

Financial Sector Assessment Program

NAIC Self-Assessment

August 26, 2009

Introduction

The insurance market in the United States is truly unique in the world. In aggregate premium dollar numbers, the U.S. market is number one on a list of the largest jurisdictions in the world based on 2008 data – and actually larger than numbers 2 through 6 combined. However, it is also true that much of the U.S. market is quite localized. There are far more firms writing insurance in the U.S. than in any other economy, and while there are some dominant firms, overall market concentration is less pronounced than in most other economies.

There are, at last count, 7,498 domestic insurers in the U.S. (14.2% life, 34.5% property/casualty, 10.3% health, 1.4% fraternal, 1.2% title, 3.5% risk retention groups, and 34.9% other risk bearing entities.) The vast majority of the business these companies write is in the U.S. - only 6.5% of premium for the U.S. domestic industry is written outside of the U.S. Some of these firms write only a few lines of business, while others are comprehensive providers. Many provide geographic specialization, some write nationally.

There is also a wide variation in market size and complexity across the states. Three individual U.S. states rank in the top 10 jurisdictions worldwide as to premium volume and nine states rank in the top 25. This variation in size and complexity, while not necessarily amenable to a one-size-fits-all approach to regulation, has allowed the U.S. state-based system of regulation to develop and implement best practice tools for a wide variety of insurance firms appropriate for their position in the market.

Logically, this unique market structure has led to the evolution of a similarly unique system of regulatory oversight and supervision. The current state-based system of regulation in the U.S. has been successfully providing sound, cooperative regulation and policyholder protections for 138 years. Indeed, one of the first projects of the newly created National Association of Insurance Commissioners (NAIC) in 1871 was to provide for the consistent valuation of assets for companies writing in more than one state jurisdiction.

As the insurance market has developed and as insurance contracts and some risk bearing organizational structures have become more complex, the state-based system of insurance regulation has continued to evolve in a coordinated, collaborative manner using the NAIC committee structure and processes to ensure the consistent application of best practices across the market. From the codification of uniform financial reporting and the uniform application of risk based capital solvency oversight, to the rigorous peer review process of the NAIC Financial Regulation Standards and Accreditation Program, the collaborative solvency oversight process embodied in the work of the NAIC Financial Analysis Working Group (FAWG), and the lead state supervisory process for multistate companies and groups, the system of state-based insurance regulation continues to develop and implement the tools and regulatory processes necessary to ensure that the promise of the insurance contract to the policyholder will be met. The record speaks for itself.

Information sharing among regulators¹ is a fundamental benefit of the insurance regulatory community that gathers as the NAIC. For well over a decade, the NAIC's FAWG has functioned as a form of peer review

¹ “Regulate” and “supervise” are used interchangeably throughout the Self Assessment to refer to functions performed by the Commissioner and staff of state insurance departments.

process, the company is asked to make corrections to its processes and the supervisor adjusts its ongoing solvency monitoring of the insurer accordingly. Through increasing reporting requirements, increasing the frequency of examinations, and other means, the regulator can provide a strong incentive for the insurer to improve internal control weaknesses. In situations where an insurer is deemed to be in a hazardous financial condition, the insurer can be ordered to correct the situation as outlined in the NAIC *Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (Model #385)*, which is a required model under the Accreditation Program.

Assessment: Observed (O)

ICP 11: Market analysis

- *Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and insurance markets. It draws conclusions and takes action as appropriate.*

U.S. state insurance regulators oversee the financial soundness of all individual insurers within their authority. However, in doing so, state insurance regulators consider not only the potential impact of insolvency on consumers, but also the impact on the insurance marketplace for consumers. This is particularly true for certain types of coverage, such as auto, home, health, where excess lines are not always available. This is one of the reasons that some states require rates to be approved, so that in those cases where the market requires a more delicate balance, the state can impact that through its approval of rates.

