NAIC White Paper

THE U.S. NATIONAL STATE-BASED SYSTEM OF INSURANCE FINANCIAL REGULATION

and the

SOLVENCY MODERNIZATION INITIATIVE

August 14, 2013

Drafted by the
Solvency Modernization Initiative (E) Task Force

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Section 1: Introduction

1. In 2008, through the NAIC, state insurance regulators in the U.S. embarked on the Solvency Modernization Initiative (SMI) to perferme

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Section 2

The United States Insurance Financial Solvency Framework and Core Principles

1. The purpose of this section is to describe the framework of the U.S. Insurance Financial Solvency System and present a set of core financial principles underlying this framework.

2. This section provides a description of the U.S. Insurance Financial Solvency Framework that, while drawing upon ideas developed by the International Association of Insurance Supervisors (IAIS), goes beyond the IAIS in important, material ways. In particular, in the U.S. regulatory system, ongoing collaborative regulatory peer review, regulatory checks and balances, and risk focused financial surveillance form the foundation of the regulatory process.[1] In addition, the framework indicates that the U.S. Insurance Financial Solvency Core Principles are embodied in the NAIC's Financial Regulation Standards and Accreditation Program, which is a uniform program to which all states subscribe. Also, included in this section is a discussion of the seven U.S. Insurance Financial Solvency Core Principles

Presentation of U.S. Insurance Financial Solvency Framework

3.

Regulatory Mission as Starting Point for Framework

6. The starting point or context for the U.S. Insurance Financial Solvency Framework is the mission of insurance regulation in the United States:

   U.S. Insurance Regulatory Mission: To protect the interests of the policyholder and those who rely on the insurance coverage provided to the policyholder first and foremost, while also facilitating the financial stability and reliability of insurance institutions for an effective and efficient market place for insurance products.

7. This mission has been used for years as the basis on which regulatory decisions have been made, including overall industry policy decisions and regulatory decisions for individual insurers. While the policyholder is the focal point of the mission, this mission is mindful that regulatory actions and decisions will have an impact on the operation of insurance markets hr

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U.S. Insurance Financial Solvency Core Principles[2] and the Accreditation Program

14. Seven core principles have been identified for the U.S. Insurance Financial Solvency Framework, as described below.

    (1) *U.S. Insurance Financial Solvency Core Principle 1:*
    Regulatory Reporting, Disclosure and Transparency

    Insurers are required to file standardized annual and quarterly financial reports that are used to assess the insurer's risk and financial condition. These reports contain both qualitative and quantitative information and are updated, as necessary, to incorporate significant common insurer risks. or222esthTf 0 Tc 0 TcoJ 22.oat()-10e rare0s-6(v)-alEMC e,-414 -m-8(p)-4(aar)3(

The regulatory framework recognizes that certain significant, broad-based transactions/activities affecting policyholders' interests must receive regulatory approval. These transactions/ activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance.

(6) *U.S. Insurance Financial Solvency Core Principle 6:*
Preventive and Corrective Measures, Including Enforcement

The regulatory authority takes preventive and corrective measures that are timely, suitable

a pass/fail system is used). To remain accredited, an accreditation review must be performed at least

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U.S. Insurance Financial Solvency Regulatory

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to, various intercompany cost sharing arrangements, guarantees, reinsurance, asset purchase

claimants and beneficiaries against financial losses due to insurer insolvencies. Fundamentally, the purpose of an insolvency guaranty law/association is to cover an insolvent insurer's financial obligations, within statutory limits, to policyholders, annuitants, beneficia

U.S. Insurance Financial Solvency Core Principle 4:
Capital Adequacy and Solvency

Risk-Based Capital (RBC) for Insurers Model Act (#312)
Risk-Based Capital (RBC) for Health Organizations Model Act (#315)
Accounting Practices and Procedures Manual
Part A, Financial Regulation Standards and Accreditation Program
Annual Statement Instructions
Risk-Based Capital Forecasting and Instructions
Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (#385)
Credit for Reinsurance Model Act (#785)

U.S. Insurance Financial Solvency Core Principle 5:
Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities

Interest Maintenance Reserve Calculation (Life Insurers)
Investments of Insurers Model Act (Defined Limits Version) (#280)
Investments of Insurers Model Act (Defined Standards Version) (#283)
Actuarial Opinion and Memorandum Regulation (#822)
Business Transacted with Producer Controlled Property/Casualty Insurer Act (#325)
Part A, Financial Regulation Standards and Accreditation Program
Insurance Holding Company System Regulatory Act (#440)

U.S. Insurance Financial Solvency Core Principle 6:
Preventive and Corrective Measures, Including Enforcement

