

# The U.S. Solvency Modernization Initiative (SMI)

Casualty Actuaries in Reinsurance

2013 Seminar

June 6, 2013

Joseph B. Sieverling

Reinsurance Association of America



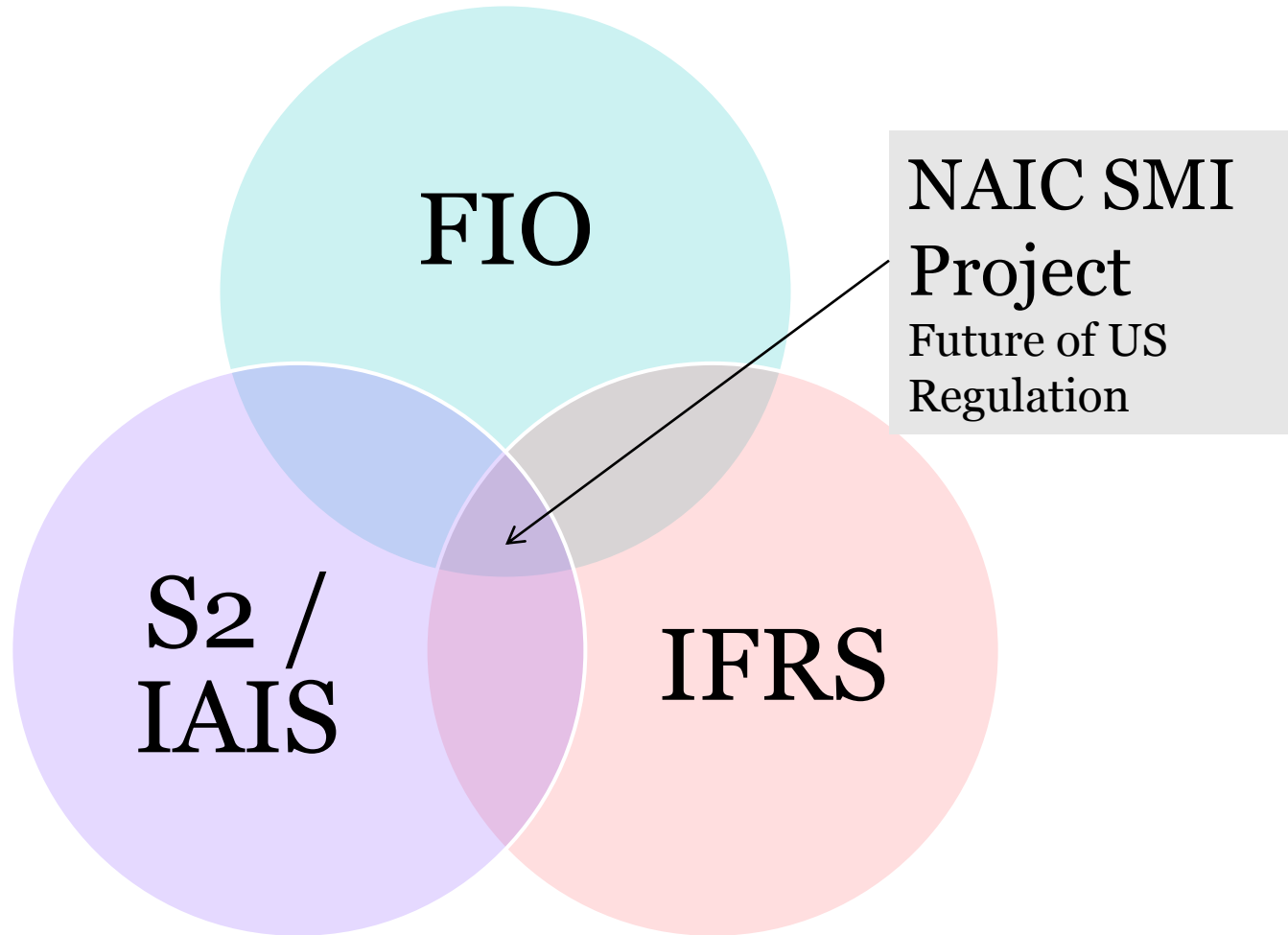
# Antitrust Notice

- **The Casualty Actuarial Society is committed to adhering strictly to the letter and spirit of the antitrust laws. Seminars conducted under the auspices of the CAS are designed solely to provide a forum for the expression of various points of view on topics described in the programs or agendas for such meetings.**
- **Under no circumstances shall CAS seminars be used as a means for competing companies or firms to reach any understanding – expressed or implied – that restricts competition or in any way impairs the ability of members to exercise independent business judgment regarding matters affecting competition.**
- **It is the responsibility of all seminar participants to be aware of antitrust regulations, to prevent any written or verbal discussions that appear to violate these laws, and to adhere in every respect to the CAS antitrust compliance policy.**

# Presentation Overview

- SMI – Purpose and Scope
- Holding Company Act Changes
- ORSA Project
- Risk-Based Capital Improvements
- Other Elements
- FIO Impact

# External Forces Shaping the Future of US Regulation



# SMI - Purpose & Scope

- Third Country Equivalence is a major catalyst for change in the U.S. System
  - Reinsurance Collateral Issue
  - 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

# 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)

# FSAP Review = SMI Scope

- U.S. State System Completed 1<sup>st</sup> 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

# 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**



# 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**

# 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

# 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 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
- Financial Analysis of HC Systems substantially increased

# 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 have been enacted in several state legislatures
- Expect adoption and implementation in most states by 2013 with effective date of January 1, 2014.

