

NAIC/FIO Meeting on Financial Regulation
(Documents shared with FIO to facilitate discussion are attached)
Thursday, December 1, 2011
Time: 9am-1pm

NAIC Attendees:

Commissioner Kevin McCarty (FL), incoming NAIC President,
Director John Huff (MO), State regulator designee to FSOC
Superintendent Joe Torti (RI), Chair of the NAIC Financial Condition Committee
Director Christina Urias (AZ), Chair of the NAIC SMI Task Force
Danny Saenz (TX), Senior Associate Commissioner, Co-Chair NAIC Group Solvency Issues Working Group
Ryan Couch (NAIC) Sr. Accounting & Reinsurance Policy Advisor
Elise Liebers (NAIC) Special Advisor, Insurance Markets and International Prudential Supervision
Ethan Sonnichsen (NAIC) Director, Government Relations
Ed Toy (NAIC) Director, Capital Market Bureau

Proposed Discussion Items:

- Introductions
- Overview of our system of financial regulation as background
- Recent enhancements to the regulatory system
 - Model Holding Company System Act and Regulation
 - Accreditation Holding Company System financial analysis guidelines effective 2012
 - Enhanced NAIC Financial Analysis Handbook, Supplemental Procedures for Holding Company System Analysis
 - Enhanced Schedule Y Part 1a – Detail of the Insurance Holding Company System (Data captured)
 - Adopted Holding Company System and Supervisory Colleges Best Practices document for inclusion in the Annual 2011/Quarterly 2012 NAIC Financial Analysis Handbook
 - SMI
 - Adopted NAIC's Own Risk and Solvency Assessment Manual
 - Capital Markets Bureau and related work (risks other than credit, liquidity, call risk)
 - Supervisory Colleges
 - RMBS/CMBS project
 - Stress Testing
 - Reinsurance collateral
 - New or revised disclosures/accounting
 - Structured securities, securities lending, letters of credit, individual annuity risk, fair value, derivatives
 - AG 38
 - Other International activity – EU dialogue, Solvency 2

Attachments

The United States Insurance Financial Solvency Framework 2010

The United States Insurance Financial Solvency Framework and Core Principles Executive Summary

Introduction

In June 2008, the NAIC's Solvency Modernization Initiative (SMI) was announced, with one of its objectives being an articulation of the United States Insurance Financial Solvency Framework and its Core Principles. The purpose of this document is to describe the framework for financial solvency insurance regulation in the United States and the core principles underlying it.

US Insurance Financial Solvency Framework

Ultimate regulatory responsibility for insurer insolvency rests with each state insurance department and the state insurance Commissioner (sometimes also known as the Administrator, Director or Superintendent of Insurance). State insurance departments are assisted by the NAIC, which is a voluntary organization of the Commissioners of the state insurance departments. The NAIC's overriding objective is to assist state insurance regulators by offering financial, actuarial, legal, computer, research and economic expertise to state regulators.

The starting point or context for the framework is the US Regulatory Mission which is to protect policyholders/claimants/beneficiaries first and foremost, while also facilitating an effective and efficient marketplace for insurance products. The U.S. meets preconditions required for effective regulation. These are primarily designed to ensure that regulators have appropriate regulatory authority over insurers, operate independently of insurer and political interference, maintain an adequate staff of sufficiently trained personnel, and treat confidential information appropriately.

The US insurance regulatory system is unique in the world in that (1) it relies on an extensive system of peer review, communication and collaborative effort that produce checks and balances in regulatory oversight; and (2) it includes a diversity of perspectives with compromise that leads to centrist solutions. These, in combination with a risk-focused approach to regulation, form the foundation for insurance regulation. As an example, the accreditation program relies on state certification by other regulators (i.e., peer review), requires risk-focused financial surveillance including on-site examinations, and requires solvency-related model laws, rules and guidelines that have been produced through consensus and collaboration.

Financial solvency core principles underlie the active regulation that exists today. A core principle, for purposes of this framework, is an approach, a process, or an action that is fundamentally and directly associated with achieving the mission. Seven core principles are identified for the US insurance regulatory system. These are discussed individually in the second part of this summary.

It is primarily through the states' adoption of NAIC model laws and model regulations, many of which are associated with accreditation, that the core principles operate through the regulatory system. Accreditation is a certification given to a state insurance department once it has demonstrated that it has met and continues to meet a wide range of legal, financial, functional and organizational standards. Fifty states and the District of Columbia are currently accredited. The purpose of the accreditation program is for state insurance departments to meet minimum, baseline standards of solvency regulation, especially with respect to regulation of multi-state insurers.

The implementation of the Accreditation program requires state adoption of model laws and regulations that incorporate Insurance Financial Solvency Standards and Monitoring. These can be categorized into Insurance Company Financial Solvency Requirements and Regulatory Monitoring Requirements. US Insurance Company Financial Solvency Requirements consist of specific state laws, guidelines, regulations, or rules that apply to insurers (e.g., filing of standardized financial statements that have been audited by a CPA). US Insurance Financial Solvency Regulatory Monitoring Requirements are laws, regulations and rules that must be adopted by the state and that apply to state regulators (e.g., insurers are required to be examined at least once every 5 years or more frequently as deemed appropriate). Additional regulatory monitoring is conducted by the NAIC through its surveillance processes (such as the Financial Analysis Solvency Tools (FAST) and the Financial Analysis Working Group).

US Insurance Financial Solvency Core Principles

Seven core principles have been identified for the US Insurance Financial Solvency Framework, as described below.

US Insurance Financial Solvency Core Principle 1: **Regulatory Reporting, Disclosure and Transparency**

Insurers are required to file standardized annual and quarterly financial reports that are used to assess the insurer's risk and financial condition. These reports contain both qualitative and quantitative information and are updated as necessary to incorporate significant common insurer risks.

US Insurance Financial Solvency Core Principle 2: **Off-site Monitoring and Analysis**

Off-site solvency monitoring is used to assess on an on-going basis the financial condition of the insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance. The results of the off-site analysis are included in an insurer profile for continual solvency monitoring. Many off-site monitoring tools are maintained by the NAIC for regulators (such as FAST).

US Insurance Financial Solvency Core Principle 3: **On-site Risk-focused Examinations**

US regulators carry out risk-focused, on-site examinations in which the insurer's corporate governance, management oversight and financial strength are evaluated, including the system of risk identification and mitigation both on a current and prospective basis. The reported financial results are assessed through the financial examination process and a determination is made of the insurer's compliance with legal requirements.

US Insurance Financial Solvency Core Principle 4: **Reserves, Capital Adequacy and Solvency**

To ensure that legal obligations to policyholders, contract holders, and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety. The most visible measure

of capital adequacy requirements is associated with the risk based capital (RBC) system. The RBC calculation uses a standardized formula to benchmark specified level of regulatory actions for weakly capitalized insurers.

US Insurance Financial Solvency Core Principle 5:

Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities

The regulatory framework recognizes that certain significant, broad-based transactions/activities affecting policyholders' interests must receive regulatory approval. These transactions/ activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance.

US Insurance Financial Solvency Core Principle 6:

Preventive and Corrective Measures, Including Enforcement

The regulatory authority takes preventive and corrective measures that are timely, suitable and necessary to reduce the impact of risks identified during on-site and off-site regulatory monitoring. These regulatory actions are enforced as necessary.

US Insurance Financial Solvency Core Principle 7:

Exiting the Market and Receivership

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines solvency and establishes a receivership scheme to ensure the payment of policyholder obligations of insolvent insurers subject to appropriate restrictions and limitations.

The United States Insurance Financial Solvency Framework

I. Objective and Overview

Objective of Paper

In June 2008, the NAIC's Solvency Modernization Initiative (SMI) was announced. This initiative has several key objectives, including articulating an overview of the United States Insurance Financial Solvency Framework and its principles. The purpose of this paper is to describe the framework of the US Insurance Financial Solvency System and present a set of core financial principles underlying this framework.

Overview of Paper

This paper provides a description of the US Insurance Financial Solvency Framework that, while drawing upon ideas developed by the International Association of Insurance Supervisors (IAIS), goes

beyond the IAIS in important, material ways. In particular, in the US regulatory system, ongoing collaborative regulatory peer review, regulatory checks and balances, and risk focused financial surveillance form the foundation of the regulatory process.¹ Also, the framework indicates that the US Insurance Financial Solvency Core Principles are embodied in the NAIC's Financial Regulation Standards and Accreditation Program, which is a uniform program to which all states subscribe. Finally, included in this paper is a discussion of the US Insurance Financial Solvency Core Principles.

II. Presentation of US Insurance Financial Solvency Framework

Introduction

The state regulatory system in the United States has had over a 100 year history of solvency regulation. This system is comprised of state insurance departments (currently 50 states, D.C. and 5 territories), and can best be described as a national system of state based regulation. The National Association of Insurance Commissioners (NAIC) assists regulators in a nonbinding, supplementary role.

Ultimate regulatory responsibility for insurer solvency rests with each state insurance department and the state insurance Commissioner.² In a free market economy, such as in the US, some insurer insolvencies are naturally expected. However, by following solvency standards, performing risk focused financial surveillance including on-site examinations, and enforcing solvency related insurance laws, regulations and guidelines, the state regulatory system has limited insurer insolvencies. A hallmark of the state regulatory system is its dynamic efforts to constantly improve the regulatory solvency system and adjust the system as needed, especially regarding inputs into the model used to determine asset, liability and capital requirements.

The NAIC is a voluntary organization of the chief insurance regulatory officials of the state insurance departments, and its overriding objective is to assist state insurance regulators in protecting consumers and helping maintain the financial stability of the insurance industry. The NAIC achieves this by offering financial, actuarial, legal, computer, research, market conduct, and economic expertise to state regulators. It is through the NAIC that insurers are provided the uniform platforms and coordinated systems they need in an ever-changing marketplace.

This paper, the US Insurance Financial Solvency Framework, has been created to document the processes utilized by regulators to monitor and assess the financial condition of insurers. It indicates how information flows to the regulator and how that information is used by regulators to take appropriate actions with respect to an insurer. Regulatory intervention, when it occurs, is generally focused on insurers where policyholders are most at risk (i.e., financially distressed insurers). Finally, the framework shows that a system of orderly exit from the market exists when insolvency becomes inevitable.

Regulatory Mission as Starting Point for Framework

¹ For purposes of this document, the term "regulator" refers to the ongoing supervision and oversight of entities under the authority of the state insurance department with the assistance of the NAIC. This terminology contrasts with the use of the term "regulator" in other parts of the world. In other parts of the world, regulator refers to the government agency responsible for developing regulations (e.g., Ministry of Finance or Treasury Department), while the term "supervisor" refers to the government officials responsible for overseeing insurance entities.

² In some states the terms Director of Insurance or Superintendent of Insurance are used rather than Commissioner.

The starting point or context for the US Insurance Financial Solvency Framework is the mission of insurance regulation in the United States. The mission or purpose of insurance regulation is:

US Insurance Regulatory Mission: To protect the interests of the policyholder and those who rely on the insurance coverage provided to the policyholder first and foremost, while also facilitating an effective and efficient market place for insurance products.

This mission has been used for years as the basis on which regulatory decisions have been made, including overall industry policy decisions and regulatory decisions for individual insurers. While the policyholder is the focal point of the mission, this mission is mindful that regulatory actions and decisions will have an impact on the operation of insurance markets and their efficiency. Because it is felt that “facilitating an effective and efficient market place for insurance products” is in the best interests of policyholders (e.g., cost efficiencies and product innovation), this is not considered to be a separate and distinct or secondary mission, but is considered to support a focus on the policyholder.

Preconditions for Effective Regulation

To achieve its mission the regulatory system must have the requisite authority. This requisite authority is comprised of the following elements: a legal basis, independence and accountability, adequate powers, financial resources, human resources, legal protection and confidentiality. These elements form the preconditions for effective insurance regulation:

Preconditions for Effective Regulation (Regulatory Authority)

The regulatory authority has adequate powers, legal protection and financial resources to exercise its functions and powers; is operationally independent from commercial and political interference in the exercise of its functions and powers; is ultimately accountable to the public; hires, trains, and maintains sufficient staff with high professional standards; and treats confidential information appropriately.

The US Insurance Financial Solvency Framework has been created over many years through the unified development of NAIC model laws, regulations, and other NAIC requirements. The adoption of these model laws within the individual states has created a legal framework for insurance regulation that is largely uniform throughout all of the states. To carry out the laws, regulations and other requirements, individual states have created insurance departments that are staffed with personnel that have the necessary knowledge and expertise. These state insurance departments act independently of insurers. In the course of pursuing their regulatory responsibilities, especially when solvency is at issue, regulators allow for the sharing of otherwise confidential documents with any state, federal agency or foreign country provided that the recipients are required, under their law, to maintain their confidentiality.

US Insurance Financial Solvency Regulation Foundations

Among the unique features of U.S. insurance regulation are (1) the extensive systems of peer review, communication and collaborative effort that produce checks and balances in regulatory oversight and (2) the diversity of perspectives with compromise that leads to centrist solutions. These, in combination with a risk-focused approach to regulation, form the foundation for insurance regulation in the U.S., as explained below.

The U.S. insurance market is comprised of thousands of small to large-sized insurance companies and groups, as well as conglomerates. To effectively regulate in such a large market, a risk-focused approach is utilized by state regulators. Under a risk-focused approach, attention is paid to the greatest risks faced by insurers and the insurance market. Explicit examples where this practice is applied are in on-site examinations and the ongoing analysis of nationally significant U.S. insurance groups (as explained later in this paper).

Mechanisms for peer review encourage effective regulatory and supervisory practices. The ongoing analysis of insurance groups provides an example of the checks and balances provided by peer review. Most regulators' interactions are collaborative and collegial. But situations arise where other state insurance commissioners can question the actions of another state insurance department, and, if necessary, pressure another state insurance department to act. This pressure is possible because regulators in other states have the power to examine all companies doing business in their state even though headquartered in other states and, in the worst case, to suspend their licenses to operate. Of course, free-flowing information among state regulators underlies this process; and the willingness of state insurance regulators to challenge and be challenged by other state regulators has developed over time in the U.S. as regulators work cooperatively with each other.