Troubled Insurance Company Handbook
Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (#385)
Risk-Based Capital (RBC) for Insurers Model Act (#312)
Administrative Supervision Model Act (#558)
Part A, Financial Regulation Standards and Accreditation Program

U.S. Insurance Financial Solvency Core Principle 7:
Exiting the Market and Receivership

Troubled Insurance Company Handbook
Insurer Receivership Model Act (#555)
Part A, Financial Regulation Standards and Accreditation Program

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(2) **Capital and Surplus Requirement**
The Department should have the ability to require that insurers have and maintain a minimum level of capital and surplus to transact business. The Department should have the authority to require additional capital and surplus based upon the type, volume and nature of insurance business transacted. The NAIC *Risk-Based Capital (RBC) for Insurers Model Act* (#312), or provisions substantially similar, shall be included in state laws or regulations.

(3) **NAIC Accounting Practices and Procedures**
The Department should require that all companies reporting to the Department file the appropriate NAIC annual statement blank, which should be prepared in accordance with the NAIC's instructions handbook and follow those accounting procedures and practices prescribed by the NAIC *Accounting Practices and Procedures Manual*, utilizing the version effective January 1, 2001, and all subsequent revisions adopted by the Financial Regulation Standards and Accreditation (F) Committee.

(4) **Corrective Action**
State law should contain the NAIC *Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in a Hazardous Financial Condition* (#325), or a substantially similar provision, which authorizes the department to order a company to take necessary corrective action or cease and desist certain practices that, if not corrected, could place the company in a hazardous financial condition.

(5) **Valuation of Investments**
The department should require that securities owned by insurance companies be valued in accordance with those standards promulgated by the NAIC Securities Valuation Office. Other invested assets should be required to be valued in accordance with the procedures promulgated by the NAIC Financial Condition (E) Committee.

(6) **Holding Company Systems**
State law should contain the NAIC *Insurance Holding Company System Regulatory Act* (#440), or an act substantially similar, and the department should have adopted the NAIC model regulation relating to this law.

(7) **Risk Limitation**
State law should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk based upon the company's capital and surplus. This limitation should be no larger than 10% of the company's capital and surplus.

(8) **Investment Regulations**
State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity. Foreign companies should be required to substantially comply with these provisions.

(9) **Liabilities and Reserves**
State statute should prescribe minimum standards for the establishment of liabilities and

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(Note: If a state can provide evidence that none of the entities contemplated in above standards 14, 16,

should be assessed. These guidelines can also assist states in preparing for the accreditation review of their Department.)

(1) **Financial Analysis**

a. **Sufficient Qualified Staff and Resources**

The Department should have the resources to review effectively on a periodic basis the financial condition of all domestic insurers.

b. **Communication of Relevant Information to/from Financial Analysis Staff**

The Department should provide relevant information and data received by the Department, which may assist in the

b. **Communication of Relevant Information to/from Examination Staff**

The Department should provide relevant information and data received by the Department, which may assist in the examination process to the examination staff and ensure that findings of the examination staff are communicated to the appropriate person(s).

c. **Use of Specialists**

The Department's examination staff should include specialists with appropriate training and/or experience or otherwise have available qualified specialists, which will permit the Department to effectively examine any insurer. These specialists should be utilized where appropriate given the complexity of the examination or identified financial concerns.

d. **Appropriate Supervisory Review**

The Department's procedures for examinations should provide for supervisory review of examination workpapers and reports to ensure that the examination procedures and findings are appropriate and complete and that the examination was conducted in an efficient and timely manner.

e. **Use of Appropriate Guid****8(i)-6(n)-48ese a-4(n)-(d)-8( )Ppced-8(u)-8(pr-10(e))]TJ 0 Tc 0 Tw 72.**

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Upon the reporting of any material adverse findings from the examination staff, the Department should take timely action in response to such findings or adequately demonstrate the determination that no action was required.

(3) **Information Sharing and Procedures for Troubled Companies**

a. **Information Sharing**

States should allow for the sharing of otherwise confidential documents, materials, information, administrative or judicial orders, or other actions with the regulatory officials of any state, federal agency or foreign countries providing that the recipients are required, under their law, to maintain its confidentiality. States also should allow for the sharing of otherwise confidential documents, materials, information, administrative or judicial orders, or other actions with the NAIC providing that the NAIC demonstrates by written statement the intent to maintain its confidentiality. The Department should have a documented policy to cooperate and share information with respect to domestic companies with the regulatory officials of any state, federal agency or foreign countries and the NAIC directly and also indirectly through committees established by the NAIC, which may be reviewing and coordinating regulatory oversight and activities. This policy should also include cooperation and sharing information with respect to domestic companies subject to delinquency proceedings.

b. **Procedures for Troubled Companies**

The Department should generally follow and observe procedures set forth in the NAIC *Troubled Insurance Company Handbook*. Appropriate variations in application of procedures and regulatory requirements should be commensurate with the identified financial concerns and operational problems of the insurer.

