National Association of Insurance Commissioners

Solvency Modernization Initiative[1]
Update as of January 2011

1. Under the leadership of Director Christina Urias (AZ), Chair of the Solvency Modernization Initiative (EX) Task Force, and James Wrynn (NY), Vice Chair, U.S. regulators will be embarking on some ambitious plans in 2011 for the Solvency Modernization Initiative (SMI). Director Urias said, "We have studied our solvency system and looked outside to see new developments in the supervisory world. Over-all, we are pleased with the risk-based system of surveillance we have built over the past 15-20 years. Going forward, SMI will focus on five key areas: capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance." She added, "We are always open to improving our policies, our procedures, and our processes and so we want to take a critical examination of what we do well and what we can improve on going forward – it is a forward-looking process."

2. The following describes key activities that have occurred to date and outlines the plans for 2011.

Group Solvency

3. In the wake of the recent financial crisis, Former Director Ann Frohman (NE) and Danny Saenz (TX) led the initial efforts to improve U.S. group supervision as co-chairs of the Group Solvency Issues (EX) Working Group. At the heart of the lessons learned from the recent financial crisis was the need for regulators to be able to assess the enterprise risk within a holding company system and its impact upon the insurers within that group. The Working Group recommended a "windows and walls" approach: clearer windows into group operations and enhancement of existing walls already included in our solvency protection regime.

4. In December 2010, the NAIC adopted the modified *Insurance Holding Company System Regulatory Act* (Model #440) and the *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions* (Model #450). These insurance holding company models apply to groups of two or more affiliated persons/organizations, at least one of which is an insurer. The new models still have the previous requirements including steps to acquire an insurer, commissioner approval of certain material transactions (e.g. large investment or reinsurance transactions) and extraordinary dividends, examination authority (of insurer and affiliates), and receivership authority. The modifications to the models include the following:

- Expansion on the ability to look at any entity within an insurance holding company system that may or may not affect the holding company system, but could pose reputational risk or financial risk to the insurer. The models enhance the "walls" established to protect the insurers within a group and open up the "windows," especially through an enterprise risk reporting requirement, to look into the holding company system.
- Enhancements to regulators rights to access information, especially regarding the examinations of affiliates and access to books and records to better ascertain the financial condition of the insurer and any enterprise risk within the insurance group. Require notification of investiture of controlling interest.
- Introduction of supervisory colleges within Act and identification of funding. While able to participate in supervisory colleges today, the Act and forthcoming documented best practices will enhance the US regulators ability to participate in supervisory colleges and will provide guidance on how to conduct and effectively contribute to and learn from colleges.
- Enhancements in corporate governance, Board of Director and Senior Management responsibilities – in line with the current NAIC Model Audit Rule and state laws and legal practices.
- Guidance on the disclaimer of affiliation filings which includes language regarding disallowance of a disclaimer of affiliation and an opportunity for an administrative hearing on those matters. Proposals for additional

[1] The Solvency Modernization Initiative (SMI) is a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation. The SMI focuses on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting & financial reporting, and reinsurance.

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standards for reviewing affiliated agreements to enhance minimum requirements. Generally found in the model regulation for cost sharing and management services, providing additional required terms and conditions, to assist regulators in determining whether transactions are fair and equitable to insurers.

5. In 2011 the new co-chairs of the Group Solvency Issues (EX) Working Group, Director John Huff (MO) and Danny Saenz (TX), plan the following activities:

- Accreditation – develop guidance for holding company financial analysis
- Holding Company and Supervisory Colleges Best Practices
- Group Capital assessments through the new "Own Risk and Solvency Assessment" tool

6. We adopted accreditation requirements with a 2012 effective date to expand the holding company review requirement to add specificity around the extent of expectations, and/or degree of analysis that should be undertaken. The appropriate depth and frequency of the analysis of a holding company of an insurer would depend on the sophistication, complexity, and financial strength of the holding company system or parts thereof. Analysis should include Forms A, B, C, D, and E and external filings such as SEC 10K or 10Q or financial reporting under International Financial Reporting Standards (IFRS). The Working Group will develop additional guidance for Accreditation review team members on how to evaluate the new guidelines.

