14 Valuation for solvency purposes**
- ICP 15 Investments
- **ICP 16 Enterprise risk management**
- **ICP 17 Capital adequacy**
- ICP 18 Intermediaries
- ICP 19 Conduct of business
- ICP 20 Disclosure
- ICP 21 Countering fraud in insurance
- ICP 22 Anti-money laundering, combating the financing of terrorism
- ICP 23 Standard on scope of group, supervisory power and legal authority
- ICP 24 Macro-prudential supervision and market analysis
- **ICP 25 Supervisory cooperation and coordination**
- **ICP 26 Cross-border cooperation on crisis management**

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Overview of the NAIC SMI Project


- Group Supervision - Holding Company Act
- Own Risk & Solvency Assessment (ORSA)
- Risk-Based Capital Improvement
- Other Elements
 - Corporate Governance Working Group
 - International and Accounting Standards
 - Principles-Based Reserving (life)
 - Reinsurance Regulatory Reform

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Group Supervision

Revised NAIC Holding Company Act in 2010


- Annual Form F filing – Annual report identifying material risk within the holding co. system that could pose material risk of financial contagion to the insurer
- Requires filing of consolidated group financial statements with the insurance regulator and with the NAIC
- Establishes the NAIC as a repository for consolidated group financial information
- Increases requirements for and reporting of affiliate transactions and management and service agreements
- Authorizes states to participate in supervisory colleges at the insurance group's expense

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Group Supervision

Revised NAIC Holding Company Act in 2010 (Cont'd)


- Provides the US insurer's domestic state with examination authority for its holding company and affiliates (regardless of national jurisdiction)
- Developed Holding Co. Regulation best practices guidance
- Holding Company Act changes are under consideration in several state legislatures this year
- Expect adoption and implementation in most states by 2013 with effective date of January 1, 2014.

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ORSA

ORSA Project Elements:


- Guidance Manual (adopted Nov. 2011)
- Statutory Authority (target Aug. 2012)
- Pilot Program (target Aug. 2012)
- Future (2013):
 - Implementation in Analysis and Exam Processes
 - Inclusion in Accreditation standards
 - Training and NAIC Staff Resources

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ORSA Guidance Manual

ORSA Purpose:


- Assess the adequacy of risk management processes
- Assess current and likely future solvency position
- Internally document the processes and results
- Provide a high-level summary report annually to the domiciliary regulator

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ORSA Guidance Manual


ORSA Elements:

- **Description of Risk Management Framework**
 - Summary of ERM Framework, RM policies, risk appetite statements, and ERM processes
- **Assessment of Risk Exposures**
 - Quantitative and qualitative assessments of risk exposure in both normal and stressed environments for each material risk category
- **Group Capital and Prospective Solvency Assessment**
 - Level of financial resources needed to manage the current business and over a longer term business cycle (2-5 years)
 - Analysis of an insurer's group risk capital requirements and associated capital adequacy and a description of the approach used in conducting the analysis

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ORSA Statutory Authority

- Industry Drafted Model Law (NAIC Amending)
- Stand Alone Model
- **Major Provisions:**
 - ORSA Requirement and Due Date (Annually by June 30)
 - Alternative for offshore owned- File global basis if includes US entities
 - Exemptions:
 - Insurer = \$500 Million Direct & Assumed Premium
 - Group = \$1 Billion Direct and Assumed Premium
 - Confidentiality
 - ORSA and related documentation is proprietary & trade secret information
 - Signed confidentiality agreements with consultants, insurer and supervisor
 - Sharing limited to Ins. regulators & others with authority to maintain confidentiality
 - Effective Date = January 1, 2014 (first report due 6/30/2014)

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ORSA Other

- Pilot Program
 - Ten industry participants
 - Filed under Texas exam/confidentiality statute
 - Special working group to review filings
 - Goal to ensure compliance with Guidance Manual is practical and that the summary report is useful to regulators
 - Result – may amend Guidance Manual
- Future (2013):
 - Implementation in Analysis and Exam Processes
 - Inclusion in Accreditation standards
 - Training and NAIC Staff Resources