Part C: Organizational and Personnel Practices

(1) **Professional Development**

The Department should have a policy that encourages the professional development of staff involved with financial surveillance and regulation through job-related college cou

property/casualty companies and this scope is narrower than that of Part B in that it does not include entities such as health maintenance organizations, health service plans, and captive insurers (including captive risk retention groups). These standards only deal with the department's analysis of domestic companies and do not include foreign or alien insurers. The initial company licensing process does not consider the "multi-state" concept since the company is in its initial licensing phase. The standards regarding Form A filings deal with only filings submitted related to multi-state insurers, as that term is defined in the Part B Preamble.

(1) Qualified Staff and Resources
The department should have minimum educational and experience requirements for licensing staff commensurate with the duties and responsibilities for analyzing company applications. Staff responsible for analyzing applications should have an accounting, insurance, financial analysis or actuarial background.

(2) Sufficient Staff and Resources
The department should have sufficient resources to effectively review applications for primary licensure or Form A filings in a timely manner.

(3) Scope of Procedures for Primary Applications
The department should have documented licensing procedures that include a review and/or analysis of key pieces of information included in a primary licensure application.

(4) Scope of Procedures for Form A Filings
The department should have documented procedures for the review of key pieces of information included in Form A filings.

(5) Use of the Form A Database
The department should utilize the Form A Database as a means of obtaining information on prior filings made by an applicant and informing other states of the receipt and status of Form A filings in a timely manner.

(6) Documentation of Work Performed
The department's files should include evidence that the department's procedures were adequately performed and well documented, including a conclusion regarding whether an application or filing is approved or denied.

Source: *Financial Regulation Standards and Accreditation Program*, March 2012, pp. 7–15.

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Stage 1: Limitation of Risk through Design of the System

Investment Requirements and/or Limitations

3. Regulators deem some risks to be so material and potentially contrary to the best interests of policyholders, that lawmakers and regulators either restrict those investment activities or require pre approval of certain material transactions. Conservative valuation of assets and liability credits and application of the RBC formula can drive insurers toward less-risky activities.

4. In the 1990s, insolvencies caused by high risk investment strategies led regulators to consider their oversight and possible restriction of insurer investments by imposing either a defined limits or a defined standards approach. Using a defined limits approach,

Pre-Approval of Material Transactions and Activities

5. Commissioner approval is required for certain material transactions, such as large investment or reinsurance transactions, and extraordinary dividends. In an insurance holding company system, insurers also need regulatory approval for change in control and the amount of dividends paid. This is to help ensure that the assets of an insurer adequately protect the policyholders and are not unfairly distributed to others.

Valuation Requirements and Reinsurance Credit

6. Statutory accounting principles value some assets conservatively and, thus, are less favorable for investment. Reinsurance provides valuable risk mitigation and can provide significant stability. Therefore, in order to receive credit for ceded reinsurance, the reinsurer must be authorized or post security to cover its obligations.

Risk-Based Capital (RBC)

7. The RBC system was created to provide 1) a capital adequacy standard that is related to risk, 2) a safety net for insurers, 3) uniformity among the states, and 4) regulatory authority for timely action. The RBC system has two main components: 1) the RBC formula, which establishes a hypothetical minimum capital level that is compared to a company's actual capital level, and 2) and RBC model law that grants automatic authority to the state insurance regulator to take specific actions based on the level of impairment. While the RBC capital requirement calculation varies based on the type of asset, RBC does not tend to drive investments, because companies typically hold capital in excess of minimum capital requirements. However, the RBC formula could have some influence on management decisions.

Stage 2: Financial Oversight and Intervention Powers

8. Capital requirements are an important part of every regulatory regime. An insurance company must hold capital greater than the minimum regulatory capital levels to continue in business; however, financial regulation extends beyond just capital requirements in most countries and, in the U.S., financial regulation is much broader still.

9. U.S. insurance regulators can order conservation, rehabilitation or liquidation on numerous statutory grounds ranging from financial insolvency to unsuitable management and operations. The Insurer Receivership Model Act (#555) includes the following grounds for regulatory action (among others):

   (1) Impairment, insolvency, or hazardous financial condition;
   (2) Improperly disposed property or concealed, altered, or destroyed financial books;
   (3) Best interest of policyholders, creditors or the public; and
   (4) Dishonest, improperly experienced, or incapable person in control.

