# **Introduction**

The framework for group-wide supervision within the state-based system of regulation is set forth in the *Insurance Holding Company System Regulatory Act* (#440), the *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions* (#450), the *Model Law on Examinations* (#390) and other NAIC tools. These NAIC models and tools, along with individual state laws and regulations establish the guidance for the analysis of insurance holding company systems. This includes a risk-focused approach to group supervision where specific risks that are germane to most insurance holding company structures are addressed directly through regulation, while other more broad-based risks are addressed in the supervision review process.

Throughout this document, the term “regulation” is used to describe statutory provisions required under state laws, state regulations, or similar requirements. Also throughout this document, the term “supervision” and “supervisory process” is used to describe the process(es) of monitoring the financial condition of the insurance group, or what is commonly referred to as the analysis process/function or examination process/function. This terminology is used to help clarify those risks addressed through statute or regulation versus those risks addressed through supervision.

State insurance regulators believe that group-wide supervision is key to helping fulfill the regulatory mission cited in the *United States Insurance Solvency Framework* (U.S. Solvency Framework)*,* which states: “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 an effective and efficient market place for insurance products.” The state-based system uses both regulation and supervision to fulfill this regulatory mission, but is focused more on the supervision process for group-wide supervision as that lends itself to a more balanced approach between free markets and solvency protection. The supervision review process is flexible as to the nature, scale and complexity of the risks presented to the group. Plus, the supervision review process is flexible in dealing with risk exposure, risk concentration and the interrelationships of risks among entities within the group. However, there are situations where specific statutory authority and regulations are deemed more appropriate.

**IAIG:** For internationally active insurance groups (IAIGs) where a state insurance regulator is acting as the group-wide supervisor (see VI.B for criteria and definitions), it may be necessary to address additional areas regarding group-wide activities and risks. Such areas are largely consistent with the International Association of Insurance Supervisors’ (IAIS) *Common Framework for the Supervision of Internationally Active Insurance Groups* (ComFrame) and have been incorporated throughout this chapter as deemed appropriate by state insurance regulators. While such considerations and procedures are applicable to insurance groups identified as IAIGs (see state adoption of Model #440 Section 7.1), similar procedures applicable under the state’s adoption of Model #440 Section 6 may also be appropriate for use in the supervision of other large insurance groups that do not meet the IAIG criteria. In assessing any such application, analysts must not exceed their legal authority and any supervisory measures should be risk-based and proportionate to the size and nature of the group.

Likewise, because ComFrame is to be applied flexibly and proportionately, not every additional area of IAIG supervision will apply to each IAIG or will apply in the same way or to the same extent. Group-wide supervisors have the flexibility to tailor implementation of supervisory requirements and application of insurance supervision. ComFrame is not a one-size-fits-all approach to IAIG supervision as the goal is to achieve the outcomes set forth in ComFrame. IAIGs have different models of governance (e.g., more centralized, or more decentralized). ComFrame does not favor any particular governance model and is intended to apply to all models. The organization of an IAIG can be structured in various ways as long as the outcomes are achieved. Proportionate application, which is called for in IAIS guidance, involves using a variety of supervisory techniques and practices tailored to the insurer. The techniques and practices applied should not go beyond what is necessary in order to achieve the intended outcomes of the IAIS’ Insurance Core Principles and ComFrame.

The following are excerpts from the NAIC models that help set forth the authority for the group-wide supervision framework.

# **Authority Related to the Supervision Review Process**

# Supervision review Model #440: (bolding and underlining used for emphasis).

**Section 6. Examination**

* 1. Power of Commissioner…the commissioner shall have the **power to examine any insurer registered under Section 4 and its affiliates to ascertain the financial condition of the insurer,** including the enterprise risk to the insurer by the ultimate controlling party, or by any entity or combination of entities within the insurance holding company system, or by the insurance holding company system on a consolidated basis.

**Section 1. Definitions**

F. “Enterprise Risk.” “Enterprise risk” shall mean any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, **is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole,** including, but not limited to, anything that would cause the insurer’s Risk-Based Capital to fall into company action level as set forth in [insert cross reference to appropriate section of Risk-Based Capital (RBC) Model Act] or would cause the insurer to be in hazardous financial condition [insert cross reference to appropriate section of Model Regulation to define standards and commissioner’s authority over companies deemed to be in hazardous financial condition].

