Solvency Modernization Initiative

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.

2. The SMI scope includes the entire U.S. financial regulatory system and all aspects relative to the financial condition of an insurer, and is not limited to the evaluation of solvency related areas. The SMI focuses on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance.
SMI Roadmap

3. This Roadmap sets out the policy direction and priorities for SMI activities and seeks to clarify the role and scope of various task forces’ and working groups’ SMI activities through year-end 2012. We anticipate that almost all major policy decisions will be completed by the end of 2012, at which time, the NAIC, through the various appropriate committees, can then choose to proceed as considered appropriate.

4. Initial activities within the SMI that are already completed include the following:
   - Initial study of international solvency systems to formulate new ideas for consideration in the United States.

5. The Solvency Modernization Initiative (EX) Task Force coordinates all NAIC efforts to successfully accomplish the SMI, utilizing the technical expertise of numerous NAIC groups. The Task Force recognizes the interplay of SMI issues and the interrelationships of activities in different NAIC groups. The Task Force will monitor the evolving proposals to ensure that work is coordinated and does not overlap.

6. The following describes the remaining projects to be completed in the SMI, establishes expected timelines for deliverables and identifies the committees involved.

Capital Requirements

7. 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 and introduction of and changes to trend tests.

8. Four ladders of intervention currently exist, two as “action” levels and two as “control” levels. The amount of capital required for each level is based on the application of industry-wide risk charges applied to each company’s investment portfolio and risk profile. The RBC is calibrated to identify “weakly capitalized companies” and does not represent the economic target levels of capital that a company should hold.

9. RBC will continue to be a component in the legal framework of U.S. solvency regulation in order to maintain a floor for triggering regulatory intervention.

10. Because the NAIC made many of the decisions regarding the RBC formulas, factors and methodology over a 20-year period, we need to maintain institutional knowledge and ensure consistency in the formulas and calibrations. Therefore, we will compile historical information to explain why we developed each RBC formula, how we calculated individual factors, why/how we calibrated the formulas and factors, and why regulators subsequently made modifications to the formulas.

11. Because we knowingly excluded some risks in the RBC calculation, regulators have re-evaluated “missing risks” to determine if we should now include them in the RBC calculation, or whether we appropriately handle those risks utilizing other regulatory methods. Regulators will continue to evaluate RBC formulas, factors and methodology, concentrating first on priority risks and the method to combine risk charges (i.e., the “square root formula”) and making adjustments to reflect other SMI changes, such as statutory accounting (e.g., principle-based reserving) or reinsurance modifications. The Capital Adequacy (E) Task Force has identified three priority areas for implementation: (1) introduction of an explicit property/casualty catastrophe risk charge; (2) increased granularity in the asset and investment risk charges (the C-1 factor review); and (3) refinement of the credit risk charge for reinsurance recoverables. Modifications to the current methodology for deriving credits for risk diversification (i.e., covariance) are being studied by the American Academy of Actuaries, utilizing the research arm of the Casualty Actuarial Society.

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1 The SMI also includes development of comments regarding the International Association of Insurance Supervisors (IAIS) papers; that aspect of the SMI is not included in this Roadmap.
2 Exceptions might include decisions around international accounting.
12. As factors and methodology are updated, we will: (1) aim for a specified safety level and time horizon, unless such calculation is not appropriate for a particular measurement (e.g., sufficient statistical data is not available or a different time horizon is more appropriate); and (2) aim for consistency between the RBC formulas (by line of business). Noticeably, there is not an aim to calibrate the final result of RBC to one safety level and time horizon, but to continue with the approach to calibrate to a level of weak capitalization, limiting the potential for false positives. A top-down approach to calibration would be unfeasible for a variety of reasons, including: 1) safety levels and time horizons should vary by the underlying types of risk; and 2) there is a lack of credible loss distributions and risk profiles needed to produce statistically valid aggregate safety levels.

13. The Capital Adequacy (E) Task Force will review the public reporting of final RBC calculations and decide whether the RBC: (1) should always be public; (2) should only be public if an action/control level is triggered; or (3) should never be public.

14. Beyond RBC, capital assessments are included in the adopted group supervisory guidance for the Own Risk and Solvency Assessment (ORSA). These additional capital assessments will more clearly distinguish the RBC as our final financial regulatory safeguard to: (1) guarantee regulatory action; and (2) provide the legal authority to intervene without extensive litigation. The group capital assessment will be the tool to: (1) assess the financial stability of a company, group or industry; and (2) disclose the capital sufficiency of the group (to potentially aid a failing entity in the group).

15. The following identifies the timeline of activities for RBC capital requirements:
   - Develop a plan for the modification to the formulas to implement missing significant risk charges: Finalized November 2011.
   - Prioritize risks in the RBC formula for evaluation: Finalized November 2011.
   - Document RBC history, including determination of the average calibration of the current RBC: March 2012.
   - Draft proposal for improvement to the methodology to combine risk charges: December 2012.
   - Draft plan of action for changes to RBC, including definition of the standard safety level and time horizon, as well as the public nature of some company-specific RBC calculations: December 2012.

16. The NAIC groups making modifications to RBC capital requirements are the Capital Adequacy (E) Task Force, its SMI RBC (E) Subgroup and its working groups. The Task Force is addressing modifications to asset categories jointly with the Valuation of Securities (E) Task Force through the C-1 Factor Review (E) Subgroup.
Governance and Risk Management

17. Historically, U.S. insurance regulators have reviewed the corporate governance of prospective insurers before granting a certificate of authority to write insurance business. On an ongoing basis, a review of an insurer’s corporate governance practices is performed during on-site financial examinations. The review of corporate governance during a financial examination has increased significantly as the U.S. has moved to a risk-focused examination process, and the increased review has highlighted the need for additional standards in this area. Examiners have identified concerns related to Board oversight, succession planning, lack of formal risk management and a failure to establish independent internal audit functions. These issues are typically dealt with indirectly, as there is not a set of uniform corporate governance standards for insurers within insurance regulation. Consequently, this is an area of solvency regulation under consideration by regulators.

18. The most recent financial crisis also led to continued discussions by regulators and international supervisors regarding the importance of corporate governance and risk management. Although most insurers weathered the crisis, regulators have recognized a need to learn from the governance problems identified in other industries and act before a crisis in corporate governance or risk management directly impacts insurers. Many of the financial supervisors around the world have taken measures to clarify standards and expectations relating to corporate governance and risk management for regulated entities in their respective areas, and U.S. regulators have identified a need to make improvements consistent with what is being done around the world.

19. In addition, comments received from the recent U.S. participation in the Financial Sector Assessment Program (FSAP) found that the United States largely observes many of the international supervisory principles related to corporate governance and risk management. However, specific deficiencies in the U.S. regulatory process were identified, and recommendations were made for improvements in certain areas. These recommendations included establishing: (1) specific suitability criteria (e.g., background, experience, etc.) for key persons; (2) requirements in relation to ongoing notifications regarding suitability; (3) additional requirements or guidance for insurers related to good corporate governance practices; (4) requirements for insurers in maintaining an internal audit function; and (5) explicit requirements for insurers in maintaining risk-management systems capable of identifying, measuring, assessing, reporting and controlling risks.

20. Many of the existing corporate governance requirements for insurers are contained in state corporate governance statutes and case law. Therefore, to get a better understanding of existing laws and regulations, the Corporate Governance (EX) Working Group performed a review of existing legislation and case law relating to corporate governance requirements for insurers and summarized corporate governance laws in California, Delaware, Georgia, Illinois, Iowa, Nevada, New York and Texas. In addition, the Working Group studied Rhode Island’s recent adoption of corporate governance provisions into its insurance code. The Working Group also performed a study of corporate governance principles and standards placed upon insurers worldwide by the IAIS, Australia, Canada, Switzerland and the United Kingdom. The study sought input from the supervisors in each of these countries on the summarized principles. As a result of this study, Working Group members noted that many of the standards and principles adopted in other countries, and included in the IAIS core principles, are not necessarily fully addressed within the current U.S. insurance regulatory system.

21. After extended consultation with interested parties, the Working Group agreed to compile a summary of existing corporate governance requirements found within NAIC/insurance-specific sources and non-NAIC/insurance-specific sources, to assist in identifying potential gaps in the existing insurance regulatory structure that could be addressed through the SMI. This summary identifies existing corporate governance requirements, standards and regulatory monitoring practices that are applied to insurance entities in the United States within the structure of The U.S. Insurance Financial Solvency Framework, which was adopted by the NAIC in 2010. Financial solvency core principles underlie the active regulation that exists today and make up the Framework. Seven core principles are identified for the U.S. insurance regulatory system and these principles were utilized to illustrate the corporate governance requirements, standards and regulatory monitoring practices that are currently in place within the U.S. system.

22. After the summary of existing corporate governance requirements is concluded, the goal of the Working Group is to identify gaps in the existing U.S. requirements by: (1) considering regulatory needs and best practices; and (2) comparing existing requirements to principles outlined within the IAIS Insurance Core Principles (ICPs). After all gaps are identified, the Working Group plans to develop additional guidance and/or requirements to address the issues before completing its primary charges by the end of 2012, as required under the SMI.
23. The projected timeline for corporate governance related activities is as follows:
   - Receive comments on and finalize the summary of existing corporate governance requirements: December 2011.
   - Hold interim conference calls to identify potential gaps in the framework: January – March 2012.
   - Discuss how to address gaps in existing structure and develop solution: March – August 2012.
   - Publicly expose solution to address gaps in existing corporate governance requirements: August 2012.
   - Receive and address comments: August – November 2012.
   - Finalize and adopt solution to address gaps in existing corporate governance requirements: November 2012.

24. The NAIC group discussing governance and risk management issues are the Corporate Governance (EX) Working Group and the Group Solvency Issues (EX) Working Group (for ORSA).

Statutory Accounting and Financial Reporting (including Valuation)

Valuation (Principle-Based Reserving)

25. Statutory accounting for life insurance reserves (“valuation”) is not yet principle-based, as it is for other lines of business. The NAIC adopted the Standard Valuation Law (#820) in late 2009, pending implementation until completion of the Valuation Manual. Regulatory actuaries drafted an initial Valuation Manual, under which an industry impact study was conducted by an NAIC-selected consultant. After issuance of the study’s findings, the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force will finalize the Valuation Manual, coordinating material issues with the SMI’s Principles-Based Reserving (EX) Working Group. The study’s findings are expected in December 2011.

26. Preliminary results from the industry impact study highlight the following:
   - Reserves for universal life with secondary guarantees and term life reserve are both moving in the expected direction.
   - The reserve exclusion tests are correctly separating less complex products from the more complex products.
   - Areas for additional follow-up and refinement have been identified and credit spread discount rate scenarios are still under review.

27. To utilize principle-based reserving, statistical agent(s) will need to provide regulators and the industry with statistical information once principle-based reserving becomes effective. We expect to determine how to collect such information in the first half of 2012.

28. The following identifies the timeline of activities for life insurance principle-based reserving:
   - Industry study completed: Fourth quarter 2011.
   - Statistical agent policy decisions: First half of 2012.
   - Implementation plans from technical groups: March 2012.
   - Valuation Manual (VM-20) – Initial: Adopted by Life Actuarial (A) Task Force, Fall 2010; Final: Adopted by Executive (EX) Committee and Plenary, Fall 2012.

29. The NAIC groups discussing principle-based reserving are the Principles-Based Reserving (EX) Working Group, the Life Actuarial (A) Task Force, and the Health Actuarial (B) Task Force.

Future of Statutory Accounting and Financial Reporting

30. Regulators analyze Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) pronouncements and International Financial Reporting Standards (IFRS), especially regarding insurance contracts and financial instruments, and provide input to the IAIS, the FASB and, occasionally, to the IASB directly.

31. Our current statutory accounting system already includes a process to consider any new Generally Accepted Accounting Principles (GAAP) pronouncements, whereby we reject, adopt or modify GAAP changes for implementation into our statutory accounting principles (SAP) system. Agreed convergence between FASB and IASB have already produced some GAAP pronouncements, but, even with this process in place, NAIC members are contemplating: (1) future policy decisions on this approach; (2) the impact of international accounting activities; (3) the extent of public disclosure vs.
regulatory reporting; (4) compliance with IAIS ICPs related to accounting and reporting; and (5) the need to communicate with international regulators.

32. Given the current state of play, we expect to address those policy decisions after completion of the IASB/FASB Insurance Contracts project and the U.S. Securities and Exchange Commission (SEC) decision regarding IFRS. Awaiting these decisions has the potential to delay the policy positions regarding (1) IFRS and its inclusion/exclusion in the U.S. Insurance Financial Solvency Framework and (2) the regulatory impacts of non-regulatory uses of statutory financial statements. We will request that the International Solvency and Accounting Standards (EX) Working Group and Statutory Accounting Principles (E) Working Group provide technical recommendations at the appropriate time.

33. The following identifies the timeline of activities for statutory accounting:
   - Document and discuss primary non-technical considerations: July 2010
   - Provide comments on IASB/FASB Insurance Contracts exposure draft/discussion paper: Nov. 30, 2010.
   - Provide comments to the IAIS on ICP 14 Valuation: April 19, 2011.
   - Draft policy positions regarding IFRS and its inclusion/exclusion from the framework of insurance solvency regulation and on the regulatory impacts of non-regulatory uses of statutory financial statements: Delayed.

34. The NAIC groups discussing the future of statutory accounting and reporting are the International Solvency and Accounting Standards (EX) Working Group and the Statutory Accounting Principles (E) Working Group.

Reinsurance

35. The Reinsurance Regulatory Modernization Framework proposal (Reinsurance Framework), adopted by the NAIC during its 2008 Winter National Meeting, is a conceptual framework that the Reinsurance (E) Task Force developed in response to its charges to consider: (1) the current collateralization requirements regarding unauthorized reinsurers; and (2) the design of a revised U.S. reinsurance regulatory framework. The Reinsurance Framework is 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.