# ORSA

## ORSA Project Elements:

- Guidance Manual (adopted Nov. 2011)
- Model Law (October 2012)
- Pilot Programs (Aug. 2012 + 2013)
- Future:
  - Implementation in Analysis and Exam Processes
  - Inclusion in Accreditation standards
  - Training + additional NAIC Staff Resources

# ORSA Guidance Manual

## ORSA Purpose:

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

# 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

# ORSA Model law

- Exempt if entity < \$500 M and Group < \$1 B premium
- But, regulators will require an ERM Framework & evaluate ERM for ALL insurers
- Major Provisions:
  - ORSA Requirement effective 1/1/15 (File in 2015 as available)
  - Alternative for offshore owned– File global basis if includes US entities
  - Confidentiality
    - ORSA and related documentation is proprietary & trade secret information
    - Written confidentiality agreements with consultants, insurer and supervisor
    - Sharing limited to Ins. regulators & others with authority to maintain confidentiality
  - Attestation – ORSA reflects insurer’s ERM practices



# ORSA Other

- 2012 Pilot Program
  - Ten industry participants
  - Filed under Texas exam/confidentiality statute
  - Goal = ensure compliance with Guidance Manual is practical and the summary report is useful
  - Result – Amended Guidance Manual
    - Identify basis of accounting
    - Define Scope of ORSA = which entities
    - Summary of material changes from prior year
    - Comparative view of group risk capital with prior year
    - Other amendments to make consistent with Model Law
  - Result – Second pilot project in 2013

# Risk-Based Capital Improvement

- Solvency Modernization Project
  - Targeted Improvements
  - Catastrophe RBC Charge

# 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 is OK
- NAIC dropped work started in 2010 to measure calibration level of RBC
- NAIC still planning targeted improvements

# SMI - RBC Targeted Improvements (P&C)

- Revise P&C Risk Correlation/Covariance Methodology (AAA Report issued in November)
- New Risks
  - Catastrophe risk charge (Ongoing, due 1/1/14)
  - Improve DTA risk charge (adopted late 2011)
  - Consider other missing risks = Operational (AAA 01/2011 Report)
- Improve derivation of U/W & Reserve Risk (R4 & R5) factors
  - Stochastic/forward looking approach (underway)

# SMI - RBC Targeted Improvements (P&C)

## - Continued

- Improve derivation of reinsurance credit risk charge (10%)
- 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)

# Catastrophe RBC Charge - Description

- Charge based on 1 of 4 commercially available models + FL
- Will require a confidential report to regulators
- Use 1 in 100 loss level but disclose 1-50, 1-250, & 1-500
- 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

# Catastrophe RBC Charge - Description Cont'd

- NAIC will remove Cat losses included in the existing RBC U/W factors (US Losses using PCS data + (re)insurers' non-US losses)
- 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 and explain any variances
  - 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 – describe variances
- Exam processes currently being updated to test cat exposure input data
- Commissioner empowered to reject insurers' models or data and require remedial action

# Catastrophe RBC Charge - Description Cont'd

- Insurers Exempt from Cat RBC Charge (in development)
  - Low Premium Volume, **and**
    - less than \$25 million in the following Annual Statement lines
    - Fire, Farmowners, Allied, Homeowners, Earthquake, CMP
  - Low insured value as a percentage of surplus
    - Insured value policy limits < 40% 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



## Other SMI Elements

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

# Group Supervision/ComFrame

- Common Framework for group supervision of IAIG's
- Controversial Issues:
  - Definition of IAIG
  - Selection of global group supervisor
  - Common Valuation or "CABS"
  - Group Capital Requirement vs. Group Capital Assessment
  - Overall prescriptive nature of proposal
- Next Consultation document ~ September 2013

# 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/S2 model?
  - Decision on whether to adopt IASB as the basis for SAP accounting depends on GAAP and SEC convergence
    - 2012 SEC Report & lack of convergence makes this unlikely

# 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
  - Draft Comprehensive Disclosure requirements
- **Controversial Issues**
  - Suitability of persons (preapproval of BOD & mgmt)
  - Prescriptive requirements
  - Overlap with other NAIC/state requirements
  - Board legal duties to policyholders

# 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
  - Eleven states have adopted similar legislation
  - Many other states considering legislation in 2013

# 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
  - Need supermajority of states to adopt

# 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)
- 2<sup>nd</sup> report due in October 2012 on Modernizing Reinsurance Regulation (also delayed)
- FIO Director is Member of FSOC
- FIO playing an important role in international regulation and ultimately US equivalence

# 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 & chair of Technical Committee
- EU/ US Dialogue Project
  - NAIC, EU Commission & EIOPA working to reach a compromise on US Equivalence with Solvency 2 (report December 2012)



**Reinsurance Association of America**  
**[www.reinsurance.org](http://www.reinsurance.org)**



**Joseph B. Sieverling**  
[sieverling@reinsurance.org](mailto:sieverling@reinsurance.org)