10. The most typical financial intervention occurs when a company is in hazardous financial condition. A regulator may deem a company in hazardous financial condition[1] based on:

    (1) Adverse findings in financial analysis or examination, market conduct examination, audits, actuarial opinions or analyses, cash flow and liquidity analyses;
    (2) Insolvencies of a company's reinsurer(s) or within the insurer's insurance holding company system;
    (3) Finding of incompetent or unfit management/director;
    (4) A failure to furnish information or provide accurate information; and,
    (5) Any other finding determined by the commissioner to be hazardous to the insurer's policyholders, creditors, or general public.

11. Financial oversight and the determination of hazardous financial condition is the most valuable and extensive part of financial regulation. Oversight focuses on appropriate asset and liability valuation, the risks accepted by the insurer, the mitigation of those risks, and the amount of capital held in light of the residual risks. Without the extensive financial reporting databases maintained by the NAIC, the financial analysis to evaluate hazardous financial condition would likely require much more significant and time-consuming company input.

12. In addition to numerous activities (such as consideration of management skills, products, sales, market activity, market concentrations, etc.), evaluation of hazardous financial condition status includes the review of an insurer's financial statement preparation, including preparation of all the schedules and audit and actuarial opinions, as well as regulators' financial surveillance, including financial statement validation, analysis and examination.

15. Generally, regulators judge financial condition based on the company's financial reporting, accompanying audits and actuarial opinions. As discussed later in this section, there are numerous financial analysis tools, including public calculations, such as NAIC's Insurance Regulatory Information System (IRIS) ratios and more detailed non-public calculations included in the Financial Analysis Solvency Tools (,,

Once the ACL is calculated, the trigger points for the regulator's four action and control levels are then determined as a percentage of the ACL number. Company Action Level is 200% of ACL, Regulatory Action Level is 150% of ACL, ACL is the third level, and Mandatory Control Level is 70% of the ACL. Then the TAC is compared to the four regulatory action and control levels, and, in accordance with the RBC regulatory framework, all state statutes include specific actions that the regulator and insurer must take at each level to resolve risk exposures and capital inadequacies. These intervention levels are established to require regulatory action, but the regulator may otherwise consider a company to be in hazardous financial condition despite a specific RBC level finding.

21. Rounding out the policyholder protections, if a financially impaired insurance company is unable to pay its insurance claims, a state guaranty fund will pay them, subject to certain limits.

Oversight of Hazardous Financial Condition Tools and Resources

22. In assessing the financial condition of an insurer, the overall goal is to identify potential adverse financial indicators as quickly as possible, evaluate and understand such problems more effectively, and develop appropriate corrective action plans sooner, thus potentially decreasing the frequency and severity of insolvencies. The U.S. solvency oversight framework is not designed to eliminate all insolvencies but, rather, to minimize the number of insolvencies and their corresponding impact on policyholders and claimants. Regulators conduct a risk-focused surveillance of insurers' financial reports that includes financial analysis, financial examination and supervisory plan development.

Financial Analysis

23. NAIC tools and resources (e.g., "FAST" scores and handbooks) supplement individual state regulatory efforts. FAST is a collection of analytical solvency tools and databases desig1 316.45

further analysis of those companies, and provides a brief synopsis of its findings in a document that only state insurance regulators and authorized NAIC staff access

2) Scoring System: The NAIC Scoring System is based

chief financial regulators from around the U.S. to provide an additional layer of solvency assessment to our national system of state-based regulation.

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Market Shares

6. Market shares can be used to determine the degree of concentration found in markets. When looking at concentration rates, it is important to evaluate insurance markets based on group status because insurance entities within a group are not competing against each other. There are several ways to look at concentration rates. One common measure used by economists is the four-firm concentration ratio which measures the market share of the four largest groups. Ratios below 50% are considered desirable in terms of competitiveness of the market.

7. A more robust tool to measure concentration is the Herfindahl-Hirschman Index (HHI). The HHI is calculated by summing the squares of the market shares (as a percent) of all groups in the market. Although there is no precise point at which the HHI indicates that a market or industry is concentrated highly enough to restrict competition, the Department of Justice has developed guidelines with regard to corporate mergers. Under these guidelines, if a merger of companies in a given market causes the HHI to rise above 1,800, the market is considered highly concentrated. If, after the merger, the HHI is between 1,000 and 1,800, the market is considered moderately concentrated, and an HHI less than 1,000 is considered not concentrated. Since these numbers are guidelines, judgment must be used to interpret what information the HHIs provide for a particular market.