7. Holding company and supervisory best practices documents have been drafted to provide guidance and best practices for use by state regulators in their regulatory oversight of insurance companies within holding company systems. Best practices include: (1) facilitating communication and coordination between cross boarder and other financial sector regulators and federal agencies; (2) uniform practices for the evaluation of mergers, acquisitions and control (including the coordination of form A reviews); (3) evaluation of form A exemptions and corporate governance policies; (4) review and approval of affiliated management and service agreements; and, (5) fair and equitable standards and best practices for participating in international supervisory colleges (including guidance on the coordination and communication of information to cross-border and other functional regulators). These best practices build upon the International Association of Insurance Supervisors' (IAIS) guidance paper on the use of supervisory colleges and group wide supervision which the Working Group endorsed in 2009. For supervisory colleges requesting U.S. participation, an international supervisor can use the NAIC web-based program that will then notify the lead state regulator to further coordinate U.S. participation in a college.

8. We investigated numerous approaches to group capital assessment, all of which could satisfy the IAIS insurance core principles used in the Financial Sector Assessment Program (FSAP). Approaches range from a group-level focus utilizing the assumption that group behavior is a single integrated entity to a legal-entity focus where group risks are assessed.

- In the "group level" focus a capital assessment can be made on the whole group, utilizing either a Consolidation Method or Aggregation Method, recognizing that risks for non-insurance members of the group require different assumptions and calculations.
    - The Working Group found the Consolidation Method has the advantage of eliminating double counting of intergroup holdings; however has a disadvantage in treating the group as one single entity, which it is not. The Consolidation Method requires one consolidated statement that may likely require re-valuation in some jurisdictions.
    - The Aggregation Method looks at each single entity and requires adjustments for intergroup holdings and, potentially, different valuation methodologies. Of the "group level" methodologies, the Aggregation Method was preferred because the individual risks and solvency levels at each single entity is evaluated in the calculation.
- In the "legal entity" focus, the insurance group is not considered as a single integrated entity, but rather a set of interdependent legal entities with each company having a capital requirement that accounts for its material risks arising from its group membership.

9. Current U.S. practice for group capital utilizes an aggregation method in RBC (limited to groups where the parent is an insurer) and group capital risks are considered during the annual Form B review (typically limited based on publicly available information). The Working Group considered a Group RBC but decided that: (1) group situations are significantly unique, so any formula would have to be complex; and, (2) we want to evaluate more than just capital in a

financial analysis. The Working Group is moving forward with a group capital assessment to incorporate into the SMI's new "Own Risk and Solvency Assessment (ORSA)" requirements.

Capital Requirements

10. Capital requirements in the U.S. have been risk-based for more than a decade, with the initial life insurance risk-based capital (RBC) formula implemented in 1993. Numerous improvements have been implemented in the RBC formulas over time, with most recent changes including development of scenario modeling for life insurance interest and market risk ("C-3" risk).

11. RBC will continue to be a component in the U.S. solvency regulation legal framework in order to maintain a floor for triggering regulatory intervention. We will continue to calibrate RBC to identify "weakly capitalized companies" and not to represent the economic target levels of capital that a company should hold. Regulators are conducting a holistic evaluation of the RBC formulas, factors, and methodology.

12. In 2011 the Capital Adequacy (E) Task Force's SMI RBC Subgroup, under leadership of Alan Seeley (NM) is focusing on the following priority issues:
    - Identification of the calibration strategy for the risk-based capital formulas.
    - Improvements to RBC formulas, including implementation of missing risk charges (e.g. property/casualty catastrophe risk, life insurance derivatives risk mitigation).
    - Improvements to the correlation/covariance methodology used in the current RBC formulas.

13. The American Academy of Actuaries ("Academy"), the Capital Initiatives Work Group (a life insurance industry group), and others are providing significant assistance in this area. The Academy is expected to document safety level calibrations and identify any missing risks in the current RBC formulas soon. The NAIC has also requested the Academy (1) list practical alternatives including the strengths and weaknesses for different time horizons, safety levels and risk metrics related to calibration of the RBC formula by mid 2011; and, (2) recommend improvement to the correlation/covariance methodology in 2011.

Governance and Risk Management

14. Under the leadership of Andrew Stolfi (IL), the Corporate Governance (EX) Working Group studied existing state corporate governance law, including case law, to understand the legal framework applicable to insurers. The Working Group also developed a summary of corporate governance principles and standards placed upon insurers worldwide, including information from the IAIS, Australia, Canada, Switzerland and the U.K.

15. In 2011, the Working Group will move forward with its primary charge of outlining high-level corporate governance principles for use in U.S. insurance regulation, considering governance work from other Working Groups. We expect a first draft at the Spring National Meeting.

