

Memorandum

To: Director Christina Urias, Chair of the Solvency Modernization Initiatives (EX) Task Force

From: Group Solvency Issues (EX) Working Group

Date: February 26, 2010

RE: Report to Solvency Modernization Initiative (EX) Task Force on Suggested “Windows and Walls” Approach for Regulation of United States Based Insurers Operating within Corporate Groups

Background:

In response to the recent global financial crisis, policymakers and international standard setting organizations are taking steps to improve the international financial services regulatory system and encourage coordination among supervisors. Several papers on oversight of corporate groups have been produced. The Solvency Modernization Initiative Task Force (“SMI”) of the National Association of Insurance Commissioners (“NAIC”) charged Group Solvency Issues Working Group (“GSIWG”) with studying the current state of play of US group supervision recommending needed enhancements to the oversight of U.S. based insurers operating within corporate groups¹. While the current prudential framework has served US policyholders well, the recent events in the global financial markets and the continued evolutionary developments of the insurance industry have challenged US regulators to reconsider some aspects of our framework to ensure that we continue to fulfill our regulatory mission.

Group structures permitted to hold US based insurers come in many different forms. These groups may include² unregulated entities as well as regulated entities, including financial services entities, within the same group holding company structure. Existing state insurance holding company laws do not differentiate between a group that is local in nature and one that is internationally active. An internationally active group might simply operate across jurisdictional borders while incorporating all entities under one jurisdiction; alternatively, a group might choose to organize entities in other jurisdictions and operate from many global bases.

In the US, group supervision and oversight is conducted primarily through licensed entities during the quarterly financial analysis monitoring efforts resulting from the implementation and execution of the Insurance Holding Company System Model Laws and Regulations (“IHC”). The US insurance regulatory system is often described as a “solo” or “legal” entity approach with oversight concentrated on the legal entity in contrast to the consolidated approach or hybrid approach found in other jurisdictions. However, upon a closer review, a “solo plus” regimen might be a more accurate description given that supervision of groups via monitoring efforts is taken into consideration by the licensing oversight, financial analysis and IHC model act and regulations. Additionally, woven into the US supervisory regime is a “lead” state concept for two or more insurers operating within a single group, but domiciled in different states, as well as a state regulator only coordinated communication forum called the Financial Analysis (E) Working Group (“FAWG”). FAWG provides an additional layer of surveillance for groups that supplements individual state insurance department’s solvency

¹ For purposes of convenience, references in this memorandum to a single insurer operating within a group will apply to multiple insurers operating within a single group, unless otherwise specifically noted.

² A few exceptions apply to certain types of entities held as subsidiaries of insurance legal entities in specific states.

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monitoring [Group considerations are also taken into account since an acquiring party is subject to a fitness test and scrutiny over its plans regarding the insurer it seeks to control.

In addition, and often overlooked, is existing authority to examine affiliates when information isn't forthcoming from an insurer. Under state IHCs, domestic regulators are required to review certain transactions between insurers and their affiliates to assure reasonableness. Most importantly, regulators must approve dividends and distribution payments in excess of a certain amount. During the recent financial crisis, the latter requirement proved to be the cornerstone protection for AIG policyholders.

Enhancements for Group-wide Supervision:

Despite the positive attributes of current insurance group regulation in the US, GSIWG recommends that the current group supervision efforts be enhanced in a few key areas. The US insurer solvency regime should consider incorporating certain prudential benefits of group supervision, providing a window into group operations, while building upon, rather than rejecting, the existing walls which provide solvency protection. Ultimately, this "windows and walls" approach should provide much needed breadth and scope enhancements to solvency regulation while retaining the highest level of policyholder protection that exists currently.

Specifically, GSIWG recommends regulatory windows be added to the current solvency regime, regardless of the multidimensional nature of the group.

1) Communication Between Regulators. Communication between regulators is the first and most important component of group supervision of regulated entities. Communication with the primary regulator is the key whether state, federal or located in another jurisdiction. At a minimum, this should occur on a bilateral "asked and answered approach." While states have entered Memoranda of Understandings (MOUs) with federal regulators, GSIWG recommends that state participation be coordinated on a similar national basis for sharing confidential information with international regulators.

