AMERICAN ACADEMY *of* ACTUARIES

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National Association of Insurance Commissioners (NAIC)
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On behalf of the Risk Management and Solvency Committee of the American Academy of Actuaries[1] I appreciate this opportunity to provide comments on the NAIC document, *United States Insurance Financial Solvency Framework.* We appreciate and value the work done here to set forth the current US framework in order to support a clearer discussion of possible desired directions that could be taken by the Solvency Modernization Initiative. In general, we have listed below areas where additional background would be helpful in clarifying the current US solvency framework

1. On page 1, the paper states the value of the US system stems from its "ongoing collaborative regulatory peer review, regulatory checks and balances, and risk-focused financial surveillance (which) form the foundation of the regulatory process." It goes on to say that this results from a "uniform program to which all states subscribe." Given the many US insurance organizations with overseas interests and the emergence of major European companies with US subsidiaries, does this mean that the US framework accepts and values regulatory checks and balances and a collaborative peer review and dialogue with regulators from other countries? Specifically, does the NAIC framework support coordinated checks and balances and coordinated risk-focused surveillance for US companies and reinsurers with foreign subsidiaries and coverages as well as for foreign companies and reinsurers with US subsidiaries and coverages?

2. A principle should contain enough information that one can tell how to apply it and assess it. Many items listed as principles seem to be closer to concepts or specific action steps. An additional level of detail would be helpful to further clarify operating principles. For example, it is stated as a principle to have solvency reporting standards, yet additional detail is needed (beyond the stated concept of conservatism) to understand the specific operating principles of the US solvency reporting standards. For example, the overview on the solvency reporting standard principle states that the US framework has both standardized and qualitative reporting. But what

[1]The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

is the purpose of additional review of the qualitative disclosures? Are they not needed or do they point out what may be missing in the standardized reporting? Under principle 2, the report states:

> "…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. 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."

The original intent and the purpose of risk-based capital (RBC) has been to identify weakly capitalized companies that need to be taken over or restricted in their businesses based on an objective numerical benchmark. What separate regulatory actions and decisions are being based on the collection of these outside sources of information? What is missing from the required reporting that all of these other sources of company data need to be read and analyzed? Additionally, how does the proposed US framework view the relative importance of statutorily reported data, the additional reviewed data as well as the more subjective one-on-one interactions with the company?

3. Principle 4 states:

> "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. 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.)."

This raises the following comments and questions where clarification would be helpful:

- Several years ago, the NAIC (with concurrence from the Academy), removed minimum reserve requirements for Property & Casualty reporting. It should be noted that the proposed US framework still requires minimum reserves be used for life insurance. Which principles are driving this distinction?
- The above paragraph states that the backbone includes state-specific requirements, but that means having the potential (and reality) of differing state requirements. Which is intended to be the intent of the current US framework, uniformity or the ability to set unique standards?
- Since the above paragraph states that conservatism is the foundation, what is (are) the standard(s) on which to decide how much conservatism is appropriate?
- If a risk-focused calculation shows less risk in the assets than would be reported by a factor based calculation can the factor be overwritten by the company? What about

vice versa? Is there a responsibility for the company to notify the regulator if an asset is riskier than the applied factor?
- The fact that asset adequacy reserves for life insurers are established based on current company specific assumptions and the use of multiple scenarios, should be referenced in the discussion of Principle 4.

4. The European Union has focused on creating a Lamfalussy process to ensure uniform adoption and coordination of regulatory requirements and oversight across multiple regulatory jurisdictions. In the US the current process relies on the NAIC deliberative process, subject to state override to set uniform standards for capital through the Annual RBC Instructions, for accounting requirements through the Accounting Practices and Procedures Handbook and for examinations through the Examiners Handbook. Currently there is no way to set uniform reserve standards in the US.

5. The US regulatory mission, on page 3 of the draft framework, is stated as: "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." What specific principles guide this mission?

a. For example, a current objective, commonly understood, is that the company be able to meet all promises.
   - But should it be based on a market or book value basis?
   - What level of conservatism should be applied to either basis?
   - What should guide the relationship and priority between formulas, standard models, and internal models?

b. Additionally, what principles guide the blending of the sometimes competing aims of solvency and competitive markets?

7. One of the foundations for regulatory authority, stated on page 4, is accountability. What are the principles that clarify to whom and how? For example, to whom are regulators accountable specifically? The public can be represented by legislators, governors, judges, consumer organizations, etc. What principles should guide how to balance the views and accountability towards these various public representatives within and across state boundaries?

8. On page 4, the paper states that "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." An additional level of principles could be helpful in clarifying the basis for determining the greatest risks:

a. For example, currently, life insurance has very little risk-focused reporting that requires a consistent reporting of actual risk exposures over time.

b. How should one balance appropriate conservatism versus undue conservatism? A contributing cause for the Variable Annuity Commissioners Annuity Reserve Valuation Method (VACARVM) taking 10 years to complete was the difficulty in finding the “right level” of conservatism. Still left open for discussion is what criteria (and principles) can and should be used for subsequent adjustments to the desired level of conservatism.

c. This is one of the reasons the Academy has previously recommended the adoption of a chief risk officer role within the regulatory community to assist in and lead the development of consistent and informative risk metrics.

9. Historically, life insurance financial reporting has allowed very little company specific reporting of liability exposures, nor of the market value of assets. A reason sometimes offered for this is the unease of a state relying on and working through a collaboration consensus with a company. Yet other regulators have felt that the health and P&C open-ended reporting and state collaboration have actually worked fairly well over time. Does the proposed US framework intend this to be an explicit philosophical split or is there a more uniform view?

10. On page 3, the statement is made that the objective of the NAIC is to “assist state insurance regulators (in both) 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.” Is this expertise offered in the course of market conduct and financial examination reviews by the states or does it occur in advising on development of model NAIC regulations?

11. Principle 7 mentions that state guarantee funds have been established, but does not mention the principles that would be needed to ensure whether adequate funds are accumulated and who should be charged with doing so.

12. Perhaps this is intended as a later project, but it would be helpful to address how well the current NAIC process meets the standards listed here. For example, in Principle 4 on pages 14 and 15 it states:

> “The RBC amount explicitly considers the size and risk profile of the insurer. 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.”

And yet, there are current modifications being proposed to ensure that the explicit risk profile of the insurer reflects the actual risks in Residential Mortgage Backed Securities, Deferred Tax Assets and the C3 charges for life insurance. Currently these are factor based and thus do not actually reflect the underlying risks.

There are several items that were not explicitly mentioned in this document. To the extent that the NAIC wishes to address them in this framework, the document could be enhanced to include:

- Corporate governance – the standards and procedures governing the role the Directors and senior leadership play in managing the company.
- Counterparty analysis – analyzing the credibility of key counterparties, such as reinsurers, third party administrators, and other financial institutions.

- Policy audit – determining that administrative practices comply with policy provisions – benefits granted are neither too rich nor sparse
- Unauthorized activity detection – the role the states play in detecting insurance activity that is unregulated – from unauthorized insurers to financial products falling outside the scope of the definition of traditional insurance (such as derivatives or letters of credit).
- Market Conduct – the principles that guide the view of company conduct with its agents, policyholders and beneficiaries.

If you would like to discuss any of these points further, feel free to contact us. Again, thank you for the opportunity to share comments on the *United States Insurance Financial Solvency Framework*.

Sincerely,

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