8. Using these two measures, the data shows that nationally there is little concentration in property/casualty insurance markets, especially within the larger lines of business (Table 1, Table 2 and Table 3). The states show slightly more concentrated markets but the data does not exhibit cause for concern. In addition, the states benefit from the fact that there is ease of entry by insurers that may be operating in neighboring states and could easily begin writing in a new state. Life, annuity, and health markets similarly show limited concentration in terms of the four-firm ratios. The market share of the four largest groups writing life insurance is 31.4%; 36.4% for the four largest groups writing annuity business; and 33.2% for the four largest groups writing health insurance.

<u>Table 1</u>

U.S. Property/Casualty Insurance – Measures of Competitiveness

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MN	387	WV	600
MS	495	WI	334
		WY	588

Source: NAIC’s 2011 Competition Database Report.

Entries/Exits

9. Those analyzing competition are usually interested in how many insurance groups are participating in a market, as well as how many insurance groups are deciding to enter or leave a market. A market demonstrating a steady increase in the number of groups providing insurance (more groups enter the market than exit) can be considered a strong market where insurers see an opportunity to make a profit. Conversely, markets where more groups are exiting the market than entering may indicate that insurers are unable to earn a profit sufficient to justify a continued presence. Insurance data show that insurers are moving into and out of markets, without either entry or exit dominating the equation (Tables 1 & 2).

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Chart1

Source: Data calculated from NAIC 2011 Market Share Reports.

13. The structure and performance criteria for insurance markets confirm competitiveness at both the national and state level. Markets have large numbers of writers and the degree of market concentration falls below that which economists would typically use to identify preconditions necessary to show a lack of competition. The criteria described above provide the framework

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11	Netherlands	$110,931	2.20%	36	Denmark	$32,691	0.65%
12	Florida	$108,122	2.14%	37	Tennessee	$32,161	0.64%
13	Texas	$106,296	2.11%	38	Wisconsin	$32,152	0.64%
14	Pennsylvania	$91,852	1.82%	39	Maryland	$30,172	0.60%
15	Australia	$89,086	1.76%	40	Missouri	$29,977	0.59%
16	Spain	$79,987	1.58%	41	Hong Kong		

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Hawaii	375	568	23	7	10
Idaho	463	821	6	13	12
Illinois	453	896	12	42	0
Indiana	483	946	18	46	25

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Average	413	784	16	24	15

Source: NAIC 2011 Insurance Department Resources Report.

U.S. Markets are Regulated by the States Due to Local Differences

17. Insurance markets in the United States are regulated at the state level rather than a federal level, partly due to Constitutional reasons and prior decisions made by U.S. c(l)-1(m)-TJ 0 Tw T
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20. In terms of factors affecting life and health insurance, states differ dramatically in population densities, ratios of urban and rural populations, age distributions, racial makeup and the overall health of the population. These factors make each state unique and call for different regulatory structures and rules.

21. The states have chosen to enact different statutory workers' compensation laws that determine the amount and forms of compensation to which employees are entitled, based upon that state's own preferences. State laws concerning automobile insurance differ because each state's legislature has enacted their own requirements on minimum levels of liability insurance and whether personal injury protection is mandatory. Each state's legislature determines the needs in that state and creates requirements based upon that state's citizens.

22. An attempt to create a "one-size-fits-all" regulatory framework for all functions of regulation (beyond solvency) does not make sense due to the great differences found between regions

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Section 5

Solvency Modernization Initiative: The Future of U.S. Financial Insurance Regulation

1. The Solvency Modernization Initiative (SMI) is a critical self-examination in the continuous effort to improve the U.S. insurance financial regulatory framework. The U.S. financial regulatory system, using general authority and excepbaisoed r2- (e ed)-4(t)((7fa0.26 (i)-

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12. Even with these differences, SAP utilizes the framework established by GAAP. It does this, in part, through the SAP maintenance process, which requires the NAIC to consider new GAAP pronouncements adopted by the Financial Accounting Standards Board (FASB). More specifically, the NAIC must adopt as is, adopt with modification or reject GAAP once adopted by the FASB

13. SAP is also the basis used for insurers in U.S. tax law, which is a consideration when regulators discuss changes to SAP.

The Path of U.S. GAAP Convergence with IFRS

14. In 2002, the International Accounting Standards Board (IASB) and the FASB signed the Norwalk Agreement and have since taken on projects with an aim to develop a single global accounting standard. Numerous projects will impact insurance company general purpose accounting, including insurance, financial instruments, leases and revenue recognition standards.