The review of market conditions and assessment of market exposure is completed regularly through various reports, publications (public and non-public), and automated financial regulatory tools. For example, in the U.S., state insurance regulators receive quarterly information on the amount of premium written and losses in their state by all insurers. The majority of this information is readily accessible from the NAIC FDR database, and the NAIC has created many automated market reports available to regulators to assist in this analysis. These regulator only reports allow the user to select from a variety of criteria needed to look at a specific perspective on the market. For example, these reports return key market share and financial data for each line of business, Key data includes details on market share, cumulative market share, and financial data such as loss ratios and losses incurred. The market share reports are available on an insurer and group basis. There are also reports to provide key financial and market data for a particular state and includes details on premiums written, key financial indicators, confirmed complaints, regulatory actions, and other relevant areas to assess state market share. From a qualitative perspective, data is collected at the NAIC within several databases, such as complaints, regulatory actions, special activities, rating agency actions, etc. These databases allow various reports and analysis to be generated. For example, the complaints report details closed complaints by company code or state. In addition, a complaint trend report lists complaints by month for the past three years or lists complaints by year for the past five years with a count of the number of complaint records in the database for this entity based on the criteria selected, showing the percentage change (+ or -) as the time period changes. The regulatory action reports provide a history of actions taken by states including details on the reason for the action, date of action, and the regulator who took the action.

The quarterly statement filed by all insurers allows further analysis as to the number of insurers and reinsurers in a particular market, any new insurers or any insurers existing in the market. In addition, the NAIC database also contains detailed information on every component of the balance sheet, the income statement, the investment mix and product mix. This information is supplemented annually with more specific product breakout information. However, many states will utilize “data calls” when additional information is needed on an even more granular level (e.g. disaster reporting).

In addition to all of the above, the NAIC Insurance Analysis & Information Department utilizes the NAIC database to perform quarterly analysis on the information submitted to the NAIC. As a result of this, industry reports are produced shortly after the financial statement date and distributed to the Chief Financial Regulators in each of the states. These summarize the operating performance of each of the major insurance sectors. In addition, other market analysis is performed by NAIC staff as needed to identify more long-term trends that may be of interest to regulators (e.g. trends with certain lines of business, accumulation of certain assets, use of debt, etc.), which is provided to the FAWG. FAWG considers the significance of such information and, if material, will distribute such information to the Chief Financial Regulators.

Any insurance regulator is also able to subscribe to investment and capital market information as supplied by the NAIC's Security Valuation Office on a daily, weekly, monthly and quarterly basis. Additionally, the NAIC Research Department also performs in depth analysis on each of the major insurance sectors and publishes such information on a periodic basis. These detailed reports from the Research Department are available to regulators as well as the general public. For example, public reports are available for quick reference to identify the largest writers per premium volume by line of business. These reports allow for monitoring increases and decreases in market share and overall level of market concentration. The reports are available for each business type and provide details on a state and countrywide basis and include data by line of business for Property/Casualty detailing the top 10 groups by state and the largest 125 groups countrywide; the Life and Fraternal reports include the largest 125 groups for life insurance, annuity considerations and total premiums written; and the Accident & Health reports include the largest 125 groups for total A&H premiums written. These reports are updated annually. A Statistical Compilation report provides aggregate annual statement data for property/casualty, life/health insurance companies, all HMOs and companies that write accident and health insurance and file annual statements with the NAIC. The report includes annual statement financial data, state and countrywide insurance data, and selected data elements from company and combined statements.

The NAIC also publicly produces various market condition reports to assess particular lines of business such as medical malpractice, Credit Life and Credit Accident and Health Insurance, and Long-Term Care. The Medical Malpractice Insurance Report studies the market conditions and is based on a review of historical data collected and compiled by the NAIC, as well as a review of other medical malpractice studies. It was conducted with the objective of reviewing regulatory and legislative solutions to be considered in response to a market crisis. The Credit Life and Credit Accident and Health Insurance Experience Report includes industry-wide data for more than 500 individual insurers. The report details earned premiums, incurred losses, loss ratios and market share information for each type of insurance for a period of two years. The Long-Term Care Experience Reports contain countrywide company-specific experience for all forms combined, with the experience segmented by duration; and countrywide company-specific experience displayed on a form-by-form basis.

Lastly, the NAIC receives reports from other U.S. regulators, IAIS members, other international regulators and various resources (e.g. Bloomberg, Rating Agencies, etc.) to assess the global market place, including the banking sector, insurance sector and capital markets.

Assessment: Observed (O)

ICP 12: Reporting to supervisors and off-site monitoring

- *The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.*

All 50 states and the District of Columbia maintain statutes, regulations or practices that require the submission of annual and quarterly financial information, including an actuarial and audit opinion, as well as other various supplements. All 50 states and the District of Columbia maintain statutes, regulations or practices that require companies to file with the insurance department 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 Accounting Practices and Procedures Manual*. This includes a requirement that management attest to the accuracy of the statement in accordance with these manuals. The results of these financial figures are used by regulators, along with other information (including required reporting on material transactions as defined by law), to determine the appropriate steps for ongoing monitoring of the financial condition of the insurer. Many states include as part of such monitoring steps the procedures outlined in the *NAIC Financial Analysis Handbook*.

Note, both the reporting requirements, as well as the analysis procedures used by states to monitor the financial condition of insurers, are updated continuously through the NAICs Blanks Working Group and Financial Analysis Handbook Working Groups respectively.

All state insurance regulators have the authority to require insurers to complete and submit to the regulator financial statements on a more regular basis (e.g. monthly) where more periodic monitoring is appropriate. All regulators also require that an annual filing of the financial statements of the ultimate controlling individual/corporation be submitted to the regulators. Additionally, specific statements of statutory accounting principles require the value of any subsidiary to be audited. The form of this audit can vary depending upon the business conducted by that subsidiary, and therefore can either be based upon statutory accounting, generally accepted accounting principles, or tax accounting. All 50 states and the District of Columbia require securities owned by insurance companies be valued in accordance with those standards promulgated by the NAIC's Securities Valuation Office. All 50 states and the District of Columbia 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. Additionally, the NAIC's *Standard Valuation Law (Model #820)* and *Actuarial Opinion and Memorandum Regulation (Model #822)* or substantially similar provisions are in place.

All states and the District of Columbia strive to maintain Financial Analysis regulatory practices and procedures in accordance with those outlined by Part B of the Accreditation Program. Review of a state insurance department's financial analysis (or off-site monitoring) process is a key component within the accreditation standards. There are eight broad standards pertaining to financial analysis and numerous specific guidelines with which a state insurance department must comply. If a state insurance department is accredited, one may be assured that the state insurance department is in substantial compliance with these standards and guidelines.

Assessment: Observed (O)

ICP 13: On-site inspection

- *The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.*

The NAIC *Model Law on Examinations (Model #390)*, as enacted in each state, authorizes the supervisor to conduct on-site examinations whenever it is deemed necessary and the supervisor is given the flexibility to decide the scope of such an examination. The objective of this model law is to direct department resources to companies having or likely to have financial difficulty; however, all companies are required to be examined once every five years, although the scope and extent of that exam will be based on the particular attributes of the company to be examined. In scheduling and determining the nature, scope and frequency of the examinations, the supervisor considers criteria as set forth in the *Financial Condition Examiners Handbook* (Examiners Handbook) adopted by the NAIC. As part of the Accreditation Program, the NAIC confirms that state insurance departments are performing full-scope examinations of all multi-state domestic companies no less frequently than once every five years. In addition, during on-site accreditation reviews, the accreditation review team assesses the state's compliance with the various requirements in the Examiners Handbook.

For purposes of completing an examination of a company under the model, the supervisor is granted the authority to investigate any person, or the business of any person, in so far as the examination or investigation is, in the sole discretion of the supervisor, necessary or material to the examination of the company. In addition, the model law requires that every company or person from whom information is sought (internal or external), shall provide to the examiners timely, convenient and free access at all reasonable hours at its offices to all books, records, accounts, papers, documents and any or all computer or other recordings relating to the property, assets, business and affairs of the company being examined. The officers, directors, employees and agents of the company or person must facilitate the examination and aid in the examination so far as it is in their power to do so. In addition to the authority granted by the *Model Law on Examinations (Model #390)*, the *NAIC Insurance Holding Company Regulatory Act (Model #440)*, as enacted in each state, grants the supervisor additional authority to order insurance holding companies and affiliates to produce such records, books, or other information necessary to ascertain the financial condition of an insurer. Adoption of this model is required under the Accreditation Program.

The *Model Law on Examinations (Model #390)* further requires that at the conclusion of the on-site examination, an examination report comprised of findings of fact as well as the conclusions and recommendations of the supervisor is issued within sixty (60) days of the completion of the examination. The report is then transmitted to the company to allow the company a reasonable opportunity of not more than thirty (30) days to make a written submission or rebuttal with respect to any matters contained in the examination report. Within thirty (30) days of the end of the period allowed for the receipt of written submissions or rebuttals, the supervisor shall fully consider and review the report, together with any written submissions or rebuttals and any relevant portions of the examiner's work papers and enter an order adopting the examination and requiring the company to cure any violations identified within the report. The company is then required to correct any violations, with such corrections subject to review of the supervisors. As part of the Accreditation Program, states are to adopt examination reports timely and send them to the other state insurance departments in which the insurer is licensed or transacts business.

For less material findings identified during the examination, the Examiners Handbook outlines a process to utilize a separate management letter to communicate non-material findings to the company. The company's response and efforts to correct these issues are then tracked and followed up on by the supervisor. The Examiners Handbook also provides additional guidance to be followed by supervisors in calling and

conducting on-site financial condition examinations. The Examiners Handbook is reviewed and updated on an annual basis to support the needs of supervisors in conducting on-site financial condition examinations.

There is also an association examination system which creates a vehicle for conducting financial examinations of multi-state licensed insurers. It allows a representative number of states to adequately plan and devote resources to the financial examination of multi-state licensed insurers.

In addition to the *Model Law on Examinations (Model #390)* and the Examiners Handbook, another standard that assists supervisors in performing on-site examinations is the NAIC *Annual Financial Reporting Model Regulation (Model #205)*. Adoption of this model is required under the Accreditation Program. The purpose of this regulation, as enacted in each state, is to improve the supervisor's surveillance of the financial condition of insurers by requiring an annual audit of financial statements reporting the financial position and the results of operations of insurers by independent certified public accountants. By requiring an annual audit, the supervisor receives evidence as to the financial solvency of its companies through additional on-site inspection performed by independent auditors. The work of the independent auditors is required by the model to be made available for review by insurance department examiners, including any communications related to the audit between the auditor and the company. In addition, the auditor's annual report is reviewed during the off-site inspection process. The Accreditation Program includes standards and guidelines to ensure that the state insurance department is adequately reviewing this filing in a timely manner.

Assessment: Observed (O)

ICP 14: Preventive and corrective measures

- *The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.*

In terms of capital triggers, states have both fixed and variable capital requirements, the latter of which is referred to as risk-based capital. [See also response to ICP 23] All 50 states and the District of Columbia have the *Risk-based Capital (RBC) for Insurers Model Act (Model #312)* or provisions substantially similar in state laws or regulations that also allow regulators to take preventive and corrective measures. This model is required for accreditation purposes. If an insurer were to trend towards or exceed the thresholds outlined by these requirements, then the state could invoke various corrective measures, including requiring an action plan be filed, taking control of the insurer, and/or issuing various preventive orders (e.g. cease and desist new writings, etc.). All 50 states and the District of Columbia have state laws that contain the NAIC's *Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition (Model #385)* or a substantially similar provision which authorizes the state insurance department to order a company to take necessary corrective action or cease and desist certain practices which, if not corrected, could place the company in hazardous financial condition.

The accreditation standards require that states adopt this model. Under this statute, there are numerous qualitative and quantitative triggers to suggest that a particular company is acting in a condition that is hazardous to the policyholder. This includes but is not limited to: 1) Adverse findings reported in financial condition and market conduct examination reports, audit reports, and actuarial opinions, reports or summaries; 2) Whether the insurer has made adequate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flows required by the contractual obligations and related expenses of the insurer, when considered in light of the assets held by the insurer with respect to such reserves and related actuarial items including, but not limited to, the investment earnings on such assets, and the considerations anticipated to be received and retained under such policies and contracts; (3) Any other finding determined by the state insurance commissioner to be hazardous to the insurer's policyholders, creditors or general public.

All 50 states and the District of Columbia have state laws setting forth a receivership scheme that can provide for protective measures for insurers prior to an insolvency and if found to be insolvent. The Accreditation Program requires that accredited states have a receivership scheme included in their statute.

The NAIC *Administrative Supervision Model Act (Model #558)* provides the states with the authority to place insurance companies under immediate administrative supervision if the state insurance commissioner determines the company to be in a hazardous financial condition.

The NAIC *Insurance Department Resources Report*, a survey of NAIC member jurisdictions conducted annually, shows that hundreds of actions to suspend or revoke authority to issue policies or take other actions are issued annually. The Report also discloses Formal Hearings from Company Disciplinary actions.

Assessment: Observed (O)