16. Director Urias has led the efforts of the International Solvency (EX) Working Group in exploring the risk management requirements in the U.S. solvency framework. We currently perform certain elements of risk management evaluation in the enhanced risk-focused surveillance process, including risk assessment and risk management or mitigation. Regulators drafted a consultation paper and discussed risk management reporting and quantification requirements (e.g. ERM/ORSA[2]-type tool) in light of risk management supervisory tools (e.g. periodic risk reporting, stress tests, and prospective solvency assessment) under development worldwide.

17. In 2011, the Working Group will develop a U.S. ORSA (Own Risk and Solvency Assessment), in cooperation with the Corporate Governance (EX) Working Group and the Group Solvency Issues (EX) Working Group, to incorporate IAIS insurance core principles and to explore the company's and/or group's risk management process, including a prospective look at solvency, and the company's ability to withstand stresses. The ORSA proposal will align regulatory requirements with business practices. We expect a first draft in February 2011 and exposure and discussion of comments at the Spring National Meeting.

[2]ERM stands for "Enterprise Risk Management"; ORSA stands for "Own Risk and Solvency Assessment"

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Statutory Accounting & Financial Reporting (including Valuation)

Valuation (Principles-Based Reserving)

18. Statutory accounting for life insurance reserves ("valuation") is not yet principles-based, as it is for other lines of business. The NAIC adopted the *Standard Valuation Law* (Model #820) in late 2009, which includes a draft Valuation Manual (approved in 2010) subject to a 2011 industry study.

19. The industry study will provide quantitative information to analyze the Valuation Manual requirements.

    - In the life PBR (VM-20), focus will be on: (1) the minimum net premium reserve in the life PBR, a formula-based reserve with all of the variables prescribed (similar to the current formula reserves and included upon ACLI's request); and, (2) the default costs and reinvestment rate spread methodology implemented to remove incentive to invest in riskier assets with higher yields that would result in lower reserves. (Note that earlier prescriptive requirements such as prescribing two sets of stochastic scenarios, margins in the mortality, lapse, and other assumptions have already been removed from the methodology.)
    - For variable annuities with guarantees (AG 43), focus will be on the seriatim minimum reserve called the standard scenario (developed by New York and supported by the ACLI) that uses prescribed discount rates, limits revenue sharing income and disallows dynamic hedging.

20. Towers Watson should provide some initial findings in March 2011 and complete the industry study this summer, in time for modification(s) to the Valuation Manual for adoption. The aim is for the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force, under the leadership of Leslie Jones (SC) and Steve Ostlund (AL), respectively, to adopt a manual in 2011.

21. We will need to collect industry statistics to utilize principles-based reserving, and a statistical agent(s) will need to provide regulators and the industry with statistical information once principle-based reserving is effective. We expect policy decisions regarding statistical agents in 2011 and Commissioner Adam Hamm (ND) will lead this effort.

Future of Statutory Accounting & Financial Reporting

22. In 2010, regulators discussed potential policy decisions about the future of statutory accounting and the financial reporting system (SAP), with an aim to do the following:

    - Document the purpose of statutory accounting in the insurance solvency regulation framework.
    - Develop a policy position and recommendation regarding International Financial Reporting Standards (IFRS) and its inclusion in, or exclusion from the insurance solvency regulation framework.
    - Develop a policy position recommendation to address the regulatory impacts of non-regulatory uses of statutory financial statements.

23. The current statutory accounting system already includes consideration of any new Generally Accepted Accounting Principles (GAAP) pronouncements, whereby we reject, adopt, or modify GAAP changes for implementation into statutory accounting. Some GAAP pronouncements have already been issued as a result of agreed convergence between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Even with this process in place, commissioners have decided they need to formulate a policy decision about our future approach.

24. In 2010, NAIC staff drafted a "Primary Considerations Document" to identify the continuum of policy options. After discussion with interested parties, it became clear that there are two main concerns: (1) the industry did not believe we should make a decision until the SEC made a decision on IFRS, and also until completion of the IASB Insurance Contracts Project; and, (2) some regulators were concerned about giving up regulatory control to the IASB or FASB. Based on this feedback, Director Urias has decided to monitor ongoing developments and postpone further discussions and decisions until the IAIS insurance core principle for valuation and the IASB, FASB, and the Securities Exchange Commission (SEC) reach their decisions. Mel Anderson (AR) chairs the SMI's International Accounting Working Group and leads the NAIC efforts in this area, including providing detailed comments to the IAIS, IASB and FASB on their extensive and on-going exposure drafts and discussion papers on these complex issues.