If the level of scrutiny given to a regulated entity is heightened to a "troubled financial status", the level of communication should immediately be elevated from the "ask and answered" approach to a "proactive confidential communication." This could possibly occur through the existing or an enhanced Master MOU mechanism with federal regulators as well with international supervisors. The legal authority to elevate this communication to a required status might need to be fully examined and potentially clarified. In any event, it is recommended that steps be taken to ensure state regulators require confidential notification be made to federal regulators and international regulators regarding troubled insurers and that it occur on a proactive basis when the insurer is operating in a group with entities subject to federal or international oversight. In addition, a mechanism should be developed to encourage other functional and international regulators to have the authority to proactively reciprocate on this basis. They too should immediately notify insurance regulators of financially troubled entities within their jurisdiction to the extent such entities operate within a corporate group containing an insurer.

2) Supervisory Colleges. Supervisory colleges should be formally incorporated into regular review processes of internationally active groups via IHC enhancement and regulator best practices. These colleges collectively provide the best optics as well as provide clear channels of communication to be used to navigate through any potential financial crisis.

3) Access to and Collection of Information. Access to meaningful information about unregulated entities which include non-operating holding companies may represent a challenge for all regulators. The US group solvency structure should enhance broader access to information upstream and with regard to all holding company groups with regulated insurance entities and all affiliates in all tributaries. Licensing of holding companies may not be necessary if regulation can accomplish a centralized, regular, and confidential reporting mechanism by the holding company with information on all entities under its control. An overhaul of the Form B registration requirements may suffice.

Additionally, regulators should consider the feasibility of establishing the central collection of group consolidating financial statement information for certain holding companies.

4) Enforcement Measures. Clear regulatory tools should exist to protect the insurer and its' policyholders when violations occur. That said, registration of a holding company may not be required if jurisdiction over a holding company exists to ensure access to information. GSIWG recommends that penalties be increased and consequences be strengthened when information is not provided. Standards for transactions with affiliates should be clarified and strengthened, as should standards used to establish whether an entity is or is not in control of an insurer.

5) Group Capital Assessment. Effective group supervision should also provide a window with a panoramic vista of the group as a whole, thereby alerting regulators to double gearing and excessive leveraging. GSIWG recommends that the US group supervision process include a review and assessment of capital on a group basis, in addition to retaining separate capital requirements for the solo insurance entity. A panoramic view which includes group capital will not only help assess the risk of financial contagion within a group but will also position regulators to better assess and participate in dialogues on systemic risk involving the insurance sector as the insurance sector can be a recipient or conduit of systemic risk.

Group capital requirements, or at a minimum group capital assessment, is a matter of international import. Jurisdictions have differing objectives, resulting in vastly different approaches. If the objective is to establish group capital as a common international requirement for regulatory triggers, such objective would be neither realistic nor practical. A common requirement will likely not achieve meaningful information as many jurisdictions impose large variations in the required treatment of capital for regulatory action purposes. For instance, capital support by a parent holding company may be permitted in one jurisdiction partially in lieu of solo entity capital when the group is deemed a single economic unit. However such an approach would be readily rejected in another jurisdiction whether the barriers are imbedded in law, economics, or a simple matter of sovereignty. Therefore, a qualitative approach to the group as a whole would be recommended.

If, on the other hand, the objective of imposing a group capital requirement is to allow earlier detection of group implications in order to avoid potential financial and reputational contagion to other entities within the group or to the group as a whole, such a goal is achievable with a group capital requirement, insofar as the insurance group is concerned, in both a quantitative and qualitative approach. This objective is currently within the jurisdiction of state regulators. GSWIG recommends a group capital requirement be pursued to the extent it is confined to the latter objective.

6) Accreditation. The NAIC Financial Regulation Standards and Accreditation Program should consider a requirement to incorporate a Holding Company Analysis Review Team Guideline. The current language requires Holding Company Filings to be reviewed, but does not express the extent of the expectations on the degree of analysis taken with such documents (e.g. Form B).

Conclusion:

If these recommendations are incorporated into the existing US group solvency supervision structure, GSWIG believes such efforts will advance a strong US financial regulatory framework for insurers operating within groups into coordinated robust oversight by all supervisors with oversight responsibilities. GSWIG believes such efforts will enhance understanding of the potential implication of group financial and reputational risks on an insurer within the group.