In regulation, there is a constant need to balance regulatory costs and benefits. Overregulation can impose unnecessary costs on consumers, while under-regulation (or de-regulation) can allow unnecessary harm to consumers and taxpayers. The balance between these two regimes is difficult to determine, but because of the multitude of diverse perspectives in the state U.S. regulatory system, it is less likely to end up at either extreme. Rather, the search for compromise tends to produce centrist solutions. Thus it is highly unlikely that a dogmatic move toward excessive deregulation (or overregulation) could occur in the state-based system.

The risk-focused approach, peer pressure/checks and balances, and ongoing collaboration based on consensus interact with each other to form the foundation of U.S. state insurance regulation. As an example of all of these approaches and processes, the accreditation program relies on state certification by other regulators, requires risk-focused financial surveillance including on-site examinations and requires enactment of solvency-related model laws, rules, and guidelines that have been reached through consensus and collaboration. This foundation makes insurance regulation in the U.S. unique in the world.

US Insurance Financial Solvency Core Principles and the Accreditation Program

For purposes of this paper, a core principle is an approach, a process or an action that is fundamentally and directly associated with achieving the mission. The following comprise the US Insurance Financial Solvency Core Principles.

Formulation of US Insurance Financial Solvency Core Principles

US Insurance Financial Solvency Core Principle 1:
Regulatory Reporting, Disclosure and Transparency

US Insurance Financial Solvency Core Principle 2:
Off-site Monitoring and Analysis

US Insurance Financial Solvency Core Principle 3:
On-site Risk-focused Examinations

US Insurance Financial Solvency Core Principle 4:
Reserves, Capital Adequacy and Solvency

US Insurance Financial Solvency Core Principle 5:
Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities

US Insurance Financial Solvency Core Principle 6:
Preventive and Corrective Measures, Including Enforcement

US Insurance Financial Solvency Core Principle 7:
Exiting the Market and Receivership

The Accreditation Program

It is primarily through the states' adoption of NAIC model laws and model regulations that the U.S. Insurance Financial Solvency Core Principles can function effectively within competitive market dynamics. Accreditation is a certification given to a state insurance department once it has demonstrated it has met and continues to meet a wide range of legal, financial, functional and organizational standards as determined by a committee of its peers. Fifty states and the District of Columbia are currently accredited.

The purpose of the accreditation program is for state insurance departments to meet minimum, baseline standards of solvency regulation especially with respect to regulation of multi-state insurers. The emphasis in the accreditation program and the processes it creates is on: (1) adequate solvency laws and regulations to protect consumers; (2) effective and efficient financial analysis and examination processes based on priority status of insurers; (3) cooperation and information sharing with other state, federal or foreign regulatory officials; (4) timely and effective action when insurance companies are identified as financially troubled or potentially troubled; (5) appropriate organizational and personnel practices; and (6) effective processes for company licensing and review of proposed changes in control. At the present time, for a state to be accredited, it must adopt certain laws, regulations or administrative practices that provide appropriate regulatory authority and consumer protections in a variety of aspects of solvency regulation.³ Appendix 2 provides more details about accreditation.

To become accredited, the state must submit to a full on-site accreditation review. Depending on the results of the review, the state is accredited or it is not (i.e., a pass/fail system is used). To remain accredited, an accreditation review must be performed at least once every five years with interim annual reviews. If necessary management letter comments may be provided to the state and interim follow-up reviews may be required.

³Specific standards must be complied with that relate to financial analysis, financial examinations, information sharing, and procedures for troubled insurers. States encourage professional development and establish organizational and personnel standards regarding minimum educational and experience requirements and must have the ability to attract and retain qualified personnel to obtain and maintain accreditation status.

US Insurance Financial Solvency Standards and Monitoring

The implementation of the Accreditation Program requires state adoption of model laws and regulations that incorporate Insurance Financial Solvency Standards and Monitoring. These can be categorized into Insurance Company Financial Solvency Requirements and Regulatory Monitoring Requirements. Examples of each are provided below.

US Insurance Company Financial Solvency Requirements

U.S. Insurance Company Financial Solvency Requirements consist of specific state laws, guidelines, regulations, or rules which are applicable to insurers. These standards are documented in the NAIC's Financial Regulation Standards and Accreditation Program.

Examples of US Insurance Company Financial Solvency Requirements:

1. Insurers' submission of the annual and quarterly financial statements ("the annual statement" or "blank").
2. Most insurers' must annually submit a financial statement audited by a CPA, and their reserve estimates must be attested to by an actuary.
3. *Management's Report of Internal Control over Financial Reporting* is required of all insurers whose premiums exceed a predefined threshold.
4. Insurers are required to report the results of their risk-based capital calculation in the annual statement.⁴
5. Insurers must adhere to state minimum capital and surplus requirements.
6. Insurers must submit to examinations as deemed necessary by the regulator.
7. Each state has statutes requiring insurers to invest in a diversified investment portfolio both with respect to type of investment and the issuer.
8. There is a limitation on the amount on any single insured risk a property casualty insurer may underwrite.
9. Producer controlled insurers must meet special contract provisions, have an audit committee and separate reporting requirements.
10. For life and accident and health insurers, reserve requirements must adhere to statutory minimums and actuarial standards.
11. All insurers are required to report investment values in the financial statements in accordance with the *Purposes and Procedures Manual of the Securities Valuation Office*.
12. Insurers are required to use the NAIC's *Accounting Practices and Procedures Manual* and the *Annual Statement Blank and Instructions* in constructing their statutory financial statements.⁵
13. Reinsurance credit is governed by the NAIC Credit for Reinsurance Model Law, which imposes standards on allowing such credit.

US Insurance Financial Solvency Regulatory Monitoring Requirements

⁴ The risk-based capital (RBC) system is discussed in more detail later in Core Principle 4.

⁵For example, these tools restrict discounting property and casualty reserves, and specific tables approved by regulators are required to establish reserves for various life insurance products. Only certain assets (admitted assets) are allowed to be considered as statutory assets. There are significant reinsurance requirements that take into account the ability of reinsurers to pay. One of these requirements includes statutory accounting requirements for taking a reserve credit for reinsurance.

US Insurance Financial Solvency Regulatory Monitoring Requirements are laws, regulations and rules that must be adopted by the state and that are applicable to state regulators. Many of these solvency standards are requirements of the accreditation program.

Examples of US Insurance Financial Solvency Regulatory Monitoring Requirements:

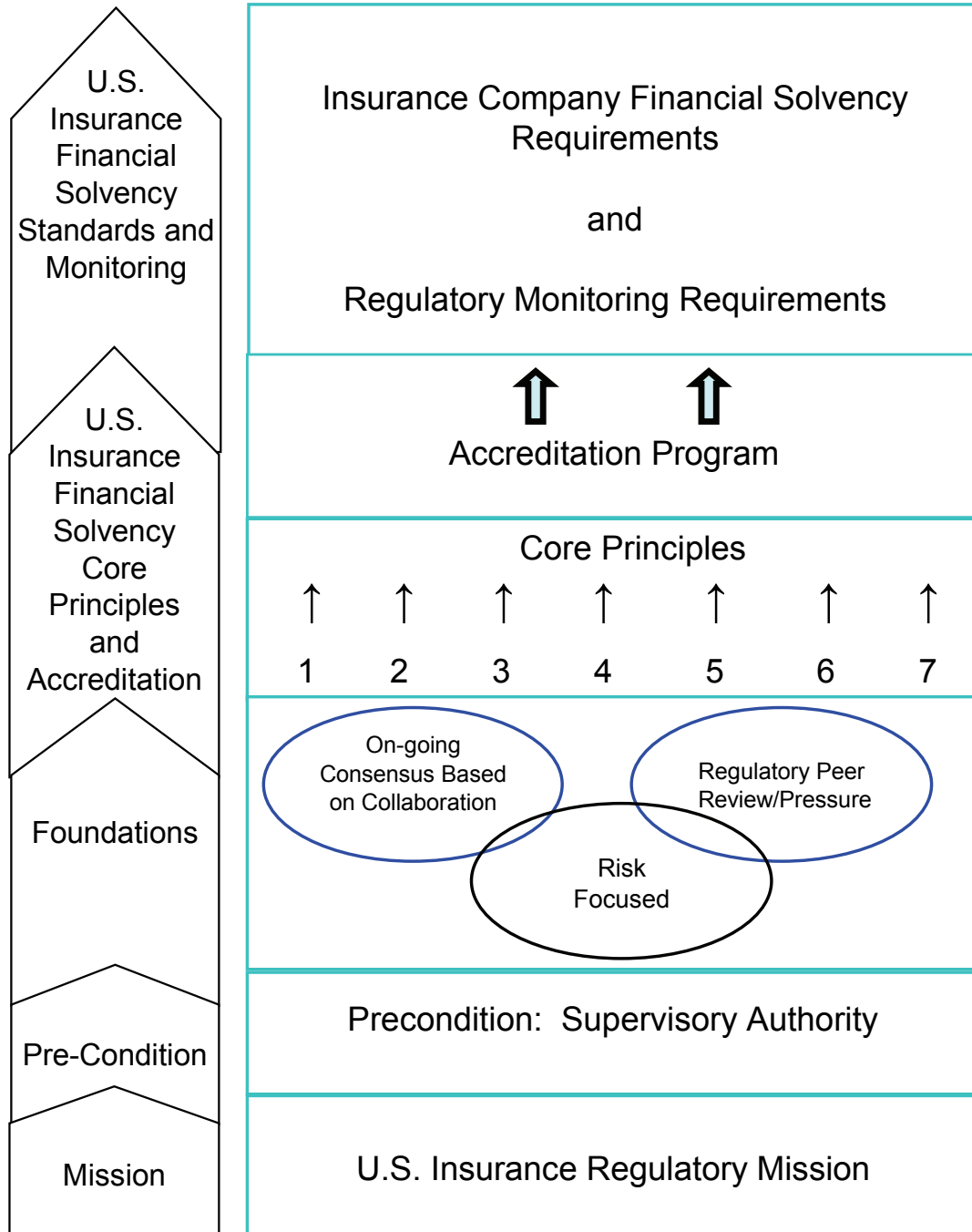
1. Regulators are required to examine an insurer at least once every five years or more frequently as deemed appropriate and have the authority to examine a company at any time it is deemed necessary by the Commissioner.
2. If a potential capital deficiency is signaled by the RBC result, a ladder of intervention exists under which regulators are required to undertake certain actions depending on the degree of deficiency. This intervention can vary from requiring insurers to file a plan of corrective action to regulatory takeover of the insurer.
3. Certain transactions require approval (e.g., transactions among affiliated insurers).

Additionally, regulatory monitoring includes other surveillance processes such as:

1. NAIC's Financial Analysis Solvency Tools (FAST). FAST encompasses a wide-ranging review/testing system that includes (but is not limited to): (1) a scoring system based on over 20 financial ratios; (2) the Analyst Team System (ATS) (an automated review process that creates a national prioritization system using statistical analysis, a scoring system, and RBC to assign review levels for insurers); (3) RBC trend test; and (4) loss reserve projection tools. Insurers deemed to be performing poorly from the FAST analysis are reviewed by experienced analysts to determine the degree of financial distress present, if any. Insurers deemed to be in financial distress are prioritized by the degree of financial distress and the results are communicated to the state insurance departments in which the insurer is licensed.⁶
2. Nationally significant insurers are reviewed every quarter and those that appear to be performing poorly are prioritized for more detailed analysis by a group of experienced, seasoned financial regulators (i.e., the Financial Analysis Working Group (FAWG)). The FAWG committee confirms/informs the lead state regulator of problems with insurers in their state and can assert peer pressure on the regulator to intervene to address the troubled insurer's situation.

⁶ The domestic regulator gives all insurers a priority status which is a driver for the level of risk focused surveillance an insurer receives.

Diagram of U.S. Insurance Financial Solvency Framework



III. Overview of US Insurance Financial Solvency Core

Principles

This section provides a brief discussion of each US Insurance Financial Solvency Core Principle.

US Insurance Financial Solvency Core Principle 1: Regulatory Reporting, Disclosure and Transparency

US regulators receive required financial reports from insurers on a regular basis that are the baseline for continual assessment of the insurer's risk and financial condition. Standardized financial reporting is used in the financial statements to ensure comparability of results among insurers. To address concerns with specific companies or issues, supplemental data is requested in addition to the standardized data, and these data may be requested on a more frequent basis from specific companies. The standardized format is updated as necessary to incorporate significant, common insurer risks.

The financial reports filed with the regulator include the set of comprehensive financial statements known collectively as the Annual Statement. Also included in the financial reporting requirements is the filing of quarterly financial statements. To increase comparability and consistency in reporting, the insurer is required to complete the annual and quarterly statements in accordance with NAIC instructions, which provide specific direction on how the statements are to be completed. In addition, NAIC statutory accounting principles are used as the baseline accounting requirements in all financial reports.

The financial reports also include numerous qualitative disclosures, each of which are designed to identify potential risks of the insurer. These include but are not limited to general and specific interrogatories, the notes to financial statements, management's discussion and analysis, an actuarial opinion, and an annual audit opinion from an independent certified public accountant. Other standardized reports are filed with the regulator throughout the year that identifies more specific risks (e.g., investment risk interrogatories).

The information contained in all of these financial reports is designed to be thorough, so that sufficient information is provided to the regulator to continually monitor and identify specific risks faced by the insurer.⁷ The financial reports are used extensively in regulatory solvency monitoring, including on-site examinations and off-site monitoring. That is, the regulatory reports feed into the off-site monitoring analysis and provide a foundation for on-site examinations. In turn, off-site monitoring and examinations are used to determine whether additional or more frequent reporting may be required of an insurer.

The annual and quarterly statements are electronically captured by the NAIC in two formats: data tables available for querying and automated analytical tool usage; and PDF files that are publicly available and intended to provide consumers with direct access to financial information submitted by any insurer.⁸

⁷ Carrying value, fair value, credit quality designation and other pertinent information are disclosed for every applicable investment held by the insurer; and the detailed disclosures are categorized by asset type, e.g., issuer obligations vs. collateralized mortgage obligations and other structured securities. Similarly, each reinsurance contract is disclosed along with various amounts payable or receivable, grouped by assumed vs. ceded insurance, and categorized by type of entity, e.g., affiliated or mandatory pool. Property and casualty lines of business, which use a principles-based reserving approach, are disclosed in great detail regarding losses and loss expenses, including loss reserve triangles and historical development of various aspects of reserves, e.g., bulk and incurred but not reported (IBNR) reserves.

⁸ Where an insurer's accounting differs from the baseline NAIC statutory accounting principles, the impact to capital and surplus as well as net income is disclosed in the notes to financial statements.

**US Insurance Financial Solvency Core Principle 2:
Off-site Monitoring and Analysis**

US regulators and the NAIC conduct off-site risk-focused analysis of insurers.

The primary purpose of off-site solvency monitoring is to assess on an on-going basis the financial condition of the insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance, the results of which are included in an insurer profile for continual solvency monitoring. To accomplish this task, state insurance regulators conduct detailed financial analysis on a quarterly basis using regulatory financial reports, financial tools and other sources of information. Two key sources of information are the results of the most recently completed independent certified public accountant (CPA) audit report and the results of the most recent on-site regulatory financial examination.⁹ Other sources utilized in the analysis include SEC filings, corporate reports, financial statements of ultimate controlling individual/corporation or reinsurers, market conduct reports, rate and policy form filings, consumer complaints, independent rating agency reports, correspondence from agents and insurers, and business media.

Off-site monitoring includes follow up on risks identified during the previous quarter's analysis and the most recent on-site examination. Otherwise, state insurance departments generally prioritize the review of their domiciliary insurers based on a system of financial ratios, other screening tools and criteria that are both qualitative and quantitative in form. When insurers with anomalous results (e.g., insurers experiencing significant variations or negative financial results) that may impact financial solvency are identified, regulators will allot necessary resources and prioritize further analysis of these insurers (relative to other non-priority insurers). The results of the ongoing financial analysis are then used to help prioritize and provide focus to future quarterly off-site monitoring activities (potentially increasing monitoring activities to a monthly or weekly basis) and any on-site examination efforts.

Many tools used by state regulators are maintained by the NAIC and have been created as regulator only tools. These tools are designed to provide an integrated approach to screening and analyzing the financial condition of insurers and are referred to collectively as FAST (i.e., Financial Analysis Solvency Tools). The tools include a comprehensive handbook that sets forth an overall analysis process to be used, as well as more specific financial analysis/tests that utilize the data provided in insurers' financial reports to identify risks or anomalies.

In addition to the NAIC tools described above, the NAIC's Financial Analysis Working Group (FAWG) performs its own analysis of the financial condition of each nationally significant insurer or group each quarter, as well as other insurers or areas posing unique risks identified during a given period, looking not only at statutory financial statements but at other public information, including such financial market metrics as the market's valuation and rating of the insurer's debt and short sales of the insurer's stock. The FAWG does not meet publicly and does not share its deliberations with the general public due to its discussion being focused on the financial condition of individual insurers. This group also monitors industry trends in various risk areas.

⁹ The CPA audit report attests to the fair presentation of the financial statements on an annual basis to allow sufficient reliance upon the insurer's financial reports utilized in all off-site monitoring (see Principle 3).

US Insurance Financial Solvency Core Principle 3: On-Site Risk-focused Examinations

US regulators carry out risk-focused, on-site examinations in which the insurer's corporate governance, management oversight and financial strength are evaluated, including the system of risk identification and mitigation. Through the examination, the reported financial results are assessed and a determination is made of the insurer's compliance with legal requirements.

Insurers are subject to a full-scope financial examination at least once every 5 years.¹⁰ However, based upon the results of off-site monitoring, regulators may place a higher priority on insurers which pose a financial risk and, therefore, conduct on-site examinations more frequently. These examinations may be limited to a review of a specific risk, as long as a full scope exam is conducted at least once every 5 years.

The primary purpose of an on-site examination is to allow state regulators to evaluate and assess the solvency of insurers as of the valuation date and to develop a forward-looking view of an insurer's risks and its risk management practices. This approach permits a direct and specific focus on the areas of greatest risk to an insurer. The results of the off-site analysis are also utilized in identifying areas of concern and key functional activities to be reviewed.

Through the on-site examination, corporate governance practices and processes that are in place to identify and mitigate risk are reviewed and assessed, including, among other things, the function and effectiveness of the board of directors and management, the adequacy of risk management (enterprise risk management), monitoring and management information systems. All significant inherent risks faced by the insurer are identified and assessed, whether they relate to financial reporting issues or to business and operational issues. After risks have been identified, the examiner is required to identify and assess the internal control processes that mitigate each identified risk. Controls are assessed by considering both their current and prospective design and operating effectiveness. The results of these on-site examination processes also provide regulators an indication of the reliability of the insurer's financial reports utilized in off-site analysis.

To prevent duplicative examination efforts by regulators for insurers writing in multiple states, regulators may rely on the exam work of the NAIC accredited domiciliary state. Additionally, for large insurance holding company groups, regulators are encouraged to coordinate their examinations of individual entities by following a lead state concept, thereby allowing the pooling of resources to complete one coordinated exam for the insurer group.

In conjunction with both the on-site examinations and off-site monitoring, regulators review insurer compliance with laws and regulations. Laws and regulations can vary by state.¹¹ Some states will combine their review of compliance with market conduct activities with a financial on-site exam.

US Insurance Financial Solvency Core Principle 4: Reserves, Capital Adequacy and Solvency

¹⁰ In some states the period is three years.

¹¹ These laws typically include, but are not limited to, compliance with investment statutes and regulations regarding types of permissible investments and diversification and liquidity of investments, compliance with (minimum) reserving standards and minimum capital and surplus requirements (including RBC), and the restriction of certain reinsurance activities.

To ensure that legal obligations to policyholders, contract holders and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety.

Accounting standards, risk-based capital requirements, minimum statutory reserves and state-specific minimum capital requirements form the backbone of the reserve and capital adequacy requirements. Conservatism is a pervasive concept in specification of these requirements. As an example, conservatism is one of the foundations of the statutory accounting system.¹² Conservative statutory accounting reporting provides a reasonable level of assurance that an insurer's resources are adequate to meet its policyholder obligations at all times. Other NAIC standards are designed with the same conservatism principle (e.g., model investment laws, credit for reinsurance laws, etc.).

The most visible measure of capital adequacy requirements is associated with the risk based capital (RBC) system. The risk-based capital calculation uses a standardized formula to benchmark specified level of regulatory actions for weakly capitalized insurers. A significant portion of the risk-based formula is derived from the annual statement, which is based upon statutory accounting. The RBC amount explicitly considers the size and risk profile of the insurer.¹³ The risk-based capital calculation provides for higher RBC charges for riskier assets or for riskier lines of business so that more capital is needed as a result. Although risk-based capital results indicate when an insurer's capital position is weak or deteriorating, a ladder of intervention levels exists within the RBC system. Thus, regulators have the authority to require insurers to take some action or the regulator may have the authority to take action with respect to an insurer when the capital level falls within certain threshold amounts that are above the minimum capital requirement. The degree of action depends upon the relative capital weakness as determined by the RBC result and the existence of any mitigating or compounding issues.

States maintain fixed minimum capital requirements (statutes) relating to incorporation and licensing within the particular state that must also be met. Further, the state has the authority to require additional capital and surplus based upon the type, volume, and nature of the insurance business transacted.

Insurers have conservative minimum reserve requirements in addition to capital requirements. Thus, the effect of having both reserves and capital adequacy requirements means that (1) policyholder obligations are covered by enough resources to meet most future economic scenarios, and (2) there are enough resources so that an adverse trend can be detected in time for the regulator to suggest/take corrective action.

**US Insurance Financial Solvency Core Principle 5:
Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities**

The regulatory framework recognizes that certain significant, broad-based transactions/activities affecting policyholders' interests must receive regulatory approval.

Certain significant, broad-based transactions/activities of insurers that affect risk are not part of the day-to-day routine of underwriting and issuing insurance and/or have broad social and equity consequences. To control these risks, regulatory approval of these transactions/activities may be required. Many of

¹² Statutory accounting practices stress measurement of the ability to pay claims of insurers in the future, while generally accepted accounting principles (GAAP) stress measurement of earnings of a business from period to period, and the matching of revenues and expenses for the measurement period. Source: Preamble of the NAIC *Accounting Practices and Procedures Manual*.

¹³ The factors used in the formula are based on considerable research and reflect industry loss experience.

these transactions are also reviewed during the off site monitoring or the on-site examination process to assess insurer compliance. These transactions/activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance as explained below.

Licensing Requirements: An insurer must be licensed before it can operate in a state. The regulator sets the criteria for licensing, and these criteria are clear, objective and public. Regulators assess the license application; this assessment consists of a review of the ownership structure, quality and history of management, internal controls, and projected financial condition. Applicants that do not meet the criteria do not obtain a certificate of authority and/or license to conduct the business of insurance.¹⁴

Change in Control: Notification is required for changes in ownership or control. No transaction involving a change in ownership or control can be completed unless regulatory approval is granted or waived. The regulator bases the approval or rejection decision on financial statements and other relevant information filed with the regulator.

Dividends: The regulator requires prior notice of all stockholder dividends and dividends in excess of a predefined standard (extraordinary dividends) must be filed for approval. Extraordinary dividends cannot be paid until regulatory approval is granted.¹⁵

Transactions with Affiliates: The regulator requires notice for transactions with affiliates and has the authority to reject the transaction. These transactions include, but are not limited to, various intercompany cost sharing arrangements, guarantees, reinsurance, asset purchase and disposal agreements, and tax allocation agreements between the insurer and its affiliates.

Reinsurance: Reinsurance transactions are subject to regulatory review and approval, with the result that some reinsurers may be required to post collateral.

US Insurance Financial Solvency Core Principle 6: Preventive and Corrective Measures, Including Enforcement

The regulatory authority takes preventive and corrective measures that are timely, suitable and necessary to reduce the impact of risks identified during on-site and off-site regulatory monitoring. These regulatory actions are enforced as necessary.

If significant solvency risks are identified as being improperly mitigated such that the insurer is in a hazardous financial condition, the regulator may take corrective or preventive measures including, but not limited to: requiring the insurer to provide an updated business plan in order to continue to transact business in the state; requiring the insurer to file interim financial reports; limiting or withdrawing the insurer from certain investments or investment practices; reducing, suspending or restricting the volume of business being accepted or renewed by the insurer; ordering an increase in the insurer's capital and surplus; ordering the insurer to correct corporate governance practice deficiencies; requiring a replacement of senior management; and seeking a court order to place the company under conservation, rehabilitation, or liquidation;

¹⁴ Effective January 1, 2012, the Accreditation Program will incorporate new standards related to company licensure and change in ownership. These standards require that state insurance departments have sufficient, qualified resources to review applications in a timely manner and have appropriate procedures to properly analyze the application.

¹⁵ This is a general requirement, but individual state requirements may vary. For example, not all states require approval of ordinary dividends. Some states require that all stockholder dividends be approved.

In addition to the corrective measures that can be taken when the insurer is determined to be in a hazardous financial condition, under the RBC system, regulators have the authority and statutory mandate to take preventive and corrective measures that vary depending on the capital deficiency indicated by the RBC result. The broad authority for determining if an insurer is considered to be in a hazardous financial condition is an important part of the US system, and allows for more precision within the RBC calculation.

These preventive and corrective measures are designed to provide for early regulatory intervention to correct problems before insolvencies become inevitable, thereby minimizing the number and adverse impact of insolvencies.

US Insurance Financial Solvency Core Principle 7:

Exiting the Market and Receivership

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines solvency and establishes a receivership scheme to ensure the payment of policyholder obligations of insolvent insurers subject to appropriate restrictions and limitations.

Receivership laws provide measures for regulators to attempt to prevent insolvencies, minimize losses and provide protection for claimants (including policyholders) before an insolvency and/or if an insurer is found to be insolvent. Options considered by regulators as possible alternatives to insolvency include mergers, acquisitions, reinsurance arrangements, non-renewal of part or all of the insurer's book of business, and the viability of allowing the insurer to be placed in run-off mode under its own management. When insolvency cannot be prevented, receivership laws give some priority to the provision of benefits to claimants, including policyholders, or the payment of claims arising under policies. State guaranty associations have been established to protect policyholders, claimants and beneficiaries against financial losses due to insurer insolvencies. Fundamentally, the purpose of an insolvency guaranty law/association is to cover an insolvent insurer's financial obligations, within statutory limits, to policyholders, annuitants, beneficiaries and third-party claimants.

Appendix 1

List of relevant Model Laws, Rules, Regulations and Working Groups by US Insurance Financial Solvency Core Principle

US Insurance Financial Solvency Core Principle 1: Regulatory Reporting, Disclosure and Transparency

NAIC *Accounting Practices and Procedures* Manual
NAIC Blanks Working Group
Statutory Accounting Practices Working Group
EAI Working Group

Financial Analysis Handbook Working Group
NAIC's Standard Valuation Law
Actuarial Opinion and Memorandum Regulation
Part B of the Financial Regulation Standards and Accreditation Program
NAIC Annual Financial Reporting Model Regulation (#205)
Securities Valuation *Purposes and Procedures* Manual.
NAIC *Annual Statement Instructions*
NAIC's *Purposes and Procedures of the Securities Valuation Office*
NAIC *Valuation of Securities Manual*
Business Transacted with Producer Controlled Property/Casualty Insurance Act (#325)

**US Insurance Financial Solvency Core Principle 2:
Off Site Monitoring and Analysis**

Analyst Team System
FAST
NAIC *Accounting Practices and Procedures Manual*
NAIC Annual Financial Reporting Model Regulation (#205)
NAIC Model Insurance Holding Company System Regulatory Act
NAIC Actuarial Opinion and Memorandum Model Regulation (#822)
NAIC Blanks Working Group
Part B of the Financial Regulation Standards and Accreditation Program
Business Transacted with Producer Controlled Property/Casualty Insurance Act (#325)
Financial Analysis Handbooks (as reviewed and updated by the Financial Analysis Handbook Working Group)

**US Insurance Financial Solvency Core Principle 3:
On-site Risk-focused Examinations**

Model Law on Examinations (#390)
Financial Condition Examiners Handbook (Examiners Handbook)
NAIC Annual Financial Reporting Model Regulation (#205)
Insurance Company Holding Company Regulatory Act
NAIC Investment of Insurers Model Act (Defined Limits Version)
NAIC Derivative Instruments Model Regulation
NAIC's Investment of Insurers Model Act (#280)
NAIC Actuarial Opinion and Memorandum Model Regulation (#822)
Part B, Financial Regulation Standards and Accreditation Program

**US Insurance Financial Solvency Core Principle 4:
Capital Adequacy and Solvency**

NAIC Risk-Based Capital for Insurers Model Act
NAIC Risk-Based Capital for Health Organizations Model Act
NAIC *Accounting Practices and Procedures Manual*
NAIC Financial Regulation Standards and Accreditation Program (Capital and Surplus Requirements)
NAIC *Annual Statement Instructions*

NAIC Risk-Based Capital Report Including Overview and Instructions
Model Regulation to Define Standards and Commissioner's Authority for Companies
Deemed to be in Hazardous Financial Condition (#385)
NAIC Credit for Reinsurance Model Law (#785)

**US Insurance Financial Solvency Core Principle 5:
Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities**

Interest Maintenance Reserve calculation (life insurers)
NAIC Investment of Insurers Model Act (#280 and 283)
Actuarial Opinion and Memorandum Regulation
Business Transacted with Producer Controlled Property/Casualty Insurance Act (#325)
Part A, Financial Regulation Standards and Accreditation Program
Insurance Holding Company Regulatory Act

**US Insurance Financial Solvency Core Principle 6:
Preventive and Corrective Measures, Including Enforcement**

NAIC Troubled Insurance Company Handbook
NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed
to be in Hazardous Financial Condition (#385)
Risk-based Capital (RBC) for Insurers Model Act
NAIC Administrative Supervision Model Act
Part A, Financial Regulation Standards and Accreditation Program

**US Insurance Financial Solvency Core Principle 7:
Exiting the Market and Receivership**

NAIC Troubled Insurance Company Handbook
NAIC's Rehabilitation and Liquidation Model Act
Part A, Financial Regulation Standards and Accreditation Program

Appendix 2

Requirements for Accreditation

The Standards have been divided into three major categories: laws and regulations (Part A); regulatory practices and procedures (Part B); and organizational and personnel practices (Part C).

Part A: Laws and Regulations

Preamble

The purpose of the Part A: Laws and Regulations Standards is to assure that an accredited state has sufficient authority to regulate the solvency of its multi-state domestic insurance industry in an effective manner. The Part A standards are the product of laws and regulations that are believed to be basic building blocks for sound insurance regulation. A state may demonstrate compliance with a Part A standard through a law, a regulation, an established practice which implements the general authority granted to the state, or any combination of laws, regulations or practice, which achieves the objective of the standard.

The Part A standards apply to traditional forms of “multi-state domestic insurers.” This scope includes life/health and property/casualty/liability insurers and reinsurers that are domiciled in the accredited state and licensed, accredited or operating in at least one other state. This scope also includes insurers that are domiciled in the accredited state and operating or accepting business on an exported basis in at least one other state as excess and surplus lines insurers or as risk retention groups; except that the term does not include risk retention groups incorporated as captive insurers. It also does not include those insurers that are licensed, accredited or operating in only their state of domicile but assuming business from insurers writing that business that is directly written in a different state. The terms “insurer” and “insurers” used in the Part A standards fall within the definition of “multi-state domestic insurers.” For the purpose of this definition, the term “state” is intended to include any NAIC member jurisdiction, including U.S. territories.

1. Examination Authority

The Department should have authority to examine companies whenever it is deemed necessary. Such authority should include complete access to the company’s books and records and, if necessary, the records of any affiliated company, agent, and/or managing general agent. Such authority should extend not only to inspect books and records but also to examine officers, employees, and agents of the company under oath when deemed necessary with respect to transactions directly or indirectly related to the company under examination. The NAIC Model Law on Examinations or substantially similar provisions shall be part of state law.

2. Capital and Surplus Requirement

The Department should have the ability to require that insurers have and maintain a minimum level of capital and surplus to transact business. The Department should have the authority to require additional capital and surplus based upon the type, volume and nature of insurance business transacted. The Risk Based Capital (RBC) for Insurers Model Act or provisions substantially similar shall be included in state laws or regulations.

3. NAIC Accounting Practices and Procedures

The Department should require that all companies reporting to the Department file the appropriate NAIC annual statement blank, which should be prepared in accordance with the

NAIC's instructions handbook and follow those accounting procedures and practices prescribed by the NAIC's *Accounting Practices and Procedures Manual*, utilizing the version effective January 1, 2001 and all subsequent revisions adopted by the Financial Regulation Standards and Accreditation (F) Committee.

4. Corrective Action

State law should contain the NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in a Hazardous Financial Condition or a substantially similar provision, which authorizes the Department to order a company to take necessary corrective action or cease and desist certain practices that, if not corrected, could place the company in a hazardous financial condition.

5. Valuation of Investments

The Department should require that securities owned by insurance companies be valued in accordance with those standards promulgated by the NAIC's Securities Valuation Office. Other invested assets should be required to be valued in accordance with the procedures promulgated by the NAIC's Financial Condition (E) Committee.

6. Holding Company Systems

State law should contain the NAIC Model Insurance Holding Company System Regulatory Act or an Act substantially similar, and the Department should have adopted the NAIC's model regulation relating to this law.

7. Risk Limitation

State law should prescribe the maximum net amount of risk to be retained by a property and liability company for an individual risk based upon the company's capital and surplus. This limitation should be no larger than 10% of the company's capital and surplus.

8. Investment Regulations

State statute should require a diversified investment portfolio for all domestic insurers both as to type and issue and include a requirement for liquidity. Foreign companies should be required to substantially comply with these provisions.

9. Liabilities and Reserves

State statute should prescribe minimum standards for the establishment of liabilities and reserves resulting from insurance contracts issued by an insurer; including life reserves, active life reserves, and unearned premium reserves, and liabilities for claims and losses unpaid and incurred but not reported claims. The NAIC's Standard Valuation Law and Actuarial Opinion and Memorandum Regulation or substantially similar provisions shall be in place.

10. Reinsurance Ceded

State law should contain the NAIC Model Law on Credit for Reinsurance, the NAIC's Credit for Reinsurance Model Regulation and the NAIC Life and Health Reinsurance Agreement Model Regulation or substantially similar laws.

11. CPA Audits

State statute or regulation should contain a requirement for annual audits of domestic insurance companies by independent certified public accountants, based on the NAIC's Annual Financial Reporting Model Regulation.

12. Actuarial Opinion

State statute or regulation should contain a requirement for an opinion on reserves and loss and loss adjustment expense reserves by a qualified actuary or specialist on an annual basis for all domestic insurance companies.

13. Receivership

State law should set forth a receivership scheme for the administration, by the insurance commissioner, of insurance companies found to be insolvent as set forth in the NAIC's Insurer Receivership Model Act.

14. Guaranty Funds

State law should provide for a regulatory framework such as that contained in the NAIC's model acts on the subject, to ensure the payment of policyholders' obligations subject to appropriate restrictions and limitations when a company is deemed insolvent.

15. Filings with NAIC

State statute, regulation or practice should mandate filing of annual and quarterly statements with the NAIC in a format acceptable to the NAIC except that states may exempt from this requirement those companies that operate only in their state of domicile.

16. Producer Controlled Insurers

States should provide evidence of a regulatory framework, such as that contained in the NAIC's model law for Business Transacted with Producer Controlled Property/Casualty Insurer Act or similar provisions.

17. Managing General Agents Act

States should provide evidence of a regulatory framework, such as that contained in the NAIC's Managing General Agents Model Act or similar provisions.

18. Reinsurance Intermediaries Act

States should provide evidence of a regulatory framework, such as that contained in the NAIC's Reinsurance Intermediary Model Act or similar provisions.

(Note: If a state can provide evidence that none of the entities contemplated in above standards 14, 16, 17 or 18, is either present or allowed to operate in the state, it will not need to demonstrate compliance with that standard.)

Part B: Regulatory Practices and Procedures

Preamble

The purpose of Part B is to identify base-line regulatory practices and procedures required to supplement and support enforcement of the states' financial solvency laws in order for the states to attain substantial compliance with the core standards established in Part A. Part B identifies standards that are to be applied in the regulation of all forms of multi-state insurers.

Part B sets out standards required to ensure adequate solvency regulation of multi-state insurers. Each state must make an appropriate allocation of its available resources to effectively address its regulatory priorities. In addition to a domestic state's examination and analysis activities, other checks and balances

exist in the regulatory environment. These include other states' regulation of licensed foreign companies, the appropriate application of FAST and IRIS ratios, the analyses by NAIC's staff, the NAIC Financial Analysis Working Group, the NAIC Analyst Team System project, and, to some extent, the evaluation by private rating agencies.

The scope of Part B is broader than the scope of Part A. "Multi-state insurer" as used in Part B encompasses all forms of insurers domiciled or chartered in the accredited state and licensed, registered, accredited or operating in at least one other state. This scope also includes insurers that are domiciled in the accredited state and operating or accepting business on an exported basis in at least one other state as excess and surplus lines insurers. It does not include those insurers that are licensed, accredited or operating in only their state of domicile but are assuming business from insurers writing that business that is directly written in a different state. The term "insurer" in Part B includes traditional insurance companies as well as, for instance, health maintenance organizations and health service plans, captive risk retention groups, and other entities organized under other statutory schemes. Although this scope includes risk retention groups organized as a captive insurer, it does not include any other type of captive insurer. While the unique organizational characteristics of some of these entities may require specialized laws, their multi-state activity demands solvency oversight that employs the base-line regulatory practices and procedures identified in Part B. For purposes of this definition, the term "state" is intended to include any NAIC member jurisdiction, including U.S. territories.

The accreditation program recognizes that complete standardization of practices and procedures across all states may not be practical or desirable because of the unique situations each state faces. States differ with respect to staff and technology resources that are available as well as the characteristics of the domestic industry regulated. For example, states may choose to emphasize automated analysis over manual or vice versa. Reliable results may be obtained using alternative, yet effective, financial solvency oversight methodologies. The accreditation program should not emphasize form over substance in its evaluation of the states' solvency regulation.

(NOTE: FRSAC has adopted Review Team Guidelines that provide detailed guidance to the review teams regarding how compliance with the Part B, Regulatory Practices and Procedures Standards should be assessed. These guidelines can also assist states in preparing for the accreditation review of their Department.)

1. Financial Analysis

a. Sufficient Qualified Staff and Resources

The Department should have the resources to review effectively on a periodic basis the financial condition of all domestic insurers.

b. Communication of Relevant Information to/from Financial Analysis Staff

The Department should provide relevant information and data received by the Department, which may assist in the financial analysis process to the financial analysis staff and ensure that findings of the financial analysis staff are communicated to the appropriate person(s).

c. Appropriate Supervisory Review

The Department's internal financial analysis process should provide for appropriate supervisory review and comment.

d. Priority-Based Analysis

The Department's financial analysis procedures should be priority-based to ensure that potential problem companies are reviewed promptly. Such a prioritization scheme should utilize appropriate factors as guidelines to assist in the consistent determination of priority designations.

e. Appropriate Depth of Review

The Department's financial analysis procedures should ensure that domestic insurers receive an appropriate level or depth of review commensurate with their financial strength and position.

f. Documented Analysis Procedures

The Department should have documented financial analysis procedures and/or guidelines to provide for consistency and continuity in the process and to ensure that appropriate analysis procedures are being performed on each domestic insurer.

g. Reporting of Material Adverse Findings

The Department's procedures should require that all material adverse indications be promptly presented to the commissioner or an appropriate designee for determination and implementation of appropriate regulatory action.

h. Action on Material Adverse Findings

Upon the reporting of any material adverse findings from the financial analysis staff, the Department should take timely action in response to such findings or adequately demonstrate the determination that no action was required.

2. Financial Examinations

a. Sufficient Qualified Staff and Resources

The Department should have the resources to effectively examine all domestic insurers on a periodic basis in a manner commensurate with the financial strength and position of each insurer.

b. Communication of Relevant Information to/from Examination Staff

The Department should provide relevant information and data received by the Department, which may assist in the examination process to the examination staff and ensure that findings of the examination staff are communicated to the appropriate person(s).

c. Use of Specialists

The Department's examination staff should include specialists with appropriate training and/or experience or otherwise have available qualified specialists, which will permit the Department to effectively examine any insurer. These specialists should be utilized where appropriate given the complexity of the examination or identified financial concerns.

d. Appropriate Supervisory Review

The Department's procedures for examinations should provide for supervisory review of examination workpapers and reports to ensure that the examination procedures and findings are appropriate and complete and that the examination was conducted in an efficient and timely manner.

e. Use of Appropriate Guidelines and Procedures

The Department's policies and procedures for the conduct of examinations should generally follow those set forth in the NAIC *Financial Condition Examiners Handbook*. Appropriate variations in methods and scope should be commensurate with the financial strength and position of the insurer.

f. Scheduling of Examinations

In scheduling financial examinations, the Department should follow procedures such as those set forth in the NAIC *Financial Condition Examiners Handbook* that provide for the periodic examination of all domestic companies on a timely basis. This system should accord priority to companies that exhibit adverse financial trends or otherwise demonstrate a need for examination.

g. Examination Reports

The Department's reports of examination should be prepared in accordance with the format adopted by the NAIC and should be sent to other states in which the insurer transacts business in a timely fashion.

h. Reporting of Material Adverse Findings

The Department's procedures should require that all material adverse findings be promptly presented to the commissioner or an appropriate designee for determination and implementation of appropriate regulatory action.

i. Action on Material Adverse Findings

Upon the reporting of any material adverse findings from the examination staff, the Department should take timely action in response to such findings or adequately demonstrate the determination that no action was required.

3. Information Sharing and Procedures for Troubled Companies

a. Information Sharing

States should allow for the sharing of otherwise confidential documents, materials, information, administrative or judicial orders, or other actions with the regulatory officials of any state, federal agency or foreign countries providing that the recipients are required, under their law, to maintain its confidentiality. States also should allow for the sharing of otherwise confidential documents, materials, information, administrative or judicial orders, or other actions with the NAIC providing that the NAIC demonstrates by written statement the intent to maintain its confidentiality. The Department should have a documented policy to cooperate and share information with respect to domestic companies with the regulatory officials of any state, federal agency or foreign countries and the NAIC directly and also indirectly through committees established by the NAIC, which may be reviewing and coordinating regulatory oversight and activities. This policy should also include cooperation and sharing information with respect to domestic companies subject to delinquency proceedings.

b. Procedures for Troubled Companies

The Department should generally follow and observe procedures set forth in the NAIC *Troubled Insurance Company Handbook*. Appropriate variations in application of

procedures and regulatory requirements should be commensurate with the identified financial concerns and operational problems of the insurer.

Part C: Organizational and Personnel Practices

1. Professional Development

The Department should have a policy that encourages the professional development of staff involved with financial surveillance and regulation through job-related college courses, professional programs, and/or other training programs.

2. Minimum Educational and Experience Requirements

The Department should establish minimum educational and experience requirements for all professional employees and contractual staff positions in the financial regulation and surveillance area, which are commensurate with the duties and responsibilities of the position.

3. Retention of Personnel

The Department should have the ability to attract and retain qualified personnel for those positions involved with financial surveillance and regulation.

Source: *Administrative Policies Manual of the Financial Regulation Standards and Accreditation Program*, January 1, 2009, pp. 9-16.

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Summary of NAIC International Activities

International Developments

Many international financial regulatory developments will have a direct impact on insurance regulation in the United States. The NAIC is working to ensure that international financial regulators and supervisors understand (1) that insurance is different than banking and other types of financial institutions, and (2) that while different in some respects from the approaches utilized by our foreign counterparts, the supervisory approaches utilized by U.S. state insurance regulators have been effective in protecting insurance consumers. The stability and performance of the U.S. insurance sector throughout the financial crisis is a testament to these facts.

IMF FSAP

The U.S. financial regulatory system, including insurance regulation, was reviewed as part of the International Monetary Fund's (IMF's) Financial Sector Assessment Program (FSAP) in 2010. Our state-based insurance regulatory system was assessed by the IMF against 28 Insurance Core Principles (ICP) developed by the International Association of Insurance Supervisors (IAIS). The IMF found that U.S. insurance regulators observed or largely observed 25 of the 28 international standards, and it also noted the overall resilience of the insurance sector through the financial crisis. According to the IMF: "There is generally a high level of observance of the Insurance Core Principles. Aspects of regulatory work such as data collection and analysis in relation to individual insurance companies are world-leading. There are mechanisms to ensure individual states implement solvency requirements effectively." While this is a positive reflection on the sector and our regulatory system, the IMF also made several recommendations regarding compliance with the standards which are currently being reviewed and assessed by state regulators. The US financial sector will be subject to an FSAP every five years, and the IMF will assess the degree to which U.S. regulators consider and address recommendations made in the previous FSAP.

International Standard Setting

The NAIC is a founding member and an active leader in the International Association of Insurance Supervisors (IAIS), which was established in 1994. The IAIS is the international standards setting body for insurance, similar to the Basel Committee on Bank Supervision (BCBS) that sets international bank standards and the International Organization of Securities Commissions (IOSCO) that sets international securities standards. State insurance regulators or their NAIC representatives are active members in all of the major IAIS committees and subcommittees. In particular, the NAIC and its members were active in recent revisions of the IAIS Insurance Core Principles (ICPs), adopted in Seoul on October 1, 2011, which will form the basis for the next IMF FSAP with respect to insurance. While IAIS activity is nonbinding on its member jurisdictions, the scope and importance of the IAIS work and its potential impact on U.S. insurers has increased significantly since the financial crisis, and subsequently our involvement at the IAIS has increased to ensure that the U.S. regulators' perspective is reflected in its projects.

Supervisory Colleges, Supervisory Forum, and the ComFrame Process

NAIC is advocating enhanced coordination through supervisory colleges as well as through the new Supervisory Forum, which the NAIC chairs. Supervisory colleges are important vehicles for enhancing supervisory cooperation and coordination among international regulators relating to a specific insurance group. U.S. and international regulators are in the process of developing best practices for participating in these discussions, including guidance on the coordination and communication of information to cross-border and other functional regulators and through international roundtables.

The Supervisory Forum at the IAIS will allow insurance supervisors to share processes globally and, at a practical level, to try to coordinate our information requests and oversight of internationally active insurers. In some respects this initiative is modeled after the multi-jurisdictional coordination framework that exists in the United States, but it will be applied on an international scale. The primary objective of this forum is to strengthen insurance supervision and to foster convergence of supervisory practices through exchange of real-world experiences.

The NAIC and the state regulators also participate in the IAIS's Common Framework for the Supervision of Internationally Active Insurance Groups, or ComFrame. This project aims to help make group-wide supervision of internationally active insurance groups more effective. It has the potential to create a multijurisdictional approach to supervision that emphasizes robust oversight and cooperation while maintaining the proper balance between home and host jurisdictions. While the ultimate role of ComFrame remains under discussion and development, the intent is given by its name – a common framework – one that lays out how supervisors around the globe can work together to supervise internationally active insurance groups. ComFrame is neither intended to be a forum to create prescriptive ways to promote a particular means for solvency standards, nor to create additional layers of regulation. The work of the Supervisory Forum will also contribute to the development and operationalization of ComFrame.

Notwithstanding these international developments and their increasing impact on NAIC and state regulation, as we talk about international convergence, we must again keep in mind that there are different regulatory systems and approaches around the globe, so convergence must be a discussion about arriving at common outcomes and not necessarily universal standards or structures. Global convergence should focus initially on information sharing and include mechanisms for peer review, just as the US insurance regulators have applied in the NAIC's Financial Accreditation program.

While we believe the U.S. solvency system contributed to the relative stability of the insurance sector during the financial crisis, regulation needs to constantly evolve over time in response to market developments. The Solvency Modernization Initiative (SMI), which is part of the NAIC's continuous improvement process, is examining international developments regarding insurance supervision, banking supervision, and international accounting standards and will consider their potential application for U.S. insurance regulation.

Financial Stability and the IAIS G-SIFI Process

The NAIC and state regulators are also active at the IAIS Financial Stability Committee, which is currently in the process of developing a methodology for identifying Globally Systemic Financial Institutions (or G-SIFIs). The recent financial crisis has clearly demonstrated that it is not just sufficient to focus on a single sector any longer, and we are increasingly being asked to participate in global dialogues with international supervisors and standard setters from across the financial spectrum. The U.S. is a member of the Financial Stability Board (FSB), which is engaging directly with the IAIS on a number of issues, including G-SIFI identification. We have been active and constructive contributors to those discussions regarding FSB projects and priorities. Our involvement here is critical, as the FSB is a bank-centric organization, and through the IAIS we continue to stress that the insurance business model needs to be distinguished from the banking business model when applying new regulatory requirements.

Communication, Collaboration and Cooperation among Supervisors

Beyond identifying systemic risk, the day-to-day supervision of insurance in the U.S. requires extensive coordination among our regulators. State insurance regulators have a long history of coordination through the NAIC, and have embedded systems of peer review into our processes to promote consistent oversight. Similar efforts to coordinate at the international level are evolving, so U.S. regulators along with their international counterparts are stepping up efforts to strengthen supervision through enhanced coordination. U.S. state insurance regulators are involved in technical exchanges, training programs, and other forms of regular dialogue. We continue to pursue the necessary bilateral and multilateral information agreements or Memoranda of Understanding that provide the foundation for these regulatory exchanges. The leadership of U.S. regulators in these efforts helps us understand the various supervisory practices and cultures and better appreciate the global risk trends that may impact domestic insurers and policyholders. This type of increased cooperation has been discussed internationally for some time, particularly with a focus on improved efficiency and teamwork among regulatory systems, but the recent financial crisis has accelerated the current efforts on developing and implementing best practices to eliminate the risk of systemic threats. To help foster a more cooperative and collaborative environment, U.S. insurance supervisors engage in recurring regulator-to-regulator dialogues with representatives from the EU, North America, China, Japan, Switzerland, and other jurisdictions around the world. These efforts promote best practices abroad.

US-EU Regulator Dialogue and Solvency II Equivalence

The NAIC and state regulators continue to have regular dialogues with European regulators and the European Insurance and Occupational Pensions Authority (EIOPA), which serves as the standard-setting organization in Europe. These regular discussions are extremely useful and timely, as the European Union (EU) and the U.S. both continue to move forward with significant enhancements to insurance regulation; Europe through Solvency II, and the United States through our Solvency Modernization Initiative (SMI). Together, the U.S. and the EU oversee approximately two-thirds of the global insurance market. The Solvency II initiative requires an assessment of “third countries” to determine if their levels of solvency supervision are equivalent

November 30, 2011

to Solvency II, notwithstanding that Solvency II is still a few years away from being operational. To the extent that Europe might not find our system of supervision equivalent, it could have negative implications on U.S. insurers doing business in Europe and European insurers doing business in the U.S. We believe Europe is committed to assessing other jurisdictions on an outcomes basis, with a focus on common principles, where they review the overall objective of protecting policyholders and ensuring strong solvency oversight, rather than requiring adoption of Solvency II itself. Although the U.S. insurance regulators do not intend to implement Solvency II in the states, and there are clear differences between the regulatory and legal structure of our markets, we do believe that our system of supervision is at least equivalent to Solvency II on an outcomes basis. The IMF assessment of our system and the performance of our market relative to other sectors during the financial crisis reinforce this view. We have encouraged our European colleagues to review our system on an outcomes basis to recognize that our system is essentially equivalent for avoid any disruptions in the transatlantic insurance market.

Final Comments

Insurance markets are becoming increasingly global and interconnected, and this trend is clearly going to continue. For these reasons, the NAIC's international involvement has been increasingly focused on the supervision of insurers that operate in multiple countries, or internationally active insurance groups (IAIGs). In light of the financial crisis and the evolving insurer business model, insurance regulators recognize it is vital to improve coordination and collaboration to better supervise IAIGs, and we are developing structures and tools to better identify internal and external risks to the insurance sector. These new tools will enable us to better anticipate risks that are evolving beyond our borders and outside our respective jurisdictions.

NAIC PRIORITIES & ASSIGNMENTS

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS (IAIS)

Level One Priority

[Comment, participate in all meetings, including interim meetings]

| IAIS COMMITTEE | COMMITTEE CHAIRS | NAIC ASSIGNMENT |
|--|--|--|
| Executive Committee | Peter Braumueller (Chair) – Austria Yasuhiro Hayasaki (Vice Chair) – Japan | EX (1) Committee International (G) Committee Members: Cmsrs. Urias (AZ), McCarty (FL); Terri Vaughan (NAIC) NAIC: Ryan Workman, Eric Thompson |
| Financial Stability Committee | Peter Braumueller (Chair) – Austria Elise Liebers (Vice Chair) – NAIC | International (EX) Leadership Group Member: Cmsr. Leonardi (CT) NAIC: Elise Liebers, Gita Timmerman, Ryan Workman, Eric Thompson |
| Audit Committee | Vacant (Chair) | EX(1) Committee, IIRLG Member: Cmsr McCarty (FL) NAIC: Ryan Workman |
| Common Assessment Framework Oversight Group | David Oakden (Chair) - Canada | G Committee; SMI (EX) TF Member: Cmsr McCarty (FL) |
| Supervisory Forum | Steve Ferguson (Chair) – (AZ) | G Committee; SMI (EX) TF Members: Steve Ferguson (AZ) NAIC: Elise Liebers, David Vacca, Larry Bruning, Ramon Calderon |
| Macroprudential Policy & Surveillance Working Group | Mary Frances Monroe – (Chair) - Bermuda | G Committee; SMI (EX) TF Members: Larry Bruning (NAIC) NAIC: Elise Liebers, David Vacca, Ramon Calderon, Gita Timmerman |
| Technical Committee | Monica Maechler (Chair) – Switzerland David Oakden (Vice Chair) – Canada (OSFI) | G Committee Member: Cmsr. McCarty (FL) NAIC: Rob Esson, Ryan Workman, Gita Timmerman, Ramon Calderon, Elise Liebers |
| Implementation Committee | Hari Narayan (Chair) – India Nora Kiss (Vice Chair) – Hungary | International Regulatory Cooperation (G)Working Group Member: Cmsr. Urias (AZ), Ekrem Sarper (NAIC) NAIC: Ekrem Sarper |

| IAIS COMMITTEE | COMMITTEE CHAIRS | NAIC ASSIGNMENT |
|--|--|--|
| <u>SUBCOMMITTEES:</u> | | |
| Governance & Compliance Subcommittee | Dhammika Amukotuwa (Chair) – Dubai Ann Nee Kee (Vice Chair) – Singapore | Corporate Governance (EX) Working Group Member: Andrew Stolfi (IL) NAIC: Ryan Workman |
| Insurance Groups & Cross Sectoral Issues | Petra Faber (Chair) – Germany Vacant (Vice Chair) | Group Solvency Issues (EX) Working Group Member: Danny Saenz (TX) NAIC: David Vacca |
| Joint Working Group on Microinsurance | Armando Virgilio dos Santos Junior (Chair) - Brazil | International Regulatory Cooperation (G)Working Group Member: Pending NAIC: Gita Timmerman |
| Market Conduct Subcommittee | Julien Reid (Chair) – Canada (Quebec) Adel Mounir (Vice Chair) – Egypt | Market Regulation and Consumer Affairs (D) Committee Member: Cmsr. Voss (IA) NAIC: Ryan Workman |
| Reinsurance & Other Forms of Risk Transfer Subcommittee | Ryan Couch (Chair) – NAIC Jeremy Cox (Vice Chair) – Bermuda | Reinsurance (E) Task Force Member: Pending NAIC: Ryan Couch, Dan Schelp |
| Reinsurance: Mutual Recognition Subgroup | Vacant (Chair) | Reinsurance (E) Task Force Member: Pending NAIC: Ryan Couch, Dan Schelp |
| Reinsurance Transparency Group | Jeremy Cox – Bermuda | Reinsurance (E) Task Force Member: Pending NAIC: Ryan Couch, Dan Schelp |
| Solvency & Actuarial Issues Subcommittee | Ramon Calderon (Chair) – NAIC Jumpei Miwa (Vice Chair) – Japan | International Solvency (EX) Working Group Member: Ramon Calderon (NAIC), Al Bottalico (CA) NAIC: Larry Bruning |
| Standards Observance Subcommittee | Jonathan Dixon (Chair) – South Africa Ekrem Sarper (Vice Chair) - NAIC | International Regulatory Cooperation (G)Working Group Member: Ekrem Sarper (NAIC) |
| Supervisory Cooperation Subcommittee | Richard Walker (Chair) – Guernsey Vacant (Vice Chair) | International Regulatory Cooperation (G)Working Group Member: Pending |

| IAIS COMMITTEE | COMMITTEE CHAIRS | NAIC ASSIGNMENT |
|-----------------------|-------------------------|------------------------------------|
| | | NAIC: Ekrem Sarper, Gita Timmerman |

Level Two Priority

| IAIS COMMITTEE | COMMITTEE CHAIR | NAIC ASSIGNMENT |
|--|---|---|
| Education Subcommittee | Walid Genadry (Chair), Lebanon Vacant (Vice Chair) | International Regulatory Cooperation (G)Working Group Member: Ekrem Sarper (NAIC) |
| Accounting and Auditing Issues Subcommittee | Richard Thorpe (Chair) – UK Rob Esson (Vice Chair) – NAIC | International Accounting (EX) Working Group Member: Rob Esson (NAIC) |
| Insurance Fraud Subcommittee | Richard Walker (Acting Chair) – Guernsey Vacant (Vice Chair) | Antifraud Task Force Member: Pending NAIC: Ryan Workman, Keri Kish |
| Budget Committee | Victor Rod (Chair) – Luxembourg David Oakden (Vice Chair) – Canada (OSFI) | G Committee Member: Ryan Workman (NAIC) |

Level Three Priority

| IAIS COMMITTEE | COMMITTEE CHAIR | NAIC ASSIGNMENT |
|-----------------------------------|-----------------------------------|------------------------|
| Pension Coordination Group | Julia Cilikova (Chair) – Slovakia | |

Other

| COMMITTEE | ISSUES | NAIC ASSIGNMENT |
|--|--|---|
| Joint Forum | Plenary | G Committee Member: Cmsr. McCarty (FL) NAIC: Elise Liebers, Rob Esson |
| Joint Forum: Working Groups | Risk Assessment & Capital Principles of Fin'l Conglomerates | G Committee; [Others] Member: Rob Esson (NAIC) |
| Financial Stability Board (FSB): Plenary & Groups | Coordination w/ US agencies | G Committee NAIC: Elise Liebers, Gita Timmerman, Eric Thompson |
| International Trade | NAFTA, bilateral, GATS | G Committee NAIC: Ekrem Sarper |
| Regulatory Cooperation | MOUs on regulatory cooperation; relationship building; training; conferences | International Regulatory Cooperation (G) WG NAIC: Ekrem Sarper, Gita Timmerman, Ryan Workman |
| OECD | Various | G Committee NAIC: Ekrem Sarper |
| FSAP Implementation | | G Committee NAIC: Gita Timmerman |
| Regulatory Dialogues: | EU, EIOPA, Solvency II | G Committee NAIC: Gita Timmerman |
| | ASSAL, Bermuda, China, India, Korea, Japan, Switzerland, Taiwan, Thailand, | G Committee NAIC: Ekrem Sarper |
| | | |

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NAIC Stress Testing Overview

NAIC Data Collection and Analysis

The National Association of Insurance Commissioners (NAIC) is the association of state insurance commissioners in the United States. Its 56 Members oversee insurance markets that collectively represent approximately 40% of the world's insurance market. U.S. state insurance regulators oversee the financial soundness of all individual insurers within their authority, and in doing so consider the potential impact of insolvency on consumers, as well as the impact on the insurance marketplace for consumers. The NAIC enhances the oversight process by allowing state regulators to more effectively monitor macro-level issues impacting the U.S. insurance market in order for appropriate responses to be considered at a micro-level. The NAIC further assists state regulatory efforts with regulatory responses that may necessitate market-wide approaches.

Policyholder protection is the foremost regulatory goal of U.S. state insurance regulators. Solvency regulation is a key component, and the NAIC data collection and analysis processes serve to facilitate regulators' efforts in this area. The data collection approach focuses on the individual insurance entity and is supported by a consistent accounting base (NAIC Statutory Accounting Principles), uniform definitions, a uniform template for statutory reporting and quality assurance processes.

The standardized quarterly and annual statements filed by all U.S. insurers are the primary vehicles that enable the compilation of data that ultimately populates the NAIC Financial Data Repository (FDR) database. The FDR facilitates the regular review of market conditions and assessment of market exposure by U.S. state insurance regulators through various reports, publications (public and non-public), and automated financial regulatory tools. The FDR contains detailed information on every component of each insurer's balance sheet, income statement, investment mix and product mix. This information is supplemented annually with more specific product breakout information. States also utilize "data calls" when additional information is needed on an even more granular level (e.g. disaster reporting).

The detailed data collected by the NAIC not only allows for analysis at the individual entity level for solvency purposes, but also allows for significant macro-level analysis to be conducted by regulators and various NAIC departments or groups, including but not limited to the Insurance Analysis & Information Services Department, Capital Markets Bureau, Research Department and the Financial Analysis Working Group (FAWG). In addition, this detailed information greatly enhances the NAIC's ability to incorporate stress testing initiatives into the U.S. national system of state-based insurance regulation.

NAIC Stress Testing: Investment and Capital Markets

In 2009, the NAIC utilized the standardized statutory financial statement and risk-based capital (RBC) data in the FDR to perform top-down stress testing of the US insurance industry. The RBC formula inputs were modified for various stress scenarios to generate the new Total Adjusted Capital (TAC) and the Authorized Control Level RBC (the denominator in the commonly used RBC ratio).

As an initial pass shortly after receipt of the 2008 statutory annual statements, the NAIC performed a simple 40% equity drop in the TAC of the companies and reviewed the results for the entire life, property/casualty and health industries. The results of this initial, high level stress test focused subsequent

efforts on the life insurance industry. As a means of addressing time constraints while still generating valuable feedback, the top 30 life insurance entities were selected for more detailed stress testing. These entities account for approximately 68% of the US life insurance premium volume.

The more detailed stress testing mostly focused on asset stresses in the life RBC formula. In the U.S. statutory financial statements, investments are reported to the NAIC in detail, by CUSIP if applicable, as well as by various categories. For example, commercial mortgage-backed securities (CMBS) are reported separately from residential mortgage-backed securities (RMBS) and other asset-backed securities. This information from the investment schedule tables within the FDR was supplemented by additional analytical information to establish breakout categories for the following: RMBS Subprime, RMBS Subprime-Like, CMBS Senior, CMBS Mezzanine, CMBS Subordinate, and the remaining bonds – industrial and miscellaneous. The RBC charges assessed against bonds increase as the credit quality designation moves from the highest quality down through to the lowest quality.

Because of this dynamic, all bonds were subjected to a downward migration schedule. The RMBS and CMBS migration percentages were based upon actual downward migrations experienced in 2008 as the stress scenario. The remaining industrial and miscellaneous bonds used an ARO moderate stress scenario. Thus, this results in larger numbers of bonds falling into higher RBC charge categories. In addition, the following specific asset stresses were performed:

- RMBS Subprime = 28% loss scenario (reduced TAC and the amount in the ACL RBC calc)
- RMBS Subprime-Like = 13% loss scenario
- CMBS Senior = 5% loss scenario
- CMBS Mezzanine = 25% loss scenario
- CMBS Subordinate = 50% loss scenario
- Unaffiliated Common Stock = 40% loss scenario
- Affiliated Common Stock = 30% loss scenario
- Preferred Stock = 5% loss scenario
- Real Estate = 30% loss scenario
- Mortgage Loans = 5% loss scenario – [analysts view US insurers as not materially subject to the reduced underwriting standards issue that has caused problems for many other institutions]
- All Other Long-Term Assets = 20% loss scenario

Since the variable annuity writers were of particular concern this cycle, it was determined that a liability stress impact should be incorporated for these entities. To do this, the NAIC recognized that 2008 resulted in significant reserve increases due to a regulatory requirement that variable annuity writers must conduct a standalone asset adequacy analysis on the variable annuity blocks of business; thus the reserves reflected the increased liability caused by the downturn in the market. Although, a majority of the reserve correction had already occurred, to further stress these entities, another 10% increase in the reserves was assumed by reducing TAC by 10% of the 2008 reserve amounts for these products. In summary, the results of this stress test indicated the following:

| | <u>2007</u> | <u>2008</u> | <u>Stress Result</u> |
|---|-------------|-------------|----------------------|
| Aggregate RBC | 862.2% | 842.6% | 475.4% |
| Companies with the RBC % Less Than 300% | 0 | 0 | 6 |
| Companies with the RBC % Less Than 200% | 0 | 0 | 2 |

The NAIC will conduct this macro-level stress testing as needed and deemed appropriate; thus, the regulators and staff will determine the appropriate stressors given the different economic environment and conduct the test accordingly. With respect to the test performed in 2009, the NAIC is already involved in the Principles Based Reserves initiative, which contemplates items that will assist with the stresses included in the previous test. The result of this initial testing was to focus regulatory oversight to the specific companies, and types of companies, that showed the most detrimental response to the stress test. Commissioners at the various domiciliary states for variable annuity writers also required insurers to perform some bottom-up stress tests, including liquidity stresses that are not able to be modeled through the RBC formula at this time.

Additional stress testing has been conducted in 2010 and 2011. The global economic weakness over the last few years has exacerbated and exposed significant economic problems and substantial budgetary shortfalls within various countries, and concerns with respect to certain countries reached a peak in the last several months. NAIC staff has analyzed the exposure of the U.S. insurance industry to investments in certain of these countries with respect to sovereign debt, as well as debt and equity exposure in companies domiciled in those countries and potentially impacted by domestic economic problems. The NAIC analysis included review of overall industry exposure by country and insurance company type. The largest individual company exposures were reviewed on a dollar level and, more importantly, as a percent of surplus and capital. The stress test assumed recognition of permanent losses in values and higher RBC factors due to downgrades. The results of this analysis are the basis of ongoing discussion within FAWG.

Similar work has been conducted with respect to commercial real estate exposure, particularly related to CMBS, with additional analysis on direct loan, municipal and real estate equity exposure. This work continues to be an ongoing area of discussion within FAWG. This includes providing regular updates on the state of the overall commercial real estate market and municipal market and focusing on specific company exposures. Extending that, the NAIC pulled together a panel discussion of experts in commercial real estate to provide a market update for the NAIC Capital Adequacy Task Force and Valuation of Securities Task Force. Specifically on CMBS, the NAIC has conducted analysis focusing on different risk attributes of the industry's exposure (position in capital structure, vintage, property type exposure). In addition, the NAIC has responded to specific requests to analyze individual company exposures. This has resulted in regular NAIC reports to FAWG, focusing on overall delinquency levels in commercial real estate and market level expectations for the near term. The results of these efforts have provided comfort to state regulators that on an overall basis, industry exposure to problems in this sector is manageable. The reports have further facilitated micro prudential analysis by individual states in instances where specific companies require a higher level of scrutiny.

Life Insurance Industry Exposure to Interest Rate Risk

Background

All U.S. domestic life insurance companies are subject to minimum valuation requirements for life insurance contracts. These minimum valuation requirements are defined in the Standard Valuation Law that has been adopted by all 50 state legislatures. The Standard Valuation Law, in addition to specifying the minimum reserve requirements for all life insurance contracts, also requires all life insurance companies to annually file an opinion of a qualified actuary. The qualified actuary must give an opinion as to whether the reserves and related actuarial items held in support of the policies and contracts are computed appropriately, are based on assumptions that satisfy contractual provisions, are consistent with prior reported amounts and comply with applicable laws of the state. The qualified actuary's opinion must take into account the assets held by the life insurance company with respect to the reserves and related actuarial items, including but not limited to the investment earnings on the assets and the considerations anticipated to be received and retained under the policies and contracts, make adequate provision for the life insurance company's obligations under the policies and contracts, including but not limited to the benefits under and expenses associated with the policies and contracts.

In addition to the Standard Valuation Law, all 50 states have adopted the Actuarial Opinion and Memorandum Regulation (AOMR) which defines the requirements for the actuarial opinion, rules that are applicable to the appointment of an appointed actuary, standards for asset adequacy analysis and the requirements for documenting the asset adequacy analysis. In particular, the AOMR states that if the appointed actuary determines as the result of asset adequacy analysis that a reserve should be held in addition to the aggregate reserve held by the life insurance company and calculated in accordance with methods set forth in the Standard Valuation Law, the life insurance company shall establish the additional reserve. The Standard Valuation Law and the Actuarial Opinion and Memorandum Regulation are accreditation requirements and currently all 50 states are accredited.

As a result of the requirements of the Standard Valuation Law and associated Actuarial Opinion and Memorandum Regulation, most life insurance companies work hard to try to match liability cash flows with asset cash flows to minimize or mitigate interest rate risk and to avoid setting up an additional asset/liability mismatch reserve. Most life insurance contract liabilities are long duration contracts and as a result it is not always possible to achieve a perfect match of asset and liability cash flows in every case. The duration of some life insurance liabilities exceed the longest duration assets that may be available for purchase and as a result companies are exposed to reinvestment rate risk. The NAIC pulled the additional reserve data for the life insurance industry for calendar year 2010. That data showed that the life insurance industry posted an additional asset/liability cash flow risk reserve of \$ 6.5 billion out of a total reserve net of reinsurance of \$ 2.2 trillion resulting in a ratio of 0.30%. As such, the asset/liability matching and the relatively low amount of additional reserves that insurance companies posted reflect that life insurance company asset and liability cash flows are relatively well matched and therefore are subject to little interest rate and reinvestment rate risk.

Asset Adequacy Analysis

In general, the annual cash flow testing exercise involves the life insurance company building a financial model of their assets and in force liabilities. The company must run the financial model for a sufficient number of years such that any remaining in force liabilities at the end of the projection period are not material. At each duration, the financial model calculates the difference between liability and asset cash flows and accumulates this difference forward under a given interest rate scenario. The metric analyzed is typically the ending market value of surplus or the present value of the ending market value of surplus. At the start of the model assets equal liabilities so surplus is zero. Most companies run both a set of stochastically generated interest rate scenarios (typically 1,000 scenarios) as well as a set of 7 deterministic interest rate scenarios that were prescribed by state insurance regulators (referred to as the New York 7). The American Academy of Actuaries (Academy) has developed an economic scenario generator that randomly generates both interest rate scenarios as well as market rate scenarios. Companies typically use the Academy's economic scenario generator to develop the stochastic interest rate scenarios they use in the asset adequacy analysis process.