15. The Insurance Contracts project initially aimed to develop a single global comprehensive accounting standard for insurance contracts. In 1997, the IASB decided to address accounting for insurance contracts in a two-phase project. The first phase of the project was completed in May 2004 with the issuance of IFRS 4 Insurance Contracts. A few restrictions in practice were made, but generally a wide variety of pre-existing insurance accounting practice was allowed. The second phase is still in progress, with release of the FASB exposure draft and the IASB proposed standard in 2013. Fundamental 6(x)-Tj ( )Tj -(opos)-1(e

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18. One such example would be the introduction of full market consistency to the accounting basis for insurance contracts. When there is low market activity, financial assets (e.g., bonds) held by an insurance enterprise would qualify for amortized cost measurement, as it is a long-standing business practice of insurers to match invested assets with liabilities by holding many of those financial assets backing the liabilities, to maturity. With limited market activity, it seems clear and consistent that such assets would be appropriately accounted for at amortized cost. Otherwise, the use of fair value can cause fluctuations within an insurer's financial statements that are inconsistent with the insurance business model; thus reflecting a financial position that does not depict the most relevant information to the user of the financial statements. A concern regulators have is that the mere fluctuation in interest rates might require them to put an otherwise financially solvent insurer into receivership. One could introduce market consistency and some adjustment in the calculations to stabilize the impact of fluctuating interest rates, but then need to weigh the extra complexity versus the benefit.

19. Another example is the treatment of short-term contracts and long-term contracts, especially related to discounting. It is the NAIC view that discounting on long-term contracts is appropriate, but that discounting on short-term contracts would have an immaterial effect and could even introduce more uncertainty in the process. More simplistic and less costly calculations could be sufficiently transparent.

20. As part of the SMI, U.S. insurance regulators decided to document the following:

    a. The purpose of the regulatory accounting model.

    b. A potential recommendation regarding whether the NAIC should continue to maintain an entire codification of statutory accounting

    c. A recommendation of whether regulatory financial statements should continue to be utilized for public purposes.

21. A "Primary Considerations Document" was drafted to frame some of these issues, and included within it a continuum of options available to regulators on the policy issue. This document was exposed and discussed at the 2010 Summer National Meeting. Comments varied, but some of the more significant comments dealt with: 1) the desire to maintain control and not relinquish it to a third party (e.g., the IASB); 2) the value of prescribed and permitted practices;ation

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23. A final NAIC policy decision on the future of statutory accounting is expected to be made once the IFRS 4 standard from the second phase is adopted by the IASB/FASB and/or when the SEC makes their decisions. As the IASB/FASB and SEC decisions are substantive, the decisions are taking more time than originally planned. It is expected that these decisions might not be made until after the SMI formally ends.

Background on PBR

24. Reserve calculations for life insurance have been formula-driven for almost 150 years. While the formulaic reserves are consistent across companies and can be easily checked for compliance, the preciseness of such reserves varies widely, especially where 1) insurance products have become more complex (e.g., universal life features and option-based policy guarantees), and 2) a company's underwriting practices or expense containment is substantially different from 0 Tw ()Tj 0.3 51 Td ( )Tj EMC /LBody <</MCID 8 12>BDC /T

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41. The Working Group also performed a study of global corporate governance principles and standards such as those established by the 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. Working Group members noted that many of the standards and principles adopted in other countries, and included in the IAIS core principles (as updated post-FSAP), were expressly addressed within the current U.S. insurance regulatory system.

42. 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 white paper outlining corporate governance principles for use in U.S. [illegible]

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insurers deemed to be in a hazardous financial condition to correct corporate governance deficiencies to the satisfaction of the commissioner

- The development of a common methodology to be used consistently by financial examiners and analysts across the states in assessing the corporate governance practices of insurers.
- The submission of referrals to NAIC groups charged with oversight of the company licensing, annual financial analysis and onsite examination processes to ensure that the responsibility to review key individuals for suitability is clear and consistent with international standards.

The developments in this area reflect regulators' opinion that a review of corporate governance practices is essential to effectively monitoring the financial solvency of insurers. The policy decisions reached by regulators in this area recognize differences between the U.S. system of corporate governance regulation and the systems of other countries. Therefore, the policy decisions sensibly balance regulatory needs, improving consistency with international standards, and avoiding placing unnecessary/redundant burdens on the insurance industry. The following table illustrates how the policy decisions reached by regulators relate to the recommendations received as a result of the 2009 FSAP