36. The Reinsurance Framework recommended implementation through federal legislation in order to: (1) best preserve and improve the state-based regulation of reinsurance; (2) ensure timely and uniform implementation of this legislation throughout all NAIC member jurisdictions; and (3) provide a more comprehensive alternative to related federal legislation. Throughout 2009, the Task Force developed federal legislation intended to implement the Reinsurance Framework and, in September 2009, the NAIC Government Relations (EX) Leadership Council approved the Reinsurance Regulatory Modernization Act, and agreed to submit the draft federal legislation to the U.S. Congress for its further action. The NAIC was unable to procure congressional sponsorship for this proposed legislation.

37. The federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law July 21, 2010. The Dodd-Frank Act includes the federal 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 (1) is 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.

38. To date, some of the states have already implemented individual state-based reinsurance collateral reforms. Florida, New York, New Jersey and Indiana have enacted reinsurance reform legislation and other states have considered similar legislation. In October 2010, in response to an informal request by the Financial Regulation Standards and Accreditation (F) Committee, the Reinsurance (E) Task Force adopted key elements of the Reinsurance Framework that should be considered in reviewing any individual state initiatives, and considered whether these key elements should be incorporated into the Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786).

39. In December 2010, the Reinsurance (E) Task Force was given a 2011 charge to consider amendments to Model #785 and Model #786 to incorporate key elements of the Reinsurance Framework. In addition, the NAIC Executive (EX)
Committee and Plenary approved its “Recommendations Regarding Key Elements of the Reinsurance Framework for Accreditation Purposes” (Accreditation Recommendations). To clarify, the Accreditation Recommendations are not a change to the current NAIC accreditation standards regarding reinsurance collateral; however, the Accreditation Recommendations will provide guidance to the Financial Regulation Standards and Accreditation (F) Committee to potentially use when reviewing any individual state reinsurance collateral reforms enacted prior to the NAIC adoption of model law/regulation amendments and/or adopting related changes to the accreditation standards. Revisions to Model #785 and Model #786 were adopted in November 2011.

40. The Reinsurance (E) Task Force will now turn its efforts toward: (1) providing guidance to the Financial Regulation Standards and Accreditation (F) Committee with respect to key elements of revised Model #785 and Model #786 to be considered for the purposes of the Financial Regulation Standards and Accreditation Program; (2) development of reporting instructions for forms CR-F and CR-S applicable to certified reinsurers under the revised Model #785 and Model #786; (3) development of an NAIC committee process to evaluate the reinsurance supervisory systems of non-U.S. jurisdictions (for the purposes of developing and maintaining a list that includes any such jurisdiction that is recommended through the NAIC committee process for recognition by the states as a qualified jurisdiction in accordance with the revised Model #785 and Model #786, under which an assuming insurer licensed and domiciled in a qualified jurisdiction is eligible to be considered for certification by a state as a certified reinsurer); and 4) formation of a new NAIC group to provide advisory support and assistance to the states in the review of reinsurance collateral reduction applications.

41. Separately, regulators may also consider the propriety of modernization of risk transfer requirements applicable to life reinsurance. The Reinsurance (E) Task Force will coordinate these considerations with the Life Actuarial (A) Task Force and Health Actuarial (B) Task Force.

42. The following identifies the timeline for reinsurance modernization activities:
   - Provide guidance to the Financial Regulation Standards and Accreditation (F) Committee with respect to key elements of the revised Model #785 and Model #786 for the purposes of the Financial Regulation Standards and Accreditation Program: 2012.
   - Develop instructions for forms CR-F and CR-S applicable to certified reinsurers under the revised Model #785 and Model #786: 2012.
   - Develop an NAIC committee process to publish a list of jurisdictions recommended to be recognized by the states as qualified jurisdictions in accordance with the revised Model #785 and Model #786: 2012.
   - Form a new NAIC group to provide advisory support and assistance to the states in the review of reinsurance collateral reduction applications: 2012.
   - Reexamine the collateral amounts included in the revised Model #785 and Model #786: November 2013.

43. The NAIC group discussing reinsurance issues is the Reinsurance (E) Task Force.

Future U.S. Insurance Financial Solvency Framework and Core Principles

44. Regulators will be making changes in the SMI that will modify the U.S. solvency framework, both in the implementation of new tools and processes, as well as the elimination of aspects no longer needed. Throughout the process, regulators will develop a “critical review” white paper to further explain the U.S. financial regulatory framework and how and why it works so successfully.

45. At the end of the SMI process, regulators will determine whether the Solvency Modernization Initiative (EX) Task Force should make changes or revisions to the U.S. Insurance Financial Solvency Framework and Core Principles to reflect the work of the SMI.