**Section 7.1. Group-wide Supervision of Internationally Active Insurance Groups**

1. If the commissioner is the group-wide supervisor for an internationally active insurance group, **the commissioner is authorized to engage in any of the following group-wide supervision activities**:
2. Assess the enterprise risks within the internationally active insurance group to ensure that:
3. The material financial condition and liquidity risks to the members of the internationally active insurance group that are engaged in the business of insurance are identified by management, and
4. Reasonable and effective mitigation measures are in place;
5. **Request, from any member of an internationally active insurance group subject to the commissioner’s supervision, information necessary and appropriate to assess enterprise risk**, including, but not limited to, information about the members of the internationally active insurance group regarding:
6. Governance, risk assessment and management,
7. Capital adequacy, and
8. Material intercompany transactions;
9. Coordinate and, through the authority of the regulatory officials of the jurisdictions where members of the internationally active insurance group are domiciled, **compel development and implementation of reasonable measures designed to ensure that the internationally active insurance group is able to timely recognize and mitigate enterprise risks** to members of such internationally active insurance group that are engaged in the business of insurance;
10. Communicate with other state, federal and international regulatory agencies for members within the internationally active insurance group and share relevant information subject to the confidentiality provisions of Section 8, through supervisory colleges as set forth in Section 7 or otherwise;
11. Enter into agreements with or obtain documentation from any insurer registered under Section 4, any member of the internationally active insurance group, and any other state, federal and international regulatory agencies for members of the internationally active insurance group, providing the basis for or otherwise clarifying the commissioner's role as group-wide supervisor, including provisions for resolving disputes with other regulatory officials. Such agreements or documentation shall not serve as evidence in any proceeding that any insurer or person within an insurance holding company system not domiciled or incorporated in this state is doing business in this state or is otherwise subject to jurisdiction in this state; and
12. Other group-wide supervision activities, consistent with the authorities and purposes enumerated above, as considered necessary by the commissioner.

Model #390:

**Section 1. Purpose**

…The purpose of this Act is to provide an effective and efficient system for examining the activities, operations, financial condition and affairs of all persons transacting the business of insurance in this state and all persons otherwise subject to the jurisdiction of the commissioner. **The provisions of the Act are intended to enable the commissioner to adopt a flexible system of examinations** that directs resources as may be deemed appropriate and necessary for the administration of the insurance and insurance related laws of this state.

**Section 3. Authority, Scope and Scheduling of Examinations**

1. The commissioner or any of the commissioner’s examiners **may conduct an examination under this Act of any company as often as the commissioner in his or her sole discretion deems appropriate…**

**Scope of Group Regulation**

The Model #440 defines the scope of group-wide regulation through various means including defining specific important terms such as the insurance holding company system, an affiliate, and control. These are important terms as they are used to define the scope of the group being the ultimate controlling person or entity, and all of its direct and indirectly controlled subsidiaries, and therefore subject to the requirements of the Model #440. It is important to note that these definitions also consider the extent to which there is either direct or indirect participation in the group, influence and contractual obligations that suggest there is control or influence over the group. Consequently, group-wide regulation and supervision includes all insurers, all operating and non-operating holding companies, non-regulated entities and special-purpose entities. It also includes other regulated entities such as banks, utilities or securities companies. In all cases, the lead state would need to understand all such entities and the risks that such entities pose to the insurer or group as a whole. However, with respect to the other regulated entities, Section VI.C. – Insurance Holding Company System Analysis Guidance (Lead State) of this Handbook discusses that the lead state’s role is to establish a plan for communicating and coordinating with other regulators as well as other supervisors (e.g., international insurance regulators), if significant events, material concerns, adverse financial condition or prospective risks are identified.

**Multi-Jurisdictional/Functional Cooperation**

The scope of group-wide regulation under Model #440 is clearly meant to apply to all entities within the controlled group; it also makes an equally important distinction regarding authority. Under the U.S. group supervision approach, the lead state is responsible for understanding all the risks posed by the regulated and non-regulated entities within the group, but it does not have authority over the other regulated entities within the group. For many years, state insurance regulators have developed different methods of cooperating with each other in an effort to maximize the effectiveness of regulation while respecting the authority that each state has to protect the policyholders in their state. The states have worked together in a multitude of ways to provide these benefits. One of the best examples of cooperation is state participation in the NAIC’s Financial Analysis (E) Working Group (commonly referred to as “FAWG”). The Working Group’s primary role is to identify insurance companies and groups of national significance that are, or may be, financially troubled, and determine whether appropriate regulatory action is being taken, and if not, what action should be taken. This group of state regulators meets and holds conference calls throughout the year. This peer review process is an essential part of the state-based system of insurance regulation in that it reinforces the communication and cooperation that is necessary to regulate insurers and insurance groups.

**IAIG**: In addition, Model #440 provides definitions for Internationally Active Insurance Group (IAIG) and group-wide supervisor, which allow state insurance regulators to fulfill roles consistent with ComFrame for cooperation across international jurisdictions in supervising IAIGs. See additional information in VI.B.