FSAP Recommendation	U.S. Policy Decision
Develop specific suitability criteri (e.g., background, experience, etc.) for key persons responsible fo governing/managing insurers.	Defining specific suitability requirements for key perso in statute could result in limiting the current process evaluating suitability through a review of biographic affidavits and onsite interviews without providing discernible benefit. Collection of additional corporate governance information annually will provide information on practices that insurers have put in place (i.e., suitability standards) to determine whether officers and key persons in control functions have the appropriate background, experience and integrity to fulfill their prospective roles. In addition, enhancements have been proposed to clarify the role of regulators and ensure consistency with international standards in reviewing the suitability of key individu during the company licensing, financial analysis an financial examination processes.
Develop ongoing requirements fo insurers to notify regulator regarding changes in the suitability status of key persons.	Insurers will be required to report any changes in a officer's or key person's suitability status as outlined the organization's internal standards.
Develop additional requiremen and/or guidance for insure related to good corporat governance practices.	The project to develop a common methodology to asse the corporate governance practices of insurers will result in the development of additional guidance relating to g and bad corporate governance practices.

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FSAP Recommendation

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2) specific input to individual insurance groups; 3) small changes to the ORSA guidance manual; and 4) initial opinions from regulators regarding the positive impact that ORSA reports will have on group supervision by U.S. regulators.

49. Regulators are also interested in working with chief risk officers of some of the largest insurers in the U.S. to increase ORSA effectiveness at the initial implementation in 2015. Chief risk officer input will help regulators to develop regulatory guidance to be used by all companies performing ORSA and may help prepare regulators to use ORSAs in regulatory practice.

50. The NAIC is currently in the process of establishing the regulator guidance for reviewing the ORSA summary reports that will be required effective January 1, 2015. The guidance is expected to be focused on using the information to increase the analyst's ability to assess the liquidity, leverage, profitability and overall financial condition and capital of the insurance group. The guidance is also expected to set forth a process in which the examiner could review the processes used by the group in establishing its assumptions and techniques that were utilized in developing the summary report. This process of reviewing assumptions and techniques is deemed to a function that must be completed during an on-site review, where the regulator is able to understand and gauge through various

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reinsurers must be 100% collateralized in order for the ceding company to take balance sheet and income statement credit.

54. The collateral requirements for reinsurers licensed outside of the U.S. have been a frequent subject of debate over the past decade at the NAIC. Numerous non-U.S. reinsurers, as well as non-

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Regulatory Action

59. In December 2010, the Reinsurance (E) Task Force was charged to consider amendments to the Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786) to incorporate key elements of the Reinsurance Framework. In November 2011, the NAIC adopted revisions to these models that serve to reduce reinsurance collateral requirements for reinsurers meeting certain criteria for financial strength and business practices that are licensed and domiciled in qualified jurisdictions.

60. Other key elements of the revisions include:

- The revised models establish a certification process for reinsurers—a certified reinsurer is eligible for collateral reduction with respect to contracts entered into or renewed subsequent to certification.

- Each state will have the authority to certify reinsurers, or a commissioner has the authority to recognize the certification issued by another NAIC-accredited state. This eliminates the need for a reinsurer to be evaluated by each and every state, but preserves a commissioner's right to do so.

- Reinsurers are subject to certain criteria in order to be eligible for certification, as well as ongoing requirements in order to maintain certification. Examples of evaluation criteria include, but are not limited to, financial strength, timely claims payment history, and the requirement that a reinsurer be domiciled and licensed in a "qualified jurisdiction."

- Each state may evaluate a non-U.S. jurisdiction in order to determine if it is a "qualified jurisdiction." A list of qualified jurisdictions will be published through the NAIC committee process. A state must consider this list in its determination of qualified jurisdictions, and if the state approves a jurisdiction not on this list, the state must thoroughly document the justifications for approving this jurisdiction in accordance with the standards for approving qualified jurisdictions contained in the model regulation.

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62. In April 2013 the NAIC adopted revisions to the accreditation standard for reinsurance ceded reflecting key elements from the revised Model #785 and Model #786. The revised standard was considered and adopted on an expedited basis and became effective immediately. The provisions within the accreditation standard pertaining to certified reinsurers do not require adoption by every NAIC jurisdiction; rather, these provisions

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67. Credit for reinsurance requirements (including collateral) within the U.S. and European Union (EU) insurance supervisory systems continue to be the subject of discussion within the ongoing U.S./EU Dialogue. This NAIC will continue to participate in this dialogue.

68. The NAIC has committed to do the following: 1) undertake a re-examination of the collateral amounts within two years from the effective date of the revisions to the models (e.g., Nov. 6, 2013); and 2) revisit the issue of state uniformity in the adoption of the models within three years of the adoption of the new accreditation standard by the NAIC (e.g., April 9, 2016).

