Testimony of the
National Association of Insurance Commissioners

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On Behalf of the National Association of Insurance Commissioners

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Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for the opportunity to testify this morning. My name is Sean Dilweg, and I am Commissioner of Insurance for the State of Wisconsin. I am also a member of the National Association of Insurance Commissioners, and I am joining my colleague from Nebraska, Director Ann Frohman, in testifying today on the NAIC's behalf.

The purpose of my testimony is to provide insight on how state insurance regulators assess the financial strength of an insurer, and to describe our unique regulatory working groups that assist and improve this assessment; in particular, the NAIC Financial Analysis Working Group (FAWG). As Director Frohman discussed in the context of our approach to group supervision, financial regulation is a critical component that ensures our most important consumer protection: *solvency*. That basic concept guarantees that damaged automobiles are repaired, that annuity payments arrive in the mail on-time, and that families hit by natural disasters can rebuild and recover. Through the NAIC, regulators have created three core solvency surveillance mechanisms – reporting, analysis, and examination – to ensure that these obligations to policyholders, claimants, contract holders, and other parties are met both today and in the future. In our unique system of state regulation, it is imperative that regulators around the country have access to these sophisticated tools, particularly when assessing large, multi-state insurers.

In order to ensure a strong and consistent level of solvency supervision around the country, NAIC members have developed an accreditation system, called the Financial Standards and Accreditation Program ("Accreditation Program"). The NAIC Accreditation Program is the cornerstone of our prudential supervision of insurers, and has set a baseline standard for effective solvency regulatory systems, while also allowing for inter-state cooperation and reducing regulatory redundancies. Among other things, this program assures that accredited states have sufficient authority to regulate the solvency of the multi-state domestic industry. All 50 states are currently accredited.

To be accredited, a state is required to conduct quarterly financial analyses on their domiciliary multi-state insurers. Most states conduct such oversight on their single-state insurers as well. Typically, insurers with anomalous results, or those that have been previously identified for attention, are subject to additional analysis.

An insurer's domiciliary state is relied upon as the primary solvency regulator for the states in which the domestic insurer is licensed to transact business. When there are concerns about the financial condition of an insurer, or when significant transactions take place, communications between the domiciliary state and the other states in which the company is licensed are increased. However, any state in which a company is licensed to conduct insurance business may perform its own monitoring, including financial analysis and examinations, and take regulatory action as appropriate.

I am here today to speak with you about three NAIC working groups that assist states with the three core solvency surveillance mechanisms – the Financial Analysis Research and Development Working Group, the Financial Analysis Handbook Working Group, and the Financial Analysis Working Group. The products generated by the first two groups provide tools and resources that supplement individual state regulatory efforts. The system of checks and balances established by the third group, the Financial Analysis Working Group, offers a layer of peer review for each regulator's solvency monitoring efforts, thus ensuring that judgments regarding a company's financial health are improved or enhanced by experienced state regulator colleagues. All three working groups are funded directly by the NAIC's operating budget each year.

The combined effort of these three working groups serves as a foundation of valuable financial solvency support and analysis that the NAIC provides to state insurance regulators. Due to the strong regulatory heritage in Wisconsin and its strong confidentiality laws, all three of these working groups are chaired out of my home state of Wisconsin.

The Financial Analysis Research and Development Working Group

The NAIC Financial Analysis Research and Development Working Group is responsible for our Financial Analysis Solvency Tools (FAST), a collection of analytical solvency tools and databases designed to provide state insurance departments with an integrated approach to reviewing the financial condition of insurers operating in their respective states. FAST is intended to assist regulators in prioritizing resources to those insurers in greatest need of regulatory attention.

The following are three key tools within the FAST System:

1. **Insurance Regulatory Information System (IRIS)**: IRIS has served as a baseline solvency screening system for the NAIC and state regulators since the mid-1970s. Its first, "statistical phase" involves calculating a series of confidential financial ratios for each insurer based on statutory annual statement data. Because the ratios by themselves are not indicative of adverse financial conditions, an experienced team of state insurance examiners and analysts then reviews the IRIS ratio results and various other financial information through the second "analytical phase."

   In this second phase, the Analyst Team meets to identify insurers that appear to require immediate regulatory attention, through the review of a computer-selected priority listing of insurers that may be experiencing weak or declining financial results. The team then validates the listing based on further analysis of those companies, and provides a brief synopsis of its findings in a document that can be accessed only by state insurance regulators and authorized NAIC staff.