# **Supervision Review Process (Risk-focused Financial Surveillance Process)**

States use specific procedures in carrying out the risk-focused financial surveillance process. Many of these procedures are focused on monitoring of the insurance legal entity and group. The legal entity regulation is performed in order to have a bottom-up view of the group, whereas the holding company analysis uses the top down approach. The NAIC has developed procedures for carrying out the risk-focused surveillance process, and such procedures are documented in this Handbook and in the Financial Condition Examiners Handbook. The following summarizes some of these requirements. For more specific information, see Section VI.B Roles and Responsibilities of the Group-Wide Supervisor/Lead State of this Handbook.

Communication: All domestic states are encouraged to communicate any significant findings or concerns they have up to the lead state for consideration in the comprehensive holding company analysis. In addition, lead states of IAIGs are expected to communicate any significant findings or concerns to the group-wide supervisor (if different than the lead state) through the use of supervisory colleges, crisis management groups or other means necessary to address any enterprise-wide concerns that arise. Domestic and lead states should not take regulatory action or place sanctions on an insurance legal entity or key individual within a broader holding-company system without first communicating with the lead state and/or group-wide supervisor.

**Financial Analysis Handbook and Role of the Analyst**

As part of the risk-focused surveillance approach, the financial analyst role is to provide continuous off-site monitoring of a group’s financial condition, monitor internal/external changes relating to all aspects of the insurer and work with examination staff to review specific risks through an on-site examination. The holding company analysis procedures are designed to determine what risks exist at the holding company. Every holding company system is reviewed in order to derive an overall assessment that highlights areas where a more detailed analysis may be necessary. The procedures are intended to be used at the discretion of analysts depending upon the sophistication, complexity and overall financial position of the holding company system, as well as the degree of interdependence and interconnectivity within the holding company system. Also, consistent with the risk-focused surveillance approach, analysts should have a firm understanding of the following branded risk categories for each group:

* **Credit (CR)—**Amounts actually collected or collectible are less than those contractually due or payments are not remitted on a timely basis.
* **Legal (LG)—**Non-conformance with laws, rules, regulations, prescribed practices or ethical standards in any jurisdiction in which the entity operates will result in a disruption in business and financial loss.
* **Liquidity (LQ)—**Inability to meet contractual obligations as they become due because of an inability to liquidate assets or obtain adequate funding without incurring unacceptable losses.
* **Market (MK)—**Movement in market rates or prices, such as interest rates, foreign exchange rates or equity prices adversely affects the reported and/or market value of investments.
* **Operational (OP)—**The risk of financial loss resulting from inadequate or failed internal processes, personnel and systems, as well as unforeseen external events.
* **Pricing/Underwriting (PR/UW)—**Pricing and underwriting practices are inadequate to provide for risks assumed.
* **Reputational (RP)—**Negative publicity, whether true or not, causes a decline in the customer base, costly litigation and/or revenue reductions.
* **Reserving (RV)—**Actual losses or other contractual payments reflected in reported reserves or other liabilities will be greater than estimated.
* **Strategic (ST)—**Inability to implement appropriate business plans, to make decisions, to allocate resources or to adapt to changes in the business environment will adversely affect competitive position and financial condition.

Analysts should also consider any prospective risk to the group. A prospective risk is a residual risk that affects future operations or conditions for the group. These prospective risks can be identified through assessments of company management and/or operations or risks associated with future business plans. Common types of such risks for insurers may include underwriting strategy, investment strategy, and reinsurance strategy and diversification/concentration. However, other risks from non-insurers can also include off-balance sheet exposures and other risks driven by the business model of that non-insurer. The analyst’s understanding of the above nine risk classifications includes an assessment of the level of that risk and the ability of the entity to appropriately manage the risk during the current period and prospectively. The assessment of these nine risk classifications both currently and prospectively should be part of the quantitative and qualitative analysis completed within the holding company analysis.

The overall risk-focused surveillance process requires a significant amount of communication and coordination between the analysis and examination function to be effective. Analysts should identify and document all material current and prospective solvency risks and communicate those risks to the respective examiners for periodic onsite inspection.

Communication across functions is also discussed in more detail below (see Coordination in Risk-Focused Surveillance), as well as in Section I.A Department Organization and Communication of this Handbook.

At the conclusion of the basic holding company analysis performed on all groups, the lead state is required to document an overall summary and conclusion regarding the financial condition of the group, including its strengths and weaknesses and any risks identified. This summary and conclusion should be provided in the Group Profile Summary (GPS) that is maintained and updated on a regular basis. See the VI.B. for discussion of the GPS.