GROUP SUPERVISION

Background

69. U.S. state insurance holding company systems[2] 69. t.676 -[4e acJ2(o2(t)-p0(-)6(c1)-6(a)4)2(a21-6(

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77. As Form A, Form D, Form E and Extraordinary Dividend/Distribution are transaction-specific, the occurrence frequency of these transactions may vary. The NAIC Financial Regulation Standards and Accreditation Program requires that the state insurance department adequately and timely analyze these transaction specific filings and Form B. The depth and frequency of the analysis performed each year is based on the complexity and financial strength of the holding company system.

78. When there are two or more U.S. domestic insurers within a group, the applicable “lead state” will coordinate with other domestic supervisors within a group regarding the analysis procedures.

79. The Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in a Hazardous Financial Condition (#385), in part, provides an additional tool by which an Insurance Department may render the continuance of an insurers business hazardous to the public or policyholders.

80. The Financial Analysis (E) Working Group provides an additional layer of surveillance for insurance groups overall, supplementing individual state insurance departments’ solvency monitoring by performing quarterly analysis on nationally significant groups that exhibit characteristics of trending toward or being financially troubled. The Working Group then works with domiciliary regulators and the lead state to advise the most appropriate regulatory strategies, methods and actions.

<u>Supervision Mechanism – Examination</u>

81. When multiple insurance legal entities are within the same group, the states may also engage in group examinations to maximize resources and create efficiencies. Examination work papers are typically shared real-time via a server and common software, which could result in a more timely update of insurer and group risk profiles under the NAIC’s risk-focused solvency surveillance system.

Looking Forward

82. Key fundamental considerations continue to drive the discussion of the most appropriate enhancements to group supervision, especially as the NAIC works with international supervisors to develop a common framework for the supervision of internationally active insurers. Considerations include the depth of the overall regulatory framework in the U.S.; the legal framework for regulatory action; the protection of policyholders at the entity level; and the absence of a clear path to the flow (“fungibility”) of capital in bad times (i.e., solvency concerns) between entities regulated by different jurisdictions and operating under different laws.

83. Essentially, the NAIC is considering incorporating certain prudential benefits of group supervision, providing clearer “windows” into the risks and overall financial strength embedded in group operations, while building upon the existing “walls” that provide the highest level of availability of capital resources and, therefore, policyholder protection. Some examples of areas receiving enhancements include enterprise risk, group capital assessment and supervisory colleges.

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Group Capital Assessment

84. As one of the ways to provide clearer "windows" into the risks and overall financial strength embedded in group operations, U.S. regulators will require a group capital assessment as part of the Own Risk and Solvency Assessment (ORSA). The assessment does not establish a group capital requirement in the same sense as the legal-entity RBC requirement. However, the group capital assessment, in combination with the entity-centric legal framework for regulatory action, regulatory restrictions on the movement (fungibility) of capital, strong communication and cooperation between regulators, and other regulatory tools and safeguards, should allow earlier detection of potential financial and reputational contagion on insurance entities within the group or to the group as a whole.

Increased Participation in Supervisory Colleges

85. The U.S. state insurance regulators welcome the concept of supervisory colleges[3] as a useful platform to improve supervisory cooperation and coordination between international regulators to discuss insurance companies operating internationally. State insurance regulators both participate in and convene supervisory colleges. U.S. insurance regulators understand and embrace supervisory colleges; the states have been conducting a similar process for U.S. insurance legal entities within the same holding company system. The NAIC refers to this process as the "lead state" approach for insurance groups. U.S. insurance regulators have adopted best practices,

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98. The RBC then aims to capture each material risk for each particular insurance type. Some of the major general risk categories in the RBC formula include asset risk, insurance/underwriting risk, credit risk, interest rate risk and business risk. Some risks may not have been included in the RBC formulas (e.g., currency risk) because they were not considered to be significant or were difficult to quantify or not quantifiable. Focus on RBC in the SMI has been about ensuring the formulas are capturing all material risks. Going forward, state insurance regulators are developing an explicit catastrophe risk charge for inclusion in the property/casualty RBC formula (with adjustments to related charges that are currently embedded in other risk calculations) and are considering a pandemic charge in the health RBC formula (and removing the current charges out of other risk calculations). The NAIC is also reviewing the credit risk calculation to improve its accuracy. At present, the NAIC is reviewing the asset risk factors, classes of investments and asset quality designations based on historical default experience.

99. Operational risk is not explicitly identified in the RBC calculation, but is, arguably, partially included in certain existing risk charges, as well as in conservatism included in

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RBC Safety Level and Time Horizon

102. Internationally there has been significant discussion about the appropriate statistical

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