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ORSA - Key Concerns

- Confidentiality
- Coordination – Lead State
- Effective Date – 1/1/15 = 1st filing 6/30/15
- Timing of Filing – notification by 1/31, ensure that states coordinate filings and reviews
- Group definition and Group filings
 - Scope of ORSA - US Holding Company or Global enterprise?
 - Include global enterprise risks affecting the US holding company system or prepare ORSA on Global level?
 - Alternate compliance method for Global groups
 - Recent controversy

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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 with Solvency II
- NAIC Met With EIOPA in 2011 to compare RBC to S2 standard formula – US concluded RBC → OK
- NAIC dropped work started in 2010 to measure calibration level of RBC
- NAIC still planning targeted improvements

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SMI - RBC Targeted Improvements (P&C)

- Revise P&C Risk Correlation/Covariance Methodology
- New Risks
 - Catastrophe risk charge (Ongoing, due 1/1/14)
 - Improve DTA risk charge (adopted late 2011)
 - Consider other missing risks (AAA 01/2011 Report)
- Improve derivation of U/W & Reserve Risk (R4 & R5) factors
 - Stochastic/forward looking approach (unlikely soon)
- Improve derivation of reinsurance credit risk (10%)

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SMI - RBC Targeted Improvements (P&C) - Continued

- Improve RBC for reinsurers (existing R4 & R5 factors)
- Introduce RBC for Captives, RRG's - (underway)
- Introduce RBC for title and financial and mortgage guaranty insurers - (under consideration)

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Catastrophe RBC Charge

- Project has been underway since 2006
- Cat RBC charge replaced statutory cat reserve as preferred approach
- Industry supports the proposal
- 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 mgmt attest to use test in confidential RBC 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 using PCS data + reinsurers' non-US losses)
 - New confidential filing will be due with 2012 Annual Statement
- Insurers will 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
- This now may slip to one year – earliest effective date 12/31/2014 filing due in March 1, 2015

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Catastrophe RBC Charge - Industry Reaction

- Industry Supports
- RAA Prefers 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
- Primary industry - should not require short-term models for solvency, while requiring LT models for ratemaking
- Reinsurers aggregate risk and don't often have access to direct insurers' geo-coded risk exposure (=alternative compliance mode for reinsurers)

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Other SMI Elements


- Group Supervision for ComFrame
- IFRS/GAAP Convergence and impact on Statutory accounting
- Corporate Governance
- Reinsurance Modernization
- Life Principles-Based Reserving

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Group Supervision/ComFrame

- Common Framework for group supervision of IAIG's
- Controversial Issues:
 - Definition of IAIG
 - Selection of global group supervisor
 - IFRS / Valuation/ "common language"
 - Group Capital Requirement vs. Group Capital Assessment
 - Overall prescriptive nature of proposal
- Next Consultation document ~ 6/30/2012

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Int'l Accounting Standards

- NAIC 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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Corporate Governance Working Group

- NAIC 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 (preapproval of BOD & mgmt)
 - Prescriptive requirements
 - Overlap with other NAIC/state requirements
 - Board legal duties to policyholders
 - General over-reach

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Reinsurance Task Force

- Reinsurance regulatory modernization (a.k.a. collateral reform)
 - 2011 NAIC adopted Revisions to NAIC Model Credit For Reinsurance Model Law and Regulation
 - Provides states with the option of requiring less than 100% collateral for certain unauthorized or “certified” reinsurers
 - Integrated with requirements of DFA (NRRA provisions)
 - CFR determined by cedent’s domestic regulator
 - Preempts host states from requiring collateral
 - Several states have adopted similar legislation (FL, NY, NJ, IN)
 - Many other states considering legislation

RAA

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

RAA


Federal Information Office (FIO)

- Established by Title V of Dodd Frank Act
- Michael McRaith Director Since June 2011
- Delayed report on Modernizing Insurance Regulation (due 1/2012 & still not issued)
- 2nd report due in October 2012 on Modernizing Reinsurance Regulation
- FIO Director is Member of FSOC
- FIO playing an important role in international regulation and ultimately US equivalence

RAA

FIO - International Role

- Can recognize other jurisdictions through “covered agreements”
- As member of FSOC and FSB, coordinating global approach to SIFI’s and GSIFI’s
- Represents the US at IAIS and is on IAIS Executive Committee
- Working together with NAIC, EU Commission on the International Steering Committee to reach a decision/compromise on US Equivalence with Solvency 2 (by 12/31/2012)

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