**Financial Examination Assessment**

Communication and/or coordination with other regulators are crucial when considering the financial condition of a group. There are various risks that the lead state may want to examine more closely through an on-site examination. The most common of such risks, or potential risk mitigators, is that which is derived from the group’s governance and risk management practices. Both of these are reviewed during a full-scope examination. This information is then communicated and shared with analysts, the lead state and other regulators as necessary. The lead state should also consider whether these areas, or components of each, should be examined more periodically. There may be several other areas where the lead state may want to consider a targeted exam with respect to the group. In considering such a targeted review, it is important to consider both the flexibility envisioned within the Model #390 for such reviews, as well as the work conducted during a full-scope examination.

The fundamental purposes of a full-scope financial condition examination report are: 1) to assess the financial condition of the company; and 2) to set forth findings of fact (together with citations of pertinent laws, regulations and rules) with regard to any material adverse findings disclosed by the examination. The report on examination is structured and written to communicate to regulatory officials’ examination findings of regulatory importance. Management letter comments are considered to be examination work papers and can be used to present results and observations noted during the examination. As it relates to groups, most of the examination work completed on a group basis is not expected to result in a report of examination, but rather is intended to communicate any concerns noted internally. In most cases, the work completed will merely inform analysts and other state regulators as it pertains to a particular area. However, to the extent the examiner witnesses practices that are noteworthy, and for which there is a need to pursue a change in such practices, a management letter may be produced. Such a management letter provides an opportunity to alert management that, if left uncorrected could ultimately lead to financial concerns.

Management letter comments generally contain the following information:

* A concise statement of the problem found
* The factors that caused or created the problem
* The materiality of the problem and its effect or potential effect on the financial statements
* The financial condition of the group
* The examiner’s recommendation to the group regarding what should be done to correct the problem.

The effectiveness of the financial examination process is enhanced if effective follow-up procedures have been established by the lead state. Periodically, after a financial examination report or management letter comment has been issued, inquiries should be made to the group to determine the extent to which corrective actions have been taken on report recommendations and findings. Because the examiners have usually moved on to another examination, many states use the financial analysts to perform this function. A lack of satisfactory corrective action by the group may be cause for further action.

The concept of risk in the risk-focused examination encompasses not only risk as of the examination date, but risks that extend or commence during the time in which the examination was conducted, and risks that are anticipated to arise or extend past the point of completion of the examination.

The risk-focused examination anticipates that risk assessment may extend through all seven phases of the examination.

* **Phase 1** – Understand the Company and Identify Key Functional Activities to be reviewed—This involves researching key business processes and business units.
* **Phase 2** – Identify and Assess Inherent Risk in Activities—These risks include credit, market, pricing/underwriting, reserving, liquidity, operational, legal, strategic and reputational.
* **Phase 3** – Identify and Evaluate Risk Mitigation Strategies/Controls—These strategies/controls include management oversight, policies and procedures, risk measurement, control monitoring, and compliance with laws.
* **Phase 4** – Determine Residual Risk—Once this risk is determined, the examiner can determine where to focus resources most effectively.
* **Phase 5** – Establish/Conduct Detail Examination Procedures—Upon completion of risk assessment, determine nature and extent of detail examination procedures to be performed.
* **Phase 6** – Update Prioritization and Supervisory Plan—Incorporate the material findings of the risk assessment and examination in the determination of the prioritization and supervisory plan.
* **Phase 7** – Draft Examination Report and Management Letter—Incorporate into the examination report and management letter the results and observations noted during the examination.

The goals of the risk-focused examinations can also apply to group-wide supervision and are as follows:

* Assessing the quality and reliability of corporate governance to identify, assess and manage the risk environment facing the insurer in order to identify current or prospective solvency risk areas. By understanding the corporate governance structure and assessing the “tone at the top,” the examiner will obtain information on the quality of guidance and oversight provided by the board of directors and the effectiveness of management, including the code of conduct established in cooperation with the board.
* Assessing the risks that a company’s surplus is materially misstated.

The procedures above are performed for purposes of completing a full-scope examination on an insurance legal entity. However, procedures related to governance and risk management can be performed at the group level when appropriate (See Section VI.B. for further discussion). In addition, for all other procedures, the states coordinate the examination of multiple insurance legal entities wherever possible. This typically involves identifying the systems that are common among members of the insurance group and only subjecting those common systems to one examination. This requires coordination among all domestic states and then further coordination in actually testing the particular system so that all domestic states can rely upon such work for their legal entity examinations.