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Reinsurance

25. The NAIC adopted the Reinsurance Regulatory Modernization Framework proposal (Reinsurance Framework), during its 2008 Winter National Meeting. The Reinsurance (E) Task Force developed this conceptual framework in response to its charges to consider: (1) the current collateralization requirements regarding unauthorized reinsurers; and, (2) a revised and modernized U.S. reinsurance regulatory framework intended to facilitate cross-border reinsurance transactions and enhance competition within the U.S. market, while ensuring that U.S. insurers and policyholders are adequately protected against the risk of insolvency.

26. The Reinsurance Framework recommended implementation through federal legislation in order to best preserve and improve state-based regulation of reinsurance, ensure timely and uniform implementation of this legislation throughout all NAIC member jurisdictions, and as a more comprehensive alternative to related federal legislation. Throughout 2009, the Reinsurance Task Force developed federal legislation intended to implement the Reinsurance Framework. In September of 2009, the NAIC Government Relations Leadership Council approved the Reinsurance Regulatory Modernization Act, and agreed to submit the draft federal legislation to Congress for its further action. Unfortunately, the NAIC has been unable to procure congressional sponsorship for this proposed legislation.

27. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was signed into law on July 21st. This Act includes the Nonadmitted and Reinsurance Reform Act (NRRA), as well as creates the Federal Insurance Office (FIO) within the U.S. Department of the Treasury. With respect to reinsurance, the NRRA prohibits a state from denying credit for reinsurance if the domiciliary state of the ceding insurer recognizes such credit and is: (1) an NAIC-accredited state; or, (2) has financial solvency requirements substantially similar to NAIC accreditation requirements. It also preempts the extraterritorial application of a non-domiciliary state's laws, regulations, or other actions (with certain limitations), and it reserves to a reinsurer's domiciliary state sole responsibility for regulating the reinsurer's financial solvency. Finally, it prohibits any other state from requiring a reinsurer to provide financial information in addition to that required by its NAIC-compliant domiciliary state.

28. In light of these developments, some states are now expressing an interest in moving forward with individual state-based reinsurance collateral reduction reforms. Florida adopted changes to its credit for reinsurance laws and regulations in 2007, and has recently approved several reinsurers for reduced collateral requirements. New York adopted changes to its credit for reinsurance regulations in November 2010, and recently approved Hannover Re for reduced collateral requirements. In December the NAIC Plenary approved Recommendations Regarding Key Elements of the Reinsurance Framework for Accreditation Purposes. To clarify, the Recommendations are not a change to the current NAIC accreditation standards regarding reinsurance collateral; however, it may be used by the Financial Regulation Standards and Accreditation (F) Committee when reviewing any individual state reforms to reduce reinsurance collateral.

29. The Reinsurance (E) Task Force, chaired by Commissioner Thomas B. Considine (NJ), will 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 by the 2011 Fall National Meeting. The Task Force will also begin to develop a process by which the NAIC will review the reinsurance supervisory systems of non-U.S. jurisdictions in order to determine which jurisdictions should be recommended to the states as qualified non-U.S. jurisdictions.

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International SMI-related Activities

30. The NAIC and each state is a member of the International Association of Insurance Supervisors (IAIS), representing U.S. positions, working collectively with the international supervisory community, and assisting in the development of agreed best practices for a regulatory/supervisory framework. The SMI Task Force and its Working Groups are charged to monitor financial, solvency, and accounting IAIS work products and recommend whether and/or how we should implement the ideas in those papers in the U.S. regulatory solvency system.

31. In 2011 the NAIC will assist in the following IAIS goals, as established by the IAIS Executive Committee:

- *Standard setting*
  - Promote effective and transparent supervision of insurance markets through global, sustainable and coherent supervisory principles, standards and guidance, while minimising opportunities for regulatory arbitrage.
- *Standard implementation*
  - Promote the development of fair, safe and stable insurance markets through the implementation of supervisory principles, standards and guidance, the assessment of their implementation, and cooperation among insurance supervisors.
- *Financial and insurance market stability*
  - Contribute to global financial stability and foster stable insurance markets for the protection of policyholders.
- *External interaction*
  - Optimise the achievement of IAIS objectives and achieve recognition as the thought leader for insurance supervision by engaging with and managing relationships with external bodies.
- *Effectiveness and efficiency*
  - Enhance and maintain effectiveness and efficiency of the IAIS.

Additional Information

For additional information about the SMI, see the SMI web page at http://www.naic.org/index_smi.htm.

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