2. **Scoring System**: The NAIC Scoring System is based on several financial ratios and is similar in concept to IRIS ratios, but provides results for both an annual and a quarterly basis. The Scoring System also includes a broader range of financial ratios, and assigns a score to each ratio based on the level of solvency concern each result generates. As with the IRIS results, the Scoring System results and scores are available only to state insurance regulators and authorized NAIC staff.

3. **Insurer Profiles System**: Finally, the Insurer Profiles System produces quarterly and annual profiles on property and casualty, life, health and fraternal insurers. These profiles provide either a quarterly or an annual five-year summary of a company's financial position. The Insurer Profile reports provide not only a snapshot of the company's statutory financial statement, but also include analytical tools such as financial ratios and industry aggregate information that can be used in an analyst's review of the company. Insurer Profile reports can assist state insurance department analysts in identifying unusual fluctuations, trends or changes in the mix of an insurer's assets, liabilities, capital and surplus, and operations.

The Financial Analysis Handbook Working Group

The *Financial Analysis Handbook* was developed by the Financial Analysis Handbook Working Group of the Examination Oversight Task Force in 1997. It is available in separate Life/Health, Property/Casualty and Health editions. The *Handbook* is a dynamic document; the Financial Analysis Handbook Working Group meets regularly to review the *Handbook* contents and to revise its guidance as necessary.

Most states use the *Handbook* in completing or supplementing their routine solvency analysis; the guide uses a stair-step approach that directs analysts to perform more in-depth analysis commensurate with the financial strength, prospective risks and complexity of each insurer. The *Handbook* requires regulators to use many analytical tools, databases and processes in completing their quarterly analysis of insurers (such as ratio analysis and review of the actuarial opinion, audited statutory financial statements, holding company filings, and the management discussions and analysis filings).

The *Handbook* provides a means for insurance departments to more accurately identify companies experiencing financial problems or posing the greatest potential for developing such problems. Furthermore, the *Handbook* provides guidance for insurance departments to define and evaluate particular areas of concern in troubled companies.

The overall goal of the *Handbook* is to better enable regulators to identify potential adverse financial indicators earlier, evaluate and understand such problems more effectively, and develop appropriate corrective action plans sooner, thus potentially decreasing the frequency and severity of insurance company insolvencies.

The Financial Analysis Working Group (FAWG)

For over a decade, state insurance financial regulators have shared information and ideas through the NAIC Financial Analysis Working Group (FAWG), which exists to identify, discuss, and monitor potentially troubled insurers and insurance groups that are typically of national significance (a classification that can change as needed, but considers the size of the company or group's premium volume combined with the number of states in which it writes business – this includes insurers that write the majority of insurance in the U.S.). FAWG leverages the expertise of select chief financial regulators from around the U.S. to provide an additional layer of solvency assessment. FAWG also identifies market trends and emerging financial issues in the insurance sector.

While FAWG does not have specific regulatory authority, no state has ever turned down a recommendation made by this working group. This reality may be because our system of supervision fosters a healthy peer review that results in a pressure to be diligent and vigilant as a domiciliary regulator – as each state where a company is licensed has the authority to act on a FAWG recommendation if the domiciliary state regulator does not.

FAWG's mission is focused around three themes:

1. Identify nationally significant insurers / groups that exhibit characteristics of trending towards financial trouble.

2. Interact with domiciliary regulators and lead states in order to assist and advise on appropriate regulatory strategies, methods, and actions.

3. Encourage, promote and support coordinated, multi-state efforts in addressing solvency issues.

FAWG's review of companies can be described generally, though not exclusively, as:

- Identify companies that are outliers when compared with benchmarks of the industry market segment. However, some companies may be referred to FAWG from other state insurance regulators.

- Develop communication for the financial staff and commissioner for the state of domicile for the insurer/group under review. This includes a description of the issue, questions, and suggestions on regulatory options.

- Review of domestic or lead state regulator responses on issues identified and questions raised.

- Consider whether responses identify a need to follow up with regulators – including a presentation by the domiciled regulator to FAWG and other regulators.