Communication between analysts and examiners in preparation of an examination should include a thorough discussion of key risks, current and prospective. This communication and coordination may be best accomplished not only through written documentation but through face-to-face interaction. For example, the examiners and analysts should meet for pre-examination planning, conduct follow-up meetings/calls to discuss analysis of subsequent filings and finally meet at the end of the examination whereby examiners can communicate examination findings to analysts that in turn may help analysts focus on their next review.

**IAIG**: In addition to the general governance and risk management considerations and the targeted procedures related to specific concerns incorporated into financial examinations, there are additional considerations highlighted in ComFrame that may be appropriate for incorporation into ongoing IAIG financial exams led by the group-wide supervisor. These considerations generally relate to ComFrame elements that are more effectively evaluated through on-site examination activities, such as the effectiveness of corporate governance, risk management and internal control frameworks in place at the head of the IAIG. For more information on IAIG examination considerations, please see section XXX of the NAIC’s *Financial Condition Examiners Handbook*.

**Coordination in Risk-Focused Surveillance**

Most, but not all state insurance departments follow a staffing model whereby separate units are responsible for off-site financial analysis and on-site financial examination activities. Such a staffing model can lead to challenges in supervising insurance groups, if state departments do not emphasize the importance of communication and coordination across units. In some cases, financial examination activities are outsourced to third parties, which can lead to additional complications. To encourage effective coordination and communication across units, state insurance departments use the common language of branded risk classifications (see discussion above) to identify and assess insurance company risk exposures and incorporate this language into meetings and reports shared across units (i.e., GPS, ORSA Lead State Summary, Exam Summary Review Memorandum). In addition, formal meetings and ongoing communication between the two units (if separate) are required during the planning, fieldwork and wrap-up stages of each financial examination to ensure effective coordination. Similar requirements are also in place to promote communication and coordination between analysis/examination staff and any subject matter experts (i.e., actuaries, investment specialists, IT specialists, reinsurance specialists) that are supporting financial surveillance efforts.

**IAIG:** Given the level of complexity of many IAIGs and the critical need to ensure effective coordination in supervision, state insurance departments are encouraged to consider the benefits of customized approaches to financial surveillance staffing for IAIGs. For example, in some jurisdictions, both domestically and internationally, group-wide supervisors utilize a team-based approach to IAIG supervision whereby financial analysts, financial examiners, department supervisors and specialists (internal or external) are integrated into a single unit for purposes of group supervision. Such an approach can promote the use of a more well-rounded and integrated team of supervisors with different backgrounds and skillsets in reviewing group regulatory reporting, holding periodic meetings with the group, conducting group risk assessments, performing on-site inspections of group functions and leading ongoing supervisory college sessions. However, there may be other approaches to financial surveillance staffing that can be applied to address the nature and complexity of IAIGs. As such, state insurance departments acting as group-wide supervisors for IAIGs are encouraged to consider the benefits of more customized approaches to staffing in this area.

**Other Holding Company Specific Risks Addressed Directly in Regulation**

State insurance regulators have consistently reviewed and monitored groups through the Form B, Form D required filings, required dividend distributions and Form A acquisition. Insurers are required to submit Form D filings for management agreements, service contracts, tax allocation agreements, guarantees, loans and all cost-sharing arrangements. All such contracts must be submitted for regulatory approval to avoid the possibility of management moving cash out of the regulated entity, which is a risk that the business model for the insurance industry is susceptible to. It also includes reinsurance agreements, where there are similar opportunities and where there must be a regulatory review of such agreements to ascertain that risk transfer has occurred within the contract. The fact is that intragroup transactions and exposures are subject to potential abuse and state insurance regulators have addressed these risks directly in this way. Also, subject to review under Model #440 are “extraordinary dividends” and change in control, since again these transactions have the potential to pose risk to the insurance group and the insurer and its policyholders.

**Lead State Summary**

The Lead State Summary Report is located in iSite+, within Summary Reports, and provides a listing of all insurance groups and the companies within each group. The purpose of the report is to improve communication between regulators regarding group examinations. It can be sorted on a particular group code or group name to determine the lead state for that group or by state to view all of the insurance groups for which that state is the lead. The report also contains contact information for the department’s analyst and chief analyst for a particular insurance group and other information such as premiums, assets and latest exam information. States should actively update its contact information throughout the year as changes occur.

Within the Lead State Summary Report the user can view the Domestic Report, which displays each group that includes an insurer domiciled in the state selected by the user. The Consolidated Domicile Data report displays consolidated data (direct and gross premiums written and percentage distribution and net admitted assets) by state within each group. For more information on the lead state refer to VI.B.

The following diagram illustrates the risk assessment cycle:

