NAIC Solvency Activities Review

State Government Representative Webinar

June 4, 2009

Opening Comments

NAIC President,

Commissioner Roger A. Sevigny

New Hampshire Department of Insurance

Accounting and Reporting

Deputy Commissioner
Ramon Calderon

California Department of Insurance

Statutory Accounting Principles

- Addresses specific needs of insurance regulators
  - Regulate insurance companies to assess solvency for the protection of policyholders
  - Ensure that policyholder, contract holder and other legal obligations are met when they come due.
  - Ensure that companies maintain capital and surplus at all times and in such forms to provide an adequate margin of safety.

Concepts of Statutory Accounting Principles

- Conservatism
  - Margin of protection for policyholders
  - Use when developing estimates and in developing statutory accounting principles
- Consistency
  - Meaningful, comparable financial information
- Recognition
  - Assets- only if can be used to pay claims
  - Liabilities- as incurred
  - Revenue - as the earning process is complete

Establishment of SAP

- Statutory Accounting Principles Utilize the GAAP Framework

- GAAP Pronouncements are considered for SAP:
  - Adoption
  - Adoption with Modification
  - Rejection

- GAAP pronouncements do not become part of statutory accounting principles until and unless adopted by statutory accounting.

Statutory Accounting and Reporting

- Accounting Practices and Procedures Manual, along with specific state regulations, contains most authoritative statutory accounting guidance
- Prescribed format for reporting in accordance with specific line of business
- Ongoing review and assessment of statutory accounting guidance

FDR Database

- About 4,800 Insurers File per Year
- 10 Years of Annual and Quarterly Financial Statement Data Maintained
  - Regulators Have Full Access
  - Public Access
    - Basic Annual Statement Financial Profile available to public for current year
    - Financial Statement PDF's available for current year

Financial Analysis

Commissioner Sean Dilweg

Wisconsin Office of the Commissioner of Insurance

Presentation Overview

- Financial Analysis Overview
- Typical Duties of Financial Analysts
- Priority Based Reviews
- Use of the NAIC Financial Analysis Handbook
- Mechanics of Financial Analysis

Financial Analysis Overview

- Regulators have enhanced their solvency monitoring activities to facilitate more timely regulatory action against troubled insurers
- Financial analysis occurs <u>every</u> quarter on all multi-state insurers within each state
- States prioritize the review of their domiciliary companies to ensure potentially troubled companies are reviewed promptly
- Most states perform some limited analysis on foreign and alien insurers operating within their state

Financial Analysis Overview

- Depth of the analysis will depend on the complexity and the financial strength of the insurer and the existing or potential issues and problems found during review of the financial statements
- At a minimum the following must be analyzed:
  - Annual and quarterly financial statements
  - Actuarial opinion
  - Management's discussion and analysis
  - Audited CPA report
  - Holding company filings
  - Financial ratios

Financial Analysis Overview

- Group holding company analysis is a standard part of the financial analysis process as outlined in the *NAIC's Financial Analysis Handbook*
  - Includes reviewing the upstream and downstream holding company entities (both financial or non-financial entities)
  - Understanding the structure, affiliated relationships, financial condition, management, etc.
  - Utilizing public available information, such as SEC filings, international filings
  - Requests for additional non-public information can be made pursuant to holding company laws

Typical Duties of A Financial Analyst

- Collection and analysis of insurer and group financial information
- Desk audits to assess risk and compliance
- Review of non-financial information regarding insurance companies
- Determining regulatory courses of action regarding identified troubled insurance companies
- Evaluating and monitoring corrective plans
- Communicating results of regulatory actions

Priority-Based Review

- Financial analysis procedures are priority based to ensure that potential problem companies are reviewed first and promptly
- State prioritization schemes utilize appropriate factors as guidelines to assist in the consistent determination of priority designations
- Justification for priority, and any change in priority, is documented each quarter
- Change in priority ranking should be approved by the appropriate supervisor

Priority-Based Review

- Timing of Analysis
  Assuming a March 1st financial statement deadline, priority insurers should have their annual review performed by the end of April and the non-priority insurers completed by the end of June

  The date by which the Department should finish its analysis of the annual statements depends in part upon the size and complexity of the domestic industry

Use of the NAIC Financial Analysis Handbook

- All states utilize the Handbook
- Purpose: to assist regulators in performing risk focused financial analysis of insurance companies in a consistent and uniform manner
- Provides qualitative and quantitative analysis techniques
- Prompts the analyst to conduct more in-depth analysis based upon risk factors
- Includes automated calculations for quantitative questions to increase efficiency

Mechanics of Financial Analysis

- Analysts use history to understand specific causes for insolvencies and then tailor their analysis accordingly, e.g., **deficient reserves, fraud**
- Analysts look for prospective risks, e.g., trends or dramatic changes in: premiums, business lines written, or number of complaints
- Financial analysts will utilize regulator only and public automated analytical tools designed to provide an integrated approach to screening, prioritization and analyzing the financial condition of insurers

Financial Examinations

Director Mary Jo Hudson

Ohio Department of Insurance

Protecting the Public Interest

- Evaluate insurer risk and detect any potential financial trouble.
- Verify compliance with state statutes and regulations.
- Compile information for timely, appropriate regulatory action.

Law on Examinations

- Conducted once every 5 years
  - Some state statutes require more frequent exams
- A state may accept an examination report on a company prepared by the company's state of domicile if:
  1. The state department was accredited at the time of the exam; or
  2. The exam was performed under the supervision of an accredited insurance department or by at least one examiner who is employed by an accredited department.

Law on Examinations

State laws and Accreditation guidelines require examinations to be conducted in accordance with policies and procedures included in the NAIC *Financial Condition Examiners Handbook*.

Risk-Focused Examination

PLANNING PHASES:

- Phase 1 – Understand the Company and Identify Key Functional Activities to be Reviewed
- Phase 2 – Identify and Assess Inherent Risks in Activities
- Phase 3 – Identify and Evaluate Risk Mitigation Strategies/Controls
- Phase 4 – Determine Residual Risk

Risk-Focused Examination

- Phase 5 – Establish/Conduct Exam Procedures
- Phase 6 – Update Prioritization and Supervisory Plan
- Phase 7 – Draft Exam Report and Management Letter Based on Findings

Additional Regulatory Actions

- Limited scope exams
- Hearings/conferences
- Implement corrective plan
- Restrict activities
- Impairment notice
- Cease and desist order (suspension)
- Supervision

Coordinating Activities

Dr. Terri Vaughan
CEO

National Association of Insurance Commissioners

Presentation Overview

- General Overview
- Accreditation and Coordination
- Financial Analysis Working Group
- Lead State Role
- Coordinated Examinations

General Overview

- NAIC Committee Actions
  - Coordinated establishment of model laws, accounting and reporting requirements, and analysis and examination procedures for the U.S. Solvency Framework
  - Coordinated responses to IAIS and other international organizations regarding solvency papers and work products
  - Coordinate with functional regulators
    - NAIC has quarterly meetings with Federal Banking and Thrift Regulatory Agencies
- State Insurance Regulators Participate in Supervisory Colleges

Coordination and the Accreditation Program

- NAIC Accreditation Program requires coordination on several levels
  - Statutory authority required to share confidential information
  - Statutory authority required to keep information confidential
  - State should make reasonable effort to respond to inquiries
  - State required to communicate with other states once insurer identified as troubled or potentially troubled

Financial Analysis Working Group

FAWG Mission

- Identify nationally significant insurers and groups that exhibit characteristics of trending towards or being financially troubled and determine if appropriate action and communication is being taken.
- Interact with domiciliary regulators and lead states to assist and advise as to what may be the most appropriate regulatory strategies, methods, and action(s).
- Encourage, promote and support coordinated multi-state efforts in addressing solvency problems, and assist in sharing information between states.

Financial Analysis Overview

- This Working Group creates a forum for state insurance regulators to identify, discuss and monitor potentially troubled insurers that are of national significance
- The Working Group meets on a routine basis with the intent of adding further strength to the states' financial monitoring system
- Although the insurers identified by the Working Group have usually already been identified by the respective states as being potentially troubled, the Working Group enhances the states' process by sharing ideas, experience and strategies on how to assist the state of domicile
- Discussions between the Working Group and the state of domicile are open to the other states where the insurer is licensed which, will allow different perspectives to be shared

Financial Analysis Overview

- The Working Group also reviews and considers trends occurring within the industry to concentrate their efforts on more specific issues, such as a particular segment of the market, product, exposure or other problem that has the potential of impacting the solvency of the industry
- In some cases these discussions lead to more focused discussions by specific states, as well as with other functional regulators or regulators of other insurers in other countries

Lead State Role

- The concept of a lead state is used to help states coordinate regulatory activities in their review of insurance groups
- The passage of the Gramm-Leach-Bliley Act (GLBA) stresses the importance of a lead state.
  - It may be necessary for other financial regulators, including the Federal Reserve Bank and other federal and state banking agencies and securities regulators, to identify a central point of contact
  - This allows for effective and efficient communication with the state regulators.
- The concept of a lead state is not intended to relinquish the authority of any state, nor is it intended to increase any state's statutory authority or to put any state at a disadvantage
- It facilitates efficiencies by using one or more states to coordinate the regulatory processes of all states involved

Lead State Approach to Exams

- Coordination
  - Call a group examination
  - Improve communication and exam efficiencies
  - Organize and allocate work-load (exam procedures) with clear responsibilities of each exam participant
  - Coordinate the utilization of specialists

Examination Coordination

- Risk-Focused Exams
  - Increased exam coordination between states
    - Corporate Governance & Interviews
    - Internal Controls
  - Formation of Financial Examiners Coordination Working Group

Financial Regulation Standards and Accreditation Program

Superintendent Joseph Torti

Rhode Island Insurance Division

Development of the Accreditation Program

- High number of insurance company insolvencies in mid to late 1980s
- Congressional inquiry began in 1988
- Congressional report “Failed Promises” issued in 1990
- Accreditation standards were adopted in 1989
- First two states accredited in December 1990

Financial Regulation Standards and Accreditation Program

- This is a voluntary program
- Currently, 49 states plus the District of Columbia are accredited
- Focus is on a state's domestic insurers that write business or are licensed in other states
- In order to be accredited, the state must meet established minimum baseline accreditation standards

What are the Accreditation Standards?

- Financial Regulation Standards
  - Part A: Laws & Regulations
  - Part B: Regulatory Practices & Procedures
  - Part C: Organizational & Personnel Practices

Part A: Laws and Regulations

- States must adopt certain laws and regulations for solvency
- These laws provide the insurance department with the regulatory authority it needs to adequately monitor the financial solvency of its domestic insurers
- 18 laws and regulations are currently required
- State must have all laws and regulations in effect to be accredited (i.e., pass or fail)

Part A: Laws and Regulations Standards

1) Examination Authority
2) Capital & Surplus Requirement
3) NAIC Accounting Practices & Procedures
4) Corrective Action
5) Valuation of Investments
6) Holding Company Systems
7) Risk Limitation
8) Investment Regulations
9) Liabilities & Reserves
10) Reinsurance Ceded
11) CPA Audits
12) Actuarial Opinion
13) Receivership
14) Guaranty Funds
15) Filings with NAIC
16) Producer Controlled Insurers
17) Managing General Agents Act
18) Reinsurance Intermediaries Act

Part B: Regulatory Practices and Procedures

- Financial Analysis (8 standards)
- Financial Examinations (9 standards)
- Information Sharing & Procedures for Troubled Companies (2 standards)

Part C: Organizational and Personnel Practices

- Standards are not scored by the accreditation team members
- Each component is evaluated and any deficiencies will be noted in the management comment letter
- Standards:
  1) Professional Development
  2) Minimum Educational & Experience Requirements
  3) Retention of Personnel

Supervision and Administration of the Accreditation Program

- Financial Regulation Standards and Accreditation (F) Committee
  - 13 Members
  - Regulator-to-Regulator Session meetings: Discuss state-specific accreditation issues
  - Open meetings: Discuss revisions to standards and policies/procedures

Types of Accreditation Reviews

- Pre-Accreditation Reviews
- Accreditation Reviews
- Interim Annual Reviews

Benefits of Being Accredited

- Interstate coordination and reduction in regulatory redundancies
  - Financial examinations
- If not accredited, states may choose to redomicile
  - A state legislator once estimated the cost of lost tax and fee revenue at $300 million
- Reputational
  - Loss of accreditation would be a “financial embarrassment nationally”

How Accreditation Helped Change Solvency Regulation

- State insurance department budgets
- Number of staff dedicated to financial solvency regulation
- Required periodic financial examinations
- Verification of financial amounts by external parties

Modernization and International Efforts

Commissioner Kevin McCarty

Florida Office of Insurance Regulation

Evolution of the U.S. Solvency System

- We have developed a detailed and uniform financial regulatory system in the U.S.
- In the 1990s we created risk-based capital requirements and have continued to improve the formula over time, including adding stochastic modeling and trend tests.
- Statutory Accounting (SAP) was codified in 2001 into a comprehensive guide and has continued to be updated & improved since that time.
- We are placing greater emphasis on Governance through revisions to the Model Audit Rule.
- We are proposing to modernize Reinsurance & Principles-Based Reserving.

Evolution of the U.S. Solvency System

What is clear is that we have been continuously improving U.S. insurance regulation for many years.

What we have on our plates now is an investigation of new ideas and an opportunity to create the globally preeminent Solvency System through the Solvency Modernization Initiative!

As we move toward change in the U.S. to achieve this goal, we also will dialogue outward in our U.S. international activities.

Solvency Modernization Initiative (SMI)

- Five Focus Areas of SMI:
  - Capital Requirements
  - International Accounting
  - Group Supervision
  - Valuation Issues in Insurance
  - Reinsurance
- Aligning NAIC Resources to Address Domestic and International Considerations in the 5 Focus Areas
  - Capital Adequacy TF and risk-based capital (RBC)
  - Statutory Accounting Principles WG and International Solvency & Accounting WG
  - New: Group Solvency Issues WG
  - Principles-Based Reserving WG
  - Reinsurance TF

SMI Work Plan – International Solvency and Accounting Working Group

- Analyze other financial supervisory modernization initiatives, to the extent appropriate. Analysis should include:
  - the Basel II international capital framework for banks and implementation in the U.S.;
  - solvency work by the International Association of Insurance Supervisors (IAIS);
  - solvency proposals under consideration in other jurisdictions, including Australia, Canada, Switzerland and the EU;
  - accounting standards being developed by the International Accounting Standards Board (IASB).
- As an on-going process, and as details emerge, complete the analysis of Europe’s Solvency 2 framework.
- Identify areas for U.S. regulators to consider including in the current NAIC programs.

SMI Work Plan – Group Solvency

- Holding Company Model Act
  - Assess needed changes based upon lessons learned from the most recent economic downturn
  - Study international solvency issues related to groups and consider changes to the model
  - Investigate the need to develop group-wide supervision, possibly group-wide capital requirements
- Recommend Courses of Action Regarding Supervisory Colleges and Other Cross-border and Cross-sectoral Coordination/Communication Efforts

SMI Work Plan – International Relations (G) Committee

- Present the US-EU/Solvency 2 comparison to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the European Commission for comment and verification.
- In coordination with the Financial Condition (E) Committee, identify issues to present for discussion with CEIOPS and the Commission in the US-EU Insurance Regulatory Dialogue.
- Follow discussions in the EU on the impact of Solvency 2 on U.S. insurers and reinsurers doing business in Europe. Consider analysis of the possible international trade implications of the treatment of U.S. (re)insurers under EU/S2, and interact with the Office of the U.S. Trade Representative, where appropriate.

SMI Work Plan – Principles-Based Reserving WG

- Continue with the Principles-Based Reserving Initiative to focus on the principles-based valuation of insurance reserves.
  - A revised Standard Valuation Law (SVL) is currently being finalized.
- Continue with the Reinsurance Regulatory Modernization Framework to focus on reinsurance modernization.
  - Draft legislation is currently being finalized.

SMI Work Plan – Framework and Principles

- Develop a Framework Document that describes the U.S. Solvency System as a whole
- Compile U.S. principles from existing regulatory processes and responsibilities
- Evaluate all for modification in the SMI

Questions from Participants