- Consider whether to request the formation of a subgroup of FAWG for certain insurers or groups to facilitate regular communication and collaboration with applicable regulators. However, states generally proactively communicate with the most relevant regulators for each situation on their own.

FAWG's membership is comprised of 16 financial regulators representing the four regional zones of the NAIC (the Midwest, the Northeast, the Southeast, and the Western); current members hail from California, Connecticut, Delaware, Florida, Illinois, Massachusetts, Minnesota, New Jersey, New York, Ohio, Pennsylvania, Texas, and Wisconsin. Since the analysis done by the working group is highly technical and requires significant experience and judgment, members are only accepted into the group after meeting specific experience and skill standards. Members are specifically not the insurance commissioners or lead regulators in the states, but rather experienced senior staff employees – a structure that provides the hands-on experience necessary to best evaluate issues while lessening the potential for any political influence. FAWG members meet during NAIC national meetings and each spring to review the

NAIC's financial analysis of insurers for the year; these forums are open to regulators from all 50 states.

FAWG evolved from reliance upon members' personal knowledge of troubled companies, and led to the creation and development of sophisticated and comprehensive financial tools and benchmarks through data management. The data benchmarks encapsulate various categories, including leverage, asset quality, liquidity, and operations. In fact, the data analysis and methods used by FAWG help develop concepts and questions that are incorporated into the *NAIC Financial Analysis Handbook* each year, as well as into the *NAIC Troubled Insurance Company Handbook* as needed.

Through the FAWG forum, individual states work together to support and guide fellow regulators for the benefit of the whole in an entirely open and confidential process. The working group also reviews and considers trends occurring within the industry, often concentrating on a particular segment of the market, product, exposure, or other problem that has the potential of impacting the solvency of the overall industry. For example, FAWG directed NAIC staff to inform all domiciliary regulators of the investment holdings of their insurers regarding mortgage-backed securities and troubled firms such as Lehman Brothers in a very timely manner for these issues. The group also suggested additional stress testing for variable annuity writers in 2009. In some cases, such discussions lead to more focused work among specific states.

Coordination with Federal Agencies

In terms of coordination with other agencies, state regulators (including members of FAWG) and NAIC staff regularly engage in both formal and informal dialogues with federal regulators at the Office of Thrift Supervision (OTS) and the Federal Reserve (the "Fed"). Just 48 hours ago, in fact, the NAIC participated in a quarterly meeting of the NAIC-Federal Banking and Thrift Regulatory Agencies Insurance Liaisons, which includes representatives from the Federal Reserve and OTS, to review the 2009 financial condition of the insurance sector, among other topics.

Furthermore, pursuant to the Gramm-Leach-Bliley Act (GLBA), each state has a number of Memoranda of Understanding agreements in place for information sharing with federal regulators at the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve. Following passage of GLBA, the Fed has also organized periodic cross-sector meetings in which a state insurance regulator is typically invited to participate. Several representatives from these federal agencies attend our thrice-annual National Meetings, where the majority of our work is accomplished each year. Additionally, through the NAIC, state regulators have access to an enormous amount of aggregate data and information about the insurance sector, and we routinely provide ad-hoc reports to federal agencies on the financial condition of the industry or a sector.

Conclusion

As a state-based system of regulation, we are keenly aware of our unique structure, and have developed tools such as Accreditation and FAWG to ensure that we are effectively and efficiently maximizing our resources to protect consumers and the solvency of our regulated entities. Clearly, there are a number of coordinated resources for state insurance regulators to assess the financial strength and condition of insurers – both small single-state insurers, and large multi-state groups. Our system is embedded in an accreditation program adopted by all states, and requires peer-review to verify the consistency and integrity of our supervisory approach.

While the recent financial crisis has dramatically illustrated that regulators can and will make mistakes, it is important that we seek a structure that minimizes the impact and opportunity for such mistakes. We believe, and history has shown, that the inherent checks and balances of our multi-state approach to group supervision and financial assessment minimizes the potential of significant problems falling through the cracks. Indeed, we see elements of this embedded in federal reforms, such as the "council" approach to systemic supervision. As the NAIC and its members improve our approach to supervising insurance holding companies and groups, these tools must be incorporated, and if necessary, improved to continue their role. In the context of increasingly large and interconnected financial institutions, this has never been more important.

Thank you for the opportunity to testify, and I look forward to your questions.