The deterministic interest rate scenarios that were prescribed by regulators were as follows:

1. Level Interest Rate Scenario
2. Uniformly increasing over 10 years at 0.5% per year and then level
3. Uniformly increasing over 5 years at 1.0% per year and then uniformly decreasing over 5 years at 1.0% per year and then level
4. An immediate increase of 3% and level forever
5. Uniformly decreasing over 10 years at 0.5% per year and then level
6. Uniformly decreasing over 5 years at 1.0% per year and then uniformly increasing over 5 years at 1.0% per year and then level
7. An immediate decrease of 3% and level forever

Such interest rate scenarios provide a good set of stress tests to ensure that life insurance companies have either well matched asset and liability cash flows or have established additional reserves that are available to cover any interest rate or reinvestment rate risk that is embedded in their balance sheets.

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RECENT FINANCIAL REGULATORY DEVELOPMENTS

State insurance regulators through the National Association of Insurance Commissioners (NAIC) continually look at ways to improve their regulation of insurers. In doing so, insurance regulators make changes in response to market conditions such as the recent financial crisis, the development of new products, or domestic or international regulatory changes. In addition, periodically, they conduct a comprehensive review of the system for improvements; the current review initiative is the NAIC's Solvency Modernization Initiative (SMI). SMI is the state insurance regulators' holistic approach to studying and, where warranted, improving state insurance laws, regulations and practices on key issues such as capital requirements, governance and risk management, group supervision, statutory accounting & financial reporting, and reinsurance.

The following highlights some of the recent, more significant financial regulatory developments within the NAIC, including significant changes to group supervision practices, accounting, reporting, capital requirements and reinsurance. The description of each item includes a summary of the action, how it is implemented, and the reason for the change in regulatory practice.

GROUP SUPERVISION

NAIC Holding Company Model Act and Regulation

On December 16, 2010, the NAIC adopted revisions to the NAIC Insurance Holding Company System Model Act (Model #440) and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (Model #450). The changes incorporate certain prudential benefits of group supervision, providing a clearer window into group operations, while building upon the existing walls which provide solvency protection. Ultimately, this enhanced "windows and walls" approach will result in additional breadth and scope to solvency regulation by providing greater insights to the risks emanating from non-insurance entities within the group. The concepts addressed in the enhanced "windows and walls" approach include items such as: communication between regulators, supervisory colleges, access to and collection of information, and enforcement measures. These changes are the result of the lessons learned from the recent financial crisis and are intended to provide regulators the ability to be able to better assess the enterprise risk within a holding company system and its impact on an insurer within the group. States have now begun the process of adopting this Model Act and incorporating it within their laws.

Group Holding Company Analysis

On October 18, 2010, the NAIC Financial Regulation Standards and Accreditation (F) Committee adopted new holding company analysis guidelines for 2011 annual statement implementation. The previous analysis guidelines require holding company filings to be reviewed, but do not express the extent of the expectations on the degree of analysis taken with such documents. In response to this as well as a variety of other similar efforts all related to group-wide supervision, the updates were made to the "Appropriate Depth of Review" and "Documented Analysis Procedures" standards to provide more defined guidance regarding holding company analysis. In conjunction with changes to the Holding Company Act and Insurance Holding Company System Model Regulation, such changes will ensure that regulators have a clearer picture of the activities of the entire group including the non-insurance entities and the risk they pose to the insurer.

NAIC STAFF DOCUMENT

Additional enhancements within the area of holding company system regulation and analysis include: 1) enhancement of the current Schedule Y – Information Concerning Activities of Insurer Members of a Holding Company System (i.e. Organization Chart) to include more detailed information about the holding company system and be data captured; 2) a new NAIC *Financial Analysis Handbook* Holding Company Supplement Chapter on Management and Corporate Governance Considerations to be performed on certain priority insurers, which includes analysis of corporate governance, changes in management, compliance, reputational risk, legal considerations, risk management and other operating considerations; 3) enhancements to the NAIC *Financial Analysis Handbook* Holding Company System Analysis Procedures Checklist (which is used by states when performing group analysis) including focus on understanding the holding company system, evaluation of the overall financial condition of the holding company, communication and coordination with other regulators, affiliated risks and additional procedures that can be completed if deemed necessary; 4) development of a web-based form to allow other jurisdictions to request U.S. state insurance regulator participation on supervisory colleges; and 5) adoption of the *Holding Company and Supervisory College Best Practices* for US regulators, which is included as an Appendix to the NAIC *Financial Analysis Handbook*, and includes topics regarding Cross Border & Other Financial Sectors Considerations; Information From Federal Agencies; Ownership and Control; Standards of Management; Affiliated Management & Service Agreements; and Lead State Coordination & Communication

NAIC Own Risk and Solvency Assessment (ORSA) Guidance Manual

The *ORSA Guidance Manual* was adopted by the Group Solvency Issues (EX) Working Group on November 2, 2011 and the Solvency Modernization Initiatives (EX) Task Force on November 5, 2011. The ORSA process is one element of an insurer's broader Enterprise Risk Management (ERM) framework. It links the insurer's risk identification, measurement and prioritization processes with capital management and strategic planning. The ORSA Summary Report includes: 1) Description of the Insurer's Risk Management Framework; 2) Insurer's Assessment of Risk Exposure; and 3) Group Risk Capital and Prospective Solvency Assessment. The Financial Condition (E) Committee will be addressing the effective date and other items related to implementation activities for ORSA.

ACCOUNTING, REPORTING AND CAPITAL REQUIREMENTS

Residential and Commercial Mortgage Backed Securities

Beginning in 2009 for residential mortgage-backed securities (RMBS) and 2010 for commercial mortgage backed securities the NAIC changed the process by which individual holdings of insurers are assigned NAIC designations. These designations are used to determine the valuation methods for financial reporting purposes and are also mapped to risk-based capital factors. The impetus for considering the change was the extreme volatility in the residential and commercial mortgage markets, as well as how that was reflected in NRSRO ratings. However, the decision to change focused on the need to improve regulatory oversight and consistency in the approach for two asset classes that have been important investment vehicles for the insurance industry. The new approach focuses on the modeling of each individual security and the development of expected recovery values assuming the securities are held to maturity. Significantly, the expected recovery values are compared with individual company's carrying values, reflecting the different risk profile of securities held at significant discounts to par value. NRSRO ratings assume holding at par, whereas in a volatile marketplace, securities are frequently purchased at deep discounts, and in an economic environment that has seen extreme stress, conservative valuation rules under statutory accounting principles require impairments to be taken. The new process results in a more accurate reflection of the risk of loss, which is translated into an NAIC

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designation. The NAIC's action was an effort to more closely align the capital requirements for a security with its economic expectations and a continuation of NAIC efforts to reduce reliance on rating agencies where deemed appropriate.

Structured Securities Accounting & Reporting

On September 3, 2010, the NAIC adopted a modification to its annual statement schedules to provide more transparency regarding types of collateral underlying asset-backed securities. The new disclosures are intended to allow the regulator to better understand the risk of each asset-backed security owned by the insurer. Insurers were required to make this disclosure in their 2010 filing, which was submitted in March 2011. On November 8, 2010, the NAIC adopted a modification to the definition of structured securities within SSAP No. 43 to more clearly capture the intent of regulators to have different accounting and reporting for such instruments when compared to traditional debt-like securities. More specifically, structured securities are now required to be accounted for based upon the expected cash flows of the security; and the regulators' expectation is that the type of collateral be described in the annual statement. These changes provide additional transparency and more appropriate valuation of these particular securities on the insurer's balance sheet.

Securities Lending Disclosure

In response to increased concerns regarding insurer's security lending activities during the financial crisis, on June 21, 2010, the NAIC adopted a new Schedule DL, Parts 1 and 2, which is required quarterly and annually, and was designed to provide additional transparency to the securities lending agreements utilized by insurers. More specifically, with the exception of the rare situation where the agreement provides that collateral received under such an agreement must be held and returned to the transferee without the ability to transfer or re-pledge the collateral, the schedule requires the insurer to report the details of any collateral held under such agreements as of the balance sheet date. More specifically, the insurer is required to report the carrying value, fair value, maturity date, and NAIC designation of every single individual investment held by the insurer as collateral under the agreement. The schedule is intended to highlight 1) any asset/liability mismatch that would result from reinvesting the collateral into longer duration assets, and 2) any market value/credit risk that could materialize if the insurer were required to return collateral to the counterparty. Schedule DL is supplemented with qualitative disclosures in the Notes to the Financial Statements that also highlight the same risks and require an explanation as to the source of liquidity when the asset values or durations do not match the terms to return the collateral. Insurers were required to make this disclosure in their 2010 filing, which was submitted in March 2011. Minor updates were added to these schedules in 2011 to ensure more consistent reporting. These new requirements may impact the nature and extent to which insurers participate in securities lending activities, which, in turn, may impact the ability of others in the financial markets to engage in such transactions with insurer.

Bank Exposure Disclosure

In 2010, the NAIC adopted a modification to its annual statement schedules for reinsurance to specifically identify any bank that has issued a letter of credit to an insurance company in connection with such a reinsurance agreement. Also in 2010, a disclosure was adopted to identify this information with respect to letters of credit that have been issued for reasons other than reinsurance, as well. These changes increase transparency of an insurer's connections with certain financial counterparties. Insurers will be required to make these disclosures in their 2011 filing, which will be submitted in March 2012.

NAIC STAFF DOCUMENT

Individual Annuity Risk & Operations Disclosure

On September 3, 2010, the NAIC adopted a new supplemental exhibit for life insurers. The new exhibit requires these insurers to report detailed information on the operating results and reserves for fixed annuities, indexed annuities and variable annuities, both for individual products and group products. This exhibit improves the information available on these products for all companies, which previously would only be gathered by regulators on a confidential basis when the company's annuity lines were experiencing less favorable results or showed higher signs of risk. This change is a significant enhancement to transparency and enables regulators to more easily see trends at the industry level and more easily identify concentration and risks in these product lines. Insurers were required to make this disclosure in their 2010 filing, which was submitted in March 2011.

Fair Value Disclosure

In 2010, the NAIC adopted revisions to SSAP No. 100—Fair Value Measurements that were initially effective for 2010 year-end reporting. These revisions included: 1) adoption with modification those disclosures required by the FASB under ASU 2010-06; 2) elimination of the requirement to differentiate and report fair value measurements on separate recurring and nonrecurring schedules; 3) clarification that the general disclosure requirements in SSAP No. 100 are for those items that are measured and reported at fair value in the statement of financial position; and 4) amendment to require a net presentation of purchases, sales, issuances and settlements in the roll-forward disclosure “Fair Value Measurements in Level 3 of the Fair Value Hierarchy.” In March 2011, the NAIC adopted additional fair value measurement disclosures providing the fair value hierarchy for items that are disclosed with a fair value measurement but may not be reported at fair value in the statement of position. To satisfy these disclosure requirements: 1) for specific investment schedules in which fair value is already captured, the new disclosure requirements for individual investments will be satisfied through the completion of an electronic column added to the investment schedules; and 2) for all financial instruments, an aggregate disclosure will also be completed through a new financial statement note that summarizes hierarchy levels by type of financial instrument. Also in March 2011, the NAIC adopted revisions (to mirror additional requirements from ASU 2010-06) to require a gross presentation of purchases, sales, issues and settlement (each separately) within the reconciliation for fair value measurements categorized within Level 3 of the fair value hierarchy. These changes provide consistency with GAAP concepts of fair value and enhance consistency and transparency of the assets on an insurer's balance sheet. All of the changes adopted in March 2011 effective the beginning of 2012.

Derivatives Disclosure

The NAIC collects detailed information on insurers' use of derivatives including a line item listing for each derivatives contract. In 2010, these disclosures were enhanced to reflect more granular information about the specific risks being hedged (e.g., interest rate, credit, currency, equity/index, or other) and identification of the underlying hedged item.

Risk Based Capital for Insurers Model Act

On November 6, 2011, the NAIC adopted two revisions to the Risk Based Capital for Insurers Model Act (#312). The first revision is related to adding fraternal benefit societies to the life section of Model #312. The revision was developed based upon the need for regulatory authority to take corrective actions as a result of a fraternal society having less than the minimum amount of capital as calculated by the fraternal RBC formula, as most states currently lack such authority. The second revision is related to changing the level at which the life RBC trend test is triggered. The purpose of this revision is to raise the level from 2.5 times to 3.0 times the authorized control level RBC for consistency with the

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property/casualty and health trend test. Changing this level would increase the number of companies that might trigger regulatory action through the trend test. This trend test change also applies to fraternal benefit societies.

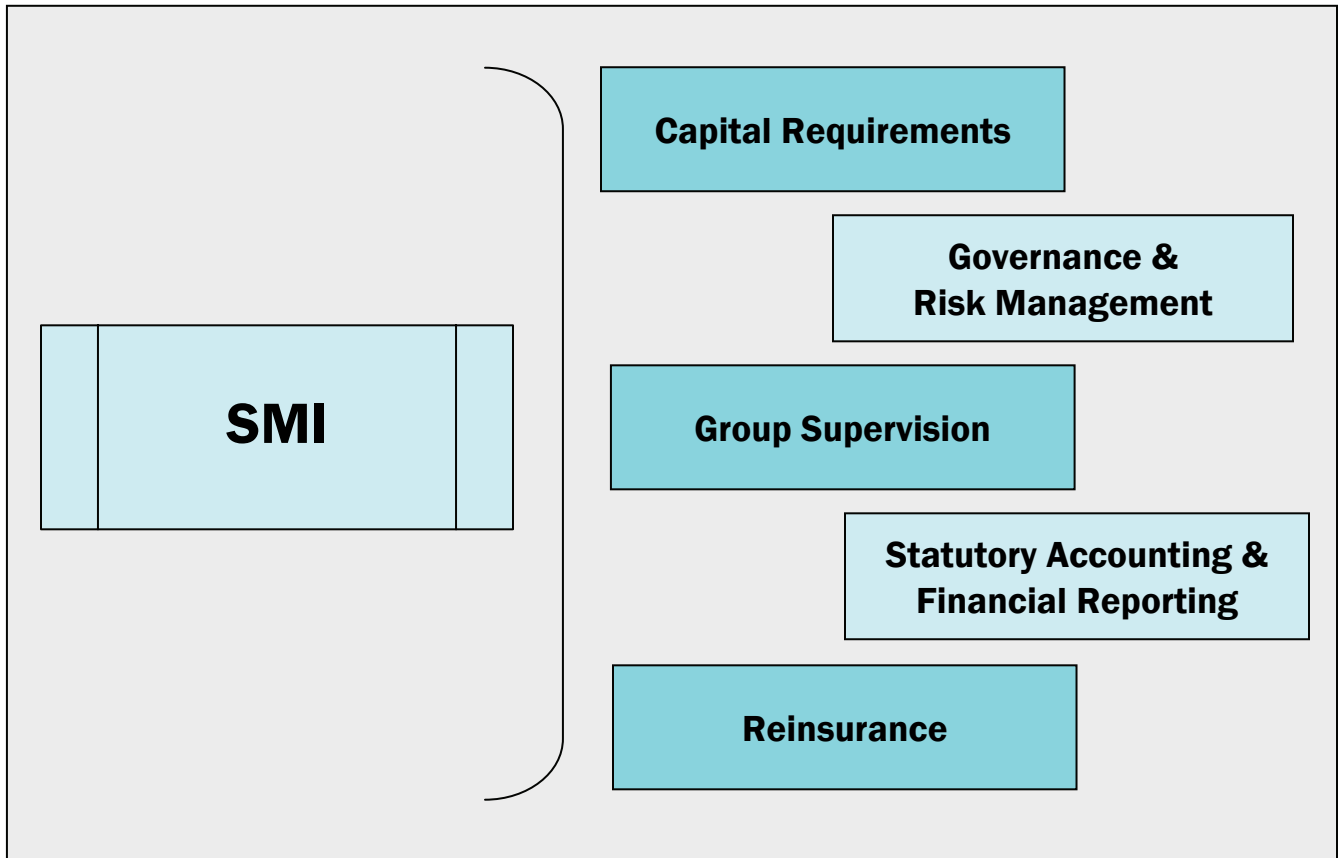
REINSURANCE

Under the current NAIC Credit for Reinsurance Model Law & Regulation, in order for U.S. ceding companies to receive reinsurance credit, the reinsurance must either be ceded to U.S. licensed reinsurers or secured by collateral representing 100% of U.S. liabilities for which the credit is recorded. The collateral requirements for non-U.S. licensed reinsurers have been a frequent subject of debate over the past decade, with various groups calling for the elimination of the collateral requirement for reinsurers licensed in well-regulated jurisdictions. On November 6, 2011, the NAIC adopted revisions to the Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786), which will act to reduce reinsurance collateral requirements for non-U.S. licensed reinsurers meeting certain criteria for financial strength and business practices that are domiciled in qualified jurisdictions. The NAIC 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 #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.

**Solvency Modernization Initiative
ROADMAP**

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 2012.¹ We anticipate that almost² 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:
 - Documentation of the current U.S. Insurance Financial Solvency Framework and Core Principles.
 - 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.

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.

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Regulating for Solvency Protects Consumers: U.S. Insurance Financial Regulatory Oversight

1. The U.S. financial regulatory system is generally built as a three-stage process. First, some risks are eliminated through restriction on activities, limited through prior approval mechanisms, and even sometimes limited when companies modify actions based upon perceived risk/reward assessment in light of the RBC. Second, and where most of the regulatory activity exists, is financial oversight. At this stage, regulators are searching for companies in hazardous financial condition and evaluating the extent of danger of insolvency. Lastly, the process ends with some backstops or safeguards, most notably the guaranty funds and RBC.

2. The core of the financial regulatory system in the U.S. is the financial surveillance process devised for financial oversight, which is predominately built around extensive and uniform financial reporting system. This financial reporting allows for detailed analysis of asset holdings, reinsurance, and loss/claim reserves. Within minutes stress tests can be performed on companies and the impact of other company insolvencies on the market can be determined. The data can be used to look for anomalies from one company to another through benchmarking and other processes and to look for new risk concentrations and/or optimistically valued risks. Because this data and disclosure is vital to regulatory system, much effort is spent to validate appropriate reporting (e.g. audits, compliance evaluation, actuarial opinions, etc.). With valid financial reporting, much analysis can be performed, and without significant extra attention from the company, keeping the regulatory disruptions to a minimum.

Limitation of Risk through Design of the System

Investment Requirements and/or Limitations

3. Some risks are deemed to be so material and potentially not in the best interests of policyholders, that law and regulation either restrict those activities or require pre-approval. Investment restrictions and pre-approval of certain material transactions are two such examples. Conservative valuation of assets and liability credits and risk-based capital formula can drive insurers toward less-risky activities.

4. In the 1990s insolvencies caused by high risk investment strategies led regulators to consider their oversight of insurers' investments. Investments are restricted by either defined limits or defined standards. Using defined limits, certain limits are placed on amounts or relative proportions of different assets that insurers can hold to ensure adequate diversification and limit risk. Using defined standards, investments are restricted based on a "prudent person" approach, such that there is discretion in investment allocation if the insurer can demonstrate they have a sound investment plan to which they adhere. Once determined to be eligible for filing in the financial statement, insurance companies report ownership of securities to be evaluated for credit risk through the NAIC's Securities Valuation Office (SVO). Credit quality of insurance company investments and the Unit Price for a security provide a sound empirical anchor for certain regulatory functions related to financial solvency regulation.

Pre-Approval of Material Transactions and Activities

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5. In an insurance holding company system, commissioner approval is required of certain material transactions, such as large investment or reinsurance transactions and extraordinary dividends. Insurers also need regulatory approval for change in control and the amount of dividends paid.

Valuation Requirements and Reinsurance Credit

6. Some assets are valued conservatively in statutory accounting and, thus, are less favorable for investment. Reinsurance is a valuable activity and can provide significant stability to an insurance company financially, but there is risk in the reinsurance reimbursement. Therefore, in order to receive credit for ceded reinsurance, the reinsurer must be authorized or post security to cover its obligations.

RBC

7. In RBC the capital requirement calculation varies based on the type of asset. While RBC does not tend to be the driver of investments because companies' target capital levels are much higher than RBC, the RBC formula could have some influence on management decisions.

Financial Intervention Powers

8. Often international discussions about financial regulation focus on capital requirements given that capital requirements are an important part of every regulatory regime. A company must hold capital greater than minimum regulatory capital levels to continue in business. But financial regulation is broader than that in most countries, and in the U.S., financial regulation is much broader.

9. U.S. commissioners can order conservation, rehabilitation or liquidation on numerous grounds. The commissioner has the power in situations ranging from financial insolvency (obviously) to non-suitable management. The following are a few of the grounds for action included in the Insurer Receivership Model Act (MO555):

- (1) Impairment, insolvency, or hazardous financial condition;
- (2) Improperly disposed property or concealed, altered, or destroyed financial books;
- (3) Best interest of policyholders, creditors or the public; and
- (4) Dishonest, improperly experienced, or incapable person in control.

10. The most typical financial intervention occurs when a company is in hazardous financial condition. As a final safeguard for policyholders, financial intervention ranging from required company actions to mandatory regulatory control of the company becomes a requirement when a company has triggered an action or control level in the risk-based capital.

Intervention Grounds: Hazardous Financial Condition

11. A company might be deemed in hazardous financial condition¹ after any of the following:

- (1) Adverse findings in financial analysis or examination, market conduct examination, audits, actuarial opinions or analyses, cash flow and liquidity analyses;
- (2) Insolvencies with a company's reinsurer(s) or within the insurer's insurance holding company system;

¹ MODEL REGULATION TO DEFINE STANDARDS AND COMMISSIONER'S AUTHORITY FOR COMPANIES DEEMED TO BE IN HAZARDOUS FINANCIAL CONDITION (MO385)

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- (3) Finding of incompetent or unfit management/director;
- (4) A failure to furnish information or provide accurate information;
- (5) Any other finding determined by the commissioner to be hazardous to the insurer's policyholders, creditors, or general public.

12. Financial condition is largely judged based upon the financial reporting of the company and the accompanying audits or actuarial opinions. There are numerous financial analysis tools, including public calculations such as IRIS ratios and more detailed non-public calculations included in the FAST system that highlight "red flags." These non-public calculations are possible because of the detailed and uniform financial reporting so that risk concentrations and anomalies can be identified.

13. Given that assets' and liabilities' valuations and reserves are a substantial portion of the risks of insurers, reserve analyses include actuarial opinions and, for life insurance, asset valuation reserves and interest maintenance reserves to help to insure that assets and liabilities are valued consistently.

Intervention Grounds: Capital Requirements

14. As a final back-stop in the oversight stage, we have the U.S. RBC². The RBC was developed to supplement the fixed minimum capital and surplus requirements which, while varying by line of business – higher for casualty lines – and varying depending on the number of lines of business – higher for multiple lines over mono-line companies – does not sufficiently account for different sizes and risks of companies or the financial condition of the company.

15. Risk-based capital (RBC) raises the safety net by recognizing the different sizes of companies, financial condition, and types of risks assumed. And even more importantly, was created to provide for timely regulatory action, whereby there is less delay because of court cases and there is a minimum level of capital calculated that requires a company or regulator to act.

16. Risk-based capital includes four stages of intervention from less intrusive to complete takeover of the company: company action, regulatory action, authorized control, and mandatory control. These levels of intervention are established to require action, but a company does not have to fail an RBC level to be considered in hazardous financial condition by the regulator.

Oversight of Hazardous Financial Condition

17. In what's considered the most valuable part of financial regulation, the oversight in search of insurers in hazardous financial condition is the most extensive work performed. Oversight focuses on appropriate valuation, the risks accepted by the insurer, the mitigation of those risks, and the amount of capital held in light of the residual risks. Without the extensive financial reporting databases, the financial analysis to evaluate hazardous financial condition would likely require much more significant and time-consuming input by the company.

18. The major activities to evaluate hazardous financial condition include insurer's financial statement preparation, including preparation of all the schedules and audit and actuarial opinions, and regulators' financial surveillance, including financial statement validation, analysis and examination.

²RISK-BASED CAPITAL (RBC) FOR INSURERS MODEL ACT (MO312)

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Financial Reporting Preparation and Requirements

19. Insurers are required to file standardized annual and quarterly financial reports that are used to assess the insurer's risk and financial condition. These reports contain both qualitative and quantitative information and are updated as necessary to incorporate significant common insurer risks. Reporting requirements are specified in two forms: through the Accounting Practices and Procedures Manual, utilizing fully codified statutory accounting principles (SAP), and through the Quarterly and Annual Statement Instructions. Requirements run the gamut from typical accounting (e.g. balance sheet and income statement) to detailed data reporting on schedules (e.g. Schedule D – Investment Schedules; Schedule F – reinsurance issues; and Schedule P – Loss triangles). Given the importance of accurate financial reporting to the financial oversight process, much attention is paid to accuracy. Actuarial opinions on major components of insurer's financial statements (asset adequacy and claim/loss/premium reserves) are required to ensure either adequacy or reasonableness of reserves. The independent financial audit helps to provide assurances that all material aspects of the reporting are accurate.

Financial Surveillance

20. In assessing the financial condition of an insurer, the overall goal is 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. Financial surveillance requires financial reporting to enter into the realm of financial analysis and financial examination, where a risk-focused surveillance process is utilized, including financial analysis, risk-focused examination, and supervisory plan development.

Financial analysis

21. NAIC tools and resources (e.g. FAST Scores and Handbooks) supplement individual state regulatory efforts. The Financial Analysis Solvency Tools (FAST) is 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 creation and development of sophisticated and comprehensive financial tools and benchmarks through data management evolved from reliance upon members' personal knowledge of troubled companies. The data benchmarks encapsulate various categories, including leverage, asset quality, liquidity, and operations.

22. The following are three key tools within the FAST System³:

- 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 other financial information through the second "analytical phase."

³From the Testimony of the National Association of Insurance Commissioners Before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises Committee on Financial Services United States House of Representatives Regarding: "Supervision of Group Holding Companies," Thursday, March 18, 2010

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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.

23. State regulators also develop an NAIC *Handbook* to advise use of 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.

24. The NAIC also helps to ensure there are a system of checks and balances, offering a layer of peer review for each regulator's solvency monitoring efforts through the Financial Analysis Working Group (FAWG), thus ensuring that judgments regarding a company's financial health are improved or enhanced by experienced state regulator colleagues. For over two decades, state insurance financial regulators have shared information and ideas through FAWG, which exists to identify, discuss, and monitor potentially troubled insurers and insurance groups that are typically of national significance (a classification that 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.

25. 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

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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.

26. 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.
27. 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.
28. 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.

Financial Examination

29. US regulators carry out periodic risk-focused, on-site examinations in which the insurer's corporate governance, management oversight and financial strength are evaluated, including a system of risk identification and mitigation both on a current and prospective basis. The reported financial results are assessed through the financial examination process and a determination is made of the insurer's compliance with legal requirements.

30. Examinations consist of a process to identify and assess risk and assess the adequacy and effectiveness of strategies/controls used to mitigate risk. The process includes a determination of the quality and reliability of the corporate governance structure and risk management programs. In addition, an examination can be used for verification of specific portions of the financial statements or other limited-scope reviews, including reviews of specific operations of an insurer.

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31. Financial examiners evaluate the current strengths and weaknesses of the insurer (e.g. Board of Directors, risk management processes, Audit function, IT function, compliance with laws/regulations, etc.) and prospective risk indications (e.g. business growth, earnings, capital; management competency and succession; future challenges, etc.)

32. The results of financial condition examinations are documented in a public examination report that assesses the financial condition of the insurer and sets forth findings of fact with regard to any material adverse findings disclosed by the examination. Examination reports may also include corrective actions required to be taken by the insurer and/or recommendations or improvements.

Supervisory Plan

33. At least once a year, a supervisory plan is developed for each domestic insurer using the results of recent examinations and the annual and quarterly analysis process. That supervisory plan outlines the type of surveillance planned, the resources dedicated to the oversight and the coordination with other states. At the end of a financial examination, the financial examiner will document appropriate future supervisory plans (e.g., earlier statutory exams, limited-scope exams, key areas for financial analysts to monitor, etc.) for each insurer. This Supervisory Plan provides the link between financial examination and financial analysis processes.

Conclusion

34. 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, making it a national state-based system, and requires peer-review to verify the consistency and integrity of our supervisory approach.